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Who Gets Paid When - The Timing and Obligation of Shut-in Gas Royalty Payments

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Who Gets Paid When? The Timing and Obligation of Shut-In Gas Royalty Payments*

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I. Introduction

As a kid watching Sunday afternoon NFL games, I remember that pretty girl dressed in oil field attire, replete with hardhat, exclaiming in The Western Company commercials, "If you don't have an oil well, get one!" What a nice incentive! Armed with this prosperous thought, I grew older and did in fact begin a career in the oil and gas industry. Throughout my career, I came to know the true meaning of that old oil field adage: "Dry holes cure a lot of problems and save a lot of necks." In short, it takes money, skill, knowledge, and lots of "guts," and sometimes just "sheer luck" to find that oil and/or gas well of which the young lady spoke. In the oftentimes fast and competitive nature of

the oil and gas business, human mistakes are made which do not become known, nor their consequences feared, until shortly before or during the drilling of such an exploratory well. Drilling a "dry" hole is commonplace and regardless of the degree of error committed, generally will result in no legal consequence in connection with the acquisition and maintenance of an oil, gas and mineral lease.

However, consider the land department's dilemma once a well capable of producing oil and/or gas is discovered; will management of the discovering oil and gas company (the operator) be as compassionate and understanding if the oil and gas lease upon which the well has been drilled (or acreage pooled therewith) is improperly maintained by human "foul-up"? The answer is clear: absolutely not!

This paper will analyze what has to be one of the most important clauses in the oil and gas lease, "the shut-in gas royalty" provision.[1] *Prior* to drilling a discovery well, it is always possible for a lessee to lose its rights in a lease by the failure to pay a delay rental,[2] the untimely initiation of some designated activity, or a variety of other contractual breaches. Prior to a discovery, such errors or breaches do not usually result in excessive expenditures on the part of lessee in order to remedy the situation. However, compare the above scenario to one in which lessee fails to maintain its lease after a discovery has been made. By example, if an operator defaults by failing to make a timely shut-in gas royalty payment, the entire well, including production equipment, can be turned over to the lessor, and lessee's entire investment is for all practical purposes lost. Moreover, even if the lessor is willing to renegotiate a new lease, the chances are excellent that the cost to the lessee will drastically reduce the lessee's profits. This is because the value of the property has increased tremendously as it is now commonly known that the property which the former lease covered possesses minerals of great worth. Surely a lessor presented with this situation will want considerably more money and a higher royalty amount than the lessor had been willing to accept prior to the discovery.

The shut-in gas royalty clause generally permits a lessee the opportunity to perpetuate its lease after the expiration of the lease's primary term, when delay rental payments can no longer be paid and a newly discovered well cannot begin producing for lack of an available market. The shut-in royalty clause can be extremely important and should thus be drafted with care and considerable

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* This paper was prepared in conjunction with the Mississippi Oil and Gas Lawyers Association 1988 Research Project.

1. A "shut-in gas royalty" clause is a lease clause which authorizes a lessee to pay a shut-in gas well royalty and thereby keep the lease alive without actual production when and if a well has been drilled which is capable of producing gas in paying quantities but which is shut-in, usually by reason of lack of a market. 8 H. WILLIAMS, OIL AND GAS LAW MANUAL OF OIL AND GAS TERMS 907 (1987).

2. A "delay rental" is money paid for the privilege of delaying commencement of drilling operations. *See* Maynard v. Ratliff, 297 Ky. 127, 179 S.W.2d 200 (1944).

forethought. This paper will address only the following issues in connection with shut-in provisions, and will highlight how these issues have been handled historically in Mississippi and how Mississippi lawyers, lessees and lessors should handle these situations in the future:

1. Who gets the shut-in gas royalty payment? Does a lessee pay 100% of the shut-in gas royalty provided under the lease to the lessors or pay lessors and fee royalty owners proportionately?
2. Timing of payment – When does a lessor pay the shut-in gas royalty? Does it matter whether the lease is "within" or "beyond" its primary term?
3. Is payment of shut-in gas royalty payments "mandatory" or "voluntary"?

Anyone who has researched the above issues to date under Mississippi law has discovered that the courts of Mississippi have not been called upon to resolve these important and recurring issues. Consequently, this paper will draw from various jurisdictions that dominate oil and gas jurisprudence and will provide a worthwhile reference to all Mississippi oil and gas lawyers, lessees and lessors.

II. Who Gets the Shut-in Gas Royalty Payment?

In discussing the shut-in royalty provisions in an oil and gas lease, the first question that arises relates to the "nature of the payment" made in accordance with such clause.[3] There is frequent confusion as to whether payments of shut-in royalties should be directed to those entitled to royalty payments or to those entitled to payments of delay rentals. The question usually arises in disputes between "non-participating royalty owners," who would be entitled to their share of royalties paid, and the "lessor" who owns the leasing or executive rights and is entitled to any rents paid under the terms of the lease.[4] The issue can be summed up by asking whether payments made under "shut-in" provisions of oil and gas leases were intended as, or should be treated as "rents" or "royalties."

A. Distinction Between "Delay Rents" and "Royalty"

In *Maynard v. Ratliff*,[5] the Kentucky court held that the term "rent" in an oil and gas lease means money paid for the privilege of delaying commencement of drilling operations, while "royalty" is a certain proportion of the oil found or so much money per gas well. Following this distinction, Professor John S. Lowe suggests that since the delay rental payment is constructive production under the lease, it ought to be paid to those persons who would receive the royalty payments.[6] The following case addresses this exact issue and follows this reasoning.

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3. Carlisle v. United Producing Co., 278 F.2d 893 (10th Cir. 1960); Annotation, *"Shut-in Royalty" Payment Provisions in Oil and Gas Leases*, 96 A.L.R.2d 345 (1964).
4. Annotation, *"Shut-in Royalty" Payment Provisions in Oil and Gas Leases*, 96 A.L.R.2d 345, 349 (1964).
5. 297 Ky. 127, 179 S.W.2d 200 (1944).
6. Lowe, *Shut-in Royalty Problems*, 5 Eastern Min. L. Inst. 18-1 at 18-30 (1984).

B. Analysis of A Landmark (Texas) Case

In *Morriss v. First National Bank of Mission,*[7] a Texas court held that a minimum royalty provided during a shut-in period was a royalty, rather than a delay rental, under the terms of the lease. Under another provision of the lease, not in question on appeal, the lease was continued throughout the shut-in period. Under paragraph 4, the provision in question, a minimum royalty was provided, while paragraph 14 specified a delay rental. The question was whether the payments under paragraph 14 (the delay rental) belonged to the royalty owners or to the owners of the rentals and bonus. Paragraph 14 read as follows:

> During the primary term of this lease if the royalty paid under the provisions of paragraph 3 hereof for any given year, commencing on the 15th day of March and ending on the 14th day of March of the succeeding year, does not amount to as much as Fifteen Thousand Nine Hundred Forty-two and no/100 ($15,942.00) Dollars, then the difference between the amount so paid and the said sum of Fifteen Thousand Nine Hundred Forty-two and no/100 ($15,942.00) Dollars shall be paid to Lessor. After the expiration of the primary term of this lease if the royalties paid under the provisions of paragraph 3 hereof for any given year, commencing on the 15th day of March and ending on the 14th day of March of the succeeding year, do not amount to as much as Seven Thousand Nine Hundred Seventy-one and no/100 ($7,971.00) Dollars, then the difference between the amount so paid and the said sum of Seven Thousand Nine Hundred Seventy-one and no/100 ($7,971.00) Dollars shall be paid within ninety (90) days from the expiration of said year. Payment or tender may be made to Lessor or to the depository bank named above by the check or draft of Lessor mailed or delivered to Lessor or to said depository bank.[8]

The court was faced with the choice of characterizing the payment under paragraph 14 as either a "royalty" or "delay rental."[9] Since failure to pay the minimum royalty provided in that paragraph would not result in forfeiture, the court held that the payment was a royalty and not a delay rental, because there was nothing under paragraph 14 to be delayed.[10]

C. Where the Shut-In Payment Is Termed a "Rental" Rather Than "Royalty"

Apparently the *Morriss* court placed substantial weight on the use of the term "royalty" in the lease before it:

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7. 249 S.W.2d 269 (Tex. Civ. App. 1952).
8. *Id.* at 272.
9. *Id.*
10. *Id.* at 274.

> When the parties prepare a finely wrought instrument and use terms of legal distinction, their classification should be given great weight as the intentional expression of their purpose . . . . To hold that the parties meant rent or bonus when they said royalty, when no mistake is urged, would be to attribute a carelessness to the parties not otherwise found in the lease.[11]

This clouds the analysis because some leases contain shut-in clauses that designate the payment to be made as "rentals" rather than "royalties."[12] The following example highlights a possible conflict:

> Assume a mineral lease provided for a one-eighth lessor's royalty with a single lessor. If that lessor conveyed a 1/32nd of 8/8ths mineral royalty interest to another individual, the lessor would be entitled to only a 3/4ths interest in the shut-in royalty payment and the owner of the mineral royalty interest would be entitled to the other 1/4 interest. On the other hand, since owners of mineral royalty interests do not share in bonus money or rentals, if the shut-in payment were designated as a rental as opposed to a royalty, the lessor would be entitled to the entire payment.[13]

Texas has maintained a consistent approach to this dilemma as reflected in *Johnson v. Phinney,*[14] decided eight years after *Morriss*. There the court was faced with a shut-in payment termed a "rental," the payment of which might avoid termination of the lease to the property involved. The district court in *Phinney* cited *Morriss* as authority for holding that the "shut-in royalty" payment tendered, being five dollars per acre for each of the 320 acres selected by the lessee around each shut-in gas well, was a "minimum" or "substitute royalty"[15] under Texas law.[16] The *Phinney* court carved out an interesting distinction between the labels "royalty" and "rental":

> If failure to make a shut-in payment *does not* result in termination of the lease, the sale of the minerals in place is still in effect. If the right to extract the minerals still belongs to the lessor, the shut-in payment in lieu of production *should be considered as "royalty"* and part of the bargained consideration for granting the lease. If failure to make a shut-in payment *does* result in termination of the lease, the sale of the minerals in place can no longer be considered effective. If the right to extract the minerals would otherwise revert to the lessor upon failure to make a shut-in payment, said payment has no relation to production of minerals by the lessee and *should*

11. *Id.* at 275.
12. Gates, *Problems of Delay Rentals & Shut-in Payments*, 27 INST. ON MIN. L. 110, 119 (1980).
13. *Id.* at 120.
14. 181 F. Supp. 315, 319 (S.D. Tex. 1960), *rev'd* (on question of tax treatment of shut-in royalty payments), 287 F.2d 544 (5th Cir. 1961).
15. A substitute royalty is a payment by a lessee to a lessor in accordance with the terms of an agreement between the parties for the privilege of keeping a lease alive without producing from a well or wells drilled thereon, the allowable for such well or wells being transferred by the lessee to another lease or lessee. 8 H. WILLIAMS, OIL AND GAS LAW MANUAL OF OIL AND GAS TERMS 957 (1987).
16. 181 F. Supp. at 319.

> *be considered "rental"* for the privilege of delaying forfeiture of the lease and performance of the obligations of the grant.[17]

The court continued by emphasizing its belief that the basic difference between "royalties" and "rentals" lies in the power of the "rental" alone to delay forfeiture or termination of the lease by payment and mere lapse of time.[18] Under *Phinney*, to determine whether the payments provided in the pertinent clause of a lease are "royalties" or "rentals", the Texas courts will examine the means by which the lease may be forfeited as to various classifications of acreage thereunder.[19]

D. The Law in Louisiana and Oklahoma

The Louisiana courts also attach little significance to whether a shut-in payment is labeled "rental" or "royalty." It is the intention of the lessee that is important.[20] In *Davis v. Laster*[21] the court stated:

> The importance of the choice available to lessees after production has been obtained and the well is shut-in is readily apparent when consideration is accorded to the fact that the shut-in payments which lessees may make, having been designated by the parties as royalty, allow others besides the mineral owner-lessor to become entitled to these payments. In many instances the mineral-owner lessor has sold royalties, and the royalty owners thereby created do not enjoy the right to participate in bonus and rentals under the lease due the mineral-owner lessor, but these nonparticipating royalty owners do become entitled to their acquired portion of royalties. To permit the lessees to elect to pay rentals where royalties are due would be to invest them with the power to foreclose nonparticipating royalty owners from receipts to which they are entitled under the lease.[22]

Davis was decided prior to the adoption of the Louisiana Mineral Code, but its rationale was later affirmed in *Acquisitions, Inc. v. Frontier Explorations*,[23] decided subsequent to Louisiana's adoption of the Code. The court therein referred to paragraph 5 (the shut-in provision) of the lease in question which designated the shut-in payments as "royalty" and not as "rental." The court stated: "[w]hile this designation alone is not dispositive of the question of whether these payments were royalties or rentals, the parties' choice of words does help identify their intent in constructing the shut-in provision."[24]

In Oklahoma, the question of whether shut-in royalties were to be treated

17. *Id.* at 320 (emphasis supplied).
18. *Id.*
19. *Id.*
20. Davis v. Laster, 242 La. 735, 750, 138 So. 2d 558, 563 (La. 1962).
21. *Id.*
22. *Id.* at 750, 138 So. 2d at 563.
23. 432 So. 2d 1095, 1099 (La. Ct. App. 1983).
24. *Id.* at 1101.

as "rental" or "royalty" was litigated in *Carlisle v. United Producing Co.*[25] Lessors, owners of one-half the mineral interest in the leased premises involved, had acquired by cross conveyances from the other mineral owners the right to receive "all sums accruing from rentals or lease fees on account of any lease or leases on the said lands." The leases involved, which were for a term of ten years and as long thereafter as oil or gas was produced therefrom, also contained a shut-in clause as follows:

> Where gas from a well or wells, capable of producing gas only, is not sold or used for a period of one year, lessee shall pay or tender as royalty, an amount equal to the delay rental as provided in paragraph (5) hereof, payable annually at the end of each year during which such gas is not sold or used, and while said royalty is so paid or tendered the lease shall be held as a producing property under paragraph numbered two [the primary term clause] hereof.[26]

The lessee had tendered the lessors only one-half of the royalties due, the amount of their mineral interest in the land, and paid the other one-half to the other mineral interest owner. The lessors refused to accept the payments contending that the leases had terminated according to their terms due to the lessee's failure to pay them all of the shut-in royalties within the time provided for in the leases. The lessors' theory was that the shut-in payments were rentals or lease fees, and not royalties, and that the failure of the lessee to make such payments in their entirety within the time specified terminated the leases.

The *Carlisle* court, applying Oklahoma law, held that the shut-in provisions of the leases were minimum royalty payments and were not to be considered rentals or lease fees, that the payments of the shut-in royalties were timely made and that the parties intended the shut-in payments to be treated as royalties. The court further held that discovery of gas in paying quantities constituted a compliance with the production requirements of the habendum clauses in the leases and that the rental provisions were no longer applicable.[27]

Where the instrument when viewed in its entirety is unambiguous, the intention of the parties is to be determined from its language.[28] This rule is well established in Oklahoma as expressed in the case of *Meeks v. Harmon:*[29]

> Where a written contract is complete in itself and, viewed in its entirety, is unambiguous, its language is the only legitimate evidence of what the parties intended, and the intention of the parties cannot be determined from

25. Carlisle v. United Producing Co., 278 F.2d 893 (10th Cir. 1960).
26. *Id.* at 894.
27. *Id.* at 895.
28. Surety Royalty Co. v. Sullivan, 275 P.2d 259 (Okla. 1954); Meeks v. Harmon, 207 Okla. 459, 250 P.2d 203 (1952).
29. 207 Okla. 459, 250 P.2d 203 (1952).

> the surrounding circumstances, but must be gathered solely from the words used.[30]

The court emphasized that payment of delay rentals would not accomplish an extension of the primary term. The court also noted that because the lease provided that while royalty was so paid or tendered the lease would be considered a producing property, those clear and specific provisions appeared to be subject to only one interpretation. That interpretation being the parties intended the shut-in payments to be treated as royalties and to have the same effect as though they were due from actual production.[31]

E. What Approach Mississippi is Likely to Take – Analysis

While the precise issue of whether a shut-in payment is in the nature of a "royalty" or a "rental"[32] has not been resolved under Mississippi law; there is some case law which hints at what Mississippi courts would hold, notwithstanding the apparent usual course of following Texas jurisprudence.

In the 1986 Mississippi case of *Southwest Gas Producing Co. v. Seale,*[33] the court proclaimed, as initially expressed in *McLaurin v. Shell Western E&P, Inc.,*[34] that the law disfavors forfeiture. "Equity abhors a forfeiture and is disposed to seize on slight circumstances to avoid one."[35] In *McLaurin*, the only loss identified by plaintiff, who was allegedly wrongfully excluded from payment of royalties under an oil, gas and mineral lease, was loss of royalty payments due under the lease. The court held that where an accounting of royalty due that party and payment to him of that amount as damage would adequately remedy the breach and avoid unduly harsh consequences of forfeiture, then cancellation of the lease for breach of an implied covenant of good faith and fair-dealing was not available as a remedy under Mississippi law.[36] Whereas the case does not deal per se with shut-in payments and distinctions between "royalty" and "rental," it does establish some analytical reasoning which may be applied to the subject. For example, an extension of the logic of the court mandates that the term "rent" in an oil and gas lease be taken to mean money paid for the privilege of delaying the commencement of drilling operations, while "royalty" is used to denote a certain proportion of the oil found.[37]

Certainly, an oil and gas lease's value increases considerably after a gas well has been discovered. The fact that a lessee may not be able to begin selling the newly discovered gas immediately but can protect and perpetuate the lease

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30. 207 Okla. at 464, 250 P.2d at 207 (citation omitted).
31. *Id.*
32. Tri M Petroleum Co. v. Getty Oil Co., 792 F.2d 558 (5th Cir. 1986).
33. 191 So. 2d 115 (Miss. 1986).
34. 778 F.2d 235 (5th Cir. 1985).
35. 191 So. 2d at 122.
36. 778 F.2d at 237.
37. Maynard v. Ratliff, 297 Ky. 127, 179 S.W.2d 200 (1944).

via a shut-in payment is significant. The idea that the shut-in payment is royalty which is in effect "constructive production" makes logical sense. This approach dictates that the lessee should pay shut-in payments proportionately to participating[38] *and* nonparticipating[39] royalty owners. By doing so, the lessee should resolve any fear of jeopardizing his valuable lease, if for no other reason than the "equity theme" stated above. Furthermore, the non-participating royalty owner's sole purpose in purchasing the interest in the first place is the anticipation of receiving proceeds attributable to a well which produces oil and/or gas. Regardless of the lessor's reason for selling a portion of his royalty interest (i.e., need of immediate funds, etc.) he should not be allowed to successfully argue that he did not understand that the non-participating royalty purchaser's sole reason for purchasing was to share in all benefits derived from a discovery. Consequently, once a discovery is made, it stands to reason that both parties intended that they should benefit from that moment forward. Equity principles should prevail and the lessor should not be able to claim all of the shut-in payment as his own.

Moreover, a lessor's contention that a shut-in payment should be deemed a "rent" would put an unfair burden on the lessee to make sure the payment was "timely" made, otherwise the lessee could easily lose a valuable lease. This is based on the premise that a rent's purpose is to delay the commencement of drilling operations and that a failure to pay results in the automatic termination of the lease. This approach is not in keeping with the principles of equity as expressed in Mississippi, particularly when an erroneous payment can so easily be corrected and the injured party compensated as suggested in *McLaurin.*[40]

In sum, if the shut-in payment is termed a "rent" and the lessee fails to make proper or timely payment to the correct party, then the lessee is likely to lose a valuable lease and a considerable investment. On the other hand, if the shut-in payment is termed a "royalty," then the lessee can easily correct any flaws in payment and still protect and perpetuate his lease. Equity would opt for the latter approach.

When a Mississippi lessor sells a portion of his royalty to a non-participating royalty owner prior to a scheduled shut-in gas royalty payment, the Mississippi lessees should pay shut-in payments proportionately to the lessor and to the non-participating royalty owner. Lessors should not be heard to insist that from the discovery of a gas well until actual production has started that lessors are entitled to one hundred percent of the shut-in payments. Mississippi equity laws

38. A participating royalty is a royalty interest, independent of a subsisting lease, if any, which shares in some other lease benefits than gross production, such as bonus, rental, or the right to join in the executions of leases. H. WILLIAMS, *supra* note 1, at 690.

39. A nonparticipating royalty is an expense-free interest in oil and or gas, as, if and when produced. The prefix "nonparticipating" indicates the interest does not share in bonus or rental nor in the right to execute leases or to explore and develop. *Id.* at 620.

40. McLaurin v. Shell Western E&P, Inc., 778 F.2d 235, 237 (5th Cir. 1985).

would not allow this argument. Moreover, as analyzed above, the heavy weight of precedent in the three major gas producing states urges this same conclusion.

III. Time and Timeliness of Payment of Shut-in Gas Royalty

A. Introductory Comments

A recurring problem associated with the shut-in gas royalty clause is that of determining the proper time for making payment of the shut-in gas payment. The problem is initially encountered with respect to the first payment that must be made and continues with respect to the proper time for making subsequent payments.

There is no simple answer to the question of when shut-in gas royalties should be paid. Nevertheless, the time of payment or tender of payment of the shut-in royalty becomes important in determining whether the actual payment or tender thereof acts to extend the term of the lease beyond the primary term.

B. When is a Well "Shut-in"?

The first question a lessee must answer prior to paying a shut-in royalty payment is: "When is a well shut-in?" In some circumstances, it may be uncertain when a well is shut-in for purposes of calculating the correct payment due date. When a well is producing and production is subsequently terminated, whether because of the lack of a market or by regulatory order, there is usually little dispute; the well is shut-in on the day production ceases.[41]

The determination is more difficult when a well is shut-in after completion without ever producing. Usually a well is shut-in when the completion unit leaves the premises.[42]

The courts have also said that a well is shut-in when all steps necessary to make it capable of producing in paying quantities have been taken, other than connection to a pipeline, which time will probably occur before the completion rig leaves the site.[43] At the least it means the cleaning out of the well after reaching a specified depth, or the shooting of the well (perforating the casing) if there is doubt as to whether it is a producer or nonproducer.[44] For safety's sake, reliance should never be placed on production department drilling reports; the earliest possible date should be selected for calculation of the shut-in royalty due date.[45]

C. Where the Lease Does Not Specify a Time for Payment

If the lease does not specify when shut-in royalty payments are due, it should be assumed that they are due in advance of shut-in. Clearly, this is the case

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41. Lowe, *supra* note 6, at 18-27.
42. *Id.*
43. Hoyt v. Continental Oil Co., 606 P.2d 560 (Okla. 1980).
44. Totah Drilling Co. v. Abraham, 64 N.M. 380, 328 P.2d 1083 (1958).
45. Lowe, *supra* note 6, at 18-27.

in Texas under *Freeman v. Magnolia Petroleum Co.*[46] There the Texas Supreme Court held that a lease containing a shut-in royalty clause, which did not specifically provide when the shut-in payment was due, terminated when a well was completed and shut-in after the end of the primary term without payment of the shut-in royalty before the end of the term. The court reasoned that the lease terminated because there was neither the actual production nor the constructive production necessary to maintain it after the end of the primary term.[47] Unless the lease provides otherwise, where a well is completed and shut-in after the end of the primary term, the shut-in payment will generally be due in advance (before the well is shut in) because the lease can no longer be maintained by rentals and there is no actual production. This reasoning suggests that where a well is completed and shut-in before the end of the primary term, the shut-in payment is due not later than the end of the period for which delay rentals have been paid.

D. Where the Lease Specifically Provides for a Grace Period

Most shut-in gas royalty clauses provide a stipulated grace period; for example: "[l]essee shall pay or tender annually at the end of each yearly period during which such gas in [sic] not sold or used."[48] The grace provision gives the lessee an administrative "grace period" to process the payment. Another way of describing such language is to say that it provides for shut-in royalties for previous periods of shut-in, rather than for advance shut-in royalties. But what if the grace period extends beyond the primary term? Will the lease terminate at the end of the primary term?

In Mississippi, it appears that a grace period specifically provided for in the lease will maintain the lease beyond the primary term. This was demonstrated in *D'Lo Royalties Inc. v. Shell Oil Co.*[49] In *D'Lo*, the primary term of the oil, gas and mineral lease was four years beginning on March 14, 1968. Under paragraph 4(e), shut-in royalties were to be paid within ninety days of the expiration of the primary term, which under paragraph 2 was four years from date. The lessee made the payment on April 27, 1972, and the court held the shut-in payment to be timely.[50]

Texas also follows the view that a grace period provided for in the contract will maintain the lease beyond the primary term, whether the grace period is included in a shut-in royalty provision as demonstrated in *Union Oil Co. of California v. Ogden*[51] or in some other clause of the lease, such as the cessa-

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46. 141 Tex. 274, 171 S.W. 2d 339 (1943).
47. *Id.* at 342. *See also* Gulf Oil Corp. v. Reid, 161 Tex. 51, 337 S.W.2d 267 (1960).
48. Lowe, *supra* note 6, at 18-21.
49. 389 F. Supp. 538 (S.D. Miss. 1975).
50. *Id.* at 549.
51. 278 S.W.2d 246 (Tex. Civ. App. 1955); *see* Phillips Petroleum Co. v. Hamly, 348 S.W.2d. 856 (Tex. Civ. App. 1961).

tion of production clause in *Shell Oil Co. v. Goodroe.*[52]

In *Ogden*, suit was brought to cancel two oil and gas leases each covering an undivided interest in the same land. Both leases were for a term of five years and were practically identical except that one lease contained a shut-in royalty clause, while the other did not. The lessee completed a gas well during the primary term but there was no gas or oil produced during that term. The court held that at the end of the primary term, the lease which contained no shut-in clause had terminated as a matter of law because of the non-production of oil and gas. As to the lease containing the shut-in clause, the court held that under the express terms of the clause the lessee was given an option to pay the lessor $100 as royalty for the well on or before the first day of January each year when there was no production, until production could be profitably marketed by the lessee. The court rejected the contention of lessor that the lessee had no right to pay the royalty because there had been no production, and therefore production could not have ceased. Also, the court found as a fact that the lessee did not tender payment of the shut-in royalty provided for in the lease until after the primary term of the lease. However, at all relevant times tenders of payment were made after the expiration of the primary term of the lease but before the first of January each year, as provided in the shut-in provision, and such lease was still in force.[53]

In *Goodroe*, the lease was for a primary period of five years and provided for shut-in payments of fifty dollars per year per gas well and contained a 90-day drilling clause. Within the primary term, lessee had completed a gas well which produced in paying quantities for some four years after the expiration of the primary term. On July 4, 1944, after the primary term, the lessee was forced to shut-in the well due to pressure problems and was unable to market the gas. On October 16, 1944, the lessee paid and lessor accepted fifty dollars as shut-in payment in lieu of production. Against the contention of the lessor that the lease had lapsed of its own terms, because the shut-in payment had not been made or tendered prior to the expiration of the primary term, the court held that the "ninety day redrilling clause" allowed the lessee to tender such payment within ninety days after cessation of production and that payment made on October 16, 1944, extended the term of the lease from July 25, 1944, to July 25, 1945. The court further held that the lessors were estopped by accepting the payment of the shut-in royalty.[54]

Notwithstanding the favorable holdings for lessees in the preceding cases, Professor Lowe urges that "a conservative approach would be to pay shut-ins by the earlier of the end of the grace period or at the end of the primary term.

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52. 197 S.W.2d 395 (Tex. Civ. App. 1946); *see* Skelly Oil Co. v. Harris, 163 Tex. 92, 352 S.W.2d 950 (1962).

53. 278 S.W.2d at 251-52.

54. Shell Oil Co. v. Goodroe, 197 S.W.2d at 399.

Otherwise, there is no benefit to the lessor to support the existence of the lease beyond the primary term."[55]

E. Summary

It is difficult to argue with the holdings of the preceding cases. The message is clear. If the lessee has properly drafted his shut-in provision, it will not matter whether production ceases during or after the primary term of the lease. This assumes, of course, that the lessee also complies with the terms as written, i.e., pays the shut-in royalty payments in a timely manner. A favorite phrase of most oil and gas lawyers used in advising clients on these matters is, "[o]ut of an abundance of caution . . . ." With an asset as valuable as a producing gas well, it makes no sense to throw caution to the wind, so when in doubt Professor Lowe's conservative approach is well worth keeping in mind.

Nevertheless, it is this author's opinion that if the lease expressly provides for a grace period, it matters not whether the lease is within or beyond its primary term. A timely payment prior to the end of the grace period will safely perpetuate the lease.

IV. "OPTIONAL" OR "OBLIGATORY" CHARACTER OF PAYMENT?

A. Examples of Optional Type Shut-in Provisions

Under the provisions of most shut-in royalty clauses, the lessee has an option to pay the specified shut-in royalty under prescribed circumstances. This option is stated in such terms as the following:

> 'an annual advance royalty . . . may be paid';
> 'if lessee shall commence or resume the payment of rentals';
> 'lessee at its election may pay or tender';
> 'lessee or any assignee hereunder may pay or tender';
> 'Lessee's rights may be maintained, in the absence of production or drilling, by commencing or resuming rental payments as hereinabove provided for in connection with the drilling of a non-producing well';
> 'this lease shall terminate unless (a) Lessee shall, on or before said 25th day of January, pay to Lessor.'[56]

B. Examples of Obligatory Type Shut-in Provisions

On the other hand, a number of shut-in royalty clauses by their terms impose an obligation upon the lessee to pay shut-in royalty in a manner as follows:[57]

> 'In consideration of the premises the said lessee covenants and agrees: . . . To pay Lessor . . . .';

55. Lowe, *supra* note 6, at 18-29.
56. 3 H. WILLIAMS, OIL AND GAS LAW § 632.8 (1986).
57. *Id.*

'lessee shall also, annually, during such shut-in period, and within the time specified above for payment or tender of rentals, pay Lessor';
'Lessee shall be obligated to pay or tender to Lessor';
'lessee shall pay or tender';
'the owner of this lease as to the lands upon which such well is located shall pay.'[58]

C. Combination

Another form of shut-in royalty clause combines obligatory and optional features in that it provides that a shut-in well shall preserve the lease to prescribed acreage (as to this acreage the payment of shut-in royalty is made obligatory) and may preserve the lease as to additional acreage (as to this acreage the payment of shut-in royalty is optional).[59]

D. Whether Optional or Obligatory Provision is Preferred

Most lessees, when given a choice between having an option to do something and having to do something, will usually opt for the former. This makes sense. After all, why would a lessee want to obligate or bind himself to a task when instead he could choose to perform the task only if it meets with his approval or benefits his position. Therefore, it would seem that a lessee would always want to incorporate the option-type shut-in clause into its leases. But the reality of the situation is that where the optional form is employed, the lease will usually provide, either expressly or by implication, that the lease shall expire under the prescribed circumstances *unless such optional payment is made.* Lessees do not want to risk losing valuable leaseholds by reason of failure to make timely payment of the optional shut-in royalty payment. For this very important reason, practically speaking, such clauses impose a duty to pay shut-in royalty. For example, in *Nordan-Lawton Oil & Gas Corp. of Texas v. Miller,*[60] the court agreed with the landowner's argument that "the obligation to pay 'lieu royalty' [shut-in royalty] is *mandatory* as opposed to *permissive* unless there is some specific expression to the contrary (emphasis added)."[61]

Nevertheless, the good news for lessees, as stated by noted Stanford University Professor Howard R. Williams, is that where an obligatory shut-in is not paid, the lessor's usual remedy is an action to recover the royalty rather than an action to cancel the lease.[62] This was demonstrated in Louisiana by *Risinger*

58. *Id.*

59. Johnson v. Phinney, 181 F. Supp. 315, 319 (S.D. Tex. 1960), *rev'd*, 287 F.2d 544 (5th Cir. 1961) (on question of tax treatment of shut-in royalty payments).

60. 272 F. Supp. 125 (W.D. La. 1967), 276 F. Supp. 16 (W.D. La. 1967), *aff'd*, 403 F.2d 946 (5th Cir. 1968) (motion for new trial denied).

61. Nordan-Lawton Oil & Gas Corp. of Texas v. Miller, 272 F. Supp. 125, 132 (W.D. La. 1967).

62. H. WILLIAMS, *supra* note 56, at 437.

v. Arkansas-Louisiana Gas Co.[63] In that case, a producing gas well had been discovered and, according to the court, "the plain language of the specific clause required the lessees to pay the lessors $200 per year for each well producing gas, only 'until such time as the gas shall be utilized or sold off the premises.' "[64] Lessee, however, paid lessor's part "but erroneously deposited the money in a bank other than the one designated."[65] The court ruled in favor of lessee, stating:

> There is nothing in the lease which requires the court to forfeit defendant's [lessee's] right as to her interest, because of this erroneous method of payment – this being merely a failure to perform with literal exactness a personal obligation and not a failure to perform a condition precedent to the continuance of the lease.[66]

Another Louisiana case on point is that of *Bollinger v. Republic Petroleum Corp.*[67] in which the court gave effect to the notice and demand clause of a lease and held that the lessor was not entitled to cancel a lease for nonpayment of shut-in royalties when lessor had failed to make demand for the payments prior to institution of the action to cancel the lease.

Professor Williams suggests, however, that "the economic burden imposed upon the lessee by the obligatory feature is relatively modest inasmuch as the lease will almost certainly contain a surrender clause and he can terminate any further obligation by an election to effect a surrender."[68]

Regardless of Professor Williams' previously stated conclusion that where an obligatory shut-in is not paid, then lessor's usual remedy is an action to recover the royalty rather than an action to cancel the lease, lessees should be cognizant of a very important distinction in this area. Whether the lease will terminate for failure to properly pay shut-in royalties can also depend on whether the constructive production necessary to maintain the lease under the shut-in language is the existence of a shut-in well capable of producing in paying quantities or the payment of the shut-in royalty.[69] If it is the existence of a well capable of production in paying quantities that extends the lease, then it will not terminate even if the shut-in royalty payment is omitted completely.[70] An example of the language that should save the lease even if the shut-in royalty is not paid is as follows:

> If, at the expiration of the primary term or at any time or times thereafter, there is any well on said land . . . *capable of producing oil or gas*, and

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63. 3 So. 2d 289 (La. 1941).
64. *Id.* at 292.
65. *Id.* at 294.
66. *Id.*
67. 194 So. 2d 139 (La. Ct. App. 1966), *writ denied* 250 La. 463, 196 So. 2d 276 (1967).
68. H. WILLIAMS, *supra* note 56, at 437-38.
69. Lowe, *supra* note 6, at 18-8.
70. Risinger v. Arkansas-Louisiana Gas Co., 3 So. 2d 289 (La. 1941); *see supra* note 56 and accompanying text.

> all such wells are shut-in, this lease shall, nevertheless, continue in force as though operations were being conducted on said land for so long as said wells are shut-in.[71]

If it is proper payment of the shut-in royalty that is the constructive production, however, then the lease will terminate where the payment is not made correctly because a failure to have either actual or constructive production will trigger the special limitation to the term of the lease. For example, the following language *probably will not* preserve the lease if shut-in royalty is not properly paid, because it is structured so that the constructive production that extends the lease is the payment of the shut-in royalty:

> While there is a gas well on this Lease, *but gas is not being sold or used* Lessee shall pay or tender annually at the end of each yearly period during which such gas is not sold or used, as royalty, an amount equal to the delay rental provided for in paragraph 5 hereof, and while said royalty is so paid or tendered this Lease shall be held as a producing Lease under paragraph 2 hereof.[72]

A Texas case on point is *Freeman v. Magnolia Petroleum Co.*[73] There the court held that the lease had terminated where payment was late, applying the following reasoning:

> Thus in paragraph 2 [the term clause], the parties agree that the lease would end on April 7, 1940, unless gas was then being produced from the land. Then in paragraph 3(b) [the shut-in royalty clause], they said that a well from which gas is not used or sold off the leased premises will be regarded as a producer by virtue of lessee paying $50 per year; that is, in clear and unequivocal language, they say that *while it is so paid* the well shall be held to be a producer, under *paragraph 2*. It necessarily follows, conversely, that while the royalty is not so paid, the well will not be held to be a producer under that paragraph.[74]

Thus, the specific language of the shut-in royalty clause may be crucial if an error is made in the shut-in payment.

E. Conditions or Covenants

The optional or obligatory character of the shut-in royalty provision is sometimes expressed in terms of whether the clause is a condition or a covenant. For example, a lease clause that has been used in an attempt to avoid cancellation or termination of the lease for failure of the lessee to comply with his obligations provides: "The covenants of lessee mentioned in this lease, as

71. Lowe, *supra* note 6, at 18-9.
72. *Id.* (emphasis added).
73. 141 Tex. 274, 171 S.W.2d 339 (1943).
74. *Id.* at 278, 171 S.W. 2d at 341.

well as all implied covenants, are not to be understood as conditions, and the breach of one or all of same will not work a forfeiture, abandonment, or termination of this lease . . . ."[75] In holding that the lease in question terminated at the end of the primary term when shut-in gas royalties had not been paid before that date, the Texas court in *Freeman v. Magnolia Petroleum Co.*[76] considered such a clause and observed that "despite the general provisions of that paragraph it remained a question of law to be determined under the express terms of the lease applicable thereto, as to which of the undertakings of the parties to the lease are covenants and which are conditions."[77]

When the shut-in clause operates as a condition, the result is that the lessor may declare a forfeiture if the lessee fails to comply with the term of the clause.[78] Note, however, University of Oklahoma Professor Eugene Kuntz's claim that the lease will not terminate automatically upon failure of the lessee to pay shut-in gas royalties.[79] If the lease contains a notice clause, the lessor must comply therewith and must give notice and make demand for performance before bringing an action to cancel the lease.[80]

In light of this broad claim, it should be noted that there has been at least one case in which the New Mexico Supreme Court identified the clause as a "condition" but concluded that the lease did expire automatically for failure to pay the shut-in gas royalty provision.[81]

In that case, *Greer v. Salmon*, no gas was "sold or used" during the period from October, 1956, through May, 1960, although the well was capable of producing in commercial quantities. Accordingly, no royalty nor shut-in gas royalty was paid during this period to the lessors, as provided for in Paragraph 3(b) of the lease which read as follows:

> *To pay to lessor, as royalty for gas from each well where gas only is found*, while such gas is being sold or used off the leased premises, one-eighth (1/8th) of the market price at the well of the amount so sold or used, *and while not so sold or used, the sum of Fifty Dollars ($50.00) per annum for each such well, payable on or before the first day of January following, and while such royalty is so paid such well shall be held to be a producing well within the meaning of paragraph 2 above.*[82]

The court concentrated on the specific language "while such royalty is so paid such well shall be held to be a producing well within the meaning of

75. 4 E. KUNTZ, LAW OF OIL AND GAS § 46.6 (1972).
76. 141 Tex. 274, 171 S.W.2d 339 (1943).
77. *Id.* at 279, 171 S.W. 2d at 342.
78. E. KUNTZ, *supra* note 75, at § 46.3.
79. *Id.*
80. Bollinger v. Republic Petroleum Corp., 194 So. 2d 139 (La. Ct. App. 1966).
81. Greer v. Salmon, 82 N.M. 245, 479 P.2d 294 (1970).
82. *Id.* at 249, 479 P.2d at 298.

paragraph 2 above" (the habendum clause) in context with the entire lease and concluded that such a shut-in royalty clause must be viewed as a condition rather than a covenant.[83] The court stated:

> The appellants could have saved themselves from automatic termination by complying with paragraph 8 [cessation of production clause]. Not having done this, they could have saved themselves from automatic termination by paying the shut-in royalty for the producible gas well, but this was not done. Therefore, the lease did expire automatically at the end of January 1, 1957.[84]

"The shut-in gas royalty clause frequently appears as a part of the royalty clause of the oil and gas lease, and the royalty clause contains covenants on the part of the lessee to deliver royalty oil and to pay for gas sold or used off the premises."[85] "If the provisions for the payment of a shut-in gas royalty are added as an additional paragraph to the royalty clause, it is likely that they will similarly contain words of covenant."[86] Examples of such possibility follow.

> The royalties reserved by Lessor, and which shall be paid by Lessee, are except as otherwise provided herein: . . .
>
> 4(d) On all other minerals mined and marketed, one-eighth (1/8) of the current market price at the wells or mine. For any period or periods when, after thirty (30) days following discovery of gas or distillate on the leased premises, such product is not being sold due to lack of a market and is not being used off the leased premises or in the manufacture of gasoline or other product, and for that reason the well or wells are shut-in, lessee shall pay as advance royalty for the shut-in well or wells an amount per well as set forth in paragraph 4(e) hereof and pro rata for any lesser period. Said advance royalty shall be payable within thirty (30) days after the shutting-in of the well or wells. Under such circumstances, it will be considered that gas or distillate is being produced, but such gas well cannot be shut-in for a period longer than two (2) consecutive years.
>
> (4)(e) For the purpose of calculating shut-in gas royalty payments, shut-in royalties shall be calculated at $50.00 per acre per well per year (an arpent is deemed to be an acre). Payment may be made either directly to lessor or to his depository bank, Raceland Bank & Trust Company, Lockport Branch, in accordance with paragraph 3(d) hereof.[87]

The following clause appeared in the lease under consideration in *Risinger v. Arkansas-Louisiana Gas Co.*:

> 2nd. To pay the lessor two hundred dollars each year for each well produc-

83. *Id.* at 299 (emphasis omitted).
84. *Id.*
85. E. KUNTZ, *supra* note 75, at § 46.3.
86. *Id.*
87. Bollinger v. Republic Petroleum Corp., 194 So. 2d 132, 141 (La Ct. App. 1966).

> ing gas only until such time as the gas shall be utilized or sold off the premises, and at that time the royalty above named shall cease, and thereafter grantor shall be paid one-eighth (1/8) of the value of such gas calculated at the rate of . . . .[88]

The significance of classifying the clause as a covenant is that the lessee becomes obligated to pay, and a failure to make payment is not cause for forfeiture unless the lease so provides.[89]

F. Summary

No matter to what degree one dissects, critiques and analyzes whether a shut-in gas royalty payment is one of option or obligation, a combination of the two, or a condition or covenant, the shrewd summation by Professor Maxwell holds true: "[t]here is apparently no crevice left by the draftsman too small to constitute at least a sporting opening for the advocate if enough is at stake."[90]

Nevertheless, the following suggestions can be gleaned from the analysis above when drafting a shut-in clause. First, draft the clause in covenant-forming language providing that the lessee becomes obligated to pay and that a failure to pay is not cause for forfeiture unless the lease expressly so provides. Second, insert a notice clause requiring that the lessor must give notice and make demand for performance before bringing an action to cancel the lease. Finally, designate that the existence of a shut-in well is constructive production rather than the proper payment of shut-in royalty.

V. A Look at Mississippi's Most Commonly Used Lease Form – Producer 88 (9/70)

The shut-in gas royalty provision is set forth in paragraph 3 of a Producers 88 (9/70) lease form. It clearly designates the payment as royalty rather than as a delay rental: "[l]essee shall pay or tender, by check or draft of lessee, *as royalty*, a sum equal to the amount of annual delay rental provided for in this lease (emphasis added)." Furthermore, the Producers 88 (9/70) lease form leaves no doubt as to who receives the shut-in gas royalty payment. Paragraph 3 reads in part: "[e]ach such payment or tender shall be made to the parties who at the time of payment would be entitled to receive the royalties which would be paid under this lease if the wells were producing . . . ."

Relative to the timing of a shut-in gas royalty payment, lessee is granted a ninety day grace period following the expiration of the primary term. The key phrase reads:

> If, at any time or times after the expiration of the primary term all such

88. 3 So. 2d 289 (La. 1941).
89. Navajo Tribe of Indians v. United States, 364 F.2d 320 (Ct. Cl. 1961).
90. Maxwell, *Termination of Oil & Gas Leases—The Failure of Drafting Solutions*, 15 Inst. on Oil & Gas L. & Tax'n 181, 194-95 (1964).

> wells are shut-in for a period of ninety consecutive days, and during such time there are no operations on said land, then at or before the expiration of said ninety day period, lessee shall pay or tender, by check or draft of lessee, as royalty, a sum equal to the amount of annual delay rental provided for in this lease.

The next sentence offers additional instruction as to the timing of the payment: "[l]essee shall make like payments or tenders at or before the end of each anniversary of the expiration of said ninety day period if upon such anniversary this lease is being continued in force solely by reason of the provisions of this paragraph."

This language does not place any limitations on the number of times or years after the primary term of the lease has expired in which lessee may tender this anniversary payment. Therefore, it would seem that lessee is allowed to perpetuate the lease indefinitely. After all, the anniversary payment is in lieu of royalty as described hereinbefore and consequently lessee could contend that as long as lessor receives royalty payments the lease is protected. However, there is a counter position to be addressed. Professor Lowe explains:

> [I]t should not be assumed that the shut-in royalty clause gives a lessee unbridled discretion to shut in wells and continue the lease. It is highly likely that an inherent limitation of a valid and reasonable business purpose for the shut-in will be imposed by the courts.[91]

This is true because "the lessee remains under an obligation to market the gas at the best available price and within a reasonable period of time."[92] Professor Lowe hypothesizes:

> Because the shut-in royalty clause does not relieve the lessee of the obligation to comply with the implied covenant to market, the clause probably will not permit a lessee to hold the lease by shut-in payments where wells are shut in for purposes that are deemed speculative.[93]

Additionally, the shut-in language is framed in obligatory language, "lessee *shall* pay or tender," and also makes the existence of a shut-in well the constructive production rather than the proper payment of shut-in royalty. Paragraph 3 states:

> If, at the expiration of the primary term or at any time or times thereafter, there is any well on said land or on lands with which said land or any portion thereof has been pooled, capable of producing gas or any other mineral covered hereby, and all such wells are shut-in, this lease shall, nevertheless, continue in force as though operations were being conducted on said land for so long as wells are shut-in, and thereafter this lease may be continued in force as if no shut-in had occurred.

91. Lowe, *supra* note 6, at 18-12.
92. 5 H. WILLIAMS, OIL AND GAS LAW § 856.2 (1986).
93. Lowe, *supra* note 6, at 18-12 to 13.

Finally, important language relative to automatic termination of the lease is found in the second clause of the first sentence of paragraph 6:

> [P]rovided, however, if such anniversary date is at the end of the primary term, or if there is no further anniversary date of the primary term, this lease *shall terminate* at the end of such term or on the nineteenth day after discontinuance of all operations, whichever is the later date, unless on such later date either (1) lessee is conducting operations or (2) the shut-in well provisions of paragraph 3 or the provisions of paragraph 11 are applicable (emphasis added).

However, despite this language's apparent conclusory intent, the lease form seems to offer the "notice provision" suggested herein. Of course, one can argue that the "notice provision" supercedes the automatic termination language cited above. The first three sentences of paragraph 9 state:

> In the event lessor considers that lessee has not complied with all its obligations hereunder, *both expressed and implied*, lessor shall notify lessee in writing, setting out specifically in what respects lessee has breached this contract. Lessee shall then have sixty (60) days after receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by lessor. *The service of said notice shall be precedent to the bringing of any action by lessor on said lease for any cause, and no such action shall be brought until the lapse of sixty (60) days after service of such notice on lessee* (emphasis added).

In short, the Producers 88 (9/70) lease form appears to provide a workable, clearly written approach to shut-in gas well situations.

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