1999

Determining the Legal Ramifications of Express Oil and Gas Lease Provisions: Do the Rules of Document Interpretation Provide Predictability?

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E&MLF

Chapter 3

Cite as 19 *E. Min. L. Inst.* ch. 3 (1999)

Determining the Legal Ramifications of Express Oil and Gas Lease Provisions: Do the Rules of Document Interpretation Provide Predictability?

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Synopsis

§ 3.01. Introduction.

The oil and gas lease has served as the basic contract for the petroleum industry since before "Colonel" Edwin Drake struck oil in Titusville, Pennsylvania in 1859.[1] In fact, the first recorded lease, dated the fourth day of July 1853, and filed in the county of Venango, Pennsylvania, contained only 10 lines and ended with the prophetic statement: "If profitable."[2] Running twice as long as this first lease, the Drake lease, signed four years later in 1857, featured familiar clauses such as a provision for a 1/8th royalty, termination conditions, and an initial 15-year term.[3]

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1 Daniel Yergin, *The Prize: The Epic Quest for Oil, Money and Power* 26 (1991). E.L. Drake assumed the title "Colonel" in an effort to impress the locals. *Id*. at 26. Early oil and gas leases were adapted from forms used in the salt industry in Pennsylvania, as oil and gas were discovered as a result of borings for salt water. The salt industry leases had evolved from the leases used for solid minerals. From the beginning, oil and gas leases were used rather than outright land purchases because the owners of the land seldom "had the money or the faith to test the productivity of their holdings." Thus the lease developed to grant to those with such resources, but with little interest in ownership of the land, the privilege of exploration and production. Leslie Moses, "The Evolution and Development of the Oil and Gas Lease," 2 *Inst. on Oil & Gas L. & Tax'n*, 1, 10 (1951).

2 Leslie Moses, "The Evolution and Development of the Oil and Gas Lease," 2 *Inst. on Oil & Gas L. & Tax'n*, 1, 6 (1951).

3 *Id*. at 7.

Dated December 30, 1857
Deed Book P, p. 357
$1 in hand.
Pennsylvania Rock Oil Company to E.B. Bonditch and E.L. Drake

"Demise and Let all the lands owned or held under lease by said company in this County of Vanango, State of Pennsylvania, 'To bore, dig, mine, search for and obtain oil, salt water, coal, and all materials existing in and upon said

By the end of the century, as the industry evolved and geological knowledge expanded, other clauses considered "typical" by today's standards began appearing in oil and gas leases, including the habendum clause, bonus payment and delay rental provisions, and drilling and savings clauses. And by 1920 these and other "standard" clauses could be found in several variations of the popular "Producers 88" form.[4]

Throughout the decades, the "typical" oil and gas lease clauses have been developed and revised in response to judicial decisions. As Professor A.W. Walker noted nearly 50 years ago, "The clauses in the modern oil and gas lease [have evolved] through many years of trial and error and after a great amount of litigation and judicial construction."[5] And, as he predicted, that evolutionary process has continued. To provide an update on that process, this chapter reviews selected court decisions construing lease clauses. The cases discussed include recent decisions and older cases providing unique lessons about particular lease clauses. In order to better evaluate these court decisions, the chapter begins with a description of the general rules of document interpretation which courts purport to follow when scrutinizing an oil and gas lease clause. The next sections provide a basic description of the wording and purposes of various clauses, followed by a discussion of cases which demonstrate the effect of those provisions.

> lands, and take, remove and sell such, etc., for their own exclusive use and benefit, for the term of 15 years, with the privilege of renewal for the same term. Rental, one-eighth of all oil as collected from the springs in barrels furnished and paid for by lessees. . . . Lessees agree to prosecute operations as early in the spring of 1858 as the season will permit, and if they fail to work the property for an unreasonable length of time, or fail to pay rent more than 60 days, the lease will be null and void.'" *Id*. at 7.

4 However, while these forms contain many "typical" clauses, one version can vary substantially from another; therefore, the Producers 88 label does not suggest a "standard" lease form. These variations caused an early Texas court to determine that the caption "Producers 88" was "incapable of definite application." Fagg v. Texas Co., 57 S.W.2d 87 (Tex. Com. App. 1933). For a description of the history behind the "Producers 88" form *see* Leslie Moses, *supra* note 2, at 27; A.W. Walker, Jr., "Defects and Ambiguities in Oil and Gas Leases," 28 *Tex. L. Rev.* 895, 896-97 (1950).

5 A.W. Walker, *supra* note 4, at 909 (1950).

6 The scope of this chapter is limited to the legal implications of express lease provisions. The effect of implied obligations, through the doctrine of implied covenants, will not be discussed.

These case discussions also examine the role played by rules of interpretation in court decisions which have determined the legal implications of express lease provisions.[6]

§ 3.02. Determining the Meaning of Express Lease Provisions.

[1] — The General Rules of Document Interpretation.

When faced with determining the legal implications of an express provision in an oil and gas lease, courts must first read the lease and determine its meaning. Therefore, court opinions construing lease clauses often recite a litany of rules governing document interpretation.[7] Although variations exist from jurisdiction to jurisdiction, these rules are frequently set forth as a three-step process.

First, a court strives to ascertain the parties' intent by examining the language contained within the "four corners" of the document. If the language is not clear, in the next step in the interpretative process courts will enlist a "catalogue of canons of construction."[8] These canons function as aids in determining intent, rather than as rules dictating a particular outcome. The list of canons began developing at common law and includes such directives as "construe the document against the drafter," "the law abhors forfeiture," and "typewritten or handwritten provisions control over printed form provisions."[9] Because the list of canons is lengthy and

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7 In general, the same rules of interpretation apply to different types of documents, including contracts, wills, deeds, and oil and gas leases. However, depending upon the document at issue, different policy considerations may be raised. For example, courts frequently stress the goal of ensuring title stability when construing deeds, and the goal of ascertaining the intent of the parties when construing wills. *Compare* Moser v. U.S. Steel Corp., 676 S.W.2d 99 (Tex. 1984)(promoting stability of land titles when construing deeds) *with* Sammons v. Elder, 940 S.W.2d 276, 281 (Tex. Civ. App. — Waco 1977, *writ denied*)(stating court's primary goal in interpreting wills is to determine intent of textratix); *see also*, 15 Richard R. Powell, *Powell on Real Property* § 85.19 (1988); 2 Richard R. Powell, *Powell on Real Property* § 16.03[6] (1988).

8 *See* Bruce Kramer, "The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction," 24 *Tex. Tech. L. Rev.* 1 (1993).

9 *See* Laura H. Burney, "The Regrettable Rebirth of the Two-Grant Doctrine in Texas Deed Construction," 34 *S. Tex. L. Rev.* 73, 76-77 (1993); *see e.g.*, Molag Inc. v. Climax Molybdenum Co., 637 A.2d 322, 323 (Pa. 1994)(stating courts are free to construe the

varied, advocates generally can produce canons which support their competing interpretations of the document.[10]

If after applying these canons a court determines that the meaning is still unclear, courts move to the third step and label the document ambiguous.[11] The determination of ambiguity, however, is a question of law for the court.[12] The ambiguity finding is significant for at least two reasons: First, it precludes the granting of a motion for summary judgment because the interpretation of the instrument becomes a fact issue.[13] Second, the ambiguity determination permits the consideration of extrinsic evidence.[14]

[2] — Can Courts Consider Extrinsic Evidence in Interpreting a Lease Clause?

In general, courts are consistent in permitting the consideration of extrinsic evidence once the document has been labeled ambiguous.[15]

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document's terms against the drafter); Sharp v. Norwood, 643 N.Y.S.2d 39, 42 (N.Y. 1996)(stating well-settled equitable principle that law abhors forfeiture of leases); Vigneau v. Storch Eng'rs, No. Civ. 8907001225, 1995 WL 767984 at 6 (Conn. Super. Ct. Dec. 4, 1995)(stating the law abhors forfeiture); Posner v. U.S. Fidelity & Guaranty Co., 226 N.Y.S.2d 1011, 1017 (N.Y. Sup. 1962)(stating typewritten or handwritten material controls over printed form).

10 As Karl Llewellyn stated in his renowned and often quoted article, "there are two opposing canons in almost every point." Karl Llewellyn, "Remarks on the Theory of Appellate Decisions and the Rules or Canons About How Statutes Are to Be Construed," 3 *Vand. L. Rev.* 395, 401 (1950).

11 *See* Kramer, *supra* note 8, at 61-62; Mark K. Glasser & Keith A. Rowley, "On Parole: The Construction and Interpretation of Written Agreements and the Role of Extrinsic Evidence in Contract Litigation," 49 *Baylor L. Rev.* 657, 693 (1997).

12 Coker v. Coker, 650 S.W.2d 391, 393 (Tex. 1983); McMahon v. Christmann, 157 Tex. 403, 407, 303 S.W.2d 341, 344 (1957); Lewis X. Cohen Insur. Trust v. Stern, 696 N.E.2d 743, 751 (Ill. App. 1998); Strader v. Sunstates Corp., 500 S.E.2d 752, 755 (N.C. App. 1998); Dechert v. Maine Ins. Guar. Ass'n, 711 A.2d 1290, 1291 (Me. 1998).

13 *See* Coker v. Coker, 650 S.W.2d at 393; Glasser & Rowley, *supra* note 11 at 701.

14 A Mississippi Supreme Court decision articulated the steps in the interpretative process as follows: 1) "the court will attempt to ascertain intent by examining the language contained within the 'four corners' of the instrument in dispute"; 2) the use of applicable canons of contract construction; and 3) consideration of extrinsic or parol evidence. Pursue Energy Corp. v. Perkins, 558 So. 2d 349, 351-53 (Miss. 1990).

However, they are frequently hesitant to consider such evidence prior to making that determination. Instead, many courts profess to be confined to the "plain meaning" of words found within "the four corners" of the document, even when determining whether the document is ambiguous as a matter of law Although courts frequently fail to articulate their reasons for excluding extrinsic evidence at this point in the interpretative process, that approach may stem from confusion about the role of the parol evidence rule in document interpretation.

The parol evidence rule is a rule of substantive contract law which prohibits courts from considering extrinsic evidence, oral or otherwise, which contradicts or varies the terms of an "integrated" document. Under this rule, then, the initial inquiry is whether the document is "integrated" and final, rather than incomplete. If the document is "integrated," a question of law for the court, then evidence of prior or contemporaneous agreements is not admissible.[16] However, evidence which does not contradict the terms of the "integrated" agreement is admissible. Moreover, extrinsic evidence could also be admitted under the fraud exception to the parol evidence rule.[17]

However, strictly speaking, the parol evidence rule does not prevent a court from considering extrinsic evidence in the interpretative process. Arthur Corbin's *Corbin on Contracts* explains the distinction as follows:

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[15] At common law, Lord Bacon determined that the admissibility of extrinsic evidence depended upon whether the document contained a patent or a latent ambiguity. In his view, no extrinsic evidence of any kind was admissible to remedy a patent ambiguity, but evidence of intention was permissible to solve a latent ambiguity. *See*, 7 W.S. Holdsworth, *A History of English Law* 389-92 (1926). Today, most courts have abandoned that distinction. Roger A. Cunningham, *et. al.*, *The Law of Property* § 11.1 at 717-18 (1984)

[16] For an excellent discussion of the parol evidence rule and rules of interpretation *see* Glasser & Rowley, *supra* note 11, at 657. On the integration question the authors explain that "while the court must determine whether the agreement is integrated before admitting parol evidence for the trier of fact's consideration, the trial court is free to rely on the very same parol evidence in reaching its threshold determination that the agreement is or is not integrated." *Id*. at 707.

[17] See Scott J. Burnham, "The Parol Evidence Rule: Don't Be Afraid of the Dark," 55 *Mont. L. Rev.* 93, 133 (1994); 2 Richard R. Powell, *Powell on Real Property* § 816.03[6] (1998).

> The "parol evidence rule" is not, and does not purport to be, a rule of interpretation or a rule as to the admission of evidence for the purpose of interpretation. Even if a written document has been assented to as the complete and accurate integration of the terms of a contract, it must still be interpreted; and all of those factors that are of assistance in this process may be proved by oral testimony.[18]

In light of this distinction, Corbin and other authorities sanction the consideration of a wide-range of extrinsic evidence in the interpretative process.[19] The *Restatement* also criticizes the "plain meaning" approach to interpreting documents for condoning the exclusion of evidence as to the circumstances of its formulation: "This rule, in so far as it causes such exclusion, is disapproved, since language is so colored by the

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[18] 3 *Corbin on Contracts* § 579 (1960). *But see* Eric A. Posner, "The Parol Evidence Rule, The Plain Meaning Rule, and The Principles of Contractual Interpretation," 146 *U. Pa. L. Rev.* 533, 534 (1998). The author states the parol evidence rule as follows: "A court will refuse to use evidence of the parties' prior negotiations in order to interpret a written contract unless the writing is (1) incomplete, (2) ambiguous, or (3) the product of fraud, mistake, or a similar bargaining defect." In a footnote, the author also notes that "[p]urists will object that I conflate the plain meaning rule, which I treat as exception two, and the parol evidence rule. As far as I can tell, nothing turns on this distinction, and my version avoids needless complexities. Because both the parol evidence rule and the plain meaning rule concern the same issue — under what circumstances extrinsic evidence can be used to supplement a writing — they are best analyzed together." *Id*. at n.1.

[19] *See, e.g.*, 3 *Corbin on Contracts* § 579 (1960). "The parol evidence rule is a rule of substantive law not related to interpretation or the admission of evidence of the purpose of interpretation. Oral testimony of facts relevant to meaning are not within that principle. Parol evidence cannot be said to vary or contradict a writing until by process of interpretation it is determined what the writing means . . . such testimony does not vary or contradict the written words; it determines that which cannot be varied or contradicted." *Id*.

A well-known debate took place between Professors Corbin and Williston on this point. Professor Williston adopted a stricter approach to the use of extrinsic evidence in the interpretative process. John D. Calamari & Joseph M. Perillo, *The Law of Contracts* §§ 3-3; 3-10 (3d ed. 1987). Similarly, regarding the interpretation of deeds, the *Restatement (Second) of Property* concludes that a conveyance should be read as an entirety "and in light of the circumstances of its formulation." *Restatement (First) of Property* § 242.

circumstances of its formulation that the exclusion of otherwise admissible evidence as to such circumstances is never justified."[20]

Therefore, according to well-respected authorities, the parol evidence rule does not provide a basis for a court's refusal to consider extrinsic evidence when interpreting a document; rather, rules of interpretation should govern. Under those rules, a court can properly consider extrinsic evidence of surrounding circumstances to ascertain the meaning of the words found within the four corners of the document.[21] "Surrounding circumstances" could include evidence of course of performance, usage of trade, and, according to the *Restatement of Property*, other evidence of the "circumstances of the instrument's formulation."[22]

However, while one can cite impressive authorities which sanction the consideration of extrinsic evidence in the interpretative process, even absent an "ambiguity" determination, many courts prefer a "plain meaning" approach.[23] Moreover, regardless of the approach used in each jurisdiction, a practitioner can rarely predict, with confidence, the interpretation a court will attach to a document. Scholars have long identified the reason for this unpredictability:

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[20] *Id*. at cmt. c.

[21] In a recent article the authors conclude, "The importance of the 'surrounding circumstances' rule cannot be overemphasized . . . this rule affirmatively invites the trial court to consider extrinsic proof even in the absence of a pleading of, much less a finding of, ambiguity, and even in those cases in which the parties stipulate that the contract is fully integrated." Glasser & Rawley, *supra* note 11, at 667.

[22] *Restatement (First) of Property* 242 at cmt. d. The *Restatement* broadly defines evidence of the "circumstances of formulation" as including prevailing manners of expression, vocabulary peculiar to the conveyor, and knowledge or belief of conveyor concerning the claimants upon his bounty. *Id*. *See also*, 3 Corbin on *Contracts* § 579 (1960); John Calamari & Joseph Perillo, *supra* note 19, § 3-7 at 115.

[23] *See, e.g.*, Grass v. Grass, 47 Conn. App. 657, 706 A.2d 1369, 1371-72 (Conn. 1998); Echo Consulting Services, Inc. v. North Conway Bank, 140 N.H. 566, 669 A.2d 227, 230 (N.H. 1995); Willison v. Consolidation Coal Co., 536 Pa. 49, 637 A.2d 979, 982 (Pa. 1994); Republic Leasing Co. v. Haywood, 495 S.E.2d 804, 806 (S.C. Ct. App. 1998); *see also*, John S. Lowe, "Defining the Royalty Obligation," 49 *SMU L. Rev.* 223, 264-65 (1996)(defining jurisdictions either as "plain terms" jurisdictions or "cooperative venture" jurisdictions dependent upon the court's interpretation of royalty obligations in gas royalty clauses).

> [T]here is no unanimity as to the content of the parol evidence rule or the process called interpretation . . . . It would, however, be a mistake to suppose that the courts follow any of these rules blindly, literally or consistently. As often as not they choose the standard or the rule that they think will give rise to a just result in the particular case. We have also seen that often under a guise of interpretation a court will actually enforce its notions of 'public policy' which is 'nothing more than an attempt to do justice.'[24]

In sum, the rules of document interpretation and the parol evidence rule traditionally have had different aims. The rules of interpretation are designed to ascertain the meaning of a document while the parol evidence rule is designed to exclude outside evidence of other agreements when the parties intend the writing to contain their entire agreement. But the two sets of rules do share a common trait: they are deceptively simple to recite but riddled with subtle difficulties, leading to unpredictable and inconsistent results in practice.[25]

In order to analyze the application of rules of interpretation in practice, the following sections of this chapter discuss specific cases interpreting various lease clauses. In addition to analyzing the interpretative approach used in each case and the legal implications of the courts' conclusions, these sections provide general information about the basic purposes of selected lease clauses.

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[24] John D. Calamari & Joseph M. Perillo, *supra* note 19, § 3-16, at 177; *see also* Laura H. Burney, *supra* note 9, at 79 ("The process of interpretation or construction, including the determination of ambiguity and the use of extrinsic evidence, is presented as beguiling precise, but scholars admit the rules are 'complex, technical, and difficult to apply.'").

[25] *See, e.g.*, Posner, *supra* note 18, at 540 (stating "In virtually every jurisdiction one finds irreconcilable cases, frequent changes in doctrine, confusion and cries of despair."); Glasser & Rowley, *supra* note 11, at 39 (stating, "[I]nterspersed in this quagmire are quicksand like state court decisions, which appear equitable in specific situations but remain perilous for legal precedent."); Burnham, *supra* note 17, at 99 (noting about the use of parol evidence rule, that "not only have different men viewed the subject differently, but the same men at different times have held opinions not easily reconciled").

§ 3.03. The Royalty Clause.

[1] — In General.

The royalty clause establishes the lessee's obligation to pay royalties to the lessor once production has been obtained. In general, the royalty obligation creates a covenant, not a condition.[26] For that reason, the lessee's failure to pay royalties does not terminate the lease. Instead, the lessor's remedy is to sue the lessee for breach of the covenant to pay. However, parties could draft a lease which converts the royalty obligation into a terminating condition, as revealed in the *Hitzelberger* case discussed below. Additionally, at least one state, North Dakota, has a statute which provides that cancellation is a remedy for the lessee's failure to pay royalties.[27]

[2] — Case Examples.

[a] — The Gas Royalty Cases.

Historically, because of market fluctuations and extensive regulatory schemes for gas, the gas royalty clause has been the subject of extensive litigation. This litigation has produced a number of cases defining the terms found in the gas royalty clause, particularly the phrase "market value at the well." The meaning of that phrase became crucial during the late 1970s and early 1980s when prevailing market values for gas were much higher than the prices lessees were receiving under their long-term gas contracts. Lessors demanded that lessees calculate their royalty based on the higher price.[28]

Ultimately, jurisdictions applied different meanings to the "market value" phrase. Professor John Lowe has categorized these contrasting decisions into "plain meaning" and "cooperative venture" jurisdictions.[29] Plain meaning jurisdictions interpreted the phrase "market value at the

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[26] The royalty clause creates a condition in an "unless" lease and a covenant in an "or" lease. These two types of leases are discussed in § 3.03.

[27] N.D. Cent. Code § 47-16-39.1 (1997).

[28] For a description of the forces which created the "market value" royalty controversies, *see* Laura H. Burney, "The Interaction of the Division Order and the Lease Royalty Clause," 28 *St. Mary's L.J.* 353, 362-363 (1997).

[29] John Lowe, *supra* note 23, at 233-36.

well" as referring to the value a willing buyer and seller would negotiate on the day of production, as opposed to the price the lessee negotiated in its long-term contract.[30] Cooperative venture jurisdictions, on the other hand, considered the marketing realities existing at the time lessees negotiated the contracts to which they had dedicated the gas, which showed that lessees had virtually no choice but to market gas through long-term sales contracts. These jurisdictions allowed lessees to calculate royalties on their lower contract prices.[31]

The different results in these cases can be explained, at least in part, by the varying approaches to document interpretation used by the courts.[32] For example, in *Texas Oil & Gas Corp. v. Vela*,[33] a plain meaning decision from the Texas Supreme Court, the court purported to focus only on the language in the lease and refused to consider the marketing realities prevailing when the leases were executed.[34] The court devoted very little space to rules of interpretation. After reviewing the gas royalty clause in the lease, the court concluded:

> It is clear then that the parties knew how to and did provide for royalties payable in kind, based upon market price or market value, and based upon proceeds derived by the lessee from the sale of gas. They might have agreed that the royalty on gas produced from a gas well would be a fractional part of the amount realized by the lessee from its sale. Instead of

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30 Jurisdictions falling into this category include Texas, Kansas, Montana, North Dakota, Mississippi, and West Virginia. *Id*.

31 Jurisdictions in this category include Louisiana, Oklahoma, and Arkansas. *Id*.

32 In addition to the rules of document interpretation, however, the courts relied upon equitable notions and other legal doctrines. For example, some of the cooperative venture decisions relied upon the implied covenant to market. *See* Hillard v. Stephens, 637 S.W.2d 581 (Ark. 1982); Tara Petroleum Corp. v. Hughey, 630 P.2d 1269, 1274 (Okla. 1981). The court in *Hughey*, also noted the "fundamental unfairness to producers of royalties based on a price higher than the contract price." *Id*. The Louisiana Supreme Court quoted extensively from *Hughey* and relied heavily on Professor Harrell's description of the oil and gas lease as a "cooperative venture." Henry v. Ballard & Cordell Corp., 418 So. 2d 1334, 1338 (La. 1982).

33 Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968).

34 *Id*. at 879.

> doing so, however, they stipulated in plain terms that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. This clearly means the prevailing market price at the time of the sale or use.[35]

Yet in a cooperative venture case from Oklahoma, *Tara Petroleum Corp. v. Hughey,*[36] the court analyzed the phrase "market value" in light of these marketing realities. In adopting the *Hughey* conclusion, the Supreme Court of Louisiana, in *Henry v. Ballard & Cordell Corp.*,[37] applied "pertinent rules of contract interpretation" and determined that "the circumstances surrounding the parties at the time of contracting are a relevant subject of inquiry."[38]

By turning to "surrounding circumstances," the approach used in cooperative venture cases coincides with the rules of interpretation described above, such as the of Property's directive that documents should be construed in light of the circumstances of their formulation.[39] The *Vela* decision, on the contrary, epitomizes the reason the *Restatement* criticizes the plain meaning rule by refusing to recognize that "language is so colored by the circumstances of its formulation that the exclusion of otherwise admissible evidence as to such circumstances is never

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35 *Id*. at 871.

36 Tara Petroleum Corp. v. Hughey, 630 P. 2d 1269 (Okla. 1981).

37 Henry v. Ballard & Cordell Corp., 418 So.2d 1334 (La. 1982).

38 *Id*. at 1339.

39 It is unclear whether the cooperative venture cases considered extrinsic evidence after labeling the document ambiguous, or whether they considered that evidence relevant, under rules of interpretation, regardless of that determination. The *Henry* case, for example, refers to the contract provisions as "ambiguous." *Henry*, 418 So. 2d at 1339. But at the same time, the court's description of the appropriate interpretative approach recognizes that it is always appropriate to consider surrounding circumstances in order to "judge the meaning of the words and the correct application of the language of the contract." *Id*. at n.12. *See also Hughey*, 630 P.2d at 1273 (viewing contract as "freighted with inherent ambiguity" but determining as a matter of law that "market value" refers to the lessee's contract if reasonable when made).

40 *Restatement (First) of Property* § 242 cmt. c.

41 These contrasts can be found not only from jurisdiction to jurisdiction, but among the judges on a court in any particular jurisdiction, as demonstrated by the strong dissenting opinions filed in "plain meaning" and "cooperative venture" decisions. For example, in

justified."[40] More importantly, these cases reveal the contrasting approaches to document interpretation used by courts[41] and the impact those approaches have on the rights and liabilities of parties to an oil and gas lease.

[b] — *Heritage Resources, Inc. v. NationsBank* — "No Deductions" Phrase Permits Deductions from Royalty.

In addition to the issue addressed by the cases discussed above, the "market value" royalty provision raises another question: whether that phrase permits the deduction of post-production costs. The cases addressing that issue have been the subject of a number of recent articles, and will not be discussed here.[42] However, this section will review a recent Texas Supreme Court case which interpreted an additional phrase in the royalty clause, a phrase which stated there would be "no deductions from the value of the Lessor's royalty."

In *Heritage Resources, Inc. v. NationsBank*,[43] NationsBank, as trustee for several interest owners, brought suit in 1989 against the lessee, Heritage, claiming that Heritage had improperly deducted post-production costs from royalty payments. The trial court ruled that the bank was entitled

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Vela, a dissenting justice concluded that "[s]ince it appears that the royalty provision fails to state as of what time the 'market price' is to be determined, I think, we must look to common practices in the industry at the time the lease contract was made in 1933 to ascertain what was the intention of the parties with reference to this matter." *Vela*, 429 S.W.2d at 879 (Hamilton, J. dissenting). In *Henry*, a dissenting justice chastised the majority for treating the leases as ambiguous and argued that the canon of construction, "construe leases against lessees," should have been applied. *Henry*, 418 So. 2d at 1343 (Watson, J., dissenting).

42 *See, e.g.*, Owen Anderson, "Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically?," (Part 1 — "Why All the Fuss? What Does History Reveal?"), 37 *Nat. Resources J.* ___ (forthcoming) and (Part 2 — "Should Courts Contemplate The Forest or Dissect Each Tree?"), 37 *Nat. Resources J.* ___ (forthcoming); John Lowe, *supra* note 23 at 232; David E. Pierce, *Developments in Non-regulatory Oil and Gas Law: The Continuing Search for Analytical Foundations* § 1.07[4][b], 47 *Inst. Oil & Gas L. & Tax'n* (1996).

43 Heritage Resources, Inc. v. NationsBank, 960 S.W.2d 619 (Tex. 1997).

to damages for the transportation deductions, plus interest and attorney fees.[44] On appeal, Heritage claimed the trial court had misinterpreted the royalty clause as prohibiting the deduction of transportation costs.[45]

The leases at issue contained "market value at the well" gas royalty clauses. However, the royalty clauses also included the following language:

> . . . [t]here shall be no deductions from the value of the Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation or other matter to market such gas.[46]

Despite this "no deductions" language, Heritage argued the clause did not prohibit the transportation-cost deductions. In making this argument, it relied upon the following syllogism. First, the phrase "the value of the Lessor's royalty" was equivalent to the "market value at the well." The "market value at the well" standard, according to Heritage, inherently permits the deduction of post-production costs, such as those incurred in transporting the gas. It follows, Heritage asserted, that the royalty clauses should be interpreted to mean that the lessee could deduct no more than the reasonable costs permitted under the "market value at the well" standard. And since the bank had not claimed the deductions were unreasonable, Heritage had not violated the terms of the royalty clause, including the "no deductions" provision.[47]

In considering Heritage's argument, the court of appeals invoked the familiar litany of rules of interpretation. The court, for instance, noted that its goal was to determine the intent of the parties as expressed in the instrument. Because neither party had viewed the lease as ambiguous, the court considered that it was confined to the plain language of the lease, without resort to extrinsic evidence.[48]

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44 895 S.W.2d 833, 835 (Tex. App. — El Paso 1995), *rev'd*, 960 S.W.2d 619 (Tex. 1997).

45 *Id*. Heritage also argued that even if that interpretation were correct, division orders had expressly permitted those deductions and were binding until revoked. For a discussion of the division order issue in *Heritage*, *see* Laura Burney, *supra* note 29, at 382.

46 *Heritage*, 895 S.W.2d at 835-36.

47 *Id*. at 836.

48 *Id*.

In applying this "plain language" rule, the court of appeals first considered the phrase "market value at the well." Ultimately, the court determined that as a general rule that phrase contemplates the deduction of post-production costs from royalty.[49] However, it found that this general rule had been modified in this case by the "no deductions" language in the royalty clause.

In reaching that conclusion, the court again relied upon rules of interpretation. Specifically, the court declared that it should make "every attempt to harmonize and give effect to all provisions of the contract so that none is rendered meaningless."[50] In rejecting Heritage's theory about the interpretation of the "no deductions" clause, the court relied heavily on this "harmonizing" canon, noting that while Heritage's interpretation would render meaningless much of the language in the royalty clauses, the bank's interpretation "allows all provisions to be harmonized, giving meaning to each."[51]

Heritage appealed to the Texas Supreme Court. That court produced opinions which exemplify the nebulous nature of the interpretative process. The court initially produced an opinion in Heritage's favor, with two justices concurring and two justices dissenting. Despite receiving dozens of *amicus curiae* briefs asking the court to change its decision, the supreme court overruled the bank's motion for rehearing. However, four justices dissented from that ruling, another switched to the concurring opinion, and yet another recused himself from participating.[52] Therefore, the opinion now stands as a four to four decision in favor of Heritage, but with only one justice signing the original majority opinion.

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[49] *Id*. at 837.

[50] *Heritage*, 895 S.W.2d at 836.

[51] *Id*. at 837. Having interpreted the lease royalty clause, the court then considered the effect of division orders on that clause and concluded those documents did not permit the deductions. *Id*. at 837. For a criticism of the court's division order analysis *see* Burney, *supra*, note 29, at 386-392.

[52] Heritage Resources, Inc. v. NationsBank, 960 S.W.2d 619, 620 (Tex. 1997)(dissenting opinion). "*Justice Cornyn* and *Justice Spector* have joined *Justice Abbott* and me in voting to grant NationsBank's motion for rehearing. *Chief Justice Phillips* has also switched his position and now agrees with *Justice Owen's* concurrence, in which *Justice Hecht* joined. *Justice Enoch* has recused himself on rehearing, leaving *Justice Baker* as the lone remaining supporter of his original majority opinion. Thus, the court is now deadlocked four-to-four on the proper disposition of the case." *Id*.

The court's original majority opinion agreed with the appellate court's assessment of the "market value" royalty phrase as permitting the deduction of post-production costs.[53] The concurring justices expressed doubt about the certainty of that conclusion under Texas law.[54] But both of these opinions adopted Heritage's interpretation of the "no deductions" clause. Those opinions focused primarily on the phrase "the value of Lessor's royalty," and agreed with Heritage's theory that the "value of the lessor's royalty" equaled the "market value at the well," a term which permits reasonable deductions. Because the bank had conceded that transportation costs were reasonable, the court concluded there had not been a deduction from the "value of the lessor's royalty."[55]

Even if one agrees with the court's conclusion about the meaning of the phrase "market value at the well," its treatment of the "no deductions" language is novel at best. In interpreting the royalty clause containing this phrase, the court contradicted the very rules of construction it recited. For example, both the majority and concurring opinions noted the presumption that parties intend "every clause to have some effect," but then held that the "no deductions" phrase in the lease "was surplusage as a matter of law."[56] Understandably, the court cited no authority for this "surplusage" canon of construction.

In disagreeing with the court's assessment of the "no deductions" clause, the dissenting justices opined that the language of this phrase could not have been "more clear."[57] The dissenting opinion also acknowledged a common phenomenon in document interpretation cases, in which both parties view the document as unambiguous while attaching opposing meanings to its language.[58] However, in outlining its view of the interpretative process, the dissent describes an approach at odds with an

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53 Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118, 121 (Tex. 1996).

54 *Id*. at 129-31 (Owen, J., *concurring*).

55 39 Tex. Sup. Ct. J. 537, 540 (Apr. 25, 1996).

56 Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118, 123. The concurring opinion also viewed the "no deductions" language as "surplusage" and "ineffective." *Id*. at 130 (Owen, J., concurring).

57 *Heritage*, 939 S.W.2d at 131 (Gonzales, J., dissenting).

58 *Id*. at 132. "The majority and the concurrence both state that they agree with the trial court and the court of appeals that the leases in question are unambiguous (citation

earlier Texas supreme Court case, the *Madeley* decision discussed below, and the *Restatement (Second) of Property* and other authorities discussed above. The divergence from these sources occurs on two issues. First, regarding the use of surrounding circumstances, the dissent suggests that such evidence may be considered only *after* the document has been labeled ambiguous. Second, that opinion would apply canons of construction, such as "leases are to be construed against the lessee," only *after* determining that the leases were ambiguous, rather than as an aid in making that determination.[59] These variances reflect the pervasive disagreement about the content and application of rules of interpretation. Yet they did not affect the dissents' conclusion since that opinion viewed the deed as unambiguously prohibiting the deductions in "plain English."[60]

According to the dissent, the final four-to-four opinion in *Heritage* permitting the deductions should have limited precedential value.[61] Moreover, because the majority and concurring opinions emphasized the "value of the Lessor's royalty" phrase, a court could interpret a "no deductions" provision without that phrase as prohibiting the deduction of post-production costs. For drafting "no deductions" clauses in the future, practitioners should heed the *Heritage* example and avoid the "value of the Lessor's royalty" phrase. The difficulty, again demonstrated by *Heritage*, is choosing language intended to prohibit deductions, which a court will actually interpret as intended.[62]

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omitted). I find their agreement odd and amusing given that, interpreting the same contracts, both opinions reach a completely opposite result than the lower courts." *Id.*

59 *Id. See* Kramer, *supra* note 8, at 13 (noting that "approach of using canons before determining legal ambiguity is borrowed from the contract arena").

60 *Heritage*, 939 S.W.2d at 131 (Gonzales, J., dissenting).

61 *Id.* at 133. In addition to disagreeing with the court's interpretation of the "no deductions" phrase, the dissent also disagreed with the court's conclusion that the phrase "market value at the well" permits the deduction of post-production costs. Instead, the dissent concluded that "cases establish that a royalty interest does not bear such expenses, contrary to the result the Court reached." *Id.* at 133.

62 Regarding the drafting of "no deductions" clauses, *see* Laura Burney, *supra* note 28, at 398 (concluding "practitioners could consider heeding the words of the concurring opinion, which suggests using clauses stating that royalty would be based on the market value at the 'point of delivery or sale.' In today's new gas market, however, marked by deregulation, unbundled prices, and evolving roles for producers, processors, and

[c] — *Sun Oil Co. v. Madeley*[63] — A Unique Royalty Provision.

While the Texas Supreme Court's opinion in favor of Heritage strayed from the traditional canons of construction and created a new one, the appellate court opinion in that case properly applied the "harmonizing" canon. A case providing another example of a careful application of the rules of document interpretation is *Sun Oil Co. v. Madeley*. In particular, in *Madeley*, the Texas Supreme Court followed the *Restatement (Second) of Property's* view regarding the use of extrinsic evidence in the interpretative process.

In *Madeley*, decided by the Texas Supreme Court in 1981, the court construed a lease, executed in 1932, with a unique royalty provision. The specific clause at issue was a royalty provision, separate from the usual lessor's royalty clause, which both parties viewed as "unambiguous."[64] The issue was whether the additional clause required the lessee to pay the lessors one-half of the working interest for gas, as well as for oil. In arguing that this payment obligation was restricted to oil, the lessee emphasized the language of that clause:

> In addition to the royalty provided for in the preceding paragraph, Lessee shall deliver to Lessors . . . one-half of the *oil* accruing to the seven-eighths working interest from that produced and saved from said land, same to be delivered in the same manner as provided for the delivery of said royalty *oil*; subject, however, to the deductions and charges hereinafter provided . . .. (emphasis added).[65]

In arguing that this obligation applied to both oil and gas, the lessors asserted two points. First, the lease contained other accounting provisions

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transporters, even that phrase may be difficult to interpret and easy to manipulate."). *See also* Judice v. Mewbourne Oil Co., 939 S.W.2d 133 (Tex. 1996), in which the court concluded that the following phrase prohibited deductions: "as to all gas sold by Lessee under a written contract, the price received by Lessee for such gas shall be conclusively presumed to be the net proceeds at the well or the market value at the well for the gas so sold." *Id*. at n.1.

63 Sun Oil Co. v. Madeley, 626 S.W.2d 726 (Tex. 1982).

64 *Id*. at 727.

65 *Id*. at 728.

governing deductions which referred to "deliveries to lessors of one-half (1/2) of the *oil, gas* and other minerals" (emphasis added).[66] Second, the lessees had for years paid the lessors one-half the working interest of oil and gas, until revoking the division orders under which it had made these payments for gas, claiming the lease did not create that obligation.[67] The trial court and the court of appeals ruled in favor of the lessors.

The Texas Supreme Court, however, reversed, holding that the working-interest provision applied only to oil, not gas. In reaching this conclusion, the court reviewed the rules of document interpretation and the role of extrinsic evidence. The court agreed with the lessors' contention that "[e]vidence of surrounding circumstances may be consulted."[68] The court stated, "If, in the light of surrounding circumstances, the language of the contract appears to be capable of only a single meaning, the court can then confine itself to the writing."[69]

At this point in the interpretive process, the court reviewed evidence of circumstances surrounding the execution of the lease. This evidence included a memorandum from the lessee's files, the prevailing market value of gas as opposed to oil at the time the lease was executed, and the fact that the lessors' bargaining position was strong at the time since their property was next to a proven oil field.[70] Significantly, however, the court refused to consider the lessee's subsequent conduct, specifically its practice of actually paying the lessors a half-working interest for both the oil and the gas. According to the court, such subsequent conduct, unlike evidence of surrounding circumstances, can only be considered once the court determines the lease is ambiguous.[71]

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66 *Id*. at 730.

67 When production was originally commenced, the amount of gas produced was minimal. However, in 1977, Sun completed gas wells in a deeper zone which were capable of producing large volumes of gas. At that point, Sun reviewed the lease clause and determined that it did not require payments of one-half of the working interest on gas. The lessors responded by filing suit. *Id*. at 727.

68 *Madeley*, 626 S.W.2d 726, 731 (Tex. 1981).

69 *Id.* at 731.

70 *Id*. at 732.

71 *Madeley*, 626 S.W.2d 726, 733 (Tex. 1981).

The court, however, disagreed with the lessor's view of the surrounding circumstances. Instead, the court viewed that evidence as consistent with the lessee's contention that the lease clause applied only to one-half the working interest in oil.[72] Having made that determination, the court treated the lease as unambiguous and confined itself to the four corners of the document.[73]

The Texas Supreme Court's approach to document interpretation appears consistent with the views of the authorities discussed above, particularly the *Restatement of Property*. Recall that the *Restatement* sanctions interpreting conveyances in light of the circumstances of their formulation.[74] In *Madeley*, the Texas court recited principles in accord with that proposition:

> . . . In interpreting contracts or clauses set forth in 'clear and unambiguous' language, the courts do not confine themselves to a mere inspection of the document. Before committing themselves, the courts carefully examine the surrounding circumstances, prior negotiations, and all other relevant incidents bearing on the intent of the parties . . . .[75]

The court adhered to these rules of interpretation by considering evidence of "surrounding circumstances," but not evidence of the parties' subsequent conduct.

[d] — *Hitzelberger v. Samedan Oil Corporation*[76] — Converting the Royalty Clause into a Terminating Condition.

Citing *Madeley*, this recent Texas court of appeals decision again refused to consider the parties' subsequent interpretation of another unique royalty provision. In *Hitzelberger*, the lessor claimed the lease had

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72 *Id*. at 731.

73 *Id*. at 732.

74 *The Restatement (First) of Property*.

75 *Madeley*, 626 S.W.2d at 731 n.5 (quoting with approval from 4 *Williston on Contracts* § 600A).

76 Hitzelberger v. Samedan Oil Corporation, 948 S.W.2d 497 (Tex. App.–Waco 1997, *writ denied*).

terminated when the lessee paid royalties late. The lessor relied upon the following provision in the lease royalty clause:

> Within 120 days following the first sale of oil or gas produced from the leased premises, settlement shall be made by Lessee or by its agent for royalties due hereunder with respect to such oil or gas sold off the premises and such royalties shall be paid monthly thereafter without the necessity of Lessor executing a division or transfer order. If said initial royalty payment is not so made under the terms hereof, this lease shall terminate as of 7 a.m. the first day of the month following expiration of said 120-day period.[77]

Although production was obtained in the primary term, after making royalty payments timely for two months the lessee failed to make the next two monthly payments within the 120 days, as stipulated in the above clause.[78] Regardless, the trial court determined the lease had not terminated, finding the lease could not terminate during the primary term.[79] The court of appeals, however, reversed and rendered holding that the lease unambiguously created a terminating condition, which modified the primary term created in the lease's habendum clause.

In reaching this conclusion, the court relied upon the familiar litany of rules of interpretation set forth in the previous section.[80] While the court adopted the lessor's interpretation of the royalty clause, it rejected his request that the court consider extrinsic evidence of the parties' subsequent interpretation. According to the court, such evidence can be considered "[o]nly where a lease is first found to be ambiguous . . . ."[81]

The lessee, however, had not urged the court to consider extrinsic evidence. Instead, the lessee argued the plain language of the lease required the court to find the lease had not terminated. Specifically, the lessee argued

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77 *Hitzelberger*, 948 S.W.2d 497, 504 (Tex. App. — Waco 1997, *writ denied*).

78 *Id*. at 502.

79 *Id*. The trial court also determined that a unit agreement had amended the lease. *Id*. at 503.

80 *Hitzelberger*, 948 S.W.2d 497, 503-04 (Tex. App. — Waco 1997, *writ denied*).

81 *Id*. at 507.

that because delay rentals had been "paid-up" in advance, the lease could not terminate during the primary term. Additionally, the lessee relied upon the habendum clause, which stated the lease would continue as long as production continued in paying quantities "and the royalties are paid as provided." But the lessee argued that this reference to paying royalties did not apply to the primary term because of the "absence of a comma separating the royalty payment condition form the secondary term."[82] The appellate court, however, rejected the lessee's version of the "plain meaning" of the document:

> We believe [the lessee's] focusing on the absence of a comma places too great a weight on too frail a reed. To accept this argument we must ignore the intent expressed in the whole document and focus on punctuation in one sentence.[83]

In *Hitzelberger*, the Texas court adhered to the approach used in *Madeley* by refusing to consider evidence of subsequent conduct in the interpretative process absent an ambiguity determination. Additionally, in light of the *Hitzelberger* court's interpretation of the royalty clause, this case provides a good example of language which will effectively convert the royalty obligation into a terminating condition. Such specific language would be necessary since generally the royalty clause does not place a limitation on the term or habendum clause of an oil and gas lease. The typical habendum clause is analyzed in the next section.

§ 3.04. The Habendum Clause.

[1] — In General: The Primary Term and the Secondary Term.

The habendum clause is also known as the term clause of an oil and gas lease. It establishes the lease's duration, generally by providing for two terms: the primary term and the secondary term. The primary term is a set amount of time, usually ranging from two to 10 years, which gives the lessee the right to explore for oil, gas and other minerals but without

82 *Id*. at 505.

83 *Id*. at 505-506.

any obligation to do so.[84] The secondary term allows the lease to continue as long as there is production from the premises. Structuring the lease's duration in this manner allows the lessee to accomplish two goals: first, insuring sufficient time for decisions about exploration, development and financing; and second, insuring the lessee can continue producing in order to capitalize on its investment.

[2] — The Effect of the Delay Rental Clause.

The typical habendum clause provides that it is "subject to the other provisions of the lease." Thus other provisions of the lease can affect its duration. For example, the lease term can be limited by the delay rental clause. And depending upon the wording of that clause, the failure to properly pay delay rentals could result in automatic termination.

[a] — The "Unless" Lease.

An "unless" delay rental clause in effect provides that the lease will terminate unless the lessee, who has not drilled by a specified date, pays delay rentals. In effect, the "unless" language creates a condition, as opposed to a covenant, which imposes a limitation on the primary term of the lease. If the lessee fails to pay according to the clause, the lease terminates automatically. In general, equitable rules against forfeiture are not applicable. In light of this automatic termination feature, the "unless" lease is viewed as creating a fee simple determinable in the lessee, and a possibility of reverter in the lessor.[85] Regardless of this classification, however, some courts have protected lessees against termination on the basis of estoppel, revivor, and ratification. The following is an example of an "unless" clause:

> If no well be commenced on said land on or before the _____ day of _____, 19__, this lease shall terminate as to

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[84] This term is usually negotiated between the parties, but some states have statutes limiting the length of the primary term. *See* La. Rev. Stat. Ann. § 31.115 (West 1998); Tenn. Code Ann. § 66-5-108 (1993).

[85] 1 Williams & Meyers, *Oil and Gas Law* § 301 (Patrick H. Martin & Bruce M. Kramer eds. 1997); Luckel v. White, 819 S.W.2d 459 (Tex. 1991); Concord Oil Co. v. Pennzoil Exploration and Prod. Co., 966 S.W.2d 451 (Tex. 1998).

> both parties unless the lessee shall on or before that date pay or tender to the lessor, the sum of _____, which shall operate as a rental and cover the privilege of deferring the commencement of a well for twelve months from said date. In like manner and upon subsequent like payments or tenders the commencement of the well may be further deferred for like periods of the same number of months successively.

[b] — The "Or" Lease.

As opposed to the "unless" lease, the "or" lease creates a covenant, not a condition. Therefore, the lessee's failure to pay delay rentals does not result in automatic termination. Instead, the lessee must take affirmative action to terminate the lease. For these reasons, the "or" lease is viewed as creating a fee simple subject to a condition subsequent in the lessee, leaving a right of reentry in the lessor.[86] However, many "or" leases contain forfeiture provisions which permit the lessor to terminate the lease if the lessee has not paid rentals in a set time period. Even absent an express forfeiture provision, courts frequently invoke equitable rules of forfeiture to cancel an "or" lease.[87] The following is an example of an "or" clause:

> Lessees agree to commence a well on said premises within _____ years from the date hereof, or pay lessor _____ cents an acre per annum, payable quarterly in advance from the _____ day of _____, 19__, until said well is commence or this lease surrendered.

[c] — Case Examples.

[i] — *Bertani v. Beck.*[88]

Bertani involved an "unless" lease with a short, one-year primary term. At the end of the first year, the lessee had failed to drill or pay delay rentals. A year later, after the lessee refused to tender rentals for two years' delay, the lessors filed an action in assumpsit to recover this sum.[89] The trial

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86 Williams & Meyers, *supra* note 85, at § 603.3(f).

87 *See, e.g.*, Warner v. Haught, 329 S.E.2d 88, 96 (Sup. Ct. App W. Va. 1985).

88 Bertani v. Beck, 330 Pa. Super. 248, 479 A.2d 534 (Pa. 1984).

89 *Id.* at 535. The lessee had initially tendered $20,405, but the total due for two years of delay rentals, according to the lease, was $27, 208.

court granted summary judgment in favor of the lessors and the lessee appealed.

The Superior Court of Pennsylvania reversed. In so doing, the court correctly assessed the nature and effect of the "unless" lease. As the court explained, the lease did not *require* the lessee to pay delay rentals: "Paragraph 6 of the lease was intended to confer upon [the lessee] the right to explore for the presence of minerals. If none were discovered, [the lessee] was free to allow the lease to be forfeited by the expedient of not paying a 'delay rental.'"[90] For that reason, the lessors had no right to receive delay rentals, meaning the summary judgment granting them the right to recover those monies was improper.[91]

[ii] — *Warner v. Haught, Inc.*[92]

While the parties in *Bertani* agreed that the delay rental clause unambiguously created an "unless" lease, in *Warner* the lessor and lessee disagreed about the effect of that clause. The delay rental clause in *Warner* read as follows: "The said Lessee *covenants* and agrees to pay rental at the rate of $1.00 per acre, per year . . . in advance, . . .until, but not after, a well yielding royalty to the Lessors is drilled on the leased premises . . ." (emphasis added).[93] In a separate paragraph, the lease also contained a surrender clause which permitted the lessee to terminate its obligations.[94]

In analyzing these lease clauses, the court began with a scholarly review of the differences between "unless" and "or" leases.[95] In light of the language in the delay rental clause stating the "lessee covenants" to pay rental, the court held the lease did not convert delay rental payments

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90 *Bertani*, at 537.

91 *Id*. at 536. The court also determined that Amoco had not revived the lease by tendering late payments since the tender was rejected by the lessors.

92 Warner v. Haught, Inc., 174 W. Va. 722, 329 S.E.2d 88 (Sup. Ct. App. W. Va. 1985).

93 *Id*. at 93.

94 *Id*. The surrender clause stated: "Upon payment of one ($1.00) Dollar at any time, by . . .[the lessee], . . . it or they shall have the right to surrender this lease for cancellation, after which all payments and liabilities thereafter to accrue under any by virtue of its terms shall cease and determine, and this lease becomes absolutely null and void."

95 *Warner*, 174 W. Va. 722, 329 S.E.2d 88, 92 (1985).

into a condition, which would lead to automatic termination of the lease. Moreover, the court noted that the surrender clause was consistent with the creation of an "or" lease, not an "unless" lease. In reaching this conclusion, the court also invoked a canon of construction: "terms are to be construed most strongly against the party who solicited and prepared the lease, in this case the lessee."[96] However, the court determined that in light of the clear language of the lease that canon did not aid the lessors' case. Therefore, the court held the lease language created an "or" lease.

In addition to interpreting the lease, however, the court also addressed the parol evidence rule. That rule was implicated because the lessors claimed that, despite the language of the lease, the lessees had represented that the lease would terminate automatically if delay rentals were not paid timely. The court recognized that such testimony could be admissible under the fraud exception to the parol evidence rule.[97] Therefore, it reversed the summary judgment granted in favor of the lessees, and remanded the case to the trial court.

Because on remand the lease could be determined to include an automatic termination provision, the court addressed another question which it viewed as the "central issue" in the case: whether a unique West Virginia statute applied to an "unless" lease.[98] That statute imposes notice and demand requirements upon lessors who have not received delay rentals. The lessors in *Warner* had not complied with this requirement. Therefore, they argued, first, that their lease was an "unless" lease, and second, that the statute did not apply to "unless" leases. After reviewing the language and history behind the statute, the West Virginia court agreed that the statute applied only to "or" leases: "[T]he statute provided an expeditious means, without resort to judicial process, to require lessees

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96 *Id*. at 93.

97 *Id*. at 94. The court recited a traditional definition of the rule: "A written contract merges all negotiations and representations which occurred before its execution, and in the absence of fraud, mistake, or material misrepresentations extrinsic evidence cannot be used to alter or interpret language in a written contract which is otherwise plain and unambiguous on its face." *Id*.

98 *Id*. at 91.

in 'or' type leases to pay the rentals due under the lease if they did not wish to have the lease canceled under the statute."[99]

Having decided the statute in general applied to "or" leases, the *Warner* court left it to the lower court to label the lease in dispute as either an "or" or "unless" lease on remand. Because an "or" determination would permit the application of equitable rules of forfeiture, the appellate court also considered the application of those rules to this case. In reviewing the function of those rules, the court noted that "forfeiture is favored, when instead of working a loss or injury contrary to equity, it promotes justice and equity and protects the owner against the indifference, laches, and injurious conduct of the lessee."[100] Regarding the interaction of the forfeiture rules and the West Virginia statute, the court concluded that if a lessee repeatedly fails to pay rentals on time, forcing the lessor to constantly seek relief under the statute, a finding of equitable forfeiture could be appropriate.[101]

Warner serves as a reminder that several sources must be consulted in order to clarify the legal obligations created by an oil and gas lease. The starting point is the language of the lease. Next, as discussed in the first section of this chapter, extrinsic evidence could be relevant in the interpretative process or under the parol evidence rule. In this case, the lessor relied upon the fraud exception to the parol evidence rule as a vehicle to introduce extrinsic evidence, a tactic which helped the lessors avoid a summary judgment rendered by the trial court in the lessee's favor.[102] Additionally, *Warner* demonstrates that statutory enactments may significantly affect the rights and liabilities of parties to an oil and gas

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[99] *Id.* at 95.

[100] *Warner*, 174 W. Va. 722, 329 S.E.2d 88, 96 (1985).

[101] *Id.* In this case, however, the court found the circuit court had not erred in finding forfeiture unjustified at the time in question. The court also determined that issues of fact precluded a summary judgment based on the doctrine of abandonment. *Id.* at 97-98.

[102] Had the lessor argued that under rules of interpretation the court should consider the lessee's representations about automatic termination, the court may have refused to do so. In that instance, the court could have determined that the plain language of the delay rental clause, particularly the word "covenant," prohibited the consideration of any extrinsic evidence to show a "condition" was created.

lease.[103] And finally, the decision reminds that equitable considerations, here the doctrine of equitable forfeiture, could alter the effect of express lease provisions.

[iii] — *Humble Oil & Refining Co. v. Harrison*[104]

Like *Warner*, the *Harrison* case provides another example of the role of equitable doctrines in determining a lessee's rights under an oil and gas lease. That case involved an "unless" lease. The Ottos owned three-fourths of the minerals under a 1074.4 acre tract. This property was eventually leased to Humble Oil. Subsequently, the Ottos executed a conveyance to Harrison which provided that Harrison would own "an undivided one-half (1/2) interest in and to all of the oil, gas and other minerals" under the property, meaning the grantors were "conveying two-thirds (2/3) of their said three-fourths (3/4) of the minerals, or an undivided one-half (1/2) of said minerals." The deed also provided that "one-half (1/2) of the money rentals" from leases on the property would be paid to the grantee.[105]

After receiving notice of this conveyance, an attorney for Humble determined that thereafter Humble should pay Harrison one-half of the delay rentals which it had previously been paying to the Ottos for their 3/4 interest. Harrison accepted two rental payments from Humble calculated in this manner. However, he rejected the next payment and claimed the lease entitled him to one-half of the total rental payments Humble owed. He also asserted that the lease had terminated, even though Humble tendered the amount Harrison demanded.[106]

Humble Oil then brought suit for removal of cloud from and to quiet its title in the leased property. The trial court and the court of appeals ruled in favor of Harrison.[107] The Texas Supreme Court, however, held that the

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[103] In addition to West Virginia, Kentucky has a statute which has been held to apply to both "unless" and "or" leases. Ky. Rev. Stat. Ann. § 353.020 (Michie 1996); Walter v. Ashland Oil & Refining Co., 300 Ky. 43, 187 S.W.2d 425 (Ky. 1945).

[104] Humble Oil & Refining Co. v. Harrison, 146 Tex. 216, 205 S.W.2d 355 (Tex. 1947).

[105] *Id*. at 357.

[106] *Id*. at 358.

[107] Humble Oil & Refining Co. v. Harrison, 199 S.W.2d 786 (Tex. Civ. App. — Galveston 1947, *writ denied*).

lease had not terminated and reversed and rendered in favor of Humble Oil.[108]

In reaching this conclusion, the court began by construing the mineral deed from the Ottos to Harrison. However, the court did not engage in a lengthy or careful review of the rules of document interpretation. Instead, the court was curt in its analysis and imprecise in its use of the ambiguity label. First, rather than rely on canons of construction in deciding *whether* the deed was ambiguous, the court stated that "where the language of the grant *is ambiguous*, it is to be construed against grantors rather than against grantee."[109] Next, the court concluded that "While an ambiguity is created by the reference in the mineral deed to the leases executed by the Ottos and the rentals payable thereunder, we conclude that, considering the deed as a whole, the intention of the parties was that Harrison was granted the right to receive one-half of the entire rentals and not merely one-half of the rentals payable to the Ottos."[110]

In light of that determination, Harrison claimed the lease had terminated since Humble's delay rental payments were not consistent with the court's conclusion about his title. Indeed, under the automatic termination feature on an "unless" lease, Harrison's contention would technically be correct. The court, however, demonstrated a well-recognized tendency to avoid the automatic forfeiture feature of such leases by turning to equitable considerations.[111] Specifically, the court determined that, "While we do not know of any case presenting the exact situation involved here, we think the general principles of equitable estoppel are applicable."[112] In this case, the court determined that Harrison was estopped to assert that the lease had terminated because of its failure to pay him correctly. In expounding upon facts which could lead to an estoppel, the court pointed to 1) the lessee's good faith mistake in

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[108] *Harrison*, 146 Tex. 216, 205 S.W.2d 355, 361 (1947).

[109] *Id*. at 360, *emphasis added*.

[110] *Id*.

[111] *See, e.g.*, Eugene Kuntz *et al.*, 2 *Oil and Gas Law* 161 (3d ed. 1998); Greer v. Stanolind Oil & Gas Co., 200 F.2d 920 (10th Cir. 1952); Vaughan v. Doss, 219 Ark. 963, 245 S.W.2d 826 (Ark. 1952); Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (Kan. 1984).

[112] *Harrison*, 146 Tex. 216, 205 S.W.2d 355, 361 (1947).

construing a deed making a partial conveyance of the lessor's interest; and, 2) the conveyee's initial silence after accepting payments.[113]

Humble established a trend which courts in Texas, and other states, have chosen to follow.[114] In several subsequent cases, the courts have turned to equitable doctrines to avoid the forfeiture created when a lessee fails to comply with the delay rental clause. In addition to equitable estoppel, these equitable defenses include waiver, ratification, and revivor. In practice, however, commentators have noted that courts and parties tend to blur the distinctions between these equitable remedies.[115] For example, in *Brannon v. Gulf States Energy Corp.*,[116] the Texas Supreme Court determined that a lease had not terminated, despite the lessee's failure to timely pay delay rentals, when the lessor later accepted a check endorsed "lease rental." In the court's view, the lessor's acceptance of this check had the effect of reviving the original lease. However, as Professors Smith and Weaver have noted, technically a revivor could occur only if the lessor in fact realized the lease had terminated and intended to execute a new one.[117] Yet *Brannon*, *Humble Oil*, and other cases demonstrate that lessees may be able to avoid the automatic termination feature of an "unless" lease by relying upon equitable remedies.

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[113] *Id.* A North Dakota case involving similar issues reached a different result. *In Schwartzenberger v. Hunt Trust Estate*, 244 N.W.2d 711 (N.D. 1976), the North Dakota Supreme Court distinguished *Humble Oil* for several reasons. First, the court considered that the lessee in *Schwartzenberger* had acted negligently in reviewing deed records; the lessors had given adequate notice to the lessee's about the dispute; and, unlike in *Humble*, the lessee had failed to tender an amount sufficient to cover the disputed amount. *Id.* at 717.

[114] *See, e.g.*, Ledford v. Atkins, 413 S.W.2d 68 (Ky. 1967); Hove v. Atchison, 238 F.2d 819 (8th Cir. N.D. 1956); *Bertani* 330 Pa. Super. 248, 479 A.2d 534 (Pa. 1984)(recognizing revivor as a feasible remedy but considering it inapplicable since the lessor had not accepted a late tender of rentals; *see also* Kuntz *et al.*, *supra* note 112, at 159).

[115] *See* Bruce Kramer, "The Temporary Cessation Doctrine: A Practical Response to an Ideological Dilemma," 43 *Baylor L. Rev.* 519, 541-42 (1991).

[116] Brannon v. Gulf States Energy Corp., 562 S.W.2d 219 (Tex. 1977).

[117] Ernest E. Smith & Jacqueline Lang Weaver, *Texas Law of Oil and Gas* §§ 3.8(B), at 134; 6.3(A), at 287-0 (1997).

[3] — The "Production" Requirement in the Habendum Clause.

The lessee's failure to comply with the delay rental clause in an oil and gas lease affects its rights only during the primary term. In order to extend its interest into the secondary term, the lessee must satisfy the "production" provision in the habendum clause. In determining the meaning of that word, courts have largely relegated the rules of document interpretation to a minor role. In fact, those rules are often decidedly absent from decisions scrutinizing the meaning of the word "produced."[118] Instead, those decisions feature other considerations. For example, in determining that the term "produced" means capable of producing in paying quantities, which does not include marketing, the Oklahoma Supreme Court rejected a literal construction of the habendum clause:

> clause, uninterrupted production — following expiration of primary term — would be indispensable to maintain a lease in force. This would mean, of course, that any cessation of production. . . would put an end to the lease. Oklahoma has rejected that literal a view. Our law is firmly settled that the result in each case must depend upon the circumstances that surround cessation. Our view is no doubt influenced in part by the strong policy of our statutory law against forfeiture of estates.[119]

In addition to policy considerations, different views about the basic purpose behind an oil and gas lease have led to different definitions for the word "produced." As Professor Kuntz has explained, jurisdictions such as Oklahoma and West Virginia view the main purpose of the lease as the discovery of oil and gas. Texas, on the other hand, views the purpose of the lease as developing the property "for the mutual benefit of the

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[118] See, *e.g.*, Babb v. Clemensen, 455 Pa. Super. 181, 687 A.2d 1120 (Pa. Super. 1996); Waddle v. Lucky Strike Oil Co., 551 S.W.2d 323 (Tenn. 1977); McCullough Oil, Inc. v. Rezek, 176 W. Va. 638, 346 S.E.2d 788 (W. Va. 1986).

[119] Stewart v. Amerada Hess Corp. 604 P.2d 854, 858 (Okla. 1979). Oklahoma is a non-ownership jurisdiction which views the oil and gas lease as creating a profit, rather than a fee simple determinable. 1 Brown, *The Law of Oil and Gas Leases* § 3.02[2], at 3-8 (1998).

lessor and lessee, and that the lessee should not be permitted to hold the lease for speculation."[120]

[4] — Savings Clauses.

[a] — In General.

Regardless of the variations in the definition of production, lessees in all jurisdictions face practical problems in satisfying that requirement. For that reason, the "typical" oil and gas lease contains savings clauses which are designed to preserve the lease despite the lessee's failure to achieve "production" at the end of the primary term, or despite the cessation of production during the secondary term. These savings clauses include:

1) *Operations Clauses*: These clauses are designed to bridge the gap from the primary term to the secondary term. But for these clauses, the lease would terminate at the end of the primary term if oil and gas are not being "produced." However, an operations clause permits a lessee to maintain its interest if it has commenced operations prior to the end of the primary term and continues those operations past that date, without cessation for more than a set period of time.[121]

Depending upon the wording of the clause, these operations may include the drilling of a well other than the one commenced prior to the end of the primary term. In that event, the operations clause has been

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[120] 2 Eugene Kuntz, *The Law of Oil and Gas* §§ 26.5, 26.6 (1987). Professor Kuntz listed three rules which have developed in order to extend an oil and gas lease beyond the primary term. These are 1) discovery alone (Oklahoma and West Virginia); 2) jurisdictions which distinguish between oil and gas, requiring extraction for oil but discovery only for gas (Montana, Wyoming, Kentucky, and Tennessee); and 3) production requires actual production and marketing (Louisiana, Texas, New Mexico, Kansas, Illinois, Michigan, and Ohio). *Id.* at § 26.6.

While jurisdictions have adopted these varying definitions of the production requirement as it applies to extending the lease into the secondary term, virtually all jurisdictions require the production to be in "paying quantities" to hold the lease. Regarding jurisdictions falling in the first category, listed above, Professor Hemingway has explained that "'production' in these states may be defined as being a well which is completed and capable of producing oil or gas in paying quantities . . . [in these states] the lessee will have a reasonable time within which to market the products." Richard Hemingway, *The Law of Oil and Gas* § 6.4, at 317 (3d ed. 1971).

[121] 3 Williams & Meyers, *supra* note 86, at § 603.3(f).

labeled a continuous operations clause. If, on the other hand, the clause requires the lessee to complete in the secondary term, the very well it commenced in the primary term, the clause is known as a "well completion" clause.[122] As demonstrated by the *Rogers* case discussed below, reasonable minds may differ about language required to create a "well completion" clause instead of a "continuous operations" clause.

2) *Cessation of Production Clauses*: As the name implies, these clauses permit the lessee to maintain its interest even if production ceases in the secondary term.[123] In general, such a clause gives the lessee 60 to 90 days to commence drilling or reworking operations or the lease will terminate. Without this savings clause, the lessee's interest under an "unless" lease would automatically terminate when production "ceased."[124]

To avoid termination in this instance, however, courts have developed the "temporary cessation of production" doctrine. Under that doctrine, a lessee has a reasonable time to resume production if the cessation resulted from "sudden stoppage of the well," "mechanical breakdown," "or the like."[125] If a lease contains an express cessation of production clause, however, courts have chosen to adhere to the time periods set forth therein, rather than permit a "reasonable time" of cessation, as allowed under the court-created doctrine. Therefore, as demonstrated by the *Samano* case discussed below, determining the presence or absence of an express clause could be crucial to the lessee's survival.

3) *Dry Hole Clauses*: A "dry hole" savings clause is designed to protect the lessee after it has drilled a non-producing well. These clauses typically give the lessee a set time to begin drilling or reworking operations after

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[122] 3 Williams & Meyers, *supra* note 86, at § 617.1.

[123] 3 Williams & Meyers, *supra* note 86, § 616.2, at 284).

[124] Whether cessation has occurred depends upon the jurisdiction's definition of the production requirement.

[125] Watson v. Rochmill, 137 Tex. 565, 155 S.W.2d 783 (Tex. 1941). *See generally*, Kramer, *supra* note 115, at 519. Under the doctrine, a lease will not terminate if the cessation lasts only for a "reasonable" amount of time. Courts have considered a cessation for as long as four years "reasonable." *See* Saulsberry v. Siegel, 252 S.W.2d 834 (Ark. 1952).

having drilled a dry hole. Significantly, these clauses rarely define the term "dry hole," but it is generally viewed as an "unsuccessful drilling operation."[126]

4) *Other Savings Clauses*: Other savings clauses found in a "typical" oil and gas lease include the shut-in royalty clause, *force majeure*, and pooling clauses. Over the decades, these and the other savings clauses discussed above have been the subject of countless court decisions and academic commentary.[127] This chapter includes examples of cases involving the operations, cessation of production, and dry hole clauses, which further demonstrate the unpredictability of the interpretative process.

[b] — Case Examples.

[i] — *Rogers v. Osborn*.[128]

Rogers illustrates the interplay of the three savings clauses described above, the operations clause, the cessation of production clause, and the dry hole clause. In that case, the lessee commenced well number one prior to the date which marked the end of the primary term, September 21, 1947. On that date, however, the well was not producing in paying quantities. Therefore, unless the lease was propelled into the secondary term by some other provision, the lease terminated.

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[126] 4 Kuntz, *supra* note 121, at § 47.2(c).

[127] 3 Williams & Meyers, *supra* note 86, at §§ 613-614.5.). While these clauses are not discussed in this chapter, they have been the subject of a number of excellent commentaries. *See, e.g.*, Robert E. Beck, "Shutting-In: For What Reasons and for How Long? " 33 *Washburn L.J.* 749 (1994)(discussing shut-in royalty clauses); John Lowe, "Shut-In Royalty Payments," 5 *E. Min. L. Inst.* ch. 18 (1984)(discussing shut-in royalty clause); Owen L. Anderson, "Calculating Royalty: 'Costs' Subsequent To Production . . . 'Figures Don't Lie But . . .,'" 33 *Washburn L.J.* 591 (1994)(discussing pooling clause); Richard F. Brown, "Oil, Gas and Mineral Law," 49 *SMU L. Rev.* 1177 (1996)(discussing pooling clause); John Lowe, "Negotiating Oil and Gas Leases for the Lessee," 1 *Nat. Resources & Env't* 1 (1985)(including a discussion on pooling clause); Joan Teshima, Annotation, "Gas and Oil Lease Force Majeure Provisions: Construction and Effect," 46 A.L.R. 4th 976 (1987)(discussing *force majeure* clauses); Owen Anderson, "Drilling for Black Gold Under the Model Form Drilling Contracts," 15 *E. Min. L. Inst.* ch. 9 (1994)(discussing *force majeure* clauses).

[128] Rogers v. Osborn, 261 S.W.2d 311 (Tex. 1953).

The three possible savings clauses were contained in paragraph 5 of the lease. This paragraph contained a typical, albeit a confusing, configuration of these clauses, with the dry hole and cessation clauses combined in the first few sentences, followed by an operations clause.[129] The court quickly dispensed with the dry hole clause since the lessees had obtained a jury finding that well number one was not a dry hole.[130] One might consider that the opposite of a dry hole is a producing well, but that was not the case here. Instead, because the well had never produced in paying quantities, it had not "produced."[131] And, as the court noted, "If production never began, it could not 'cease,'"[132] rendering the cessation of production clause inapplicable.

After that analysis, the operations clause remained as the only savings clause which could save the lease. That clause read as follows:

> If at the expiration of the primary term oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or re-working operations thereon, this lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other mineral so long thereafter as oil, gas or other mineral is produced from said land . . . .[133]

The lessee argued that it had complied with the terms of this clause. While well number one never produced in paying quantities, the lessee had also drilled well number two after the expiration of the primary term, which became a producer. By relying upon well number two, the lessee in effect viewed this clause as a "continuous operations" clause, as described above. The court, however, disagreed and read the clause as creating a "well completion" clause.

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[129] *Id.* at 312.

[130] *Id.* at 312.

[131] After the well was completed it was subjected to "periodic flowing" of "oily mud." *Id.* at 311.

[132] *Rogers*, 261 S.W.2d at 313.

[133] *Id.* at 312.

In reaching this conclusion, the court scrutinized the language of the lease by comparing language in the operations clause with language in the dry hole and cessation of production clauses. Specifically, the court noted that while the dry hole and cessation of production clauses provided that "additional" drilling or reworking operations would maintain the lease,[134] the word "additional" was missing from the operations clause. Therefore, according to the court, "This sentence means that if production results from the continuous prosecution of the very operations being engaged in by the lessees upon the expiration of the primary term, the lease is good."[135]

A dissenting justice would have classified the operations clause as a continuous operations clause, a conclusion which would have allowed the lessee to rely on its work on well number two to save the lease. The dissent adopted the opinion of the intermediate appellate court: "No limitation is placed upon the word 'operations' the second time it is used in the clause . . . [t]here is no verbal basis for restricting 'operations' to those actually being prosecuted at the end of the primary term."[136]

In reaching their respective opinions, neither the dissent, the majority, nor the court of appeals recited the rules of document interpretation.[137] Nonetheless, these opinions stand as a reminder that one can rarely predict the interpretation a judge will attach to an oil and gas lease provision. As

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[134] The dry hole and cessation of production clauses read as follows: "If prior to discovery of oil or gas on said land Lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or reworking operations within sixty (60) days thereafter . . .." *Id.* at 313.

[135] *Rogers*, 261 S.W.2d at 315.

[136] Rogers v. Osborn, 250 S.W.2d 296, 298 (Tex. Civ. App. — San Antonio 1952), *rev'd*, 261 S.W.2d 311 (Tex. 1953).

[137] *Id.*

[138] As a result of *Rogers*, operations clauses frequently have the phrase "or any other such operations" inserted to insure the clause is classified as a continuous operations clause, rather than a well completion clause. Eugene Kuntz, *supra* note 111, at 211.

always, the *Rogers* decision provides direction, but no guarantees, for future drafting, which is little consolation for the losing party.[138]

[ii] — *McCullough Oil, Inc. v. Rezek.*[139]

Rezek presented the opportunity for the Supreme Court of Appeals of West Virginia to explain the effect of a temporary cessation clause on the application of the temporary cessation doctrine. While these disputes generally arise between lessors and their lessees, in this case the original lessee sued assignees of the lease. The original lease, executed in 1966, contained a cessation of production clause which allowed the lessee, McCullough, 60 days to resume operations after cessation. Subsequently, McCullough assigned the lease to Rezek. That assignment provided that if Rezek abandoned the lease for any reason, then it would revert to McCullough. This lease was eventually assigned to Reynolds in 1977. Three years later, he executed a surrender of this lease to the lessors, who then executed a new lease to Reynolds.[140]

These actions prompted McCullough to file suit claiming that Reynold's surrender of the lease constituted an abandonment of the lease under the terms of the assignment. For that reason, McCullough claimed the lease had reverted to him. The trial court disagreed, finding that McCullough's lease had terminated "due to cessation of production after the primary term without resumption of operations within sixty days as required by the lease."[141]

The Supreme Court of Appeals of West Virginia affirmed. In so doing, the court began with an examination of the nature of the oil and gas lease and the effect of the cessation of production clause on the lessee's rights.[142] Because of the presence of this clause, the court clarified:

> [t]he parties are bound by such clause's definition of a "temporary" cessation of production, and the imprecise common law doctrine of temporary cessation of production

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[139] McCullough Oil, Inc. v. Rezek, 176 W. Va. 638, 346 S.E.2d 788 (W. Va. 1986).

[140] *Id.* at 791.

[141] *Id.* at 792.

[142] *Id.* at 792. The court noted that "[a]n oil and gas lease (or other mineral lease) is both a conveyance and a contract."

> (which allows a "reasonable" period of time to resume operations) is not applicable to extend the lease beyond the precisely fixed "grace" period stated in the cessation of production clause of the lease.[143]

However, while the court determined that the common law doctrine did not apply in this case, the court nevertheless concluded that the nine-year period of cessation in this case, "without any attempted justification," was not "temporary."[144]

[iii] — *Jolynne Corp. v. Michels*[145]

In *Michels*, the Supreme Court of Appeals of West Virginia again turned to the "temporary cessation of production" doctrine to determine whether a lease had terminated. In that case, the lease apparently did not contain a cessation of production clause.[146] For that reason, the court relied upon the description of the "temporary cessation of production" doctrine as set forth in *Rezek*. According to *Rezek*, the following factors should be considered in determining whether a cessation was temporary: the length of time, the cause of the delay, and whether the lessee had exercised reasonable diligence to resume production.[147] After weighing these factors, the court in *Michels* determined the lease had terminated

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[143] *Id*. at 794 n.5.

[144] *Id*. The court also addressed another clause in the lease, the notice and demand clause. The lessee had argued that this clause entitled him to notice before the lease automatically terminated under the terms of the lease. The court stressed that under an "unless" lease a lessee is under no obligation to resume operations after cessation and the notice and demand clause applies only to obligations, or covenants, imposed by the lease. *Id*. at 796.

[145] Jolynne Corp. v. Michels, 446. S.E.2d 494 (W. Va. 1994).

[146] Although the court's opinion never directly acknowledges the absence of a cessation of production clause, it proceeds as if the lease contained no such clause.

[147] *Id*. at 500 (quoting *Rezek*).

[148] *Id*. at 500. The court also noted that the domestic use of gas does not satisfy the "production" requirement of the habendum clause. *Id*. (*citing* Goodwin v. Wright, 255 S.E.2d 924 (1979)).

when no production had occurred for nine years and after that date gas was produced only for domestic use.[148]

While the *Rezek* opinion contains no recitation of rules of interpretation, the *Michels* opinion did address the parties' differing interpretations of the lease. The habendum clause established a primary term of two years and a secondary term that would last "as long thereafter as the said land is operated by the Lessee in the search for or production of oil or gas."[149] Additionally, the lease stated that it was "for the sole and only purpose of operating for and producing oil and gas . . . ." The lessee, however, argued that the lease had another noncommercial purpose, which was to supply gas for the lessor's consumption. In rejecting this argument, the court relied upon the following rule:

A written contract merges all negotiations and representations which occurred before its execution, and in the absence of fraud, mistake, or material misrepresentations, extrinsic evidence cannot be used to alter or interpret language in a written contract which is otherwise plain and unambiguous.[150]

In light of the mixed signals contained in this recitation, it is unclear whether the court relied upon the parol evidence rule or rules of interpretation. By stating that a contract "merges all negotiations and representations" and noting the fraud exception, the court adopted language identified with the parol evidence rule. But the court also used syntax associated with the "plain meaning" approach to interpretation by proclaiming that extrinsic evidence cannot be considered to interpret an unambiguous contract.

The court's intermixing of "parol evidence" terms with rules of interpretation reflects the common confusion about the two sets of rules and a prevailing tendency among courts, lawyers, and commentators to merge the concepts. But *Michels* also represents the reason the distinction often makes no difference: the court likely would have reached the same conclusion about whether extrinsic evidence could be considered based on either the parol evidence rule or the rules of document interpretation. The distinction became particularly insignificant in *Michels* when the court

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[149] *Michels*, 446 S.E.2d at 500.

[150] *Id*. at 499.

determined that even assuming the lease had a noncommercial purpose, as the lessee asserted, that purpose had not been satisfied where no production of gas occurred for almost 10 years.[151]

[iv] — *Samano v. Sun Oil Company.*[152]

In *Samano*, the Texas Supreme Court produced majority and dissenting opinions which agreed that an express cessation of production clause precluded the application of the "temporary cessation" doctrine. These opinions also agreed that the plain meaning of the lease should control. However, exemplifying a trait common among document interpretation cases, the opinions disagreed about the plain meaning of the lease at issue.

The habendum clause of the lease in dispute read as follows:

> 2. Subject to the other provisions herein contained, this lease shall remain in force for a term of ten (10) years from this date, called "primary term," and as long thereafter as oil, gas or other mineral is produced from said land, or as long thereafter as Lessee shall conduct drilling or reworking operations thereon with no cessation of more than sixty consecutive days until production results, and if production results, so long as any such mineral is produced.[153]

The primary term ended March 29, 1944. The lease was extended into the secondary term by production, which ceased on May 4, 1977. The lessee did not restore production until July 15, resulting in a cessation of 73 days. The lessors claimed the lease had terminated since the cessation lasted longer than 60 days as permitted by the lease. The lessees countered that the 60-day provision did not cover cessation of production, meaning the "temporary cessation of production" doctrine applied. In effect, the lessees viewed the 60-day provision as a continuous operations clause, not a cessation of production clause.

The trial court agreed with the lessors and held the lease had terminated by its own terms. The court of appeals, however, reversed in favor of the

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[151] *Id*. at 500.

[152] Samano v. Sun Oil Company, 621 S.W.2d 580 (Tex. 1981).

[153] *Id*. at 581.

lessees. The lessors appealed to the Texas Supreme Court, which ultimately agreed with the trial court's determination.

In interpreting the lease's habendum clause, the author of the supreme court's majority opinion invoked "Standard Rules of English."[154] He also viewed the clause as containing three divisions, one ending after the description of the primary term, the next beginning with the phrase "and as long thereafter as oil, gas or other mineral is produced," and the final division as reading "or as long thereafter as Lessee shall conduct drilling or re-working operations thereon with no cessation of more than sixty consecutive days until production results . . . ."

According to the majority opinion, the court of appeals and the dissent ignored these three divisions. Relying on several textbooks on English grammar, the majority determined that "modifiers are intended to refer to the words closest to them."[155] Because the 60-day provision followed the division describing the secondary term, not the primary term, the majority concluded that the clause applied to "both parts of the habendum clause that is, to operations at the end of the primary term and also the cessation of production during the secondary term."[156]

While disagreeing with the majority's conclusion, the dissent also focused on English grammar, particular the role of modifiers. Specifically, the dissent determined that the word "'or' should be read as disjunctive, not conjunctive."[157] Read in this manner, according to the dissent, the "or" provides an alternative to the preceding phrase regarding production, and thereby modifies the first phrase establishing the primary term. In other words, the dissent concluded the word "cessation" referred to operations in effect at the end of the primary term, not the cessation of production in the secondary term. Therefore, the lease contained an operations clause, not a cessation of production clause, permitting the application of the "temporary cessation of production" doctrine. And under

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[154] *Samano*, 621 S.W.2d at 581. The majority opinion was written by Justice Pope.

[155] *Id.* at 581.

[156] *Id.* at 582.

[157] *Id.* at 585 (Denton, J., dissenting).

[158] *Id.* at 587.

that doctrine the inquiry would be whether a 73 day cessation constituted a reasonable time.[158]

In addition to disagreeing with the majority's application of grammar rules, the dissent disagreed with the majority's analysis of case law. For example, the dissent pointed to *Gulf Oil Corporation v. Reid*, a case cited by the majority, and noted stark differences between the language in the savings clause in that case and the lease at issue. Specifically, the clause in *Reid* stated "if after the discovery of oil or gas in paying quantities the production thereof should cease from any cause, this lease shall not terminate if the lessee commences additional drilling" in a set time period.[159] The *Samano* lease, on the contrary, contained no specific reference to the "cessation of production" after production had been obtained.

Many lawyers, including this author, may have predicted that the lessee's interpretation of the lease would prevail. Indeed, the dissent's analysis of case law and its reading of the habendum clause seem accurate. Obviously, however, as demonstrated by the conflicting opinions produced in the *Samano* case, accuracy is an ephemeral concept in document interpretation cases.

§ 3.05. Equipment Removal Provisions.

[1] — In General.

In addition to clauses which determine *if* a lease has terminated, oil and gas leases generally contain clauses that determine the lessee's rights *after* the lease has terminated. One example is equipment removal provisions. After investing considerable amounts of money in equipment, a lessee wants to insure that it has the right to remove this equipment. Absent an express provision protecting this right, courts often turn to common law concepts, such as implied licenses, to permit the lessee a reasonable time to return to the property and remove its personal property.[160] Rather than rely on these concepts, however, lessees prefer an express clause to protect their rights. To provide the lessee with wide discretion, these clauses frequently provide that a lessee may remove its

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[159] *Id*. at 585.

[160] 1 Brown, *supra* note 119, at § 10.02; 4 Kuntz, *supra* note 120, at § 50.3.

equipment "at any time." However, as demonstrated by the case discussed below, courts have disagreed about the meaning of that phrase.

[2] — Case Examples.

[a] — *Willison v. Consolidation Coal Company*.[161]

Willison involved a lease which was originally executed in 1901. This lease provided that the lessee would "pay ($300.00) . . . per year for the gas from each and every gas well. . . ." Another clause stated the lessee would "have the privilege . . . at any time to remove all machinery and fixtures placed on said premises, and further, upon the payment of $50.00, at any time . . . Lessee shall have the right to surrender this lease for cancellation . . . ."[162]

Under this lease, a well was drilled which produced natural gas. In 1932, the lease was amended to reduce the rental payments for gas, since inadequate quantities of gas were being produced. The amendment also provided that this rent was to be paid "so long thereafter as the [lessee] shall find it profitable to maintain its equipment at said well . . . ."[163]

Over 50 years later, in 1987, the lease was assigned to Consol, which had the coal rights under the leased land. Consol had acquired the lease in order to plug the gas well and facilitate the extraction of the more valuable coal.[164] Therefore, it gave notice to the Willisons, who were the successors-in-interest to the original lessors, of its intent to plug the well and remove equipment. Although the well was producing only small quantities of gas, the lease allowed the Willisons to use the gas, for their own purposes, free of charge. For that reason, the Willisons filed suit seeking to enjoin Consol from plugging the well. The trial court granted the injunction, relying in part on an implied covenant that requires a lessee

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[161] Willison v. Consolidation Coal Company, 637 A.2d 979 (Pa. 1993).

[162] *Id*. at 980.

[163] *Id*.

[164] If the well had not been plugged, the coal would have to remain in place "to provide physical support for the operating well." *Id*. at 981.

[165] *Willison*, 637 A.2d at 981.

to operate a well as long as it is profitable. The superior court affirmed that decision.[165]

The Supreme Court of Pennsylvania, however, reversed. In so doing, the court criticized the trial court for failing to apply "the plain language of the lease that allowed Consol to remove its equipment 'at any time'. . . ."[166] Having invoked the "plain language" approach, the court acknowledged the perpetual debate about "whether to accord a literal interpretation to language chosen by the parties or interpret their language in light of other factors such as surmised purpose, common commercial practice, public interest, etc."[167] Ultimately, the court decided that precedents in Pennsylvania require giving effect to the plain meaning of terms used in a contract. Because the express language of this lease provided that Consol could remove its equipment "any time," Consol was not required to continue operating the well.

Ironically, a concurring justice opined that, "I also believe that the plain language of the lease controls the outcome of this case."[168] However, he viewed the lease, as amended in 1932, as expressly requiring the lessee to operate the well until it was no longer profitable to do so.[169] Thus even though the concurring and majority opinions agreed upon the "plain meaning" approach, they could not agree upon the plain meaning of the lease.

3.06. Conclusion.

Theoretically, the rules of document interpretation should provide a reliable guide when courts are asked to determine the legal ramifications of express lease provisions. But the cases discussed herein reveal several problems with that theory. First, pervasive disagreement exists about the

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[166] *Id.*

[167] *Id.*

[168] *Id.* at 982 (Montemuro, J., concurring). The concurring justice also recognized that other jurisdictions, such as Oklahoma, had chosen to require lessees to operate a well as long as it was profitable, despite the presence of the phrase "at any time" in an equipment removal clause. *Id.*

[169] For that reason, the concurring justice would have remanded the case for a determination as to the well's profitability. *Id.*

substance of the interpretative process. In particular, courts and commentators disagree about the use of extrinsic evidence. Second, even when judges and parties agree that a lease is "unambiguous," and its "plain meaning" should govern, they more often than not disagree about that meaning. Finally, courts frequently relegate the rules of interpretation to a minor role, focusing instead on other considerations, such as public policy, equitable doctrines, or statutory enactments.

For the practitioner, these problems lead to unpredictability. On the other hand, they also expand the list of arguments an advocate can assert when faced with litigation over the meaning of express lease provisions. In order to avoid such litigation, drafters, before selecting language, should carefully scrutinize past court decisions and anticipate changes in circumstances and differing interpretations. While these efforts will not guarantee that a court will interpret a lease clause as intended, they provide the only safeguard against the nebulous nature of the interpretative process.