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By Camisha L. Simmons[1]

Termination of Oil and Gas Leases for Failure to "Produce"

Camisha L. Simmons
Simmons Legal PLLC
Dallas

Camisha Simmons is the founder and managing member of Simmons Legal PLLC in Dallas and serves as a coordinating editor of the ABI Journal.

The oil and gas industry is in a state of uncertainty. The price of crude oil, which is depressed and fluctuating, has fallen significantly in the past year. Some exploration and production (E&P) and services companies in the industry have filed for bankruptcy protection, while others are experiencing operational distress and may soon follow suit.

One consequence of the decline in the price of crude oil is that E&P companies and the companies' secured lenders may lose interests in oil and gas leases on property on which E&P companies are currently actively producing oil and/or gas. For a lessee to avoid termination of an oil and gas lease on a lessor's property, the lessee is required not only to produce oil and/or gas, but the production must be in "paying quantities." This article discusses a typical *habendum* clause of an oil and gas lease, the importance and definition of "production in paying quantities," "production in paying quantities" litigation in bankruptcy, and the best practices for parties holding interests in oil and gas leases that may terminate due to unprofitable production.

Typical *Habendum* Clause

The *habendum* clause of an oil and gas lease sets forth the duration of the lease.[2] Under the *habendum* clause, the lessee is typically granted a fixed "primary term" and an additional "secondary term."[3] Extension of the lease into the secondary term is usually conditioned upon the lessee's actual production of oil and/or gas.[4]

For example, a *habendum* clause may provide that the "lease shall remain in force for a term of *three years* from the date hereof, and *as long thereafter as oil or gas is produced* from said land." In this example, the primary term of the lease is three years and will be extended indefinitely after the primary term for so long as oil and/or gas is being produced from the leased property. The term "produced" under the *habendum* clause is understood to mean "production in paying quantities."[5] Parties generally look to applicable state law to determine how "production in paying quantities" is defined and calculated.

Termination Due to Failure to Produce in Paying Quantities

In the event that production has commenced under a lease and the lease is in the "secondary term," a lease may still automatically terminate if actual "production in paying quantities" ceases.[6] The requirement of "production in paying quantities" under the *habendum* clause has been traditionally regarded as protection for the lessee, given that a lessee would not want to pay rent for unproductive premises.[7] Landowners and/or mineral estate owners now use the "production in paying quantities" requirement to terminate oil and leases.[8]

Applicable state law provides guidance as to how to determine whether a lease is producing in paying quantities. With respect to oil and gas leases covering mineral estates in Texas, "production in paying quantities" is determined utilizing a two-prong test.[9] The first prong, the "mathematical test,"

1 This article represents the views of the author, and such views should not necessarily be imputed to Simmons Legal PLLC or its respective affiliates and clients.
2 *See, e.g., Andarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 554 (Tex. 2002) ("A lease's *habendum* clause defines the mineral estate's duration.") (citation omitted).
3 *See, e.g., id.*
4 *See, e.g., id.*
5 *See, e.g., id.* ("In Texas, such a *habendum* clause requires actual production in paying quantities.") (citation omitted).
6 *See, e.g., id.* (noting that "a typical Texas lease that lasts 'as long as oil or gas is produced' automatically terminates if actual production permanently ceases during the secondary term") (citation omitted). *See also Sun Operating Ltd. P'Ship v. Murphy Oil Corp.*, 182 F.3d 914, 1999 WL 423044 at *14 (5th Cir. 1999) (not for publication) (noting that "it is the well-known standard in the oil and gas industry that 'termination' usually occurs upon cessation of production in paying quantities") (citation omitted).
7 *See, e.g., T.W. Phillips Gas and Oil Co. v. Jedlicka*, 42 A.3d 261, 268 (Pa. 2012) (citation omitted).
8 *See, e.g., id.*
9 *See, e.g., Clifton v. Koontz*, 325 S.W.2d 684, 690 (Tex. 1959).

requires that operating expenses exceed operating costs over a *reasonable period of time*:

> If a well pays a profit, even small, over operating expenses, it produces in paying quantities, though it may never repay its costs, and the enterprise as a whole may prove unprofitable.[10]

The operating expenses usually included in the calculation are "the landowner's share of royalty; labor, marketing, and repair costs; depreciation on salvable equipment; overhead expenses attributable to the well; and taxes on the operator's interest."[11] When dealing with leases covering multiple wells, the allocation and calculation of operating expenses on a per-well basis is a fact question.[12]

Courts do not employ a rigid arbitrarily fixed time period for an assessment of profitability.[13] Determination of what is a "reasonable time period" for evaluating the profitability of a lease is based on the unique circumstances of each case.[14] Moreover, the time period "to be used in assessing the performance of the lease should be one long enough to provide the information [that] a prudent operator would take into account in [deciding] whether to continue or abandon operations."[15]

If, under the mathematical test, operating revenue does not exceed operating costs over a *reasonable period of time*, then a "prudent operator" analysis is required.[16] Although the wells under a lease are not operating at a profit, a lessee may still retain its interest in an oil and gas lease if, given all of the relevant circumstances, "a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation," continue to operate the producing wells.[17]

Further, under the prudent-operator analysis, "all matters [that] would influence a reasonable and prudent operator" must be taken into consideration.[18] The following are some of the factors that might be considered in the analysis:

> The depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes.[19]

Pennsylvania courts, similar to Texas, utilize a two-prong test. With respect to leases in Pennsylvania, courts analyze and determine whether (1) there is an operating profit under the mathematical calculation; and (2) if there is no operating profit over a reasonable period of time, whether the operator has exercised his/her good-faith judgment in maintaining operation of the wells under a lease to re-establish profitability. The Pennsylvania Supreme Court explained that the two-prong analysis protects both lessors and lessees:

> Under the standard ... a lessor will be protected from such acts because, if the well fails to pay a profit over operating expenses, and the evidence establishes that the lessee was not operating the wells for profit in good faith, the lease will terminate. Consideration of the operator's good-faith judgment in determining whether a well has produced in paying quantities, however, also protects a lessee from lessors who, by exploiting a brief period when a well has not produced a profit, seek to invalidate a lease with the hope of making a more profitable leasing arrangement. In the instant case, for example, [the lessor] seeks to invalidate a nearly 80-year-old lease based on a single-year loss [that] occurred more than more than 45 years ago, after which the wells resumed and continued production at a profit.[20]

[L]enders should consider demanding detailed information from borrowers regarding operating expenses and income ... for the purpose of monitoring the profitability of the [oil and gas] lease.

Unlike Texas and Pennsylvania, Kansas courts appear to only utilize the objective mathematical test to determine whether there is production in paying quantities. Similar to Texas, Kansas courts also consider "paying quantities" to mean production of oil or gas that yields a profit to the lessee over operating expenses, "although the cost of the drilling and equipping the well might never be paid, and the operation as a whole might result in a loss to the lessee."[21] North Dakota also appears to only utilize the mathematical test.[22] Other states may take a slightly different approach to determining whether there is "production in paying quantities."

"Production in Paying Quantities" Litigation in Bankruptcy

Although there are few written decisions related to bankruptcy litigation regarding the termination of leases for failure to "produce," two bankruptcy courts in Texas have decided issues relating to such litigation. In *Breithaupt v. Nueces Petroleum Corp. (In re Nueces Petroleum Corp.)*,[23] the lessee oil and gas company, Nueces Petroleum, filed for bankruptcy protection, and its principal asset was an oil and gas lease.[24] The lessors under the lease commenced an adversary proceeding in bankruptcy court seeking a declaration that the oil and gas lease had been terminated due to a failure to produce in paying quantities.[25] Upon review and analysis of the pro-

10 *See, e.g., Garcia v. King*, 164 S.W. 2d 509, 511 (Tex. 1942). *See also Jedlicka*, 42 A.3d at 275-76.

11 *See, e.g., Hutchison v. Tex-Lee Drilling & Dev. Co.*, No. 03-96-00453-CV, 1997 WL 703180, at *3 n.4 (Tex. App. Nov. 13, 1997) (citations omitted) (not for publication).

12 *See, e.g., Patton v. U.E. Rogers*, 417 S.W.2d 470, 476 (Tex. App. 1967) (citation omitted).

13 *See, e.g., Ladd Petroleum Corp. v. Eagle Oil and Gas Co.*, 695 S.W.2d 99, 108 (Tex. App. 1985) (quoting *Koontz*, 325 S.W.2d 684).

14 *See, e.g., Jedlicka*, 42 A.3d at 275-76. *See also Sorum v. Schwartz*, 411 N.W.2d 652, 654-55 (N.D. 1987) ("A reasonable time must be allowed for production in paying quantities in order to determine the average production of oil and gas, the cost of production, and the availability of markets."); *Dreher v. Cassidy Ltd. P'ship*, 99 S.W.3d 267, 269 (Tex. App. 2003) (noting that "[the a]ppellee produced evidence to show that the lease was not profitable for a period of eight months.... However, [the] appellee produced no evidence to show why the eight-month period was a reasonable period of time").

15 *See, e.g., Jedlicka*, 42 A.3d at 271 (citations and internal quotation marks omitted) (alteration in original).

16 *See, e.g., Koontz*, 325 S.W.2d at 691.

17 *Id.*

18 *Id.*

19 *Id.*

20 *Jedlicka*, 42 A.3d at 277.

21 *See, e.g., Reese Enter. Inc. v. Lawson*, 553 P.2d 885, 895-97 (Kan. 1976). *See also Texaco Inc. v. Fox*, 618 P.2d 844 (Kan. 1980).

22 *See, e.g., Tank v. Citation Oil & Gas Corp.*, 848 N.W.2d 691, 696 (N.D. 2014) (citation omitted).

23 Bankr. Case No. 05-44617, Adv. Pro. No. 06-3696, 2007 WL 418889, at *1 (Bankr. S.D. Tex. Feb. 2, 2007).

24 *Id.*

25 *Id.*

duction and expense reports for the time period of September 2003 through June 2006, Hon. Marvin Isgur determined that "there was never production in paying quantities as necessary to maintain the lease."[26] Therefore, the court concluded that the subject oil and gas lease terminated by its own terms due to the lessee's failure to produce in paying quantities.[27] Consequently, the bankruptcy estate lost its principal asset.

Hon. Brenda Rhoades also decided a production-in-paying-quantities issue in *Wickford Inc. v. Energytec Inc. (In re Energytec Inc.)*.[28] The debtors were the lessee and operator with respect to certain oil and gas leases.[29] Prior to the debtors' bankruptcy filing and before a formal declaration that the debtors' interest in the subject oil and gas leases had terminated, the lessor landowners had released the same property covered by the oil and gas leases.[30] After the bankruptcy commenced, the new lessees brought claims of trespass against the debtors on the basis that the subject leases had terminated pre-petition due to the lack of production in paying quantities.[31] Upon analysis of the facts, particularly the debtors' prolonged halt of production prepetition, the court agreed with the new lessees and declared that the debtors' interests in the subject oil and gas leases had been terminated.[32]

These cases highlight that lessors may use the next wave of oil and gas bankruptcies as an avenue to challenge the viability of some oil and gas leases.

Conclusion and Best Practices

A lengthy period of low oil prices may result in unprofitable production with respect to some oil and gas leases. Therefore, some E&P companies may experience an automatic termination of their leases due to the lack of production in paying quantities. Following termination, the mineral estate owner is allowed to release the mineral estate to another lessee.

To safeguard against lease termination resulting from a decline in oil and gas prices, an E&P company at the outset should bargain for a number of key provisions in the oil and gas lease. The companies should negotiate a right of first refusal to "top lease" the property.[33] If an E&P company has negotiated a right of first refusal, an E&P company operating in a distressed oil and gas market that is at risk of losing a lease may enter into a "top lease" of the property prior to termination of the existing lease. The top lease, which will take effect upon termination of the lease expiring due to the cessation of production in paying quantities, should have a lengthy primary term to enable the E&P company to ride out the period of depressed oil prices. An E&P company can recommence production on shut-in wells once oil prices climb to a price allowing for the company to realize an operating profit.

A second key provision that will provide some protection is a savings clause in the leases to prevent termination in the event of a short period of cessation of production in paying quantities. A third contract drafting option is for lessees to insist that the *habendum* clause provide that the lease will be kept alive in the secondary term as long as oil and/or gas is "produced whether or not in 'paying quantities.'" With respect to lenders holding interests in oil and gas leases that may terminate for failure to produce in paying quantities, lenders should consider demanding detailed information from borrowers regarding operating expenses and income on a periodic basis for the purpose of monitoring the profitability of the lease. **abi**

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26 *Id.* at *3.
27 *Id.* at *3-*5.
28 Bankr. Case No. 09-41477-btr11, Adv. Pro. No. 09-4202, 2009 WL 5101765, at *1 (Bankr. E.D. Tex. Dec. 17, 2009).
29 *Id.* at *1-*2.
30 *Id.* at *3.
31 *Id.* at *4.
32 *Id.* at *3-*6.
33 *See, e.g., Burk v. Nance Petroleum Corp.*, 10 F.3d 539, 540 n. 2 (8th Cir. 1993) (explaining that "[a] top lease is a lease granted before the expiration of an existing lease that becomes effective when the existing lease expires") (citation omitted).