

## NOTES

### *Anadarko Petroleum Corp. v. Thompson: Interpretation of Oil and Gas Lease Habendum Clauses in Texas and Why Oklahoma Should Maintain Its Divergent Approach to Keep Leases Alive*\*

#### *I. Introduction*

The relevant clause of an oil and gas lease which sets the lease's duration is known as the habendum clause.<sup>1</sup> Typically, the habendum clause divides the lease into a primary term and a secondary term.<sup>2</sup> The primary term is a fixed period during which the lessee (most often, an oil and gas company) has the right to explore or drill for oil and gas on the leased premises but has no obligation to do so.<sup>3</sup> During the secondary term, the lease and its associated rights are further extended, but subject to the lessee's obtaining, and then maintaining, production.<sup>4</sup>

The definition of the word "production" would appear to be self-explanatory. Nevertheless, two major oil and gas jurisdictions, Texas and Oklahoma, have differing views as to what constitutes "production" for habendum clause purposes. As one commentator states:

As in all contracts, the terms used are subject to definition and usage guidelines, and those guidelines vary from state to state. A dichotomy in the interpretation of oil and gas leases has developed in Texas and Oklahoma, the two leading jurisdictions in oil and gas law. Texas favors a strict application of lease language, while Oklahoma has adopted a more equitable posture.<sup>5</sup>

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1. JOHN S. LOWE ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 336 (5th ed. 2008).

2. *Id.*

3. *Id.*

4. *Id.*

5. Williston H. Symonds, Note, *The Michelangelo of the Oklahoma Oil & Gas Industry: The Cessation of Production Clause, Spontaneous Lease Terminations, and Cyclical or Marginal Production Problems*, 17 OKLA. CITY U.L. REV. 413, 417 (1992) (footnotes omitted).

Both jurisdictions concur that “production *in paying quantities*” is required,<sup>6</sup> but only Texas courts view production in paying quantities as requiring *actual* physical production and marketing.<sup>7</sup> In contrast, Oklahoma courts hold that the production requirement in the habendum clause of an oil and gas lease requires only that the well be “capable” of producing in paying quantities (with the marketing of oil and gas being a separate matter governed by the implied covenant to market within a reasonable time).<sup>8</sup> This “capability rule” applies in Oklahoma to both oil and gas wells, while some states adopt a “capability rule” only applicable to gas wells.<sup>9</sup>

Although actual production is physically quantifiable, “capability” is an elusive concept that can be difficult for courts to define. Though Texas historically has rejected the “capability rule” in interpreting typical habendum clauses—clauses using “is produced” language—in *Anadarko Petroleum Co. v. Thompson*, when confronted with contractual language that extended a lease as long as oil and gas “is *or can be* produced,”<sup>10</sup> the Texas Supreme Court could not avoid construing “capability.”<sup>11</sup> In doing so, the court offered a relatively detailed description of what is required for a well to be capable of producing in paying quantities.<sup>12</sup> This culminated in a result requiring operators to be able to “turn on” their wells to begin production at any given moment to have them regarded by the courts as “capable” of production.<sup>13</sup> The court’s construction of “capable,” in conformity with its strict “actual production” general rule, places significant requirements on oil and gas lessees to maintain a well “capable” of production.<sup>14</sup> In contrast, Oklahoma courts have not specifically defined what is necessary to have an oil or gas well *capable* of production in

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6. See *Smith v. Marshall Oil Corp.*, 2004 OK 10, ¶ 9, 85 P.3d 830, 833; *Stewart v. Amerada Hess Corp.*, 1979 OK 145, ¶ 5, 604 P.2d 854, 857; *State ex rel. Comm’rs of Land Office v. Carter Oil Co. of W. Va.*, 1958 OK 289, ¶ 36, 336 P.2d 1086, 1093-94; *Clifton v. Koontz*, 325 S.W.2d 684, 690 (Tex. 1959); *Garcia v. King*, 164 S.W.2d 509, 512 (Tex. 1942).

7. See *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 269-70 (Tex. 1960); *Clifton*, 325 S.W.2d at 691; *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746, 748 (Tex. Civ. App. 1937).

8. See *Pack v. Santa Fe Minerals*, 1994 OK 23, ¶¶ 8-10, 869 P.2d 323, 326-27; *McVicker v. Horn, Robinson & Nathan*, 1958 OK 49, ¶ 6, 322 P.2d 410, 413-14; *Geyer Bros. Equip. Co. v. Standard Res.*, 2006 OK CIV APP 924, ¶ 8, 140 P.3d 563, 566; *Danne v. Texaco Exploration & Prod., Inc.*, 1994 OK CIV APP 138, ¶¶ 22-23, 883 P.2d 210, 217.

9. 2 EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 26.6 (1989) (distinguishing between oil wells and gas wells because gas, unlike oil, cannot be economically stored and gas wells are often reasonably shut-in to await a market).

10. 94 S.W.3d 550, 553 (Tex. 2002) (emphasis added).

11. *Id.* at 558.

12. *Id.* at 558-59.

13. *Id.*

14. *Id.*

paying quantities.<sup>15</sup> Oklahoma law interpreting habendum clauses under the “capability rule” centers on equitable principles which will be undermined if Oklahoma courts follow Texas’ path to a strict construction of “capable.” For this reason, Oklahoma should maintain a “capability rule” that balances the equities between lessee and lessor and avoids the forfeiture of interests.

This note will examine the Texas Supreme Court’s strict interpretation of the “capability rule” for use in construing the atypical habendum clause in *Thompson*<sup>16</sup> through the lens of Oklahoma’s general application of the rule. Part II will briefly consider Texas’ “actual production” rule and proceed to more acutely analyze Oklahoma’s “capability rule” and the nuances in its application. Part III will consider the *Thompson* decision in greater detail, including the atypical lease provision involved and factual background, the holding, and the rationale behind the court’s limited definition of “capable.” Part IV will discuss the implications a limited construction of “capable” would have on Oklahoma’s general application of the “capability rule.” This includes a discussion of how such an interpretation would interfere with practical considerations, impact the implied covenant to market, and alter the interpretation of the cessation-of-production clause in Oklahoma. Part IV will also offer an argument for maintaining Oklahoma’s more relaxed, less definitive “capability rule” to encourage oil and gas operations in the state and support this vital industry. This note will conclude in Part V.

## *II. Texas’ and Oklahoma’s Differing Views Regarding “Production”*

Historically, Oklahoma and Texas courts have taken widely divergent views on the interpretation of oil and gas lease habendum clauses. Texas courts have maintained an interpretation of the word “production” in leases that requires actual, physical production of oil or gas.<sup>17</sup> Examining why Texas courts strictly construe what is necessary to make a well productive will offer insight into the strict definition of “capable” adopted by the Texas Supreme Court in *Thompson*. Furthermore, a look into Oklahoma case law developing and

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15. See generally *Pack*, 1994 OK 23, 869 P.2d 323; *McVicker*, 1958 OK 49, 322 P.2d 410; *Geyer Bros.*, 2006 OK CIV APP 924, 140 P.3d 563; *Danne*, 1994 OK CIV APP 138, 883 P.2d 210.

16. A “typical” habendum clause used in both Oklahoma and Texas provides that the lease is maintained as long as oil or gas “is produced” in paying quantities. See *infra* note 20; see also *supra* notes 1-9. Oklahoma courts interpret this language to require capability of production, while Texas courts require actual production. See *supra* notes 1-9; see also *infra* Part II. The “atypical” habendum clause language allowing the lease to survive as long as oil or gas “is or can be produced” clearly invokes the capability rule. See *supra* notes 10-11 and accompanying text.

17. See *supra* note 7 and accompanying text.

applying the “capability rule,” where production is satisfied by mere capability of production, highlights the great differences in approach taken by these jurisdictions. Analyzing case law in Oklahoma and Texas also reveals the interplay between satisfying the habendum clause and complying with the implied covenant to market. The formulation chosen for interpreting the capability rule further impacts the interpretation of cessation-of-production clauses. This section reviews the relevant cases in these areas and provides a framework for analyzing the impact a strict definition of “capable,” as adopted by the Texas Supreme Court in *Thompson*, would have on Oklahoma oil and gas law.

#### A. Texas’ “Actual Production” Rule

When considering the differences in Texas’ and Oklahoma’s interpretation of the habendum clause in oil and gas leases, it is helpful to consider the nature of the leasehold interest conveyed, which is an important source of disagreement between these jurisdictions. Texas uses the ownership-in-place theory to classify the rights granted by an oil and gas lease.<sup>18</sup> Under this theory, courts generally view the interest granted by the lessor to the lessee as a fee simple determinable in the oil and gas in place.<sup>19</sup> It is seen as a fee simple because it extends indefinitely “*as long thereafter as oil or gas . . . is produced in paying quantities.*”<sup>20</sup> However, it is *determinable* because certain limitations can terminate the lease, such as failure to obtain production by the end of the primary term or failure to maintain production in the secondary term.<sup>21</sup> The fee’s determinable nature calls for a strict construction of the habendum clause.<sup>22</sup> Accordingly, “satisfaction of an oil and gas lease in Texas requires not only the discovery of a potentially profitable mineral formation, but also *the actual production and marketing of product from that formation.*”<sup>23</sup>

An early case reflecting Texas’ strict interpretation of “production in paying quantities” is *Stanolind Oil & Gas Co. v. Barnhill*.<sup>24</sup> In *Barnhill*, the well was drilled within the relevant time frame and was discovered to have highly productive potential.<sup>25</sup> Unfortunately, this potential was for great volumes of

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18. KUNTZ, *supra* note 9, § 23.26; *see also* *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746 (Tex. Civ. App. 1937).

19. KUNTZ, *supra* note 9, § 23.26; *see also* *Barnhill*, 107 S.W.2d 746.

20. *Barnhill*, 107 S.W.2d at 748 (emphasis added).

21. *See id.*

22. Symonds, *supra* note 5, at 418-19 (noting, “As a result of the determinable nature of the grant, the lessee’s failure to satisfy the production requirements of the lease will cause an automatic termination of the lease.”).

23. *Id.* at 419 (emphasis added).

24. 107 S.W.2d 746.

25. *Id.* at 747.

unmarketable sour gas.<sup>26</sup> The habendum clause of the lease was typical, providing for a five year primary term and extending “as long thereafter as oil or gas, or either of them, is produced in paying quantities from the land by the lessee.”<sup>27</sup> Without discussion, the court found that “if oil or gas is not produced from the land within the period of five years, the lease comes to an end.”<sup>28</sup> While the court did not explicitly assert “actual production” as the rule in Texas, this conclusion was implied throughout the decision and confirmed by the addition of a requirement *beyond* actual production: marketing of gas.<sup>29</sup> Although actual production was established, the lease was determined to be expired because no *market* existed for the sour gas produced from the leased premises.<sup>30</sup> According to the court,

[the lessee] did *not* contract for a term which would depend upon the *possibility* of procuring a market for the product at some date subsequent to its express date of expiration. The lease did *not* provide that it should remain in force and effect for five years, and as long thereafter as there *may be prospects* of a market for the product, and it is not the duty of the courts to make contracts for parties but only to construe such contracts as they make for themselves.<sup>31</sup>

Therefore, the court construed the habendum clause language not only to require *actual* production, but marketing as well.<sup>32</sup> Although there is generally imposed on the oil and gas lessee an “implied duty to market,” the breach of which can result in the imposition of damages, the court in *Barnhill* seemed to merge this duty into the requirements to satisfy the habendum clause and keep the lease alive.<sup>33</sup> More definitive answers about the “actual production” rule were given in the 1960 case of *Gulf Oil Corp. v. Reid*.<sup>34</sup>

In *Reid*, a well was drilled and found to be capable of producing gas in paying quantities.<sup>35</sup> However, the well was shut-in due to lack of marketing

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26. *Id.* Sour gas is “[n]atural gas contaminated with chemical impurities, notably hydrogen sulphide or other sulphur compounds, which impart to the gas a foul odor. Such compounds must be removed before the gas can be used for commercial and domestic purposes.” 8 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 986 (2007).

27. *Barnhill*, 107 S.W.2d at 748.

28. *Id.*

29. *Id.* at 749.

30. *Id.*

31. *Id.* (emphasis added).

32. *Id.*

33. *Id.*

34. 337 S.W.2d 267, 270 (Tex. 1960).

35. *Id.* at 268.

infrastructure (i.e., pipelines).<sup>36</sup> Thereafter, the lessee contracted with a pipeline company to purchase the gas, the necessary pipelines were laid, and the well began actually producing in paying quantities.<sup>37</sup> Nevertheless, the lessor rejected shut-in royalty payments and sued maintaining the lease had expired when the well was shut-in.<sup>38</sup> Reiterating the holding of *Barnhill*<sup>39</sup> and stating a proposition “that [has] been well established during the development of oil and gas law in [Texas],” the Texas Supreme Court stated that “no matter how great the *potential* production may be or how many million cubic feet of gas may have been flared, there would be no production or production in paying quantities unless there was an available market.”<sup>40</sup> In other words, proffering “lack of a market for oil and/or gas production” as an excuse at the expiration of the primary term will not keep a lease alive in Texas.<sup>41</sup> Furthermore, the court denied a “reasonable time” to market the product, which the lessee may have satisfied in this case.<sup>42</sup> Thus, in accordance with the “actual production” rule, production in paying quantities, as well as marketing of that product, was strictly required to satisfy the habendum clause of the lease.<sup>43</sup>

Though application of the “actual production” rule to satisfy the habendum clause became well-established in Texas through cases such as *Barnhill*<sup>44</sup> and *Reid*,<sup>45</sup> years later in 1993, a Texas Court of Appeals was confronted with defining “capability” for the purposes of construing a savings clause.<sup>46</sup> In *Hydrocarbon Management, Inc. v. Tracker Exploration, Inc.*, the lease contained a “savings clause,”<sup>47</sup> which is a provision that allows the lease to stay alive without production, as defined in the habendum clause, if certain requirements in the clause are met.<sup>48</sup> Thus, actual production is generally required to satisfy the typical habendum clause in Texas, but satisfaction of the

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36. *Id.*

37. *Id.*

38. *Id.*

39. 107 S.W.2d 746 (Tex. Civ. App. 1937).

40. *Reid*, 337 S.W.2d at 269-70 (emphasis added).

41. *Id.*

42. *Id.* Also, the court denied a reasonable time to pay shut-in royalty payments in accordance with a savings provision allowing such payments in lieu of actual production in the lease. *Id.* at 271.

43. *Id.* at 271-72.

44. 107 S.W.2d 746.

45. 337 S.W.2d 267.

46. *Hydrocarbon Mgmt., Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 433 (Tex. App. 1993).

47. *Id.*

48. *Id.* at 432 (citing RICHARD W. HEMINGWAY, *THE LAW OF OIL AND GAS* § 6.5, at 304 (2d ed. 1983)) (equating the satisfaction of a savings clause to “constructive production”).

savings clause serves as “constructive production” and would keep the lease alive even if there were no actual production.

In *Hydrocarbon*, the savings clause was in the form of a “shut-in royalties” provision.<sup>49</sup> This clause allowed the lease to stay alive if two requirements were met.<sup>50</sup> First, there must be a well “capable of producing gas” (maintaining that “producing” is synonymous with “producing gas in paying quantities”), and second, if that well is shut-in, a shut-in royalty payment must be paid.<sup>51</sup> If both requirements are met, the shut-in royalty clause serves as constructive *actual* production. Consequently, to satisfy the first requirement, the court had to determine when a well was *capable* of production. In doing so, the court held:

We believe that the phrase ‘capable of production in paying quantities’ means a well that will produce in paying quantities if the well is turned ‘on,’ and it begins flowing, without additional equipment or repair. Conversely, a well would not be capable of producing in paying quantities if the well switch were turned ‘on,’ and the well did not flow, because of mechanical problems or because the well needs rods, tubing, or pumping equipment.<sup>52</sup>

The well in question in *Hydrocarbon* was clearly not *capable* of production on the date it was shut-in because the well casing and tubing were dysfunctional, despite the operator’s failing efforts to swab the well and repair the problems.<sup>53</sup> Thus, even without such a demanding definition of “capable,” this lease would not have survived.<sup>54</sup> Nevertheless, this strict definition became the foundation of the Texas Supreme Court’s decision in *Thompson*, and is influential in construing “capability” in a habendum clause.<sup>55</sup>

These Texas decisions demonstrate that the “actual production” rule is well-established in the state to interpret habendum clauses and determine what is necessary to keep a lease alive past its primary term and throughout the secondary term.<sup>56</sup> Thus, Texas requires not only *actual* production in paying

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49. *Hydrocarbon*, 861 S.W.2d at 433. According to one source, a shut-in royalty clause “permits the lessee to maintain or extend the lease, while there is no production because wells capable of production have been shut-in, by paying royalties in lieu of production.” TEX. JUR. 3D *Oil and Gas* § 205 (1995). Effectively, such a clause “provides for substitute or contractual method of production, which will maintain the lease in force and effect when a gas well is drilled for the production from which no market exists . . .” *Id.*

50. *Hydrocarbon*, 861 S.W.2d at 433.

51. *Id.*

52. *Id.*

53. *Id.* at 434.

54. *Id.* at 434-35.

55. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 558 (Tex. 2002).

56. *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267 (Tex. 1960); *Hydrocarbon*, 861 S.W.2d 427;

quantities—as opposed to simply the *capability* of production needed in Oklahoma—but also *marketing* to keep the lease alive.<sup>57</sup>

*B. Oklahoma's "Capability Rule"*

Oklahoma's interpretation of "producing" in the typical habendum clause is strikingly different from Texas' interpretation, stemming primarily from a different view of the property interest conveyed by a lease. Oklahoma uses an exclusive-right-to-take theory as opposed to the ownership-in-place theory used by Texas courts.<sup>58</sup> Under exclusive-right-to-take, because the lessor does not own the oil and gas in place, he or she cannot transfer it to the lessee.<sup>59</sup> Thus, the lessee cannot own the oil and gas in place either.<sup>60</sup> Instead, the interest transferred in the lease is a *profit à prendre*, or an irrevocable license which vests upon discovery. Actual production is not required;<sup>61</sup> thus, Oklahoma "merely requires a well capable of production . . . to satisfy the lessee's obligation."<sup>62</sup>

In case after case, Oklahoma courts have applied the "capability rule" without specifically defining "capability."<sup>63</sup> The cases discussed in this section, however, reveal a "capability rule" favorable to the oil and gas industry and considerably more relaxed than the "actual production" rule used in Texas.

In 1958, the Oklahoma Supreme Court decided *McVicker v. Horn, Robinson & Nathan*, adopting the "capability rule" as Oklahoma law.<sup>64</sup> In *McVicker*, the habendum clause allowed for a primary term of one year and for the lease to continue "as long thereafter as oil or gas, or either of them, *is produced* from said lands."<sup>65</sup> The lessor claimed the lease expired on its own terms because of the lessee's failure to produce gas from the leased land by October 31, 1954,

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Stanolind Oil & Gas Co. v. Barnhill, 107 S.W.2d 746 (Tex. Civ. App. 1937).

57. *Reid*, 337 S.W.2d 267; *Hydrocarbon*, 861 S.W.2d 427; *Barnhill*, 107 S.W.2d 746.

58. HEMINGWAY, *supra* note 48, § 1.3.

59. KUNTZ, *supra* note 9, § 23.23; *see also* *Stewart v. Amerada Hess Corp.*, 1979 OK 145, 604 P.2d 854; *Hunter v. Clarkson*, 1967 OK 114, 428 P.2d 210.

60. KUNTZ, *supra* note 9, § 23.23; *see also* *Stewart*, 1979 OK 145, 604 P.2d 854; *Hunter*, 1967 OK 114, 428 P.2d 210.

61. KUNTZ, *supra* note 9, § 23.23; *see also* *Stewart*, 1979 OK 145, 604 P.2d 854; *Hunter*, 1967 OK 114, 428 P.2d 210.

62. Symonds, *supra* note 5, at 424.

63. *See generally* *Pack v. Santa Fe Minerals*, 1994 OK 23, 869 P.2d 323; *McVicker v. Horn, Robinson & Nathan*, 1958 OK 49, 322 P.2d 410; *Geyer Bros. Equip. Co. v. Standard Res.*, 2006 OK CIV APP 924, 140 P.3d 563; *Danne v. Texaco Exploration & Prod., Inc.*, 1994 OK CIV APP 138, 883 P.2d 210.

64. 1958 OK 49, 322 P.2d 410.

65. *Id.* ¶ 5, 322 P.2d at 412 (emphasis omitted).



which was the end of the one-year primary term.<sup>66</sup> The facts indicate, however, that the lessee drilled a well on the leased premises and was actually drawing gas to the surface and “reducing it to possession in a manner in which it could be, but had not yet been, marketed.”<sup>67</sup> The failure to market was not, as the court found, related to the lessee’s lack of effort; rather, the circumstances indicated that the lessee was diligently negotiating for a pipeline connection to transport the available gas from the well and had reason to believe the negotiations would be successful.<sup>68</sup> Meanwhile, the well was shut-in to maintain the product and await a market.<sup>69</sup>

The defendants’ primary argument was that extending the lease beyond its primary term did not require “production” in the ordinary sense of the word, claiming that to “produce” does not require “marketing” as the plaintiff suggested.<sup>70</sup> Though the Oklahoma Supreme Court recognized that Kansas courts had required marketing to satisfy their definition of production, it refused to include additional elements within the “production” requirement.<sup>71</sup> The court favored the defendants’ practical argument that gas *could have* been produced in the ordinary sense (meaning actual production up the well bore and reduced to usable possession), but without an available market it would have been a complete waste and contrary to the interest of both the lessee and lessor.<sup>72</sup> The court restated this argument by writing, “They say they could have ‘produced’ gas from the leased premises, within the ordinary meaning of the word, if they had not ‘shut in’ the well, but had left it open to waste its gaseous product into the air.”<sup>73</sup> The court cited a Tenth Circuit decision finding that “in the very nature of the oil business . . . a reasonable time must intervene between the completion of the drilling operations resulting in production and the ability to market and sell the product of a well.”<sup>74</sup> Importantly, the Oklahoma Supreme Court indicated the word “produced” was not to be construed as requiring of the lessee something beyond what is reasonable from the perspective of the oil and gas industry.<sup>75</sup>

Later the same year, the Oklahoma Supreme Court decided *State ex rel. Commissioners of the Land Office v. Carter Oil Co. of West Virginia*, further

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66. *Id.* ¶ 2, 322 P.2d at 411.

67. *Id.* ¶ 5, 322 P.2d at 413.

68. *Id.* ¶¶ 8-9, 322 P.2d at 414-15.

69. *Id.* ¶ 8, 322 P.2d at 414.

70. *Id.* ¶ 5, 322 P.2d at 412-13.

71. *Id.* ¶ 5, 322 P.2d at 413.

72. *Id.*

73. *Id.*

74. *Id.* (quoting *Christianson v. Champlin Refining Co.*, 169 F.2d 207, 210 (10th Cir. 1948)).

75. *Id.*

defining the “capability rule.”<sup>76</sup> In this case, the Commissioners of the Land Office executed an oil and gas lease of publicly-owned lands to a third-party, which subsequently assigned the lease to the defendant oil company.<sup>77</sup> The lease’s habendum clause was in the typical form, stating that the lease would continue “as long thereafter as oil or gas or either of them *is produced* in paying quantities . . . .”<sup>78</sup> The plaintiff/lessor claimed the company had conducted no drilling operations on the leased premises before expiration of the primary term.<sup>79</sup> On the contrary, the lessee/oil company claimed “that a well producing gas in paying quantities was completed on the unit prior to the expiration of the term of its leases from the Commissioners,” but “there was no pipe line in the area and it was impossible to market the gas.”<sup>80</sup> Diligent efforts were undertaken to find a market and one was eventually secured.<sup>81</sup>

The fact that mineral interests in public lands were leased introduces a complication rendering this case more interesting to consider in combination with the *Thompson* decision.<sup>82</sup> The situation in *Commissioners of the Land Office* was actually an inverse of *Thompson*. The statute authorizing the Commissioners of the Land Office to grant oil and gas leases of public lands sets minimum requirements for the habendum clauses of such leases. Particularly, the minimally-restrictive clause required by statute must have provided that the lease would continue “for the term of five years and as long thereafter as oil or gas *may be produced* therefrom in paying quantities.”<sup>83</sup> The Commissioners, however, went a step further, inserting the typical “is produced” language.<sup>84</sup> The court found:

“May be” as used in the statute connotes the possibility of production in paying quantities. In other words the minimum statutory requirement prescribed would be in effect, the *capability* to produce oil or gas in paying quantities within the primary term.

“Is” ordinarily means an objective fact. Thus it is apparent that in prescribing in the lease “as long thereafter as oil or gas *is produced* therefrom in paying quantities” the commissioners went beyond the minimum statutory restrictions hereinbefore detailed.

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76. 1958 OK 289, 336 P.2d 1086.

77. *Id.* ¶¶ 4, 6, 336 P.2d at 1089-90.

78. *Id.* ¶ 5, 336 P.2d at 1089 (quoting the lease in question).

79. *Id.* ¶ 15, 336 P.2d at 1091.

80. *Id.* ¶ 16, 336 P.2d at 1091-92.

81. *Id.* ¶ 16, 336 P.2d at 1092.

82. *Id.* ¶¶ 0-4, 336 P.2d at 1088-89.

83. *Id.* ¶ 22, 336 P.2d at 1092 (citing 64 OKLA. STAT. § 281 (1951)) (emphasis added).

84. *Id.* ¶ 5, 336 P.2d at 1089.

This being true and further since this provision “as long thereafter as oil or gas *is produced* in paying quantities” is in common usage in commercial oil and gas leases, it is necessary to look to our decisions involving such commercial leases and determine what we have held to be the meaning thereof, the commissioners’ lease never having been before this court in regard thereto.<sup>85</sup>

Thus, the court had an opportunity to distinguish between “may be” and “is” language in a habendum clause and find that “may be” denotes capability while “is” does not. This was not the result.<sup>86</sup> The oil company contended, and the Commissioners stipulated, that the oil company had completed a well *capable* of producing in paying quantities before the expiration of the primary term and had diligently searched for and obtained a market.<sup>87</sup> The Commissioners, however, did not feel capability was enough to satisfy the habendum clause and argued the lease unambiguously required a completed well and marketed production before expiration of the primary term.<sup>88</sup> Thus, the court was directly confronted with the decision of whether or not to adopt the “capability rule.”<sup>89</sup>

The Oklahoma Supreme Court refused the Commissioners’ rationale, stating that the lease necessarily implied “the right to obtain a market and sell the production therefrom after the period fixed for completion had expired.”<sup>90</sup> The court ruled that completion of a well *capable* of producing in paying quantities extended the term of the lease.<sup>91</sup> In reconciling this holding with prior rulings, the court first considered *Walden v. Potts*,<sup>92</sup> where it was held that production means not only discovery, but also production in pursuance of the covenants and purposes of the lease.<sup>93</sup> Further, the court considered *McVicker*, where production and marketing were distinguished and the court held that the lessee was allowed a reasonable time after completion to comply with the implied covenant to market.<sup>94</sup> The decision to apply the “capability rule” in *Commissioners of the Land Office* was an effort to “implement[] and complement[]” these two decisions.<sup>95</sup> Ultimately, the court adopted a “capability rule” that allows the lessee to exercise the right granted to him in the

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85. *Id.* ¶¶ 25-27, 336 P.2d at 1092-93 (emphasis added) (citations omitted).

86. *Id.* ¶ 42, 336 P.2d at 1094-95.

87. *Id.* ¶¶ 28-30, 336 P.2d at 1093.

88. *Id.* ¶ 28, 336 P.2d at 1093.

89. *Id.* ¶¶ 28-30, 336 P.2d at 1093.

90. *Id.* ¶ 41, 336 P.2d at 1094.

91. *Id.* ¶ 42, 336 P.2d at 1094-95.

92. 1944 OK 299, 152 P.2d 923.

93. *Id.* ¶ 46, 336 P.2d at 1095 (citing *Walden*, 1944 OK 299, 152 P.2d 923).

94. *Id.* (citing *McVicker v. Horn, Robinson & Nathan*, 1958 OK 49, 322 P.2d 410).

95. *Id.*

primary term to complete a well producing in paying quantities “by allowing a reasonable time after discovery . . . to acquire a market and thereafter requiring the lessee to take and market the product . . . .”<sup>96</sup> The court also carefully distinguished the habendum clause “production” requirement with the requirements imposed by the implied covenant to market, clarifying that the two concepts are not merged in Oklahoma.<sup>97</sup>

While the decision effectively outlined the rationale behind the “capability rule,”<sup>98</sup> the court failed to describe with particularity what is necessary to have a well “capable of producing in paying quantities.” At a minimum, the court indicated that a well needs to be successfully drilled on the leased premises;<sup>99</sup> however, the court did not indicate whether capability requires the operator be able to “flip the ‘on’ switch” and immediately procure oil and/or gas, as required by the *Thompson* decision.<sup>100</sup> Furthermore, though this case’s holding only applied the “capability rule” to the primary term of the lease, the rule has subsequently been extended to production in the secondary term.<sup>101</sup>

In 1994, the Oklahoma Supreme Court decided *Pack v. Santa Fe Minerals*, which provides a clear example of its application of the “capability rule.”<sup>102</sup> In *Pack*, the lessors claimed their leases with Santa Fe Minerals had terminated due to the wells’ failure to produce during a sixty-day period and the lessee’s failure to commence drilling operations or pay shut-in royalty payments, in violation of express terms of the lease.<sup>103</sup> Relevant to the court’s analysis was its discussion of habendum clause interpretation.<sup>104</sup> The court quickly determined the leases had been extended beyond the primary term “due to the wells’ *capability* to produce in paying or commercial quantities.”<sup>105</sup> The court relied on stipulated facts that indicated the wells were capable of producing in paying quantities through the time of trial, even though the lessee had chosen not to *market* gas from the wells for longer than sixty days because of natural

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96. *Id.* ¶ 46, 336 P.2d at 1095-96.

97. *Id.*, ¶¶ 43-46, 336 P.2d at 1095.

98. *Id.* ¶¶ 45-46, 336 P.2d at 1095-96.

99. *Id.*

100. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 558 (Tex. 2002).

101. Lisa S. McCalmont, Note, *Vanishing Rights of the Mineral Lessor: The Pack v. Santa Fe Minerals Ruling*, 30 TULSA L.J. 695, 708 (1995).

102. 1994 OK 23, 869 P.2d 323.

103. *Id.* ¶ 7, 869 P.2d at 326.

104. *Id.* ¶¶ 8-10, 869 P.2d at 326-27.

105. *Id.* ¶ 5, 869 P.2d at 325 (emphasis added). This conclusion cited to the court’s discussion in a later section of what they refer to as “the long-standing rule that the term ‘production’ as used in the habendum clause means ‘capable of producing in paying quantities.’” *See id.* ¶ 5 n.1, 869 P.2d at 325 n.1.

demand and price fluctuations in the market.<sup>106</sup> The court noted this was common practice because of allowable limitations on production imposed by the Oklahoma Corporation Commission.<sup>107</sup> The court held that “when a lease has the capability to produce and hydrocarbons have been reduced to the capture and control of the lessee, a lease cannot be terminated.”<sup>108</sup> Thus, the court preserved the rule that “the lease in the case at bar cannot terminate under the terms of the habendum clause because the parties stipulated that the subject wells were *at all times capable of producing in paying quantities.*”<sup>109</sup>

Although the court provided “much needed clarification of its perspective on mineral lease terminations,” it nevertheless failed to precisely define what “capability to produce” means.<sup>110</sup> In *Pack*, the court clarified that the requirement of “capability of production” and the requirement imposed by the implied covenant to market were separate.<sup>111</sup> As a result, the “capability rule” in Oklahoma does not require marketing, but the separate doctrine of the implied covenant to market does require the operator to seek a market with due diligence.<sup>112</sup>

The Oklahoma Court of Civil Appeals applied *Pack* in *Danne v. Texaco Exploration and Production, Inc.*<sup>113</sup> In *Danne*, the court held capability of production satisfies the habendum clause in the secondary term, but continuation of the lease is also subject to other implied covenants.<sup>114</sup> The court found the lease could not automatically terminate in the secondary term because “the lessee has proved a valuable asset and has established a right to develop that asset.”<sup>115</sup> The lessor, however, could seek forfeiture of the lease if other implied covenants, such as the implied covenant to market, were not satisfied.<sup>116</sup> Thus, Oklahoma’s separation allows for incorporation of the more relaxed view of the implied covenant to market, simply requiring “market[ing] the product with due diligence,” or “a significant attempt to market the product.”<sup>117</sup> In contrast, Texas’ “actual production” rule, merges the requirements of satisfying the habendum clause and the requirements of the implied covenant to market.<sup>118</sup>

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106. *Id.* ¶¶ 3-5, 869 P.2d at 325.

107. *Id.* ¶ 5, 869 P.2d at 325.

108. McCalmont, *supra* note 101, at 695; *see Pack*, ¶¶ 16-20, 869 P.2d at 328-29.

109. *Pack*, ¶ 10, 869 P.2d at 327 (emphasis added).

110. McCalmont, *supra* note 101, at 695.

111. *Pack*, ¶ 9, 869 P.2d at 327.

112. *Id.*

113. 1994 OK CIV APP 138, ¶¶ 22-24, 883 P.2d 210, 216-17.

114. *Id.* ¶ 24, 883 P.2d at 217 (citing *Pack*, ¶ 26, 869 P.2d at 330).

115. *Id.* ¶ 12, 883 P.2d at 214.

116. *Id.* ¶ 21, 883 P.2d at 216.

117. *Id.* ¶ 24, 883 P.2d at 217.

118. *See Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 269-70 (Tex. 1960); *Clifton v. Koontz*,

After considering these Oklahoma decisions interpreting habendum clauses, certain trends are discernable, forming the “Oklahoma lens” through which *Thompson* may be analyzed. First, these cases show that the “capability rule” has wide application in Oklahoma. It applies not only to the determination of what extends the lease beyond the primary term, but also applies to extension of the lease within the secondary term. In *Pack*, as will be analyzed in Part IV, the application of the rule was further extended to interpreting cessation-of-production clauses.<sup>119</sup> This only makes the question of what “capability” means more significant. Second, it may be gleaned from this authority that Oklahoma has a general policy disfavoring the forfeiture of interests.<sup>120</sup> Consequently, “courts avoid the effect of forfeiture by giving due consideration to compelling *equitable* circumstances.”<sup>121</sup> Therefore, reasonable circumstances likely will be influential to an Oklahoma court when determining whether a particular well is “capable” of producing in paying quantities. Finally, the distinction between the requirements of the habendum clause and the implied covenant to market may be indicative of the type of “capability” a well must exhibit in Oklahoma to satisfy the “capability rule” (simply capable of production or capable of marketing as well). *Thompson* will be analyzed through this lens to determine how Oklahoma courts should construe “capability” in future cases.

### III. Statement of the Case—Anadarko Petroleum Corp. v. Thompson

#### A. Facts and Issues of the Case

The facts of the *Thompson* case are relatively simple—they involve the interpretation of a lease written sixty-six years before the Texas Supreme Court endeavored to construe its provisions.<sup>122</sup> In 1936, the mineral owners, Phillip Thompson’s predecessors in interest, executed an oil and gas lease as lessors with Anadarko’s predecessor in interest as lessee.<sup>123</sup> The lease contained an atypical habendum clause reading, “This lease shall remain in force for a term of one (1) year and as long thereafter as gas is *or can be* produced.”<sup>124</sup> Also

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325 S.W.2d 684, 691 (Tex. 1959); *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746, 748 (Tex. Civ. App. 1937).

119. See *infra* Part IV; *Pack*, ¶¶ 11-20, 26-29, 869 P.2d at 327-29.

120. *Pack*, ¶ 9, 869 P.2d at 327 (citing 23 OKLA. STAT. § 2 (1971), which provides, “Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful or fraudulent breach of duty.”).

121. *Id.* (emphasis added).

122. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 553 (Tex. 2002).

123. *Id.*

124. *Id.* (emphasis added).

included in the lease was a cessation-of-production clause.<sup>125</sup> The purpose of this clause was to keep the lease alive after the expiration of the primary term, stating that if *production* on the leased land ceased for any reason, but the lessee resumed drilling operations within sixty days of the cessation, the lease would remain alive as if production never halted.<sup>126</sup> The litigation centered on the apparent contradiction between these two clauses.

Because gas production commenced in 1936, the year the lease was signed, the lease extended beyond its primary term.<sup>127</sup> However, while pipeline repairs were conducted by the gas purchaser, production completely ceased for sixty-one days in 1981 and for ninety-one days in 1985.<sup>128</sup>

Thompson sued in 1997, requesting a declaration from the District Court of Moore County, Texas<sup>129</sup> that the lease terminated in 1981 when production ceased and seeking to recover conversion damages.<sup>130</sup> The trial court granted partial summary judgment in favor of Thompson and held the lease had terminated because of the cessation-in-production in excess of sixty days; the court awarded him damages and attorney's fees.<sup>131</sup> Anadarko appealed, contending the trial court erred in holding that the cessation-of-production terminated the lease.<sup>132</sup>

The dispute in *Thompson* primarily concerned the parties' different interpretations of the lease's habendum clause and its language stating the lease would be maintained as long as oil or gas "*is or can be produced.*"<sup>133</sup> Anadarko argued the "can be produced" language in the habendum clause of the lease should be interpreted literally; therefore, because the well was at all times "capable" of producing in paying quantities, the lease survived.<sup>134</sup> Anadarko's argument maintained that the "capability rule," as established in Oklahoma,<sup>135</sup>

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125. *Id.* The specific cessation-of-production clause in the lease read, "If, after the expiration of the primary term of this lease, production on the leased premises shall cease from any cause, this lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and if production results therefrom, then as long as production continues."

*Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* at 550, 553.

130. *Id.* at 553.

131. *Id.*

132. *Anadarko Petroleum Corp. v. Thompson*, 60 S.W.3d 134, 137 (Tex. App. 2000), *rev'd*, 94 S.W.3d 550 (Tex. 2002).

133. *Id.* at 137-38 (emphasis added).

134. *Id.* at 138.

135. *See Pack v. Santa Fe Minerals*, 1994 OK 23, ¶¶ 8-10, 869 P.2d 323, 326-27; *McVicker*

was written into the lease and should be given effect.<sup>136</sup> In opposition, Thompson urged the court to apply the “actual production rule” in interpreting the habendum clause, despite the inclusion of the “can be” language.<sup>137</sup> Because *actual* production ceased for over sixty days, Thompson thought the lease had expired.<sup>138</sup> The Texas Court of Civil Appeals held in favor of Thompson, rejecting the “capability rule” even when confronted by the “can be produced” contractual language.<sup>139</sup> Although it acknowledged that a literal interpretation of the habendum clause would extend the lease if the well were capable of producing gas in paying quantities, the court flatly rejected a literal construction.<sup>140</sup>

In lieu of a literal construction, the appellate court relied upon the Texas Supreme Court’s decision in *Garcia v. King* where the controversy concerned the omission of the qualifier “in paying quantities” from the “is produced” language in a habendum clause.<sup>141</sup> In *Garcia*, the Texas Supreme Court noted that a literal reading omitted “in paying quantities,” but considered that the intent of the parties was “to secure development of the property for the mutual [economic] benefit of the parties.”<sup>142</sup> Therefore, the court reasoned, “produced” necessarily meant “production in paying quantities.”<sup>143</sup>

The appellate court in *Thompson* derived two rules from *Garcia* to apply to the *Thompson* dispute:

The first . . . pertains to the need to construe mineral leases in accordance with the objectives of the parties. . . . The second rule compelled by *Garcia* involves the objectives or intent attributable to those entering such agreements. One of them is the intent to reap economic benefit from the development of the property. And, unless the agreement readily illustrates the purpose to be something else, we must construe the document and its words in a way fulfilling that purpose.<sup>144</sup>

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v. Horn, Robinson & Nathan, 1958 OK 49, ¶ 6, 322 P.2d 410, 413-14; Geyer Bros. Equip. Co. v. Standard Res., 2006 OK CIV APP 924, ¶ 8, 140 P.3d 563, 566; Danne v. Texaco Exploration & Prod., Inc., 1994 OK CIV APP 138, ¶¶ 22-23, 883 P.2d 210, 217.

136. *Thompson*, 60 S.W.3d at 138, *rev'd*, 94 S.W.3d 550 (Tex. 2002).

137. *Id.* at 137-38.

138. *Id.*

139. *Id.* at 138.

140. *Id.*

141. *Id.* (citing *Garcia v. King*, 164 S.W.2d 509 (Tex. 1942)).

142. *Thompson*, 60 S.W.2d at 138 (quoting *Garcia*, 164 S.W.2d at 512) (alteration in original).

143. *Id.* (citing *Garcia*, 164 S.W.2d at 512).

144. *Id.* at 138-39 (citing *Garcia*, 164 S.W.2d at 512).



The *Thompson* court—drawing upon the implicit purpose of all oil and gas leases, as stated in *Garcia*, to seek the “mutual [economic] benefit of the parties”—determined the effect of the “can be” language in the *Thompson* habendum clause.<sup>145</sup> This implicit purpose of economic benefit was the primary reason the Texas Court of Civil Appeals rejected a literal interpretation of the habendum clause.<sup>146</sup> The appellate court reasoned that if only “capability” was required, the lessee could fail to develop the land but continue to maintain the lease by simply establishing that gas could be produced in paying quantities.<sup>147</sup> In that case, the lessee would be allowed to hold a lease for improper speculative purposes. This possibility prompted the court’s holding that “the goal legally implicit and factually explicit in [the] lease would be thwarted if ‘can be produced’ meant nothing more than ‘physical ability’ to draw gas in paying quantities.”<sup>148</sup>

Furthermore, the Texas Court of Civil Appeals concluded the cessation-of-production clause would be rendered useless if only *capability* was required to hold the lease.<sup>149</sup> The court rhetorically asked, “Why should there be any reason to mention the need to resume drilling operations and, thereby, pursue actual production to maintain the lease if the only thing that was required was the mere ability to produce?”<sup>150</sup> Because no sound reason existed for inclusion of the cessation-of-production clause if the “capability rule” applied, the court reinforced its decision requiring actual production to satisfy the habendum clause.<sup>151</sup> In so holding, the court cited precedent from other states, including Oklahoma, for finding that a cessation-of-production clause is rendered useless by allowing *capability of production* to maintain a lease in the secondary term.<sup>152</sup> Anadarko appealed to the Texas Supreme Court.<sup>153</sup>

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145. *Id.* at 138 (citing *Garcia*, 164 S.W.2d at 512) (alteration in original).

146. *Id.* at 139-40.

147. *Id.* at 139.

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.* at 140.

152. *Id.* (citing *Greer v. Salmon*, 479 P.2d 294, 295 (N.M. 1970) (holding that capability of production was not sufficient to maintain a lease where the habendum clause read “is produced or *producible*” but in the absence of actual production, the shut-in royalty clause required either actual production or payment of shut-in royalty payments, therefore, *capability* of production would not suffice); *Fisher v. Grace Petroleum Corp.*, 1991 OK CIV APP 112, 830 P.2d 1380 (holding that the capability to produce, as is usually sufficient to maintain a lease in Oklahoma, would not maintain a lease in the secondary term where a cessation-of-production clause would be rendered useless if actual production were not required in the secondary term of the lease)).

153. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550 (Tex. 2002).

*B. Decision and Rationale of the Texas Supreme Court in Thompson*

The Texas Supreme Court began their analysis by laying the foundation for how oil and gas lease terms, including the habendum clause, should be construed.<sup>154</sup> The court maintained that the plain grammatical meaning of a term should control unless it defeats the parties' intentions.<sup>155</sup> Next, the court acknowledged the basic rule in Texas that "actual production in paying quantities" is required to satisfy the language in the habendum clause of an oil and gas lease which states that the lease continues "as long thereafter as oil, gas or other mineral is produced."<sup>156</sup> The habendum clause in this case, however, presented the court with the atypical "is *or can be* produced" language in tandem with a sixty-day cessation-of-production clause.<sup>157</sup>

In holding that actual production was not necessary to maintain the lease, the Texas Supreme Court carefully distinguished the uncommon habendum clause in *Thompson* with those typically found in oil and gas leases.<sup>158</sup> The court determined that because neither party contended the lease term was ambiguous, the parties' intent should first be resolved by considering the language within the four corners of the lease.<sup>159</sup> Holding that the "actual production" rule continued to apply to "is produced" habendum clause language, and thus upholding their precedent in *Reid*<sup>160</sup> and *Garcia*,<sup>161</sup> the court further held that the "actual production" rule did not necessarily apply to the atypical "is *or can be* produced" language in the *Thompson* lease.<sup>162</sup> Instead the court found that "[t]he habendum clause's plain language shows that the parties intended that a well actually produce gas, *or be capable of producing gas*, to sustain the lease"; thus, the plain meaning of the words was found to be expressive of the parties' intent.<sup>163</sup>

The Texas Supreme Court also rejected the Court of Appeals' idea that the cessation-of-production clause would be rendered useless by giving effect to the "can be produced" language so that capability of production continues the lease.<sup>164</sup> Quite similarly to the Oklahoma Supreme Court's application of the

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154. *Id.* at 554.

155. *Id.*

156. *Id.* (citing *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 269 (Tex. 1960); *Garcia v. King*, 164 S.W.2d 509, 512 (Tex. 1942)).

157. *Id.* at 555 (emphasis added).

158. *Id.* at 555-56.

159. *Id.* at 554.

160. *Reid*, 337 S.W.2d at 269-70.

161. *Garcia*, 164 S.W.2d at 512.

162. *Thompson*, 94 S.W.3d at 555-56.

163. *Id.* at 555.

164. *Id.* at 556.

“capability rule” in *Pack v. Santa Fe Minerals*,<sup>165</sup> the Texas Supreme Court found that in this case, “the cessation-of-production clause only applies if a well holding the lease ceases to be *capable of producing gas*.”<sup>166</sup> According to the court, “[c]onstruing the cessation-of-production clause to apply when a well holding the lease ceases to be capable of production—and not simply when actual production ceases—accords with the cessation-of-production clause’s plain language.”<sup>167</sup>

To this point in its analysis, the Texas Supreme Court interpreted the “can be produced” language in the *Thompson* lease just as an Oklahoma court would interpret “is produced” *or* “can be produced” language in a habendum clause.<sup>168</sup> The opinion, however, did not stop with this construction; the court went further, expressly defining what “capability” means with regard to such lease terms in Texas.<sup>169</sup> The court adopted the definition of “capable” proffered by the Texas Court of Civil Appeals in *Hydrocarbon Management, Inc. v. Tracker Exploration, Inc.*,<sup>170</sup> which determined whether the lessee’s payment of shut-in royalties maintained the lease despite the fact that actual production had ceased.<sup>171</sup> According to the *Hydrocarbon* court’s definition, “capable” means

a well that will produce in paying quantities if the well is turned “on,” and it begins flowing, without additional equipment or repair. Conversely, a well would not be capable of producing in paying quantities if the well switch were turned “on,” and the well did not flow, because of mechanical problems or because the well needs rods, tubing, or pumping equipment.<sup>172</sup>

Accordingly, the Texas Supreme Court found this definition “consistent with existing cases that discuss the difference between actual production and capability of production.”<sup>173</sup> Therefore, the *Thompson* lease did not terminate because the wells were found to be at all times *capable* of producing in paying quantities without additional equipment or repair, and the wells were actually connected to a pipeline facility.<sup>174</sup>

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165. 1994 OK 23, 869 P.2d 323.

166. *Thompson*, 94 S.W.3d at 556-57.

167. *Id.* at 556.

168. *Id.* at 557-58.

169. *Id.*

170. 861 S.W.2d 427, 433-34 (Tex. App. 1993).

171. *Thompson*, 94 S.W.3d at 558.

172. *Id.* (citing *Hydrocarbon*, 861 S.W.2d at 433-34).

173. *Id.*

174. *Id.* at 559.

Thompson's motion for rehearing was denied.<sup>175</sup> However, the Texas Supreme Court wrote a per curiam opinion to clarify its previously issued opinion, primarily discussing the retention of the longstanding definition of "paying quantities" and the interplay of marketing requirements with capability under their decision in *Thompson*.<sup>176</sup> Although intended to clarify the original opinion, the per curiam decision further confused the issue. That opinion began by stating:

[W]e did not overrule or modify the longstanding requirement that for a well to produce in paying quantities, *or to be capable of producing in paying quantities*, there must be facilities located near enough to the well that it would be economically feasible to establish a connection so that production could be marketed at a profit.<sup>177</sup>

This raises the question of whether the Texas Supreme Court held that a well must be *capable of marketing* the product to be *capable of producing* in paying quantities, which the *Thompson* court seems to answer in the affirmative. It has been established that the "actual production" rule in Texas requires marketing as well as production, merging the concepts of the implied covenant to market and the habendum clause.<sup>178</sup> *Thompson*, however, incorporates a marketing requirement into the "capability rule" when it is made applicable by relevant lease language.

Despite the fact that the court proceeded to carefully distinguish between a breach of an implied covenant and a failure to satisfy the habendum clause, the court's language merged the concepts. The court stated that they "did not intend to imply that the remedy for breach of an implied covenant to market production would be forfeiture or termination of a lease," but rather maintained the rule that the breaching party is subject to "liability for monetary damages."<sup>179</sup> However, the court then stated:

We meant in our original decision that, as a practical matter, *a lessee will not sustain a lease based on a well's capability of production without actual production of the well* because the payment of damages for the failure to reasonably market the gas would be a strong incentive to connect the well to facilities that would permit

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175. *Id.* at 558.

176. *Id.* at 558-61.

177. *Id.* at 559 (emphasis added).

178. *See supra* Part II.A; *see also* *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 270 (Tex. 1960); *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746, 749 (Tex. Civ. App. 1937).

179. *Thompson*, 94 S.W.3d at 560 (citing *Rogers v. Ricane Enters., Inc.*, 772 S.W.2d 76, 79 (Tex. 1989)).

actual production. And, in an extraordinary case, when damages would not furnish an adequate remedy, a court could conditionally order termination if a connection and actual production were not commenced within a reasonable time.<sup>180</sup>

The court clearly was aware that the consequence of its language would be to require the capability of marketing to maintain the lease.<sup>181</sup>

In its original opinion, the court accepted the idea that capability was written into the lease language, and thus decided to forego application of the “actual production” rule to give full-effect to that language and the parties’ intent.<sup>182</sup> However, the after-the-fact per curiam opinion, written upon the denial of the motion for rehearing, shows that the departure from the “actual production” rule is not as pronounced as the original opinion seemed to suggest. First, the court required that for a well to be capable, it must not need any additional equipment or repairs before it begins to flow.<sup>183</sup> Furthermore, the court suggested in its additional opinion that—although only damages are available for breach of the implied covenant to market—it is a virtual impossibility to sustain a lease without actual production and marketing because of the impending threat of substantial monetary damages.<sup>184</sup> The application of the “capability rule” in *Thompson* should be approached with caution by Oklahoma courts because it neither translates to Oklahoma’s liberal application of the rule<sup>185</sup> nor comports with Oklahoma’s goal of avoiding the forfeiture of property interests.<sup>186</sup>

### C. Application of the Thompson “Capability Rule” in *Chesapeake Exploration Limited Partnership v. Corine, Inc.*

Texas courts have showed no sign of retreat from their strict interpretation of “capability” announced in *Thompson*. In 2007, the Texas Court of Appeals strictly applied the *Thompson* rule in *Chesapeake Exploration Ltd. Partnership v. Corine, Inc.*<sup>187</sup> In *Corine*, the lease language provided that the lease

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180. *Id.* (emphasis added).

181. *Id.* at 560-61.

182. *Id.* at 555-56.

183. *Id.* at 558.

184. *Id.* at 560.

185. See *Pack v. Santa Fe Minerals*, 1994 OK 23, ¶¶ 8-10, 869 P.2d 323, 326; *McVicker v. Horn, Robinson & Nathan*, 1958 OK 49, ¶ 6, 322 P.2d 410, 413-14; *Geyer Bros. Equip. Co. v. Standard Res.*, 2006 OK CIV APP 924, ¶ 8, 140 P.3d 563, 566; *Danne v. Texaco Exploration & Prod., Inc.*, 1994 OK CIV APP 138, ¶¶ 22-23, 883 P.2d 210, 217.

186. See *supra* text accompanying notes 115-16, 120-21.

187. No. 10-06-00265-CV, 2007 WL 2447293, at \*2-3 (Tex. App. Aug. 29, 2007). It should be noted that the court later granted the parties’ motion to withdraw its judgment in this case because the parties came to a formal settlement agreement. *Chesapeake Exploration Ltd. P’ship v. Corine, Inc.*, No. 10-06-00265-CV, 2007 WL 2729576 (Tex. App. Sept. 19, 2007). However,

terminated if, at the end of the primary term, the well was not *capable* of producing in paying quantities.<sup>188</sup> The court cited the *Thompson* rule: “A well is capable of production if it is capable of producing in paying quantities without additional equipment or repairs.”<sup>189</sup> The lessor, Corine, introduced evidence showing that the well on the leased premises “was not equipped with rods, tubing, or pumping equipment when the primary term of the lease ended.”<sup>190</sup> Corine then filed for partial summary judgment on the grounds that the well was not capable of producing in paying quantities; the trial court granted his motion, which was affirmed on appeal.<sup>191</sup>

Chesapeake admitted the well needed this equipment before it would “turn on” and attached an affidavit to its response to the motion for summary judgment to explain the well’s minor engineering situation.<sup>192</sup> Instead of hearing a practical explanation, the court “struck all of the attempts to explain” because the fact that additional equipment was needed, in combination with the strict *Thompson* “capability rule,” left nothing to resolve.<sup>193</sup> The trial court interpreted the Texas Supreme Court’s rule from *Thompson* as a severe mandate and terminated the lease of a lessee who had diligently sought production and heavily invested in a project.<sup>194</sup>

#### *IV. The Thompson “Capability Rule” Is Not Congruent with Oklahoma Jurisprudence Interpreting the Habendum Clauses of Oil and Gas Leases*

In Texas, where actual production is the default rule for the typical “is produced” habendum clause language,<sup>195</sup> parties insert “can be produced” language to avoid the strict requirements of the “actual production” rule.<sup>196</sup> The “capability rule,” as applied by the Texas Supreme Court in *Anadarko Petroleum Corp. v. Thompson*,<sup>197</sup> does not comport with the intent of the parties when capability is written into a lease. If Oklahoma courts were to define

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the court denied the associated motion to withdraw its opinion in *Corine. Id.* at \*1. Therefore, although the judgment was ineffectual, the opinion remains on the books.

188. *Corine*, 2007 WL 2447293, at \*2.

189. *Id.* at \*3 (citing *Thompson*, 94 S.W.3d at 558).

190. *Id.*

191. *Id.* at \*1.

192. *Id.* at \*3.

193. *Id.*

194. *Id.* at \*2-4.

195. See *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 270 (Tex. 1960); *Clifton v. Koontz*, 325 S.W.2d 684, 691 (Tex. 1959); *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746, 748 (Tex. Civ. App. 1937).

196. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 555-56 (Tex. 2002).

197. *Id.* at 558 (citing *Hydrocarbon Mgmt., Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 433 (Tex. App. 1993)).

“capability” as the Texas Supreme Court has done—or in a similar way—the results would be even more far-reaching. As previously discussed, Oklahoma applies the “capability rule” in *all* circumstances, including when “is produced” language is present in the lease, but no clear definition of “capable” has been offered.<sup>198</sup> Therefore, a definition similar to that given in *Thompson* would be especially burdensome to the Oklahoma oil and gas industry.

This section will focus on the practical frustrations such a definition would cause for operators from an engineering standpoint and the associated danger of forfeiture, the implications on the implied covenant to market, and the definition’s relationship with Oklahoma’s application of the common law doctrine of temporary cessation or cessation-of-production clauses.

#### *A. The Thompson Definition of “Capable” is Incompatible with Engineering Realities*

The strict definition of “capable” adopted by the Texas Supreme Court in *Thompson* would not be a practical rule to apply generally in Oklahoma to interpret habendum clauses primarily because it is untenable with engineering realities.<sup>199</sup> As stated previously, the court in *Thompson* borrowed the definition of “capable” from an earlier Texas case, which defines a capable well as:

[A] well that will produce in paying quantities if the well is turned “on,” and it begins flowing, without additional equipment or repair. Conversely, a well would not be capable of producing in paying quantities if the well switch were turned “on,” and the well did not flow, because of mechanical problems or because the well needs rods, tubing, or pumping equipment.<sup>200</sup>

The first question that necessarily arises from this seemingly simplistic definition is, “What is this magic switch?”

Oil and gas wells are a complex set of working parts, and the Texas Supreme Court’s definition seems to indicate that failure of any one of these, no matter how minor or repairable, causes the entire lease to be cancelled. As one experienced petroleum engineer has stated:

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198. *See supra* Part II.B; *see also* *Pack v. Santa Fe Minerals*, 1994 OK 23, ¶¶ 8-10, 869 P.2d 323, 326; *McVicker v. Horn, Robinson & Nathan*, 1958 OK 49, ¶ 6, 322 P.2d 410, 413-14; *Geyer Bros. Equip. Co. v. Standard Res.*, 2006 OK CIV APP 924, ¶ 8, 140 P.3d 563, 566; *Danne v. Texaco Exploration & Prod., Inc.*, 1994 OK CIV APP 138, ¶¶ 22-23, 883 P.2d 210, 217.

199. *Thompson*, 94 S.W.3d at 558 (citing *Hydrocarbon*, 861 S.W.2d at 433-34).

200. *Id.*

The language adopted by the Texas Supreme Court indicates that “turning on a well” is like throwing a light switch in your bathroom. Very rarely it may be that simple, but usually it is more akin to getting your entertainment center working, requiring manipulation of several different devices to achieve the desired outcome. This could involve opening numerous valves, setting choke sizes, separators, compressors, heater treaters, dehydration units, line heaters, and other devices.<sup>201</sup>

The *Thompson* “capability rule” suggests that if there were a failure at any of the several points in this complex chain, the well would be declared incapable. This would mean in this most exceptional case that something as simple as a blown fuse on a shut-in well could render a well incapable absent a relevant savings clause or a favorable application of the doctrine of temporary cessation.

There are also common difficulties in actually producing oil or gas that can be, and often are, remedied through mechanical processes.<sup>202</sup> The *Thompson* definition indicates that simply the necessity of such processes would render a well incapable.<sup>203</sup> For example, gas wells usually produce some amount of liquid water and/or condensate during their normal production cycle.<sup>204</sup> During a shut-in period, the gas and liquid segregate with the gas on top, then a layer of condensate, and the water at the bottom of the well.<sup>205</sup> If an abundance of water is in the well, the gas is prevented from entering the well bore, and the flow of gas cannot be sustained.<sup>206</sup> If this were the case, the well would not be able to immediately flow after being “turned on.”<sup>207</sup> However, an operator commonly “swabs” the well to lift liquid from the hole, removing hydrostatic pressure and allowing the well to flow.<sup>208</sup> Under *Thompson*, the necessity of swabbing would make the well “incapable,” but after a normal swabbing process, an economically profitable well may resume flowing.<sup>209</sup> If such a well were deemed incapable and the lease were lost, the operator would suffer a considerable forfeiture of time and resources.

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201. Interview with Kim Hatfield, President, Crawley Petroleum Corp., in Okla. City, Okla. (Dec. 21, 2007) (on file with author).

202. *Id.*

203. 94 S.W.3d at 558 (citing *Hydrocarbon*, 861 S.W.2d at 433).

204. Interview with Kim Hatfield, *supra* note 201.

205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.*

209. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 558 (Tex. 2002) (citing *Hydrocarbon Mgmt., Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 433 (Tex. App. 1993)).



Often, gas wells are shut-in to await a market or pipeline in the area.<sup>210</sup> The pipelines, which are routed through a given geographic location, have specific pressure requirements that necessitate specialized equipment on gas wells.<sup>211</sup> For example, if a gas well's pressure is lower than the line's required pressure, a piece of equipment known as a compressor must be attached so the gas may be transported through the pipeline and marketed.<sup>212</sup> On the other hand, if the well's pressure is higher than the line's threshold, equipment will be attached to the well to regulate the pressure.<sup>213</sup> Under either scenario, these devices cannot be determined necessary or properly sized without knowing the pipeline requirements.<sup>214</sup> Such requirements may not be known for a considerable amount of time in some circumstances.<sup>215</sup>

Therefore, while the well is shut-in, it might not immediately flow because the proper equipment is not attached and the pipeline connection has yet to be established. In *Thompson*, the Texas Supreme Court suggests capability of *marketing* is also required for a well to be capable of producing.<sup>216</sup> Therefore, simply the lack of pipeline connection will be enough to declare the well "incapable." In contrast, Oklahoma courts have maintained that the implied covenant to market and satisfying the habendum clause are two *separate* requirements.<sup>217</sup> Thus, it seems unlikely that Oklahoma courts would declare a well incapable for lack of a pipeline connection. However, if the Texas view were adopted, it is possible that lack of other equipment to regulate the pressure would be enough to declare a well incapable. This is completely beyond the operator's control, and such a result would be highly inequitable considering the operator's substantial investment in drilling the well.

The strict requirements of capability adopted by the Texas Supreme Court are neither practical nor equitable. Oil and gas companies invest hundreds of thousands of dollars drilling wells, and it is clearly in the operator's best interest to have a well "capable" of producing in paying quantities. However, if they have taken all the necessary steps to develop a well except one component that is out of their control, such as gaining access to a pipeline or power source or procuring a government easement or permit, the operator may choose to wait before adding expensive additional equipment that would be determinative in

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210. Interview with Kim Hatfield, *supra* note 201.

211. *Id.*

212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.*

216. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 560 (Tex. 2002).

217. *See supra* text accompanying notes 87-97; *see also* *State ex rel. Comm'rs of Land Office v. Carter Oil Co. of W. Va.*, 1958 OK 289, ¶ 36, 336 P.2d 1086, 1095.

finding a well “capable” of production.<sup>218</sup> As noted, this may be the case simply because they do not have the pipeline requirements.<sup>219</sup> Furthermore, they may not want to add additional equipment to sit idle in the field while the well is shut-in at the risk of weathering and exposure to theft.<sup>220</sup> Therefore, an operator may take certain actions that will cause their well to be incapable because they believe it is in the lessor’s and lessee’s best cooperative interest to do so.

The Oklahoma Supreme Court has stated that the definition of “produced” would not extend beyond what is reasonable for the oil and gas industry.<sup>221</sup> A strict definition akin to that used in *Thompson* would violate this principle. Furthermore, Oklahoma has a general policy disfavoring the forfeiture of interests and “courts avoid the effect of forfeiture by giving due consideration to compelling equitable circumstances.”<sup>222</sup> The Oklahoma “capability rule” is an important way the courts consider the equitable posture of the lessee/lessor relationship and its version of the rule should be maintained to its fullest extent. The Texas “capability” interpretation disregards both the practicalities of the oil and gas industry and leads to inequitable results for operators. Therefore, it has no place in Oklahoma’s jurisprudence interpreting the “capability rule.”

*B. The Thompson Definition of “Capable” Confuses the Requirements of Satisfying the Habendum Clause with the Implied Covenant to Market*

With regard to oil and gas leases, there is an implied covenant to market, which includes the operator’s duty to market within a reasonable time, at a reasonable price.<sup>223</sup> As discussed in Part III.B, the interpretation of the “capability rule” in *Thompson* merges the concepts of satisfying the habendum clause and satisfying the implied covenant to market, even though the opinion insists the distinction remains.<sup>224</sup> Though the Texas Supreme Court stated it did not intend to merge the concepts, it acknowledged that the effect nevertheless occurs due to its strict “capability rule.”<sup>225</sup> On the other hand, Oklahoma courts have made it clear that these two principles have separate requirements.<sup>226</sup> If Oklahoma were to adopt the Texas construction, satisfaction of the implied

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218. Interview with Kim Hatfield, *supra* note 201.

219. *Id.*

220. *Id.*

221. *McVicker v. Horn, Robinson & Nathan*, 1958 OK 49, ¶ 6, 322 P.2d 410, 413.

222. *Pack v. Santa Fe Minerals*, 1994 OK 23, ¶ 9, 869 P.2d 323, 327; *see supra* text accompanying note 120.

223. 38 AM. JUR. 2D *Gas and Oil* § 137 (2007).

224. *See supra* Part III.B.

225. *See supra* text accompanying notes 170-72; *see also* *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 560 (Tex. 2002).

226. *See supra* text accompanying notes 87-97; *see also* *State ex rel. Comm’rs of Land Office v. Carter Oil Co. of W. Va.*, 1958 OK 289, ¶ 36, 336 P.2d 1086, 1095.

covenant to market and the habendum clause would also be unintentionally merged—an unfortunate result for Oklahoma’s vital oil and gas industry.

An operator should have a reasonable amount of time after a well is established to procure a market for their product. If they fail to do so, damages are the proper remedy for breach of the implied covenant to market rather than termination of the lease, which would result in forfeiture of a tremendous investment. Primarily, the difficulty with marketing involves gas wells. Because natural gas, unlike oil, cannot be stored, it must immediately be diverted into a pipeline to reach its market. Because a capable gas well is often shut-in to await a market, or pipeline, in the geographic area, requiring the capability of marketing to sustain a lease is a substantial burden on an operator attempting to establish a natural gas production field. This discourages new frontier exploration by oil and gas companies. For example, the Barnett and Woodford shale areas offer unconventional resources often unassociated with traditional production and without immediate access to a pipeline connection.<sup>227</sup> Also, because no single well would likely be prolific enough to justify the needed construction on its own merit, these types of areas would require drilling numerous wells to establish the necessary resource base and justify construction of pipelines and other surface facilities such as central delivery points, gas treatment plants, and water disposal facilities.<sup>228</sup> “It becomes a “chicken and egg” problem. Nobody will invest in the surface facilities until enough wells have been drilled, but you can’t afford to drill the wells because your leases may expire before the facilities are completed.”<sup>229</sup>

For these reasons and to encourage new development, the requirement of marketing and the requirement of capability of production in paying quantities should remain separate inquiries for the court. Considering the decisions in *Pack*<sup>230</sup> and *Danne*,<sup>231</sup> it is clear Oklahoma courts do not read any marketing requirement into the “capability rule.”

### *C. The Oklahoma Court’s Application of the Common Law Doctrine of Temporary Cessation Conflicts with Texas’ “Capability Rule”*

In many oil and gas leases, the parties obviously contemplate interruptions in production on the leased premises and write cessation-of-production clauses into the lease to save it if production temporarily ceases.<sup>232</sup> These clauses serve

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227. Interview with Kim Hatfield, *supra* note 201.

228. *Id.*

229. *Id.*

230. *Pack v. Santa Fe Minerals*, 1994 OK 23, 869 P.2d 323, 327.

231. *Danne v. Texaco Exploration & Prod., Inc.*, 1994 OK CIV APP 138, ¶ 22, 883 P.2d 210, 216-17.

232. *See Pack*, 1994 OK 23, 869 P.2d 323; *French v. Tenneco Oil Co.*, 1986 OK 22, 725

to “save” the lease by setting a time period, usually sixty days, where production may be discontinued. As was held in *Pack* by the Oklahoma Supreme Court and in *Thompson* by the Texas Supreme Court, the definition of “production” for the purposes of interpreting a cessation-of-production clause is the same as the definition of “production” used to satisfy the habendum clause. Therefore, if *capability* of production satisfies the habendum clause, the “clock” does not begin running on the cessation-of-production time limit until a well ceases to be *capable* of producing.

The strict *Thompson* definition of “capability” will, therefore, also impact the interpretation of cessation-of-production clauses. Under the Texas Supreme Court’s logic, though the purpose of a cessation-of-production clause is to *save* a lease, if a well is *incapable* of production solely because it needs any sort of equipment or repair, the sixty day clock would begin to run. A brief hypothetical serves to illustrate this point: if a simple fuse is blown on a well and it cannot be repaired for sixty days (or the relevant period) because of weather conditions, lack of an appropriate part to repair the fuse, or lack of knowledge of the problem, the lease would be terminated. Such extreme illustrations may be the exception rather than the rule, but the effect remains that a diligent operator may lose a potentially profitable lease because of a strict interpretation of the term “capable”—a term meant to have a liberal effect.

When no cessation-of-production clause is present in the lease, courts generally apply the doctrine of temporary cessation. This common law doctrine also serves to save the lease because production interruptions are foreseeable. “Oklahoma has adopted the common law doctrine of temporary cessation-of-production which provides an oil and gas lease will continue in force during the secondary term unless the period of cessation, viewed in light of all the circumstances is for an unreasonable time.”<sup>233</sup> Whether or not this doctrine will serve to save a lease generally depends on three factors: the period over which cessation extends, the cause of termination, and the lessee’s efforts to restore production. Therefore, depending on the *facts and circumstances* of the case, the doctrine may serve to maintain a lease where it is equitable to do so. Jurisdictions such as Oklahoma applying this doctrine “note that the lessee makes a very substantial investment and bears the entire loss if the well is unproductive, so it is harsh and inequitable to allow the lessor, on a temporary cessation of production, to declare forfeiture and take over the property himself or herself.”<sup>234</sup> The Texas view of capability of production subverts this effect.

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P.2d 275; *Fisher v. Grace Petroleum Corp.*, 1991 OK CIV APP 112, 830 P.2d 1380.

233. *Fisher*, ¶ 13, 830 P.2d at 1386-87 (citing *Cotner v. Warren*, 1958 OK 208, 330 P.2d 217).

234. 38 AM. JUR. 2D, *supra* note 223, § 238 (citing *Woodruff v. Brady*, 1937 OK 537, 72 P.2d 709).

As previous examples have shown, forfeiture results from the strict interpretation of “capable” and leases are lost for relatively minor reasons. The doctrine of temporary cessation supports looking to equitable considerations to determine if a well is capable of producing in paying quantities, even if modest work is needed before the well actually produces.

#### *V. Conclusion*

Oklahoma’s “capability rule” offers oil and gas companies who undertake risky exploration and costly drilling activities an avenue to maintain their leases, which furthers State policy by disfavoring forfeiture of interests and maintaining equity among lessor and lessee. The strict interpretation of “capable” adopted by the Texas Supreme Court leads to inequitable consequences. Although the results of the rule are less dramatic in Texas because of the generally applicable “actual production” rule in the state, when Oklahoma courts are forced to more explicitly define “capability,” equitable considerations should remain the primary consideration. Therefore, the strict Texas construction of “capable” has no place in Oklahoma law interpreting oil and gas leases.

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