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## RECENT DEVELOPMENTS IN OIL AND GAS HABENDUM CLAUSE AND SAVINGS CLAUSE INTERPRETATION

EMILY RICHARD\*

### *I. Introduction*

The oil and gas industry relies on the symbiotic relationship between mineral owners and oil companies. The majority of mineral rights in the United States are privately owned as fractional interests in small tracts.<sup>1</sup> These mineral owners generally lack the capital or expertise to explore, drill, and develop the oil and gas. It is in their interest to transfer those rights to an oil company who has the capital and expertise to develop the land. The oil and gas lease is the most important document in oil and gas production, because it outlines the arrangement between the parties. Most courts treat oil and gas leases as both conveyances and contracts.<sup>2</sup> “A lease is a conveyance because it is the legal instrument by which the mineral owner conveys a property right to an oil company to explore for and produce oil and gas, reserving a royalty interest in production.”<sup>3</sup> A lease is also a contract “because it is burdened with certain express and implied promises.”<sup>4</sup> It is typical for parties to modify the printed lease form, and

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\* University of Oklahoma College of Law, JD Candidate 2023. This article is dedicated to Admiral Charles Richard and Mrs. Lisa Richard. Special thanks to Professor Paul Trimble and to the ONE-J Editorial Board.

1. John Lowe & Owen Anderson et al., *Cases and Materials on Oil and Gas Law* 190 (7th ed. 2018).

2. *Id.* at 189.

3. *Id.*

4. *Id.*

during their negotiations will alter common default provisions. Though minor alterations can be made and initialed in the margins, extensive alterations are often included in a lease addendum signed by both the lessor and the lessee.<sup>5</sup>

These leases are typically pre-printed forms drafted or chosen by the lessee, the oil company, who contacts mineral owners about leasing.<sup>6</sup> Therefore, these pre-printed lease forms will reflect the two baseline goals of the lessee. The first goal of the lessee is to obtain “the rights to explore, drill, develop, and produce for an initial term without obligations to do so.”<sup>7</sup> This initial term is called the primary term, and it usually lasts for a few years.<sup>8</sup> This period of time is outlined in the habendum clause of the lease.<sup>9</sup> The lessee’s second goal is to obtain the right to maintain the lease for as long as it is advantageous to the lessee.<sup>10</sup> Since it is difficult to determine how long a lease will produce oil and gas, and thus be advantageous to the lessee, a fixed term is not in the lessee’s interest. The habendum clause will often include language that will maintain the lease only if there is “production in paying quantities” or a similar indefinite period. This period is called the secondary term.<sup>11</sup>

The mineral owner, or lessor, has fundamental goals and interests as well. As previously mentioned, the lessor wants to find an entity to explore, produce and market oil and gas from the premises. They earn a financial benefit primarily through bonuses and royalties. Typically, once the lease is in place, the lessee will simultaneously pay the lessor a cash payment, called a bonus.<sup>12</sup> The value of the bonus is typically a certain dollar amount per net mineral acre leased.<sup>13</sup> The value of the bonus can also depend on the length of the primary lease term. A primary lease term that is considered to be long, such as ten years, would justify a larger bonus than if the lease had a shorter primary term.<sup>14</sup> If oil and gas is produced from the lease, “the lessor receives a royalty that is usually based upon the quantity of the production, its value, or the price the lessee receives when it is sold.”<sup>15</sup>

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5. *Id.*

6. *Id.*

7. *Id.* at 190.

8. *Id.* at 189.

9. *Id.*

10. *Id.*

11. *Id.* at 190.

12. *Id.* at 191.

13. *Id.*

14. 2 Kuntz, *Law of Oil and Gas* (2021).

15. Lowe, *supra* note 1, at 191.

These leases are contracts, so interpretative disputes are often resolved through breach of contract lawsuits.

This article samples recent case law on oil and gas lease interpretation regarding the secondary term, retained acreage clauses, and savings clauses, and broadly analyze the pitfalls of lease construction. Section I introduces the habendum clause and the oil and gas lease. Section II provides an overview of the savings clauses, pooling clauses and retained acreage clauses. Sections III through X analyze recent case law from several states addressing various secondary term, savings clause, and retained acreage clause disputes. Section XI examines the particularities of oil and gas contracting and addresses possible solutions.

## *II. Background on the Habendum Clause*

An oil and gas lease's Habendum clause, or term clause, expresses the duration of the lease.<sup>16</sup> The lease is typically composed of a primary and secondary term. The primary term is a "fixed term of years, generally ranging from one to five years, during which the lessee has the right, without the obligation, to explore for oil and gas on the leased premises".<sup>17</sup> However, the primary term is not as secure as its purpose may suggest. As a contract, leases are subject to implied promises. Historically, this promise included the "implied covenant to drill an initial test well."<sup>18</sup> To avoid this obligation, lessees would include a delay rental clause. This clause allowed the lessee to avoid this drilling obligation and still maintain the lease throughout the primary term by paying periodic delay rentals, usually on an annual basis.<sup>19</sup> Courts have generally upheld this clause, which allows delay rental payments to obviate the implied covenant to drill an initial test well.<sup>20</sup> These delay rental payments are usually nominal and paid per net mineral acre leased. Delay rental clauses are increasingly rare, as lessees typically favor using "paid up" leases, which expressly allow the lessee to maintain the lease for the full primary term without an obligation to drill a test well.<sup>21</sup> These leases allow the lessee to pay the entirety of the sum up front, avoiding the annual payments in a delay rental clause.

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16. *Id.* at 226.

17. *Id.*

18. *Id.* at 227.

19. *Id.*

20. *Id.*

21. *Id.*

The primary lease can also be maintained through operations, “[m]ost oil and gas leases provide that a lessee may maintain its rights during the primary term by commencing a well.”<sup>22</sup> Most oil and gas leases are drafted to terminate at the end of the primary term unless the lessee is actively engaged in operations or is producing oil or gas.<sup>23</sup> “A well completion or operations saving clause extends the lease if the lessee is engaged in required operations at the end of the primary term.”<sup>24</sup> These clauses are also called commencement provisions and can be included within a delay rental clause.<sup>25</sup> Courts are often called upon to determine if a well has been commenced under the provisions of the drilling clause.<sup>26</sup> The factors which have been considered in determining whether or not a well had been commenced include (a) acts on the premises, (b) good faith of the lessee, and (c) diligence in continuing drilling operations.<sup>27</sup> If a lessee ceases preliminary operations without penetrating the surface or without completing the drilling operation, then it is necessary to consider the lessee’s objective for its preparatory activity.<sup>28</sup> The general rule is that a lessee has commenced a well if operations have been conducted on the land in good faith preparation for the drilling of a well for oil and gas and have been continued in good faith and with due diligence.<sup>29</sup> It is generally held that acts which are preparatory to drilling are sufficient to constitute the commencement of a well and that it is not essential that the lessee be in the process of making hole.<sup>30</sup> However, language may be added to the lease or related contract which requires that the lessee penetrate the surface with drilling equipment and be in the process of making hole.

The secondary term is the extended period of the lease that is initiated after the lessee explores and develops the lease premises and allows the lessee to hold the lease premises for as long as production continues.<sup>31</sup> A universal definition of “production” for the purposes of these clauses does not exist between jurisdictions.<sup>32</sup> Some states require the lessee to have a well that is actively producing in paying quantities, while others require the

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22. *Id.* at 244.

23. *Id.* at 251.

24. *Id.* at 244.

25. *Id.* at 245.

26. Kuntz, *supra* note 14, at § 32.3.

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. Lowe, *supra* note 1, at 226.

32. *Id.* at 251.

well be merely capable of producing in paying quantities.<sup>33</sup> There is a tension between the competing interests of the lessor and lessee; the lessor seeks to profit from the royalty revenue from production, but it is the lessee who bears the risk when drilling wells and seeking to maintain control over the drilling operations. Lessors are more amenable to longer fixed terms when the drilling operations are speculative.<sup>34</sup> When nearby drilling or exploratory operations have proven the productive value of the land, lessors will be in favor of shorter primary terms. Under conditions where the lessee is prepared to commence drilling operations, a primary term may only last several months. The lease in those cases is designed to permit the lessee to complete the proposed well and continue operations into the secondary term.<sup>35</sup>

As previously mentioned, the “production in paying quantities” element to the secondary term has been the subject of disagreement among courts. A two-part test exists, which includes an objective and subject test. The objective test seeks to determine whether operating revenues exceed operating expenses over a reasonable period of time. The operating revenues are calculated as the gross amount for all sales minus the gross production taxes and lessor’s royalty. The operating expenses, also called lifting costs, include expenses directly related to the lifting of the product, such as pump operations, pumper’s salaries, saltwater disposal, well repairs, transportation and fuel. They are the “boots on the ground” costs and do not include administrative costs such as lease acquisition costs, or one-time expenses such as drilling, completing, and equipping the well. It has been suggested that the phrase “over a reasonable period of time” must be “sufficiently long to provide the information which a prudent operator would take into account in deciding whether to continue or to abandon the operation.”<sup>36</sup> As a general matter, courts usually do not consider a period less than one year.<sup>37</sup>

The Lease Operating Statement is a good starting point to determine if a given well is producing in paying quantities. It is not designed to respond to a lease cancellation suit, but to provide information on the status of the well. Though the lessee will provide a value at the end of each month, it is viewed holistically, as opposed to month to month. This reasonable period of time standard is in place because it is common to have good and bad

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33. *Id.*

34. Kuntz, *supra* note 14, at § 26.1.

35. *Id.*

36. Kuntz, *supra* note 14, at § 26.7.

37. Lowe, *supra* note 1, at 270.

months in the oil and gas industry. If in one given month, lifting costs exceed operating revenues, that is not dispositive that the well is not producing in paying quantities. If the objective test is satisfied, and operating revenues exceed lifting costs over a reasonable period of time, the lease is considered as producing in paying quantities and the inquiry ends.

If the objective test fails, the subjective test is utilized, which seeks to determine whether the failure to produce in paying quantities is reasonable and justified when considering all circumstances. The circumstances that can provide justification include accidents, maintenance, repair, and the temporary loss of market for the product. The lessee cannot maintain the lease for speculative purposes. The court will determine whether the lessee is seeking to hold the lease for speculative purposes or if a reasonably prudent operator is attempting to address issues and resume production.

### *III. The Impact of Savings Clauses*

An important contractual inquiry under any oil and gas lease is whether a savings clause imposes new conditions that must be satisfied in addition to the basic production requirement under the habendum clause.<sup>38</sup> As previously mentioned, savings clauses are designed to broaden the habendum clause by specifying events that will continue the lease or interest in effect, despite a failure to satisfy the habendum clause.<sup>39</sup> If the habendum clause is independently satisfied, the savings clause is unnecessary to extend the lease term.<sup>40</sup> The state of production for a given oil and gas lease may not fit neatly into the primary and secondary term definitions. For example, a lease may not be currently producing, but the lessee is in the process of drilling a new well when the primary term expires. The continuous drilling clause and the continuous operations clauses are designed to address this problem and solidify the lessee's right to complete a drilling operation that was commenced during the primary term.<sup>41</sup>

Though the names seem similar, they do contain important differences. The continuous drilling clause has also been referred to as the well completion clause. This clause is designed to allow the lessor to permit the

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38. David E. Pierce, *Maintaining the Oil and Gas Lease Beyond the Primary Term*, The Eugene Kuntz Conference on Natural Resources Law and Policy, 2 (2008), [https://www.washburnlaw.edu/profiles/faculty/activity/\\_fulltext/pierce-david-2008-eugene-kuntzconference.pdf](https://www.washburnlaw.edu/profiles/faculty/activity/_fulltext/pierce-david-2008-eugene-kuntzconference.pdf).

39. *Id.*

40. *Id.*

41. Kuntz, *supra* note 14, at § 47.4.

lessee to complete a drilling operation that was commenced during the primary term and extend the term of the lease for that specific purpose.<sup>42</sup> The continuous operations clause is designed not only to permit the lessee to complete a well that was being drilled as the primary term expired, but also permits the lessee to commence other operations within the prescribed time.<sup>43</sup>

The burden of showing “production” to maintain the secondary term of the lease is placed on lessees.<sup>44</sup> This is a heavy demand on the lessee, who may fail to meet these production requirements despite careful planning and actions taken in good faith.<sup>45</sup> Therefore, most modern oil and gas leases include additional savings clauses such as shut-in clauses, cessation-of-production clauses, dry-hole clauses, force-majeure clauses, and pooling clauses.<sup>46</sup> These lease savings clauses furnish the lease with substitutes for production, often called “constructive production,” that function to extend the lease.<sup>47</sup> When courts are asked to apply lease savings clauses in contract disputes over the maintenance of the lease, an evaluation is made on “(1) whether the clauses provide for constructive production and (2) whether the requirements for constructive production have been satisfied.”<sup>48</sup>

Force majeure clauses are written to preserve a lease when circumstances beyond the lessee’s control prevent operations and interfere with production.<sup>49</sup> These clauses assume the lease provisions cannot be performed despite due care and unavoidable issues.<sup>50</sup> Contract disputes can arise when parties disagree on whether the force majeure clause applies to a given situation. Force majeure clauses are analyzed through a four-step evaluation:

A force-majeure clause has been described as providing constructive production of an oil and gas lease if “(1) the event complained of is defined as a force-majeure event by the language of the clause, (2) production is excused by the event defined as force majeure, (3) there is causal relationship between

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42. *Id.*

43. *Id.*

44. Lowe, *supra* note 1, at 273.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at 296.

50. *Id.*

the event defined as force majeure and the failure of production, and (4) the lessee gives timely notice, if the clause requires it.”<sup>51</sup>

Force majeure clauses are not overly common in oil and gas leases, and “judicial willingness to find oil and gas leases terminated by lack of production may explain the paucity of reported cases in which force majeure is raised as a defense.”<sup>52</sup> However, due to the court’s application of the traditional principles of equity, a lease lacking a force majeure clause does not entirely prevent a court from considering a lessee’s explanation for failure to production when the reasons are beyond his control.<sup>53</sup> The majority of courts have ruled that when a lessee failed to exercise due care and diligence to overcome the alleged condition or failed to explore alternative options to overcome the condition, the force majeure clause cannot act to excuse the nonperformance.<sup>54</sup> Courts are historically strict on force majeure clauses in the oil and gas industry due to the inherently competitive and time sensitive nature of oil and gas leases. The consideration of the lease is reliant on the payment of royalties, so when production ceases, the lessors’ land is burdened by a lease that is profitless due to the lessee’s action or inaction. And since the lessor is contractually locked into the profitless lease, other operators on surrounding land may be producing oil “to his irreparable injury” due to the competitive nature of the industry.<sup>55</sup>

#### *IV. Efforts to Sever the Lease Acreage: Pooling Clauses and Retained Acreage Clauses*

Oil and gas pooling is the result of lessees’ objective to conduct operations on configurations that do not fit neatly into their leasehold interests.<sup>56</sup> This can happen frequently as the geology of an oil and gas producing formation is not subject to the geography of the acreage units that are defined by individuals and courts. Lessees must also comply with their respective state’s conservation agency, which can set standards such as minimum-acreage requirements which may require the lessee to conduct

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51. *Id.* at 301, 302.

52. Joan Teshima, Annotation, *Gas and oil lease force majeure provisions: construction and effect*, 46 A.L.R. 4th 976, § 2[a] (1986).

53. *Id.*

54. *Id.*

55. *Id.*

56. Lowe, *supra* note 1, at 305.



operations that do not fit squarely within land ownership boundaries.<sup>57</sup> The pooling clause “gives a lessee the right to combine leases, or parts of leases, covering tracts or fractional mineral interests for drilling and to apportion production to each interest.”<sup>58</sup> Production from the lease is viewed as operations upon and production from anywhere on the pooled acreage. While pooling can be voluntary, all oil and gas producing states, other than Kansas, have enacted some variation of a forced pooling statute.<sup>59</sup> They occur through a regulatory process, and force mineral owners to participate in production while being justly compensated.<sup>60</sup> In order to force pool, applicants must have an established spacing unit, have previously tried to enter into a joint operating agreement or lease with each owner, and be the owner of the right to drill. These proceedings frequently take place in front of an administrative law judge and are adversarial in nature.

When force pooling is not at issue, and lessors and lessees are in conflict over the pooling, Pugh clauses are often utilized to provide a compromise.<sup>61</sup> Pooling clauses grant the lessees considerable power to unilaterally alter the lease agreement by bringing leases together and conducting operations across combined acreages. Pugh clauses, however, empower lessors and work to rebalance the dynamic between the parties. Pugh clauses limit the constructive-production effect of typical pooling provisions to require that operations on or production resulting from a pooled unit will preserve only that portion of the lease included in a pooled unit.<sup>62</sup> The end result of the clauses separates the lease into pooled and unpooled parts.<sup>63</sup> This is a huge benefit for lessors, because although the lessors’ royalty is still diluted proportionally, the unit operations do not hold that portion of the leased acreage not included in the pooled unit. Pugh clauses may not operate when the acreage is subject to forced pooling.<sup>64</sup> However, some forced pooling statutes also contain Pugh-like provisions.<sup>65</sup>

Pugh clauses are defined as either vertical, horizontal, or both.<sup>66</sup> Vertical Pugh clauses sever the lease “into a pooled tract from the surface to the

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57. Lowe, *supra* note 1, at 306.

58. *Id.*

59. *Id.* at 762.

60. *Id.*

61. *Id.* at 324.

62. *Id.*

63. *Id.*

64. *Id.* at 325.

65. *Id.*

66. *Id.*

center of the earth and an unpooled tract from the surface to the center of the earth.”<sup>67</sup> Pugh clauses that operate horizontally sever the leased premises between pooled formations and unproductive formations by depth. An example horizontal Pugh clause reads: “this lease shall terminate automatically as to all horizons situated 100 feet below the deepest depth drilled... from which a well ... is producing in paying quantities.”<sup>68</sup>

A retained acreage clause, also called a continuous-development clause, divides a lease as drilling or proration units are formed. The result of this clause is that “production from one unit extends the lease secondary term only as to land within the productive unit.”<sup>69</sup> This clause, which can also operate to divide the lease horizontally, “modifies the secondary term of the habendum clause by limiting the lease acreage held by production.”<sup>70</sup> Retained acreage provisions are often drafted ineffectively because they are often added to a printed lease form during lease negotiations, resulting in a lease that is disjointed or contradictory.<sup>71</sup> The following cases illustrate how the ineffective drafting of clauses found in oil and gas leases can result in expensive, lengthy legal battles.

#### *V. Sundown Energy & the Definition of “Drilling-Operations”*

In *Sundown Energy LP v. HJSA No. 3, Ltd. P’ship*, the Supreme Court of Texas reviewed a contract dispute involving a mineral lease’s “continuous drilling program” provision. The Lessor HJSA No. 3 LP (“HJSA”) and lessee Sundown Energy LP (“Sundown”) were parties to an oil and gas lease covering a 30,450-acre parcel of land in Ward County, Texas.<sup>72</sup> The lease became effective in August 2000 and featured a six-year primary term. During the primary term, the lease for the entire parcel could be maintained through production in paying quantities from anywhere on the leased premises.<sup>73</sup> At the end of the 6-year term, Sundown was required to “reassign to Lessor ... all of Lessee’s operating rights in [each individual tract] of the lease not then held by production’ unless Sundown was engaged in a ‘continuous drilling program.’”<sup>74</sup>

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67. *Id.*

68. *Id.*

69. *Id.* at 326.

70. *Id.*

71. *Id.*

72. *Sundown Energy LP v. HJSA No. 3, LP*, 622 S.W.3d 884, 886 (Tex. 2021).

73. *Id.*

74. *Id.*

[7](b) The obligation ... to reassign tracts not held by production shall be delayed for so long as Lessee is engaged in a continuous drilling program on that part of the Leased Premises outside of the Producing Areas. The first such continuous development well shall be *spudded-in* on or before the sixth anniversary of the Effective Date, with no more than 120 days to elapse between completion or abandonment of operations on one well and commencement of *drilling operations* on the next ensuing well.

In the oil and gas industry, “spudding-in” is a term of art that means “[t]he first boring of the hole in the drilling of an oil well.”<sup>75</sup> The phrase “drilling operations” is defined in Paragraph 18 of the lease:

*Whenever used in this lease* the term “drilling operations” shall mean: [1] actual operations for drilling, testing, completing and equipping a well (spud in with equipment capable of drilling to Lessee's object depth); [2] reworking operations, including fracturing and acidizing; and [3] reconditioning, deepening, plugging back, cleaning out, repairing or testing of a well.

Before the primary term expired, Sundown satisfied the requirement in Paragraph 7(b), that a timely spudded “first such continuous development well” be placed by spudding in three development wells.<sup>76</sup> Sundown then proceeded to engage in other activities under the Paragraph 18 definition of “drilling operations” from 2006 to 2015, including drilling fourteen development wells.<sup>77</sup> Sundown spent approximately \$40 million developing the lease.<sup>78</sup> HJSA filed suit seeking a declaration that the lease of the non-producing tracts terminated in 2007 due to Sundown’s failure to participate in a “continuous drilling program,” as Sundown had not spud-in a new well every 120 days after the completion or abandonment of operations on a prior well.<sup>79</sup> At the trial court, summary judgment was granted for the lessee.<sup>80</sup> A divided court of appeals reversed, finding that the meaning of

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75. *Id.* at n.1.

76. *Id.* at 886.

77. *Id.*

78. John McFarland, *Sundown Energy v. HJSA No. 3 Limited Partnership: Another Poorly Drafted Retained Acreage Clause*, Oil and Gas Lawyer Blog (Apr. 11, 2021), <https://www.oilandgaslawyerblog.com/sundown-energy-v-hjsa-no-3-limited-partnership-another-poorly-drafted-retained-acreage-clause/>.

79. *Sundown Energy LP*, 622 S.W.3d at 887.

80. McFarland, *supra* note 73.

“drilling operations” in the continuous development provision was intended to be narrower than its usage elsewhere in the lease. The case was then taken up the Supreme Court of Texas.<sup>81</sup>

Sundown argued that under the plain language of the lease, the non-producing tracts could be held by engaging in any of the three categories of “drilling operations.”<sup>82</sup> The parties were in agreement that if the controlling definition of “operations” is taken from Paragraph 18, Sundown adequately met the requirements of the continuous drilling program and therefore held those tracts from reassignment back to the lessor.<sup>83</sup> Sundown noted that the lease expressly provides “whenever” the phrase “drilling operations” is used in the lease, the definition from Paragraph 18 applied. The Court held that the lease requires “drilling operations” in Paragraph 7(b) to include all of the operations Paragraph 18 offers and is not limited to spudding-in a new well.<sup>84</sup> The Court emphasized that it applied the same principles in the construction of both contracts and mineral leases.<sup>85</sup> The Court noted it would not substitute “spudded-in” for “drilling operations” when the parties chose not to in their express agreement.<sup>86</sup> The holding in *Sundown Energy* reinforced that courts will not find a special limitation unless the contract language is so clear, precise, and unambiguous that the Court could reasonably give it no other meaning. The lessor failed to ensure its intent was clearly expressed and needed to specify “drilling operations” to include only the drilling of new wells.<sup>87</sup>

The Court addressed HJSA’s concern that Sundown could theoretically use the broader definition of “drilling operations” from Paragraph 18 to stymie production. As the lessor, they have an interest in the royalty payments from production. The lessor gains value from productive wells, whereas the lessee’s central asset is not solely in the well that holds the lease, but the acreage held within the lease. The asset is holding the property for future development, not necessarily in a marginal well. However, the Court did not find this concern as compelling as upholding the lease’s express language.<sup>88</sup> The Court noted that the lease expressly imposed on Sundown an implied duty to reasonably develop the leased

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81. *Id.*

82. *Sundown Energy LP*, 622 S.W.3d at 887.

83. *Id.*

84. *Id.* at 888.

85. *Id.*

86. *Id.*

87. McFarland, *supra* note 73.

88. *Sundown Energy LP*, 622 S.W.3d at 889.

premises, notwithstanding any other language found in the lease, including the continuous drilling program.<sup>89</sup> The Court was not willing to disregard clear interpretation of lease language in order to address potential advantages that lessee's gain from broadly written continuous drilling clauses.

#### *VI. Endeavor Energy & the Importance of Specific Language*

These contract disputes can turn on the meaning of the smallest phrases. In *Endeavor Energy Resources, L.P. v. Energen Resources Corp.*, the parties were in dispute over the meaning of a retained acreage agreement.<sup>90</sup> The lease featured a three-year primary term and a secondary term that would last as long as oil or gas was produced in paying quantities.<sup>91</sup> The secondary term was subject to other provisions in the lease, including a "continuous-development clause" which allowed the lessee, Endeavor Energy Resources ("Endeavor") to retain the entire parcel's leasehold interest only by drilling a new well every 150 days. However, the lease also provided that Endeavor could "accumulate unused days in any 150-day term... in order to extend the next allowed 150-day term between the completion of one well and the drilling of a subsequent well."<sup>92</sup> Endeavor's failure to maintain the drilling schedule would result in termination of the lease as to the non-producing tracts. The court addressed how to calculate the number of "unused days." The relevant portion of the lease reads:

(c) This lease shall terminate as to all non-dedicated acreage any time a subsequent well is not commenced within one hundred fifty (150) days from the completion of a preceding well. Each well herein provided to be drilled, once spudded, shall thereafter be drilled with reasonable and continuous diligence to a depth below three thousand five hundred one feet (3,501') below the surface and shall be deemed to be completed ten (10) days after the drilling rig moves off the hole or upon removal of the completion rig, whichever is sooner. **Lessee shall have the right to accumulate unused days in any 150-day term during the continuous development program in order to extend the next**

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89. *Id.*

90. *Endeavor Energy Res., L.P. v. Energen Res. Corp.*, 615 S.W.3d 144 (Tex. 2020).

91. *Id.* at 146.

92. *Id.*

**allowed 150-day term between the completion of one well  
and the drilling of a subsequent well.**

Endeavor timely drilled new wells at the end of the primary term, extending the lease into the secondary term.<sup>93</sup> The first twelve wells were drilled without controversy, however, the thirteenth well was drilled 320 days after the completion of the twelfth.<sup>94</sup> Energen, the lessor, contested that Endeavor's lease had terminated due to excessive delay in drilling the thirteenth well.<sup>95</sup> Energen argued the continuous-development provision in the lease allowed unused days from a given 150-day term to carry over only to the immediately following term.<sup>96</sup> Endeavor argued that the provision allowed the lessee to accumulate unused days across multiple terms.<sup>97</sup> Endeavor had accumulated 377 days throughout the secondary term due to drilling earlier wells ahead of the mandatory schedule.<sup>98</sup> Alternatively, Endeavor argued the provision is ambiguous as to whether Endeavor may accumulate unused days across multiple terms and therefore cannot operate as a special limitation.<sup>99</sup> A special limitation in an oil and gas lease is a contractual term that "provides that the lease will automatically terminate upon the happening of a stipulated event."<sup>100</sup>

The dispute rests on the interpretation of one sentence. The parties contest over the words "any... term" as singular or plural, referring to the immediately preceding 150-day term or multiple 150-day terms.<sup>101</sup> The Court noted that the "analysis of the Lease's operative text is inconclusive" and that neither parties' interpretation is unreasonable based on the text alone.<sup>102</sup> Since the Court found the provision at issue to be ambiguous, it could not operate as a special limitation leading to termination of the leasehold interest.<sup>103</sup>

[I]t has long been the rule that contractual language will not be held to automatically terminate the leasehold estate unless that language . . . can be given no other reasonable construction than

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93. *Id.* at 147.

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.* at n.1.

101. *Id.* at 147.

102. *Id.* at 151-52.

103. *Id.* at 155.

one which works such a result.” *Knight*, 188 S.W.2d at 566 (citing *Decker*, 216 S.W. 38). As explained above, the Lease’s description of the drilling schedule required to avoid termination is ambiguous under these circumstances. Courts should not treat an obligation so “lacking in definiteness and certainty as introducing” into a lease a “limitation[] leading to . . . termination of [a] vested estate[.]” *W.T. Waggoner Estate*, 19 S.W.2d at 31. Because the disputed provision is ambiguous, it cannot operate as a special limitation under these circumstances.<sup>104</sup>

The *Decker* case cited by the Court is a 1919 case from the Supreme Court of Texas. There, the *Decker* Court found that:

“[i]f the provision is ambiguous, that alone condemns it as a forfeiture provision. A forfeiture should rest upon surer ground. Where a contract is so vague in its terms that a court cannot determine its meaning, it would be unjust to enforce a forfeiture under it against one whose only fault has been to possibly mistake its meaning . . . . [Forfeitures] are not favored by the law, and ought not to be. The authority to forfeit a vested right or estate should not rest in provisions whose meaning uncertain and obscure.”<sup>105</sup>

Noting the opinion from *Decker*, as well as the analysis in the *Knight* and *W.T. Waggoner Estate* cases, a judgment was rendered in favor of Endeavor as to title, and the case was remanded for further proceedings.<sup>106</sup>

Though ultimately unpersuasive, Energen contended that continuous-development (or continuous-operations) clauses are generally intended to “permit[] a lease to be preserved under certain circumstances, even though there is no production after the expiration of the primary term during *continuous* drilling operations.”<sup>107</sup> Energen argued that this category of clauses aimed to reach the requirement that development efforts “be continuous with no gap,” and the lessor’s goal was to avoid excessively long gaps.<sup>108</sup> The Court declined to place dispositive weight on any

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104. *Id.*

105. *Decker v. Kirlicks*, 216 S.W. 385, 386 (Tex. 1919).

106. *Endeavor Energy Res.*, 615 S.W.3d at 156.

107. *Id.* at 153 (quoting Patrick H. Martin & Brice M. Kramer, *Williams & Meyers Oil and Gas Law* § 617 (7th ed. 2018)).

108. *Id.* at 154.

proposed objectives of the contracting parties in the absence of clear text in the provision.<sup>109</sup> Endeavor prevailed; the Court determined that the continuous-development clause was ambiguous, and therefore declined to enforce the clause as a special limitation on Endeavor's leasehold interests.<sup>110</sup>

### *VII. MRC Permain & Force Majeure Clauses*

The designated secondary term of the oil and gas lease often interacts with several other types of savings clauses. As previously mentioned, the force majeure clause is invoked in situations outside of the lessee's control. In *MRC Permain Co. v. Point Energy Partners Permain LLC*, a former lessee filed suit against a lessor and a subsequent lessee to protect its leasehold interest following an attempted invocation of a force majeure clause.<sup>111</sup> The clause stated that MRC, the former lessee, could extend any continuous drilling deadline in the event of a non-economic event beyond its control which delayed operations.<sup>112</sup> The lease executed between MRC and the mineral owners featured a three-year primary term and automatically terminated the lease interest in "all lands and depths of the Leasehold Estate not then included in a production unit containing a Commercial Well . . . ."<sup>113</sup> The secondary term of the lease then applied to the lands held in the production unit, and would remain in effect "as long thereafter as oil or gas are produced from the Leasehold Estate in paying quantities . . . ."<sup>114</sup> The lease also featured language that allowed MRC to suspend the automatic termination of the primary term by conducting a continuous drilling program.<sup>115</sup> The program required MRC to begin drilling a new well within 180 days from the commencement of drilling its previous well. If MRC maintained this drilling schedule, it would maintain the leasehold estate for further development of new production units.<sup>116</sup> The court noted that within the oil and gas industry, this category of continuous drilling requirements is called "spud to spud drilling."<sup>117</sup> The Force Majeure

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109. *Id.*

110. *Id.* at 155.

111. *MRC Permain Co. v. Point Energy Partners Permain LLC*, 624 S.W.3d 643 (Tex. App. 2011).

112. *Id.* at 652.

113. *Id.* at 651.

114. *Id.* at 652.

115. *Id.*

116. *Id.*

117. *Id.*



clause required MRC to provide the lessors a reasonable written explanation of the problem within 60 days after commencement.<sup>118</sup> If MRC complied with the requirement, the lease would be preserved “during the continuance of such delay and up to 90 days after the removal of the force majeure.”<sup>119</sup>

MRC developed five wells on the leasehold estate on the date the primary term was set to expire.<sup>120</sup> In order to comply with the 180-day drilling schedule pursuant to the continuous drilling program, MRC had to begin drilling another well by May 21, 2017 or provide lessors with written explanation of a force-majeure event.<sup>121</sup> Failing to do so would automatically terminate MRC’s leasehold interest on all lands and depths not held by a production unit of a developed commercial well.<sup>122</sup> As the court carefully describes, under the language of the lease, if the force majeure event was encountered within 60 days of the 180-day continuous drilling deadline, MRC would not be obligated to provide notice to lessors of the event until after the deadline passed.<sup>123</sup> Due to this lease language, MRC could reasonably interpret the lease to be in effect given the force majeure savings clause. However, the lessor would be unaware due to a lack of notice and may interpret the lease as expired to all lands not held by production unit.<sup>124</sup> The dispute at issue is a direct result of the lack of required communication. Due to an encountered force majeure event, “lessors would not know for certain whether their lease had terminated until 60 days after MRC’s failure to spud a new well by a continuous-drilling deadline.”<sup>125</sup>

An MRC executive testified that MRC was using a specific rig for well drilling operations in the area in and around the leasehold estate, as drillers were encountering abnormally high pressures.<sup>126</sup> The equipment and more experienced crewmen made this specific rig was better suited to these pressures.<sup>127</sup> The rig encountered both administrative scheduling delays and geological factors that prevented it from conducting operations on the

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118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.* at 653.

125. *Id.*

126. *Id.*

127. *Id.*

leasehold at issue. Specifically, the rig encountered “unexpected wellbore instability” that required a reaming process, resulting a thirty-hour delay.<sup>128</sup> 53 days after the delay, MRC provided notice of the events to lessors, which was within the 60-day time allotment included within the force majeure clause, but this notice fell short of the continuous drilling deadline by several weeks.<sup>129</sup> MRC received a response by Point Energy, who stated that it entered into new leases with the lessors and acquired their rights to seek termination of MRC’s leases.<sup>130</sup> MRC filed suit seeking declaratory judgment on its use of the force majeure clause to extend the drilling deadline.<sup>131</sup> The trial court granted Point Energy’s motion for summary judgment on whether the leases were entirely extended by the operation of the force majeure clause.<sup>132</sup> The summary judgment ruling was found to be in error, and the appeal sought to determine whether the lease automatically terminated all lands not held in a production unit, and if so, to determine the acreage retained in production units.<sup>133</sup>

The court noted in its standard of review that the “scope and effect of a ‘force majeure’ clause depends on the specific contract language, and not on any traditional definition of the term.”<sup>134</sup> Point Energy argued that the force majeure encounter cannot originate at an off-lease location and must be encountered on the leasehold estate.<sup>135</sup> MRC disagreed, urging that requirement was added language and a limitation not included by the parties in the lease terms. The court agreed with MRC, noting, “if the parties had intended the force majeure clause to only cover on-lease delays, the provision would presumably have included requirements where the location of the triggering event must occur.”<sup>136</sup> The court noted the specific requirements included in the force majeure clause, such as the 60-day notice window. The court was strict in maintaining the position that it will “not add conditions based on what the parties now argue they intended for the lease but failed to include in its terms.”<sup>137</sup> The court strictly construed the force majeure clause’s language and found that off-lease delays can fall

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128. *Id.*

129. *Id.*

130. *Id.* at 654.

131. *Id.* at 655.

132. *Id.*

133. *Id.*

134. *Id.* at 657. (quoting *Va. Power Energy Mktg., Inc. v. Apache Corp.*, 297 S.W.3d 397, 402 (Tex. App. –Houston [14th Dist.] 2009, pet. denied)).

135. *Id.* at 658.

136. *Id.* at 659.

137. *Id.* at 659. (quoting *URI, Inc. v. Kleberg Cnty.*, 543 S.W.3d 755, 758 (Tex. 2018)).

within the scope of the clause.<sup>138</sup> They further held that such delays are not required to be a substantial factor in MRC's failure to meet the continuous drilling deadline.<sup>139</sup> The court found that the lease was unambiguous in that it did not require the force majeure encounter to be the "direct link" in MRC's failure to meet the continuous drilling deadline.<sup>140</sup> Pursuant to the lease language, MRC only needed to have operations delayed by a non-economic event that was outside of its control.<sup>141</sup> The court further noted that even if the force majeure clause featured an implied causation requirement, there was a genuine issue of material fact over whether the offsite wellbore instability did directly cause MRC to miss the deadline.<sup>142</sup> The MRC executive testimony noted the occurrence as "extraordinary," "unforeseeable," and non-economic in that the instability blocked a hole, preventing the crew from continuing production operations.<sup>143</sup> Due to this conflicting evidence, the court found summary judgment was inappropriate.<sup>144</sup> The *MRC Permain Co.* case illustrates courts' unwillingness to insert constraints not evident in the lease's language.

In the *MRC Permain Co.* case, Point Energy wrote to MRC that without providing sufficient information showing MRC complied with the continuous development program, they were concerned that MRC's entry onto the leasehold estate to drill the intended well "may constitute bad faith trespass."<sup>145</sup> Bad faith trespass occurs when the trespasser knows they lack the right to conduct operations on the acreage. If MRC had been deemed a bad faith trespasser, they would be ejected from the leasehold estate, unable to keep the value of any reserves, and unable to recover any drilling costs.

### *VIII. Lawson and Commencement on Off-Unit Acreage*

Pooling clauses often interact with continuous drilling provisions. In *Lawson v. Citizen Energy II, LLC*, the Court of Civil Appeals of Oklahoma addressed an issue of first impression: whether commencement operations on acreage off-unit satisfies the commencement clause.<sup>146</sup> Acreage off-unit

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138. *Id.* at 662.

139. *Id.*

140. *Id.* at 660.

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.* at 661.

145. *Id.* at 654.

146. *Lawson, Trustee of Harold Lawson Living Trust v. Citizen Energy II, LLC*, 2021 OK CIV APP 1, ¶ 8, 481 P.3d 287 (OK CIV APP 2020).

is defined as property not included in an extant spacing unit or included in a pending application for a drilling and spacing unit.<sup>147</sup> The lessee was granted an application for a multi-unit horizontal well across Sections 11 and 14.<sup>148</sup> The lease at issue stated that the lessee must “commence to drill a well . . . within the term of the lease . . . or on the pooled acreage pooled therewith.”<sup>149</sup> The lessor argued that the lessee must physically enter and commence drilling on the leased or pooled acreage within the lease’s primary term.<sup>150</sup> The lessee countered that physical entry was not required, and that commencement of drilling in Section 14 would function to extend the lease.<sup>151</sup> The Court noted that the Oklahoma Supreme Court has “interpreted ‘commence to drill’ language in an oil and gas lease to mean something less than actual spudding of a well, absent specific language in the lease to the contrary.”<sup>152</sup>

The court’s ruling draws heavily on the *Kuykendall v. Helmerich & Payne, Inc.* case, wherein the Oklahoma Supreme Court held that a lease’s commencement clause along with statutory provisions “had the legal effect of continuing the lease where the drilling was commenced to the common source of supply named in the application.”<sup>153</sup> The *Kuykendall* opinion was handed down in 1987, and the *Lawson* court notes that the Oklahoma legislature has attempted to modernize its statutes to reflect the technological advances in the oil and gas industry. Multi-unit horizontal wells were specifically authorized in 52 O.S. § 87.8 and provides that these wells “shall be treated as a well in each of the affected units;” the Court further supplies that “affected” is defined as “attached to” or “deliberately chosen.”<sup>154</sup> In this case, the Corporation Commission authorized a multi-unit horizontal well for Section 11 and Section 14—two separately spaced and pooled units that target a common source of supply.<sup>155</sup> As Sections 11 and 14 are affected units, the court ruled that “a multi-well horizontal well drilled in the Section 14 unit is treated as a well in the Section 11 unit.”<sup>156</sup> Commencement operations conducted in the Section 14 unit during the

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147. *Id.* at ¶ 9.

148. *Id.* at ¶ 2.

149. *Id.* at ¶ 7.

150. *Id.*

151. *Id.*

152. *Id.* at ¶ 12.

153. *Id.* at ¶ 10.

154. *Id.* (quoting 52 O.S. § 87.8).

155. *Id.* at ¶ 11.

156. *Id.* at ¶ 14.

primary term of the lease would extend the lease if the well commenced is completed as a producing well.<sup>157</sup> The Court noted that such a holding supported the legislature's intent and the Corporation Commission's directive to reduce waste and protect the correlative rights of owners.<sup>158</sup>

### *IX. Johnson and Pugh Clause Conflicts*

In *Johnson v. Statoil Oil & Gas LP*, the Supreme Court of North Dakota reversed a district court finding that a lease's continuous drilling operations clause extended the primary term.<sup>159</sup> The lease at issue contained a habendum, continuous drilling operations, and Pugh clauses. The habendum and continuous drilling operations clauses were included in the form oil and gas lease, and the parties added the Pugh clauses to the form leases.<sup>160</sup> The habendum clause provided for a three year primary term, and a secondary term lasting as long as production is occurring on the leased premises or pooled acreage, or drilling operations are continued as provided in the continuous drilling operations clause.<sup>161</sup> The continuous drilling operations clause, standard to the oil and gas clause, read:

If, at the expiration of the primary term of this lease, oil or gas is not being produced on the leased premises or on acreage pooled therewith but Lessee is then engaged in drilling or reworking operations thereon, then this lease shall continue in force so long as operations are being continuously prosecuted on the leased premises or on acreage pooled therewith, and operations shall be considered to be continuously prosecuted if not more than ninety (90) days shall elapse between the completion or abandonment of one well and the beginning of operations for the drilling of a subsequent well. . . . If oil or gas shall be discovered and produced as a result of such operations at or after the expiration of the primary term of this lease, this lease shall continue in force so long as oil or gas is produced from the leased premises or on acreage pooled therewith.<sup>162</sup>

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157. *Id.*

158. *Id.* at ¶15.

159. *Johnson v. Statoil Oil & Gas LP*, 2018 ND 227, ¶ 1, 918 N.W.2d 58.

160. *Id.* at ¶ 3.

161. *Id.* at ¶ 3.

162. *Id.* at ¶ 4.

The lease's Pugh clause read as follows:

Notwithstanding anything to the contrary, on expiration of the primary term of the lease, the lease shall terminate as to any part of the property not included within a well unit or units, as established by appropriate regulating authority, from which oil or gas is being produced in paying quantities and shall also terminate as to 100' below geologic strata or formations from which production has not occurred during the primary term.<sup>163</sup>

The Pugh clause seeks to divide the lease both vertically and horizontally. The clause divides the lease vertically by terminating the lease on acreage not included in a well unit, and horizontally by terminating the lease by depth by excluding formations below the deepest producing formation.

The parties agreed that three of the eight units, known as the undisputed units, were producing at the end of the primary term.<sup>164</sup> The issue arose from the five remaining units—the disputed units. The lessor, Johnson, argued the Pugh clause terminated the lease on the disputed units because they were not being held in production of paying quantities.<sup>165</sup> The lessee, Statoil, argued the drilling operations at the end of the primary lease acted under the continuous drilling operations clause to extend the leases for both the undisputed and disputed units.<sup>166</sup> The court noted that while generally, oil and gas leases are by their nature indivisible, a clear and explicit Pugh clause can make a lease divisible.<sup>167</sup> The court found the Pugh clause at issue to be unambiguous.<sup>168</sup> The parties agreed that the disputed units were not producing in paying quantities.<sup>169</sup>

Statoil argued that although the Pugh clause limited the extension of the leases, when the provisions are viewed in their totality, a “harmonizing” of these provisions.<sup>170</sup> This allowed for the extension of the lease as to the non-producing units by the drilling operations that satisfied the continuous drilling clause.<sup>171</sup> The court noted, “[b]ecause Pugh clauses vary widely in form, the interpretation of how a Pugh clause may affect other provisions in

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163. *Id.*

164. *Id.* at ¶5.

165. *Id.*

166. *Id.*

167. *Id.* at ¶ 9 (quoting *Egeland v. Cont'l Res., Inc.*, 2000 ND 169, ¶ 16, 616 N.W.2d 861 (N.D. 2000)).

168. *Id.* at ¶ 9.

169. *Id.*

170. *Id.* at ¶ 11.

171. *Id.*

a lease may also vary.”<sup>172</sup> Statoil cited *Egeland*, wherein the Court interpreted a Pugh clause to support extending a lease beyond the primary term.<sup>173</sup> The Court was unpersuaded, distinguishing *Egeland*; the Pugh clause at issue did not contemplate the effect of drilling operations or any method of extension.<sup>174</sup> Furthermore, the lease in *Egeland* did not encounter a conflict between the Pugh clause and the habendum and continuous drilling operations clauses of the lease like the case at issue.<sup>175</sup> Here, the Pugh clauses included an express limitation on the methods capable of extending the leases, whereas the habendum and continuous drilling operations clauses provide for both production and drilling as methods to extend the lease.<sup>176</sup> The Pugh clause at issue applied “[n]otwithstanding anything to the contrary” within the lease.<sup>177</sup> Therefore, Court held the Pugh clauses provide both the acreage subject to an extension and the extension method.<sup>178</sup> In its reasoning the Court referenced its prior ruling in *Tank*, wherein the court addressed whether the continuous operations or Pugh clause controlled when a contradiction occurred.<sup>179</sup> The Court interpreted the lease as giving effect to both clauses, with the Pugh clause controlling when conflict arose.<sup>180</sup> Pugh clauses do not require contemplation of the exact words “drilling operations” in order to control over a continuous operations clause—they require an individualized interpretation.<sup>181</sup>

The *Johnson* Court held that the continuous drilling operations and habendum clauses were irreconcilable and incapable of harmonization with the lease’s Pugh clause.<sup>182</sup> The Court noted that “parts of the contract that are purely original control those parts which are copied from a form.”<sup>183</sup> As the Pugh clauses were original and added by the parties to the lease forms, the Pugh clause is controlling. The Pugh clause provides oil and gas production in paying quantities as the method of extension, and as such, the

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172. *Id.* at ¶ 12 (quoting *Tank v. Citation Oil & Gas Corp.*, 2014 ND 123, ¶ 32, 848 N.W.2d 691 (N.D. 2014)).

173. *Id.* at ¶ 12.

174. *Id.* at ¶ 13.

175. *Id.*

176. *Id.* at ¶ 14.

177. *Id.*

178. *Id.*

179. *Id.* at ¶ 15.

180. *Id.*

181. *Id.*

182. *Id.* at ¶ 16.

183. *Id.* at ¶ 17 (citing Section 9-07-16, N.D.C.C.).

lease could not be extended as to the disputed, non-producing units by the continuous drilling operations clause.<sup>184</sup>

#### *X. Vermillion and the Impact of Regulatory Language*

Aspects of the oil and gas industry can vary widely by state, especially in terms of regulation. For example, the Texas Railroad Commission (“RRC”) began regulating the oil and gas industry within the state in the late 1800s.<sup>185</sup> The RRC’s current role is a steward of the state’s natural resources<sup>186</sup> The RRC carries out its duties primarily through promulgating spacing rules, handing down “field rules,” and setting “allowables.”<sup>187</sup> The spacing depends on operators (lessees) assigning certain acreage to wells in a proration unit, which designate “the acreage assigned to a well in order to allocate production allowables to that well.”<sup>188</sup> Production allowables are the “maximum amount of hydrocarbons a well may recover . . . and are designed to limit production from a well in order to control the rate of production from the field.”<sup>189</sup> Field rules are rules adopted by the RRC detailing specific regulations for specific production across the state to “accommodate unique circumstances existing within particular production areas.”<sup>190</sup>

The Court of Appeals of San Antonio recently determined the impact of the phrase “notwithstanding the above,” a reference to “governmental authority” on a retained acreage clause.<sup>191</sup> In 2010, the parties entered into an oil and gas lease encompassing an estimated 1,100 acres in Zavala County, Texas.<sup>192</sup> The lessee, 1776 Energy, drilled a horizontal oil well and began production within the primary term of three years.<sup>193</sup> Following the

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184. *Id.* at ¶ 17.

185. Scott C. Petry, *Drafting the Retained Acreage Clause: The Effect of Governmental Authority on Retained Acreage*, State Bar of Tex. Prof. Dev. Program, 7th Annual Advanced Oil, Gas, and Energy Resources Law Course 3 (2009).

186. *Id.*

187. *Id.*

188. Brittany Blakey, Charles Sartain, *Texas Court Rules on a Retained Acreage Clause*, JD SUPRA, (Oct. 11, 2021), <https://www.jdsupra.com/legalnews/texas-court-rules-on-a-retained-acreage-8427739/>.

189. *Vermillion FC, LP v. 1776 Energy Partners, LLC*, No. 04-20-00089-CV, 2021 WL 3743514, at 4 (Tex. App. 2021) (quoting *Endeavor Energy Res., L.P. v. Discovery Op., Inc.*, 554 S.W.3d 586, 595 (Tex. 2018)).

190. *Id.*

191. Blakey, *supra* note 186.

192. *Vermillion*, 2021 WL 3743514 at 1.

193. *Id.*



well's production, 1776 Energy also filed a well tract for the well, designated 320 acres, and provided notice to the lessor, Vermillion.<sup>194</sup> The lease provided that following the three-year primary term, "only acreage designated as part of a well tract would remain subject to the lease unless 1776 Energy exercised a two-year option by paying an option fee to extend the lease to acreage outside the tract."<sup>195</sup> The parties also agreed to follow the applicable field rules for designating how much acreage would be retained.<sup>196</sup> The following three years were spent in a dispute over whether 1776 Energy breached the lease's terms by retaining excess acreage in the well tract and untimely filing a partial release of non-retained acreage under the lease.<sup>197</sup> A breach of contract suit was filed by Vermillion in October 2016, wherein it argued that the 320-acre well tract designated by 1776 Energy should have been designated as 40 acres, and that all other acreage was not led by the lease.<sup>198</sup>

Vermillion argued the lease's retained acreage clause provided that the well tract should designate as few acres as possible for actual production, and claimed this construction was supported by a recent Texas Supreme Court case, *Endeavor Energy Res., L.P. v. Discovery Op., Inc.*, wherein a retained acreage clause was interpreted in its relationship with RRC rules.<sup>199</sup> The lease between Vermillion and 1776 Energy provided that:

Notwithstanding the above, in the event any governmental authority having jurisdiction should hereafter establish a density or spacing pattern of a different number of acres around oil and/or gas wells for full allowable purposes than the number of acres specified above, then lessee may only retain around each oil well and each gas well such number of acres as necessary to allow maximum production.<sup>200</sup>

1776 Energy utilized the "notwithstanding the above" clause to designate 320 acres, without which, "1776 would arguably only have been able to

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194. *Id.*

195. *Id.*

196. Kiefaber & Oliva LLP, *Vermillion FC, LLC v. 1776 Energy Partners*, Kiefaber & Oliva LLP blog, (Nov. 15, 2021), <https://www.kolawllp.com/vermillion-fc-llc-v-1776-energy-partners/>.

197. *Vermillion*, 2021 WL 3743514 at 1.

198. *Id.*

199. *Id.* at 4.

200. *Id.* at 5.

retain 40 acres surrounding [the well.]”<sup>201</sup> The trial court ruled in favor of 1776 Energy, and Vermillion timely appealed.<sup>202</sup>

The Court of Appeals gave effect to the “notwithstanding the above” portion of the retained acreage clause, finding such a clause “contemplates the possibility that other parts of the provision may conflict with it, and they agree that this paragraph must be given effect.”<sup>203</sup> The preceding provision regarding well-tract designations, taken together, provide that “40 acres should be used if permitted under the RRC rules, but if multiple proration unit sizes are recommended under the RRC rules, 1776 Energy should use the smallest proration unit permitted to create the well tract.”<sup>204</sup> However, the “notwithstanding the above” clause contemplated that if the RRC “establishes a density or spacing pattern of a different number of acres for allowables from the above, then 1776 Energy may retain that number of acres for such production allowables.”<sup>205</sup> The Court analyzed the well given the applicable field rules, the Eagleville Field Rules, and found the proration units therein consist of 80 acres, and that additional acreage may be assigned to horizontal drainhole wells pursuant to Statewide Rule 86.<sup>206</sup> 1776 Energy’s well featured a “horizontal drainhole displacement of 3,962 feet, entitling them to an additional 200 acres.”<sup>207</sup> The Court therefore determined that 1776 Energy retained a total of 280 acres, 40 acres less than 1776 Energy’s claim.<sup>208</sup> 1776 Energy was therefore in breach of contract for failing to release 40 acres under the retained acreage clause.<sup>209</sup>

This case has multiple important implications for oil and gas lease parties. It provides a strong warning to parties to carefully analyze lease language, particularly the use of phrases such as “notwithstanding.” The court gave deference to this language in the lease, and therefore engaged in a multi-step process to parse through the retained acreage clause and its interaction with field rules.<sup>210</sup> According to the Court, neither party presented a correct interpretation of their own lease’s provision. The Court

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201. Kiefaber & Oliva LLP, *supra* note 194.

202. *Vermillion*, 2021 WL 3743514 at 1, 2.

203. *Id.* at 5.

204. *Id.*

205. *Id.*

206. *Id.* at 6.

207. Kiefaber & Oliva LLP, *supra* note 194.

208. *Id.*

209. Blakey, *supra* note 186.

210. Kiefaber & Oliva LLP, *supra* note 194.

itself echoed warnings of the potential consequences of utilizing regulatory language in leases:

Retained acreage clauses often use proration units as the lodestar for determining what acreage is retained by the operator and what acreage is released. However, including proration units in a lease “may also cause confusion or disappointment, as the contracting parties may not fully understand the ramifications of including [such] a regulatory term.”

While the intent of using such language is understandable, it may appear to lessors to be industry-wide terminology, and it has potential benefits for lessees. “If the governmental authority, such as the RRC, allows a larger unit size under its rules, the [lessee] should be able to take advantage of such allowances to create a bigger unit.”<sup>211</sup> However, parties must ensure they have a solid understanding of the regulatory language involved, the references therein to various RRC rules and state laws, and the unique geological landscape of the well’s location. In *Vermillion*, the well featured a horizontal drainhole displacement that allocated an additional 200 acres to the well-tract designation.<sup>212</sup> Parties should carefully review the allocation formula for the specific proposed field if the lessee intends to retain additional acreage based on a “maximum allowable,” and ensure that the acreage permitted is necessary to achieve these allowables.<sup>213</sup> “If the technical evidence clearly shows that the well is draining 80 acres, but the operator is claiming 320 acres under the maximum allowable, that [lessee] may open itself up to claims that it did not act in good faith in retaining the full 320 acres.”<sup>214</sup> A party to an oil and gas lease should not insert stock language taken from governmental rules and regulations. Any party attempting to use terminology related to these rules and regulations must understand the implications toward any lease language and “proactively draft around the pitfalls that may occur[.]”<sup>215</sup>

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211. Scott C. Petry, *Drafting the Retained Acreage Clause: The Effect of Governmental Authority on Retained Acreage*, State Bar of Tex. Prof. Dev. Program, 7th Annual Advanced Oil, Gas, and Energy Resources Law Course 3 (2009).

212. *Vermillion*, 2021 WL 3743514 at 6.

213. Petry, *supra* note 213, page 4.

214. *Id.*

215. *Id.*

*XI. Analysis**A. Interpretation of Oil and Gas Leases*

When faced with an oil and gas lease dispute, courts typically start with an application of the basic contract law to parse the rights and liabilities of the parties. The oil and gas lease has been described as:

“. . . merely a contract which permits the lessee to explore for minerals on the land of the lessor in consideration of the payment of a rental and/or bonuses. All of the clauses of the agreement of lease are to be interpreted ‘the one by the other,’ giving to each the sense that results from the entire act.”<sup>216</sup>

Though courts will often cite well-known principles of contract law when deciding on oil and gas lease disputes, a “body of rules has developed which may well be considered *sui generis*.”<sup>217</sup> A court’s determination of the meaning of terms used in oil and gas leases typically looks to the industry standard over a dictionary definition of the term.<sup>218</sup> Oil and gas leases more closely resemble a coal or mining lease, and there is “scarcely any comparison between them and the ordinary farm or house lease[.]”<sup>219</sup>

Though it may be common to assume that a longer contract is inherently more complicated, Kuntz noted that when drafting a continuous drilling clause, “a simple modification of the habendum clause is the least certain and the least desirable method[.]”<sup>220</sup> This, Kuntz described, is because it is the lease descriptive, and therefore susceptible to requiring judicial construction.<sup>221</sup> Take the following clause as an example:

“To have and to hold the same for and during the term of three years from the date hereof, and as much longer thereafter as oil or gas is found therein or said premises are being developed or are being operated.”<sup>222</sup>

The court interpreted this habendum clause as having the same effect as a continuous drilling clause. Inserting both a separate special clause and a

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216. 17 Williston on Contracts § 50:57 (2021) (quoting *Odom v. Union Producing Co.*, 243 La. 48, 141 So. 2d 649 (1961)).

217. *Id.* at § 50:57.

218. *Id.*

219. *Id.*

220. Kuntz, *supra* note 14, at § 47.4.

221. *Id.*

222. *Id.* (quoting *Prowant v. Sealy*, 77 Okla. 244, 187 Pac 235 (1920)).

modification of the habendum clause can be a more desirable method of achieving the parties' desired purpose.<sup>223</sup> It ensures courts do not consider the special clause to undermine the habendum clause, rendering the clause ineffective.<sup>224</sup>

Lessors should not attempt to rely on broad language to satisfy the habendum clause and commencement clause. Lessors should seek to include specific language in the lease and provide for detailed commencement clauses. Commencement clauses can objectively define when commencement begins, such as requiring a rig on location. Moreover, the rig on location may have to be capable of drilling to total depth or be required to have a turning bit. When lessors fail to provide specific language, typically the general rule is used. It features broad language that a well has been commenced if operations are conducted on the land in good faith preparation for the drilling of a well for oil or gas, and the operations have been continued in good faith and with due diligence, with the intention of completing a well. Under the general rule, the building of the oil and gas drilling pad, the area cleared and prepared for the drilling of the well, would likely suffice as meeting the definition of commencement if the lessee continued operations in good faith with the intent to complete the well.

Not only must the continuous drilling operation clause itself be written precisely, as the *MRC Permian Co.* case showed, but other savings clauses must also be carefully constructed, as they can work to extend a lease in the secondary term even when it is not held by production. It is evident that continuous drilling provisions interact with the other provisions in an oil and gas lease and do not enjoy a preference over other savings clauses. Courts have been understanding of the individualized nature and effect of Pugh clauses, which are often added onto a standard form lease and vary widely. These phrases, including "notwithstanding," are added by the parties. The phrase "notwithstanding" is often used to integrate the clause into the overall lease. "When parties use the phrase 'notwithstanding' in a contract, they contemplate the possibility that other parts of their contract may conflict with that provision and they agree that the 'notwithstanding' provision must be given effect regardless of any contrary provisions of the contract."<sup>225</sup> Lessees should be cautious of Pugh clauses, as they can serve to negate continuous drilling operations clauses' effectiveness to preserve

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223. *Id.*, at note 14, at § 47.4.

224. *Id.*

225. *Greehyco, Inc. v. Brown*, 565 S.W.3d 309 (quoting *Helmerich & Payne Int'l Drilling Co. v. Swift Energy Co.*, 180 S.W.3d 635, 643 (Tex. App. – Houston [14th Dist.] 2005, no pet.).

an entire lease by production. These partial termination clauses limit the benefits of a continuous operations provision to the lessee, who has an interest in maintaining the entirety of the lease. Retained acreage clauses can have a similar effect, as they are even broader than a Pugh clause, and are added onto leases subject to pooling.

The *Endeavor* court noted that neither the court nor the parties could find an example of the same continuous-development clause used before or since the lease at issue.<sup>226</sup> The court lamented that the litigation could have been avoided if greater care had been taken when drafting the continuous-development clause.<sup>227</sup> When leases implement savings clauses, the multitude of names used for these provisions and the frequent attempts by lessors to include “special limitations” requires parties to undergo the drafting process with diligence.

Historically, American courts tend to construe lease language in favor of the lessor, because of either the lessee’s more common role as the lease drafter, or the lease itself acting as an option agreement.<sup>228</sup> Due to the highly speculative nature of oil and gas, some courts view protecting the lessor as an important consideration.<sup>229</sup> However, recent case law reflects that courts are stringent to the wording of the clauses even to the lessee’s benefit. Additionally, some courts have recently shown a liberal inclination to favor the lessee when language is ambiguous—specifically when the lessee’s immediate right to drill is at issue.<sup>230</sup> This goes against the common thought that Texas courts are reluctant to hold oil and gas lease provisions as ambiguous. This thought is consistent with the reluctance to hold deeds and wills as ambiguous.<sup>231</sup> “These instruments affect title to land, and if an instrument is ambiguous, land titles become uncertain, resulting in jury trials over the parties’ intent using extrinsic evidence.”<sup>232</sup> The litigation typically involves each party testifying their interpretation of the instrument, which is difficult for juries to understand. Courts make great efforts to avoid a finding of ambiguity, even when the court itself is unclear

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226. *Endeavor Energy Res., L.P. v. Energen Res. Corp.*, 615 S.W.3d 144, 155 (Tex. 2020).

227. *Id.*

228. Lowe, *supra* note 1, at 191.

229. Williston, *supra* note 210 § 50:57.

230. *Id.*

231. John McFarland, *After Five Years of Litigation, Texas Supreme Court Concludes that Lease’s Continuous Development Clause is Ambiguous*, Oil and Gas Lawyer Blog, (Dec. 21, 2021), <https://www.oilandgaslawyerblog.com/after-five-years-of-litigation-texas-supreme-court-concludes-that-leases-continuous-development-clause-is-ambiguous/>.

232. *Id.*

about the meaning of the instrument's language, because jury trials are not advantageous for resolving complicated and industry-specific contract disputes.<sup>233</sup> However, as discussed in *Endeavor*, the Supreme of Court Texas ultimately concluded that the lease language was ambiguous. The court's reasoning spanned eighteen pages that closely examined the language, looked to other retained-acreage clauses and surrounding facts and circumstances, all viewed "from a utilitarian standpoint bearing in mind the particular business activity sought to be served."<sup>234</sup> The Court remanded the case to the trial court to admit evidence of the parties' intent.<sup>235</sup>

As shown through the reasoning provided in *Decker* and the *Endeavor* above, courts generally dislike forfeitures, and will not view lease language as imposing a special limitation on the lease, absent clear, precise, and unequivocal language.<sup>236</sup> Like mineral leases, which are interpreted in light of their unique subject matter, the construction of oil and gas leases typically promote development and production.<sup>237</sup>

#### *B. The Impact of Horizontal Wells*

Technology has made significant strides in geological surveying and oil and gas drilling, introducing new drilling techniques that strive to be more cost efficient and more efficient in draining oil and gas formations. This includes the rise of horizontal wells, an alternative to traditional vertical wells. Horizontal well drilling can be combined with hydraulic fracturing, allowing previously unproductive rocks to be used as sources of natural gas. This includes formations that contain shale gas or tight gas.<sup>238</sup> "In 2004, horizontal wells accounted for about 15% of U.S. crude oil formation in tight oil formations. By the end of 2018, that percentage had increased to 96%."<sup>239</sup> Additionally, by 2018, Horizontal wells made up 97% of U.S. natural gas production in shale formations.<sup>240</sup>

Horizontal wells are started by drilling a vertical well, and after drilling down to the target rock, the pipe is pulled out of the well and a motor is

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233. *Id.*

234. *Id.*

235. *Id.*

236. Williston, *supra* note 210 § 50:57.

237. *Id.*

238. Jordan Hanania, et al., *Horizontal Well*, Energy Education, (Aug. 29, 2017), [https://energyeducation.ca/encyclopedia/Horizontal\\_well](https://energyeducation.ca/encyclopedia/Horizontal_well).

239. Jack Perrin, *Horizontally Drilled Wells Dominate U.S. Tight Formation Production*, TODAY IN ENERGY, (June 6, 2019), <https://www.eia.gov/todayinenergy/detail.php?id=39752>.

240. *Id.*

attached to the drill bit.<sup>241</sup> The bit is able to rotate without rotating the entire pipe, allowing the drill bit to create a path that is different from the orientation of the drill pipe.<sup>242</sup> The bit and pipe are lowered down into the well, and the bit drills a path that curves from vertical to horizontal.<sup>243</sup> Once the drill has the proper angle, the drill resumes in a fully horizontal direction.<sup>244</sup> Drilling at a non-vertical angle can reach targets and stimulate reservoirs otherwise impossible to reach by vertical wells.<sup>245</sup> Reservoirs located under residential areas or parks can be reached through horizontal drilling underneath the area.<sup>246</sup>

Horizontal drilling can cost as much as three times more than vertical drilling, however, this extra cost is generally recouped by the increased well production.<sup>247</sup> Horizontal wells also leave a smaller footprint on the surface, as one well can drain a large area and branch off numerous times from the main well.<sup>248</sup> Because horizontal wells have this increased reach below the surface, they disrupt previous notions of retained acreage clauses. It is logical for the amount of acreage maintained by the horizontal well to depend on the length of its lateral reach, because the amount of acreage drained by the well is proportional to the length of the lateral.<sup>249</sup> As previously discussed, retained acreage clauses involve the classification of “production units” to determine which portions of the lease acreage can be severed. Identifying these production units can be complicated by the use of horizontal wells. As previously mentioned in *Lawson*, the Oklahoma statute provides that “multi-unit horizontal wells shall be treated as a well in each of the affected units,” despite lacking production in any one unit.<sup>250</sup> It follows that closely spaced horizontal wells should be grouped into one production unit for the purposes of the clause.<sup>251</sup> Similar to the lessee’s intent in *Lawson*, the lessee, or operator, is likely seeking common sources of supply. Parties to these leases must take the time to negotiate a retained acreage clause that reflects the use of horizontal wells and should not rely

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241. Hanania, *supra* note 232.

242. *Id.*

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.*

247. *Id.*

248. *Id.*

249. McFarland, *supra* note 243.

250. *Lawson, Trustee of Harold Lawson Living Trust v. Citizen Energy II, LLC*, 2021 OK CIV APP 1, ¶ 14, 481 P.3d 287 (OK CIV APP 2020).

251. McFarland, *supra* note 243.



on the standard language used prior to the prominence of vertical wells.<sup>252</sup> Parties should also pay close attention to RRC rules that distinguish between horizontal and vertical wells. In *Vermillion*, the RRC rule applied permitted greater acreage assigned to a horizontal drainhole well in comparison to a vertical well, reasoning that horizontal wells may be assigned “up to the amount specified by applicable rules for a proration unit for a vertical well plus the additional acreage assignment as provided [for fields with a density rule of greater than 40 acres.]”<sup>253</sup> As previously discussed, both parties incorrectly calculated the acreage retained by the well during litigation. Two other recent Texas cases on retained acreage clauses, *Endeavor Energy v. Discovery Op.* and *XOG Operating v. Chesapeake Exploration*, were distinguished by the Court in part because the wells were vertical as opposed to horizontal. The difference between horizontal and vertical wells should not be overlooked by parties when drafting clauses.

### *XII. Conclusion*

Though the United States is making significant strides toward renewable energy, oil and gas continues to be drilled, processed, sold, and utilized to power millions of homes and businesses. The U.S. Energy Information Administration reported in January 2022 that recent technological innovation in drilling and production has resulted in rapid *growth* in U.S. oil and natural gas production.<sup>254</sup> U.S. oil production reached 12.9 million barrels per day in December 2019.<sup>255</sup> The number of producing wells in 2020 was approximately 936,934.<sup>256</sup> Oil and gas leasing continues to be a lucrative relationship for mineral owners and oil companies alike. However, too many of these parties engage in contracting practices that result in costly legal disputes. It is imperative for parties to carefully draft the oil and gas lease, ensuring the instrument fully encapsulates their intent and correctly identifies the type of well in use. This is particularly important for lessors, as courts have been moving away from any historical sympathies toward their interests. Lessors and lessees alike should avoid boilerplate lease language and ensure that any addendums align with the pre-existing

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252. *Id.*

253. *Vermillion*, 2021 WL 3743514 at 6.

254. U.S. Energy Information Administration (EIA), *U.S. Oil and Natural Gas Wells by Production Rate*, (Jan. 13, 2022), <https://www.eia.gov/petroleum/wells/>.

255. *Id.*

256. *Id.*

lease language. Failing to do so may be costly in legal fees and can potentially waste time and derail years of oil and gas production. Time of the essence in the oil and gas industry; oil and natural gas prices are subject to a fluctuating market and the resources themselves are fugacious and migratory. Time spent diligently drafting the oil and gas lease is never wasted.