

Oil And Gas Shut-Ins Risk Royalty Litigation

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With the fall of commodity prices and other worldwide issues, many oil and gas exploration and production companies are considering whether to shut in certain hydrocarbon wells. There are a number of considerations that producers should take into account when evaluating whether to shut in production, including: (1) existing contractual obligations (such as minimum volume commitments); (2) obligations under any debt facility or facilities and/or hedging program; and (3) operational impacts.

But as producers weigh their options, plaintiffs attorneys are simultaneously working to combat producers' efforts. Consequently, another shut-in consideration producers should evaluate is the potential for future royalty litigation.

The decision to shut in a well can give rise to royalty litigation and, specifically, claims for breach of lease and breach of the duty to market. As with most royalty litigation, the specific terms of the lease are key. Most modern oil and gas leases contain provisions allowing for shut-ins, but not all expressly address them.

Sometimes shut-in provisions apply only to certain hydrocarbons (e.g., gas but not oil). And some clauses limit when shut-ins can be applied, although many shut-in clauses provide for the payment of a shut-in royalty to perpetuate the lease when there is a gas well on the premises, but gas is not being sold or used due to a lack of market (which is frequently construed as a lack of any physical market), lack of marketing facilities or governmental restrictions on production.

Other shut-in provisions may impose lessor notice requirements, limitations on the length of time a well can be shut in and/or required payment of shut-in royalties. Some shut-in provisions further specify the timing for royalty payments – for example, prior to shutting in a well, within a specified time period after a well is shut in, or before the lease anniversary date following shut-in.

Given these substantial variations, producers should carefully evaluate the terms of

the specific shut-in provision, as well as the lease on the whole, to ensure compliance with the lease's terms. Noncompliance with any of these provisions can provide the lessor grounds for a breach-of-lease claim.

A breach-of-lease allegation regarding a shut-in provision can be particularly concerning for producers, because the requested remedy may be for lease termination rather than damages due to cessation of production in paying quantities. Generally, courts view termination as a disfavored remedy. However, in a majority of jurisdictions, including California, Colorado, Illinois, Indiana, Kansas, Louisiana, Michigan, New York, Ohio, Pennsylvania and Texas, once a well is shut in, a lessee's failure to pay the shut-in royalty – or to perpetuate the secondary term under other lease provisions – may give rise to a lease-termination action.

That is because the payment of a shut-in royalty acts as a substitute for production, enabling the lessee to extend or maintain the lease. Under those circumstances, the failure to make a timely shut-in payment is the equivalent of cessation of production, and the lease may automatically terminate.¹

Of course, this rule of construction can be overcome with clearly expressed, contrary lease language. If the shut-in clause is worded so that the mere existence of a shut-in well extends the lease, or if payment of shut-in royalty is expressed as a covenant (i.e., a promise to pay), a lessee's failure to pay the shut-in royalty may give rise only to damages – not to lease termination.

In a minority of jurisdictions, including Kentucky, Oklahoma and West Virginia, the existence of a well capable of production is sufficient to hold the lease by production, so long as the lessee is reasonably diligent in its marketing efforts.² In those jurisdictions, damages, rather than lease termination, are the default remedy for a breach of a lease's shut-in provision.

That said, lessors can still seek lease forfeiture under a separate action if they allege that the lessee failed to market the hydrocarbons with necessary due diligence. And again, express, contrary lease language can always change the background rules.³

The decision to shut in a well can also give rise to claims for breach of the duty to market, which imposes "an obligation upon the lessee to use due diligence to market the gas and/or oil produced from a well."⁴ The standard is also referred to that of a reasonably (or ordinarily) prudent operator, and it is a lower standard than that of a fiduciary.⁵

In most jurisdictions, the duty to market is an implied covenant that exists regardless of whether the lease contains an express marketing clause. Rather, courts will read the duty into the lease unless it is expressly disavowed.

The duty to market requires a lessee to make a “diligent effort to market the [hydrocarbons] in order that the lessor may realize a return on his royalty interest,”⁶ and “begin marketing the product within a reasonable time” after completion of the well.⁷ Different jurisdictions have different rules regarding the appropriate remedy for a breach-of-duty-to-market claim. For instance, under Colorado law, a lessor may seek to cancel a lease.⁸ Under Ohio law, in contrast, damages generally provide the appropriate remedy.⁹

The lessee’s obligation to market oil and/or gas is generally not relieved or suspended by the decision to shut in a well. Rather, the lessee must still act as a reasonably prudent operator in attempting to market the hydrocarbons.¹⁰ Thus, a producer must continually evaluate the decision to shut in a well. Maintaining a shut-in well after oil prices rebound could itself give rise to a claim of breach of the duty to market.

On the other hand, producers may not escape royalty litigation by choosing not to shut in a well. Producers could still face actions for breach of the duty to market if they fail to act as a reasonably prudent operator and shut in the well when market conditions demand.¹¹

Additional consideration should be given to the habendum clause of the lease. Under a typical oil and gas lease, the habendum clause provides for a fixed term of one to five years (the primary term) and thereafter, for so long as oil and/or gas are produced “in paying quantities” (the secondary term).

Absent specific language in the lease explaining how paying quantities are to be measured, the most common test for determining whether production is in paying quantities looks to both whether lessee makes some profit (however small) over the cost of operating the well – and whether or not, under all relevant circumstances, a reasonable prudent operator would, for purposes of making a profit and not merely speculation, continue to operate a well in the manner in which such well was operated.¹²

Thus, in the majority of states, a lessor must meet a fairly high burden of proof to succeed in a claim that a well has ceased to produce in paying quantities, unless the lessor produced evidence that a reasonable prudent operator would not have continued to operate the well under the circumstances.¹³

As noted above, any shut-in analysis must be performed on a lease-by-lease basis to understand the ramifications of shutting in a well, taking into account the facts and circumstances of operations on each lease, as well as the other contractual provisions set forth in such lease. Many modern leases include Pugh clauses (either horizontal, vertical or both), which may terminate portions of the lease outside of the currently producing unit (for horizontal Pugh clauses) or formations below the deepest producing formation (for vertical Pugh clauses) upon cessation of production or failure of continued operations, even if shut-in royalties are paid.

Additionally, many leases contain savings clauses, such as a cessation of production clause and/or continuous development clause, which permit perpetuation of a lease if the lessee performs additional operations on the lease (i.e., reworks existing wells or drill new wells) within specified time periods, or if the lessee restores production from the lease within a specified time period. However, a producer attempting to rely on such a clause should carefully review whether it requires hydrocarbon production to be online by a specified date and ensure that such restoration is operationally feasible.¹⁴

In sum, when considering whether to shut in a well, producers should begin with the text of the lease, as well as the facts and circumstances giving rise to a potential shut-in with respect to each separate lease. They should first evaluate whether the lease contains a shut-in provision and, if so, what the specific terms are – particularly with regard to the conditions upon which shut-in can be applied, notice, timing and required payments.

Producers should also determine whether the lease is silent with regard to the implied covenants, or if it specifically disallows them. Moreover, the state where the property is located is key, as jurisdictions vary in terms of the remedies allowed, as well as the standards they will apply to lessee's actions.

1. See *Amber Oil and Gas Co. v. Bratton*, 711 S.W.2d 741 (Tex. Int. App. Ct. 1986).↵

2. See, e.g., *Pack v. Santa Fe Minerals*, 869 P.2d 323, 330 (Okla. 1994) (discovery of production in paying quantities sufficient to extend the lease); *Roye Realty & Developing Inc. v. Watson*, 791 P.2d 821, 823 (Okla. Ct. App. 1990) (similar).↵

3. See, e.g., *Blaser Farms Inc. v. Anadarko Petroleum Corp.*, 893 F.2d 259, 261 (10th Cir. 1990).↵

4. *Moore v. Adams*, No. 2007AP099966, 2008 WL 4907590, at *5 (Ohio Ct. App. Nov. 17, 2008).↵

5. See, e.g., 5 Kuntz, Law of Oil and Gas §60.3.↔

6. *Davis v. Cooper*, 837 P.2d 218, 22 (Colo. App. 1992).↔

7. *McVicker v. Horn, Robinson & Nathan*, 322 P.2d 410 (Okla. 1958).↔

8. See *Gillette v. Pepper Tank Co.*, 694 P.2d 369 (Colo. App. 1984).↔

9. See *Harris v. Ohio Oil Co.*, 48 N.E. 502, 506 (Ohio 1897).↔

10. See, e.g., *Am. Energy Serv. v. Lekan*, 598 N.E.2d 1315, 1322 (Ohio Ct. App. 1992) (“The covenant to market the product places an obligation upon a lessee to use due diligence to market the gas and/or oil produced from a well. This covenant is not eliminated by a shut-in royalty clause”); *Pray v. Premier Petroleum*, 662 P.2d 255, 258 (Kan. 1983) (“[T]he fact that the lease is held by payment of shut-in gas royalties does not excuse the lessee from his duty to diligently search for a market”).↔

11. Cf. *Smith v. McGill*, 12 F.2d 32, 34-35 (8th Cir. 1926).↔

12. *Clifton v. Koontz*, 325 S.W.2d 684 (Tex. 1959).↔

13. *Skelly Oil v. Archer*, 356 S.W.2d 774, 783 (Tex. 1962).↔

14. See, e.g., *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 271-72 (Tex. 1960) (holding that shut-in of well prior to expiration of primary term due to lack of market did not extend lease because well never produced prior to expiration of primary term).↔

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