Partial Termination Provisions in Oil and Gas Leases

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In an era of continued commodity price volatility, lessors and lessees continue to struggle to find the right amount of flexibility in lease language—especially when it comes to keeping leases alive past their primary terms. Lessors want big bonuses as frequently as possible and lots of fat royalty checks without having their land tied up for decades. Lessees, on the other hand, want the flexibility to develop acreage when the economics are most favorable. Partial termination provisions certainly help meet lessors' goals by forcing lessees to "drill it or lose it," but can often backfire by introducing uncertainty and inefficiencies that can lead to less ultimate recovery. And because secondary terms can extend indefinitely, attempts to keep lessees "honest" decades ago continue to cause consternation today. The last five years have seen numerous rulings illustrating the potential pitfalls of partial termination provisions (*Chesapeake v. Energen*, *Apache v. Double Eagle*, *Endeavor v. Discovery*, and *XOG v. Chesapeake*), and therefore, landmen should strive to familiarize themselves with all of the various scenarios they may encounter when dealing with such provisions.

Partial termination provisions are typically divided into one of three categories—Pugh clauses, retained acreage clauses, and depth-severance clauses. Pugh clauses (also sometimes called "Freestone Riders") typically provide that if a lessee has formed a pooled unit, production from that unit will not hold acreage outside of the unit. Although generally useful in striking a balance between lessors and lessees, problems can arise with defining a "unit" and situations where no unit is actually formed. Many Pugh clauses do not contemplate the drilling of tract wells or allocation wells across non-pooled portions of the lease. So, even if a portion of the lease is pooled, the entire remaining non-pooled portion could be held by production by a single well or portion of a lateral.

Retained acreage clauses do not face the same issue. In a typical retained acreage clause, a lease will terminate as to lands not included within pooled or proration units at a given date. Retained acreage clauses are often tied to continuous drilling provisions such that lessees are given ample time to fully develop the lease, but lessees must pay careful attention to the time limits imposed by such provisions. Retained acreage clauses can also run into the same unit terminology issues as Pugh clauses, but the timing of the partial termination has proven to be more controversial in recent years. Retained acreage clauses are more lessor-friendly than Pugh clauses, but do allow some measure of flexibility for the lessee (especially if lessees can "bank" extra time between wells in a continuous drilling program).

Depth-severance clauses, however, tilt the scales even further in the lessors' favor, and can be structured like Pugh clauses—*i.e.*, production from pooled depths won't hold remaining depths—or like retained acreage clauses—*i.e.*, at a certain date, the lease will expire as to depths other than those drilled. Such clauses allow lessors to lease multiple productive intervals under their lands, but minimize the lessee's ability to develop different depths. Again, issues as to unit terminology and timing arise regularly, but describing the actual depths involved can be especially problematic. Whatever provisions lessors and lessees decide upon to allow for partial termination, particular attention must be paid to the timing of the partial termination and defining of what is and is not kept.

In recent years, issues with partial termination have typically arisen with respect to "snapshot v. rolling" timing issues, defining what a "unit" is, tying retained acreage clauses to regulatory filings, and determining what depths are held by production. Firstly, partial termination provisions can typically be triggered at either one fixed point in time (a "snapshot" provision) or from time to time as certain portions of the lease stop producing (a "rolling" provision). With a "snapshot" provision, at the end of the primary term *or* at the end of a continuous drilling program, the lease terminates as to all lands not included in a pooled or proration unit. In such a scenario, it does not matter what happens to individual units and wells later on—so long as one well is still producing, the lease is held by production as to all lands and depths in those proration or pooled units in existence at the end of the primary term.

With a "rolling" provision, instead of looking to a single point in time to determine what is and is not held by production, one must continuously look at production from each well. As each well stops producing, the lease expires as to the lands and depths associated with that well. Rolling terminations can also be achieved by combining a "snapshot" provision with a "separate tracts" clause. With both clauses together, after the "snapshot" occurs, each proration or pooled unit is treated separately such that if production ceases on that unit, the lease will not be held as to that unit by production from others.

An additional problem faced by those navigating the muddy waters of partial termination clauses is that the term "unit" itself is imprecise—units come in proration, pooled and fieldwide flavors. Pooled units are formed voluntarily by contract among the lessors and lessees of adjoining tracts of land. Proration units are a regulatory creature and are defined by statute as acreage assigned to a well for the purpose of assigning production allowables to a well. Fieldwide units (the least common type) involve the joint operation of separately owned tracts, pooled units or proration units within an entire oil and gas field typically for the purposes of enhanced recovery. Given recent decisions by the Texas Supreme Court that call into question reliance on long-held industry standard terminology (*US Shale v. Laborde Properties*, and *Murphy E&P Co. USA v. Adams*), lessors

and lessees should carefully define "units" in Pugh clauses and retained acreage provisions.

Furthermore, partial termination clauses that are based on proration units are very carefully scrutinized by courts in light of 2018's *Endeavor* and *XOG* cases. In *Endeavor*, a clause stating that "[this] lease shall automatically terminate … save and except those lands and depths located within a governmental proration unit *assigned* to a well" only allowed Endeavor to retain the 80-acre proration units actually assigned to the wells in its P-15s filed with the Railroad Commission even though 160-acre units were permitted under the field rules.[1] In *XOG*, the opposite conclusion was reached because acreage "included within the proration unit for each well … prescribed by filed rules" referred to acreage set by the field rules, not acreage "assigned" in the P-15.[2] Parties to leases should pay special attention to the specific language used and lessees/operators should be aware of field rules for the area and should be extra careful with regulatory filings that might affect lease clauses.

Lastly, consideration must be given to what depths are held by production with depth-severance clauses. Texas courts have frequently addressed the differences between "intervals", "*stratigraphic* intervals", and "total depths" (both measured depths and total vertical depths), holding that each have separate meanings. A further wrinkle is that the term "formation" is currently not well defined by Texas law. Because of this, it is unclear what exactly happens when a lease calls for partial termination below the deepest producing "formation". Would a well drilled into the Wolfcamp A "formation" hold depths associated with the Wolfcamp B "formation"? In *Amarillo Oil Co. v. Energy-Agri Prods., Inc.*, the Texas Supreme Court discussed several definitions of the terms "formation," "reservoir," "field," "stratum" and "horizon," noting that a formation, field or reservoir may include multiple producing strata or horizons.[3] The Court defined a formation as "[a] succession of sedimentary beds that were deposited continuously and under the same general conditions [that] may consist of one type of rock or of alterations of types," but also noted that "[a]n individual bed or group of beds distinct in character from the rest of the formation and persisting over a large area is called a 'member' of [said] formation." A later Texas case has called into question the precedential value of these definitions, and therefore, this issue remains unsettled. However, careful drafting can provide certainty and prevent these issues from causing major problems later on.

Ultimately, there are many ways to structure partial termination provisions to accommodate the desires of lessors and lessees, but every word used matters. Texas courts are increasingly putting the onus on parties to oil and gas leases to "say what they mean and mean what they say" and are unlikely to swoop in and save the day of those who draft their contracts poorly. Careful consultation with your client (and legal counsel!) should be made to ensure that leases are providing enough flexibility without being so vague as to create more problems than are being solved.

About the author:

With significant experience in numerous areas of natural resources law, Ethan M. Wood advises upstream and midstream energy clients on the entire range of transactions and issues that arise during oil and gas operations in Texas and many states across the country. He has guided clients through a variety of multi-million-dollar deals and other operational transactions, with a strong emphasis on the acquisition and divestiture of producing assets, and negotiations of oil and gas leases and joint operating agreements.

Ethan also conducts title examinations and renders opinions for producers with drilling operations throughout Texas and coordinates identical activities with local counsel in multiple jurisdictions, including New Mexico, Ohio, Pennsylvania and Oklahoma. As a former independent petroleum landman, Ethan has a unique perspective on the most important aspects of title examination, which allows him to focus on identifying practical ways for landmen to address issues quickly and proactively in the field.

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[1] 554 S.W.3d 586 (Tex. 2018)

[2] 554 S.W.3d 607 (Tex. 2018)

[3] 794 S.W.2d 20 (Tex. 1990)