

Presented at

42nd Annual Ernest E. Smith
Oil, Gas and Mineral Law

2016 Fundamentals of Oil, Gas and Mineral Law

April 14, 2016

Houston, Texas

**ARE WE THERE YET?
THE START AND FINISH OF AN OIL AND GAS LEASE**

Peter E. Hosey

Author Contact Information:

Peter E. Hosey
Jackson Walker L.L.P.
112 E. Pecan St., Suite 2400
San Antonio, TX 78205
phosey@jw.com

S. Jordan Smith
Jackson Walker L.L.P.
2323 Ross Avenue, Suite 600
Dallas, Texas 75201
sjsmith@jw.com

Peter E. Hosey
Jackson Walker L.L.P.
112 E. Pecan St., Suite 2400
San Antonio, TX 78205
phone: (210) 228-2423
phosey@jw.com

BACKGROUND, EDUCATION AND PRACTICE

Peter E. Hosey is a Partner in the San Antonio, Texas office of Jackson Walker L.L.P. He received a Bachelor of Arts degree from The University of Texas at El Paso in 1976, and is a 1979 graduate of St. Mary's University School of Law. He practices primarily in the areas of oil, gas and mineral law, title and transactional matters, real estate law, business law, and international business law. Since 1998, he has served on the Joint Editorial Board for the development of the Texas Title Examinations Standards established by the Real Property, Probate and Trust Law and Oil, Gas and Energy Resources Law Sections of the State Bar of Texas, which are published in the Texas Property Code. He is a member of the San Antonio Bar Association (has served several times as President and Treasurer of the Natural Resources Committee of the San Antonio Bar Association), a member of the American Bar Association and the State Bar of Texas. He is also a member of the College of the State Bar of Texas. Mr. Hosey is a frequent lecturer around the State of Texas at various CLE sponsored events concerning oil and gas issues, land titles, title insurance and other real estate related topics, including writing articles for and speaking at the 50th Annual Rocky Mountain Mineral Law Institute in 2004, the 23rd, the 29th the 32nd and 33rd Annual Advanced Oil, Gas and Energy Resources Law Course in 2005, 2011, 2014 and 2015, and the 33rd, 35th and 37th Annual Ernest E. Smith Oil, Gas and Mineral Law Institutes in 2007, 2009 and 2011. Mr. Hosey has also written articles for the Section Report of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas (December 2008 and June 2011) and wrote an article in the November 14, 2011, edition of the *Texas Lawyer* magazine on representing land owners in oil and gas leasing transactions. He also wrote *"Follow the Money!" Oil and Gas Leases and Division Orders, "To Whom it May Concern" - Title To The Title Opinion and the Duty of the Examiner, Title To Uranium and Other Minerals (Still Crazy After All These Years), "Are We There Yet?" The Start and Finish of an Oil and Gas Lease, "What Am I Still Missing?" Mineral Title Examination and Due Diligence: Additional Selected Pitfalls and Problems, "Come Out, Come Out Wherever You Are:" Constructive Notice of Unrecorded Agreements in Oil and Gas Titles, Quench My Thirst: Water Rights in the Context of Water Treatment Technologies*, which was co-written with Jesse Lotay and published in the Oil, Gas and Energy Resources Law Section Report, Winter 2013, and *"Where There is a Well There is a Way:" Out Tract Title Issues Regarding Horizontal Wells*. He is a member of the Council of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas. He is currently an Adjunct Professor of Law at St. Mary's University School of Law, teaching Texas Land Titles. Mr. Hosey was named a San Antonio "Best Lawyer" by *Scene in S.A.* (2007-2009) and a "Super Lawyer" (2009-2011) by Thomson Reuters and has been named a "Who's Who in Energy (2012-2014). In 2011, he was named an "Outstanding Lawyer" by the *San Antonio Business Journal*. Mr. Hosey is the Vice-Chair of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas, A Life Sustaining Fellow of the Texas Bar Foundation and was the 2013 Distinguished Graduate of St Mary's University School of Law.

S. Jordan Smith
Jackson Walker L.L.P.
2323 Ross Avenue, Suite 600
Dallas, Texas 75201
phone: (214) 953-5984
sjsmith@jw.com

BACKGROUND, EDUCATION AND PRACTICE

Jordan Smith is an associate in the Dallas office of Jackson Walker L.L.P. He received a Bachelor of Arts degree from The University of Texas at Austin, *with honors*, in 2005 and his law degree from St. Mary's University School of Law in 2009 where he was a member of the Phi Delta Phi Legal Honors Fraternity as well as Research and Articles Editor of the St. Mary's Law Journal. He practices primarily in the areas of energy, natural resources, real estate and general corporate transactions, with an emphasis on negotiation agreements pertaining to upstream exploration and production activities. Mr. Smith has experience in leasing for oil and gas exploration, and advises oil and gas clients on a wide variety of issues, including title issues, water right issues, horizontal drilling under special field rules and lease development obligations. He also has experience in various business transactions, including the acquisition and development of real estate, entity formation, and contract negotiations. Mr. Smith was named a "Rising Star" in the San Antonio legal community by *S.A. Scene* (2013). Mr. Smith is a member of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas, the Natural Resources Section of the San Antonio Bar Association, and the San Antonio Young Lawyer's Association and a Fellow of the Texas Bar Foundation. He is also a member of the Real Estate Council of San Antonio, where he was a participant and graduate of the 2010 – 2011 Leadership Development Program. He is also a member of the William S. Sessions American Inn of Courts, the San Antonio Young Lawyer's Association and is currently serving on the Membership Committee of the San Antonio Bar Association.

SUMMARY OF CONTENTS

| | | |
|------|---|----|
| I. | COMMENCEMENT OF AN OIL AND GAS LEASE | 1 |
| A. | Introduction | 1 |
| B. | The Interest Conveyed by an Oil and Gas Lease..... | 1 |
| 1. | The Fee Simple Determinable Estate | 2 |
| 2. | The Rule in Texas | 3 |
| C. | The Creation of the Oil and Gas Lease..... | 3 |
| 1. | Statute of Frauds..... | 3 |
| 2. | Bonus..... | 3 |
| 3. | Delivery and Acceptance | 4 |
| a. | Actual and Constructive Delivery | 4 |
| b. | Conditional Delivery | 5 |
| c. | Acceptance | 7 |
| 4. | Offer Sheets and Letter Agreements | 7 |
| 5. | Top Leases..... | 9 |
| D. | The End of the Beginning..... | 10 |
| II. | TERMINATION OF AN OIL & GAS LEASE | 10 |
| A. | Understanding Lease Termination Issues..... | 10 |
| B. | Termination During the Primary Term..... | 11 |
| 1. | Commencement of Drilling Operations | 12 |
| a. | Payment of Delay Rentals | 12 |
| C. | Termination at the End of the Primary Term or During the Secondary Term | 13 |
| 1. | Lack of Production in Paying Quantities | 13 |
| 2. | Permanent Cessation of Production | 14 |
| D. | Savings Clauses | 15 |
| 1. | Dry Hole, Cessation of Production and Drilling Operations Provisions..... | 16 |
| a. | Dry Hole Clause | 16 |
| b. | Cessation of Production Clause..... | 17 |
| c. | Drilling Operations Clause..... | 17 |
| 2. | Shut-in Royalty Provisions..... | 19 |
| 3. | Force Majeure Provisions..... | 20 |
| E. | Termination Resulting From an Express Condition | 21 |
| F. | Avoiding Termination Claims | 22 |
| 1. | Waiver | 22 |
| 2. | Ratification | 22 |
| 3. | Quasi-Estoppel & Equitable Estoppel | 22 |
| 4. | Statute of Limitations | 23 |
| 5. | Revivor | 23 |
| III. | CONCLUSION..... | 24 |

ARE WE THERE YET?

I. COMMENCEMENT OF AN OIL AND GAS LEASE

A. Introduction

In this paper, we will focus on when an oil and gas lease starts and ends. In order to answer these questions, we must know what it is and how it works.

We all know that the oil and gas industry is cyclical, subject to many factors, including the price of hydrocarbons, regulatory changes and the success or failure of drilling operations. This is the reality within which oil and gas leases are negotiated.

Although a lease typically covers all minerals where the granting clause includes, “oil, gas and other minerals,”¹ our focus will be upon the operation, production and sale of oil and gas.

The lessor wishes to maximize the value of the bonus, the royalty and its bargaining position with regard to the minerals to be leased and the surface to be encumbered (where the lessor is also the surface owner). The lessee prefers to pay no more than the negotiations require, nor to include any more onerous terms in the oil and gas lease than it must. Timing in these negotiations is critical.

It is essential for the parties to the lease to know when the real property rights in the substances covered by the lease become vested in the lessee and when the leasehold

interest held by the lessee terminates so that the underlying mineral estate is no longer encumbered by the lease. That which occurs in between will not be covered in this paper, unless such events affect the continuation of the lease.

Our journey begins with the creation of the oil and gas lease through the execution by the lessor of a written document containing the identity of the lessor and the lessee, a description of the leased premises, the essential terms and delivery of the executed instrument to the lessee. The oil and gas lease may last forever. Thus far, none has.

Time does not permit, nor does space allow, a discussion of all of the potential contingencies which could occur. This is not an examination of all of the lease terms which can be created, the breach of which may result in the termination of an oil and gas lease.

The parties to an oil and gas lease should always pay particular attention to the terms and provisions of the lease as written. Although the death of an oil and gas lease may be sudden and without warning, some defenses do exist. Where the lease is held to have expired, these judgments generally do not terminate the lease, but rather confirm that the lease has already expired.

B. The Interest Conveyed by an Oil and Gas Lease

Since the 1920s, the Texas Supreme Court has held that an oil and gas lease conveys a fee simple determinable estate to the minerals in place in the acreage described as a result of the language of the habendum

¹ For a discussion of the meaning of “and other minerals” under Texas law, please see this author’s article entitled “*Title to Uranium and Other Minerals (Still Crazy After All These Years)*” published in the Oil, Gas and Energy Resources Law Section Report, December 2008.

clause of the typical lease.² Although the document is called a “lease,” it does not create a landlord-tenant relationship. A fee simple determinable estate is subject to a special limitation, although the duration of the lease may be perpetual if the special limitation never occurs. However, the estate will automatically terminate by operation of law upon the occurrence of the limitation condition.

1. The Fee Simple Determinable Estate

Under the common law, a special limitation creates a fee simple determinable estate in which A conveys Blackacre to B, “for so long as” B shall use Blackacre for a particular purpose. The instant that Blackacre is no longer used for such purpose, by operation of law the estate terminates and vests in the grantor, or grantor’s successors, as a result of the limitation of the grant. The automatic reversion to the grantor of the title to the estate granted is not a forfeiture, but is the result of the “possibility of reverter” retained by the grantor upon the execution and delivery of the fee simple determinable conveyance.³

The fee simple determinable estate is distinguished from the fee simple absolute estate in that the determinable estate is subject to defeasance. The fee simple determinable estate is an exception to the common law rule requiring as a prerequisite,

the filing of an action to recover the land. A determinable fee estate is also distinguishable from the fee simple estate subject to a condition subsequent.⁴ The conveyance of a fee simple estate subject to a condition subsequent requires the grantor to take an affirmative action, or to make an actual re-entry in order to terminate the granted estate. The termination of a fee simple estate subject to a condition subsequent is not automatic, but vests in the grantor the power of termination or a right of entry. Today the grantor would bring an action to recover the land without the need for actual prior entry.⁵

In the case of a fee simple estate subject to a condition subsequent, the grantor must know of the termination of the estate in order to bring an action for the recovery of the fee simple title. In the case of a fee simple determinable interest, the grantor need not know of the termination of the estate as a result of the occurrence of the special limitation in order to become vested with fee simple absolute. Moreover, since the estate reverts to the grantor instantaneously upon the occurrence of the limitation by operation of law, the grantor may not waive its right to terminate the fee simple determinable estate.⁶ The fee simple determinable estate terminates upon the terms of the grant through the habendum clause as a consequence of the limitation of the estate

² *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 173, 254 S.W. 290, 295 (1923). See generally, A.W. Walker, Jr., *Fee Simple Ownership of Oil and Gas in Texas*, 6 TEX. L. REV. 125 (1928); A.W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 8 TEX. L. REV. 483 (1930).

³ FRED A. LANGE & ALOYSIUS A. LEOPOLD, 3 TEXAS PRACTICE: LAND TITLES AND TITLE EXAMINATION § 331, at 602–03 (2d ed. 1992).

⁴ However, see Section II.E, *infra*, discussing conditions subsequent contained in provisions other than the granting clause.

⁵ FRED A. LANGE & ALOYSIUS A. LEOPOLD, 3 TEXAS PRACTICE: LAND TITLES AND TITLE EXAMINATION § 341, at 702–13 (2d ed. 1992).

⁶ However, see Section II.F, *infra*, discussing Texas courts’ application of defenses to termination claims.

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](http://utcle.org/elibrary)

Title search: Are We There Yet? The Start and Finish of an Oil and Gas Lease

Also available as part of the eCourse

[Oil, Gas and Mineral Lease Perpetuation Issues; plus State Oil and Gas Leases](#)

First appeared as part of the conference materials for the
2016 Fundamentals of Oil, Gas and Mineral Law session

"Are We There Yet? The Beginning and the Termination of an Oil and Gas Lease"