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Oil and Gas - Construction of Lease-Dry Hole and Cessation of Production Clause

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OIL AND GAS—CONSTRUCTION OF LEASE—DRY HOLE AND CESSATION OF PRODUCTION CLAUSE—Newman Brothers Drilling Company obtained an oil and gas lease on land subject to a prior lease held by Stanolind Oil and Gas Company and under which a well commenced within the primary term had been completed as a dry hole after the expiration of the primary term. Forty-nine days after completion of the dry hole Stanolind commenced and completed a second well as a producer. Upon suit by Newman in trespass to try title and for declaratory judgment the court of civil appeals, reversing the trial court, held that the lease under which Stanolind claimed had terminated with the completion of the first well as a dry hole. On appeal to the supreme court, *held*, reversed, two judges dissenting.¹ *Stanolind Oil and Gas Company v. Newman Drilling Company*, (Tex. 1957) 305 S.W. (2d) 169.

Stanolind claimed under a typical “unless” lease² and the court’s holding turned on the construction and application of the following two provisions:

“2. Subject to the provisions herein contained, this lease shall be for a term of five (5) years from this date (called ‘primary term’) and as

¹ The dissenters argued that the 30 and 60-day clauses were mutually exclusive and that since the 30-day clause specifically dealt with drilling at the expiration of the primary term, the general language of the 60-day clause was not applicable.

² The “unless” drilling clause was that if operations are not commenced within one year the lease shall terminate unless delay rentals are paid as provided therein; and the commencement of such operations may be further deferred in the same manner for successive periods of 12 months each during the primary term.

long thereafter as oil, gas or other mineral is produced from said land hereunder. . . .

"5. If prior to discovery of oil or gas on said land Lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this lease shall not terminate if Lessee commences additional drilling or reworking operations within sixty (60) days thereafter or (if it be within the primary term) commences or resumes the payment or tender of rentals on or before the rental paying date next ensuing after the expiration of three months from date of completion of dry hole or cessation of production. If at the expiration of the primary term oil, gas or other mineral is not being produced on said land but Lessee is then engaged in drilling or re-working operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other minerals so long thereafter as oil, gas or other mineral is produced from said land."

Although the second sentence of provision 5, the 30-day clause, had been narrowly construed in *Rogers v. Osborn*³ as allowing only the completion of the very well commenced within the primary term and not to authorize the drilling of additional wells, the court in the principal case found in the first sentence of provision 5, the 60-day clause, authorization for the same continuous drilling which had previously been denied in the 30-day clause. The court attributed this continuous drilling concept to the dry hole clause by taking four steps. (1) The iteration in *Rogers v. Osborn* that, "The conditions contained in the two separate sentences should not be jumbled,"⁴ was limited to the facts of that case. (2) The initial qualifying phrase of the habendum clause, provision 2, "Subject to the other provisions herein contained," was held to engraft all of provision 5 onto the entire habendum clause and thereby to extend the lease. (3) Since no dry hole had been completed when the primary term expired, the 60-day clause was inapplicable, but drilling operations being prosecuted at the expiration of that term qualified to extend the lease under the 30-day clause alone. (4) Since the lease was extended by these operations and since their completion resulted in a dry hole, that dry hole occurred within the life of the lease, and the 60-day clause was then applicable to authorize additional drilling. The *logic* of this reasoning is unassailable, and the result will probably meet with the wide approval of the oil industry.⁵

³ 152 Tex. 540 at 546, 261 S.W. (2d) 311 (1953). The second use of the term "operations" in the second sentence of an identical provision 5 was held to refer to "the continuous prosecution of the very operation being engaged in by the lessees upon the expiration of the primary term." These provisions or very similar ones have also been scrutinized in *St. Louis Royalty Co. v. Continental Oil Co.*, (5th Cir. 1952) 193 F. (2d) 778, and *Continental Oil Co. v. Boston-Texas Land Trust*, (5th Cir. 1955) 221 F. (2d) 124.

⁴ Martin, J., in his concurring opinion in the principal case at the appeals court level, 296 S.W. (2d) 567 at 574, did not jumble the sentences and reached the opposite conclusion from that of the supreme court.

⁵ See 5TH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 361, where Hawley

This particular form of a dry hole clause, however, when interpreted in the light of its historical and legal context, is incapable of the construction attributed to it and is at most ambiguous and subject to the general rule of construction that ambiguity should be resolved in favor of the lessor.⁶ The historical context of a particular clause of an oil and gas lease has long been recognized as a pertinent consideration when the judiciary attempts to interpret that clause.⁷ Provision 5 represents an attempt to amalgamate the attributes of three different leasing concepts with diverse pedigrees and to express them in one paragraph. (1) The 30-day clause was developed to afford relief to the lessee who commenced drilling a well within the primary term, but who completed it after the primary term had expired.⁸ This clause allowed him to complete such a well and to hold the lease if there were production.⁹ (2) The dry hole clause was an attempt to define the obligation of the lessee to develop the lease or to make delay rental payments when the lessee had completed a dry hole before the last year of the primary term.¹⁰ Generally, the dry hole clause extended to the lessee the option of drilling another well or resuming the payment of delay rentals in order to hold the lease.¹¹ (3) The final problem involved the rights of the parties when the lease was being held by production and that production ceased, either before or after the expiration of the primary term. Generally, in the absence of a contract provision to the contrary, the lease terminated when production ceased after the primary term expired unless production was resumed within a reasonable time.¹² The cessation of production within the primary term was considered similar to the completion of a dry hole within the primary term with the same problems arising. Provision 5 in the principal

C. Kerr, General Counsel for Skelly Oil Co., predicts the holding of the principal case and interprets the 30-day clause not to be limited in its application to the very operations being engaged in at the expiration of the primary term, notwithstanding *Rogers v. Osborn*.

⁶ *Zeppa v. Houston Oil Co. of Texas*, (Tex. Civ. App. 1938) 113 S.W. (2d) 612, error refused n.r.e.

⁷ 2 SUMMERS, *THE LAW OF OIL AND GAS*, perm. ed., 169 (1938).

⁸ In *Kentucky*, *Simpson v. Buckners Admr.*, 247 Ky. 564, 57 S.W. (2d) 464 (1933); *Montana*, *Consolidated Gas Co. v. Rieckhoff*, 116 Mont. 1, 151 P. (2d) 588 (1944); *Oklahoma*, *Simons v. McDaniel*, 154 Okla. 168, 7 P. (2d) 419 (1932); and *West Virginia*, *Eastern Oil Co. v. Coulehan*, 65 W. Va. 531, 64 S.E. 836 (1909), such relief is unnecessary, for a lessee has the right to complete any well commenced within the primary term. But see 19 MICH. L. REV. 161 at 182 (1920).

⁹ The original 30-day clause was to effect the same result as permitted by the states in note 8 supra without any provisions. A further innovation was the "continuous drilling operations clause" which extended this saving aspect to include additional drilling after the well was completed as a dry hole after the primary term had expired.

¹⁰ See *Texas Co. v. Davis*, 113 Tex. 321, 254 S.W. 304 (1923). See also Masterson, "A Survey of Basic Oil and Gas Law," 4TH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 219 at 268 (1953).

¹¹ See WALKER, *CASES ON OIL AND GAS* 567 (1949).

¹² See 2 SUMMERS, *THE LAW OF OIL AND GAS*, perm. ed., §305 (1938).

case attempts to solve both problems by allowing additional drilling within 60 days and by extending to the lessee after production ceases within the primary term the same option which is available when a dry hole is completed within the primary term.¹³ In the principal case¹⁴ the court rightly says that the 60-day clause deals with the problems of both completion of a dry hole and cessation of production. The parenthetical expression (if it be within the primary term) appearing in the 60-day clause indicates to the court that both of these events may occur after the end of the primary term: "The lessee is specifically given the right to keep the lease alive by resuming payment of rentals in either situation provided it occurs before the end of the primary term. By necessary implication the lease may be kept in force by the additional drilling or reworking operations in either fact situation whether occurring within or after the end of the primary term. . . . The parenthetical expression shows beyond any question that the parties contemplated that the provision would be effective both during and after such term." Historical context, however, indicates that the real purpose of the dry hole clause is to allow the drilling of an additional well to comply with the development requirement and to substitute for payment of delay rentals. Since payment of delay rentals is never allowed to extend the primary term but is capable only of holding the lease during the primary term, drilling that is to substitute for delay rental must retain these same characteristics and cannot extend the primary term. Drilling, however, may be a substitute for royalty production. Since production results in royalty payments to the lessor which, unlike delay rental payments, are capable of extending the primary term, drilling after production ceases, as a substitute for production, may then extend the primary term. Drilling after completion of a dry hole and drilling after production ceases are two separate situations; drilling should take on the character of that which it replaces.¹⁵ The parenthetical clause, which therefore has no significance where a dry hole is completed, is an attempt to remedy the situation created by the cessation of production within the primary term by extending the same option of paying delay rental afforded by the completion of a dry hole within

13 "Experience has demonstrated that limiting this clause to a dry hole does not adequately protect the lessee. A similar provision is necessary when a well capable of producing is completed, but is shut in for lack of a market; or where production starts but then ceases. . . ." Masterson, "A Survey of Basic Oil and Gas Law," 4th ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 219 at 269 (1953).

14 Principal case at 174.

15 The identification of a substitute with the capabilities and limitations of that which it replaces was adopted to characterize shut-in royalty; *Freeman v. Magnolia Petroleum Co.*, 141 Tex. 274, 171 S.W. (2d) 339 (1943); and to determine whether an oil payment was royalty or bonus, *State Nat. Bank of Corpus Christi v. Morgan*, 135 Tex. 509, 143 S.W. (2d) 757 (1940); and to determine whether funds were royalty or delay rental, *Morriss v. First National Bank of Mission*, (Tex. Civ. App. 1952) 249 S.W. (2d) 269, error refused n.r.e.

the primary term.¹⁶ It was never intended to permit drilling after a dry hole to extend the primary term as does drilling after production ceases. To allow this is to nullify both the agreement for development within the primary term and the 30-day drilling operations savings clause, and would convert many dry hole clauses into continuous drilling clauses.¹⁷ Combined with this general historical background is the specific legal history of this particular provision in *Rogers v. Osborn* where the court held that the 30-day clause was not a continuous drilling operations clause as the lessee contended. To imply now the desired result in a dry hole clause which also defined the rights of the parties when production ceased within the primary term is to ignore both historical and legal context of the clauses as well as to refuse to recognize the ambiguity in the wording itself. This is not to say that the parties cannot contract for such a result. However, the history of this clause and the purpose for which it was created and modified combine with the general rule that ambiguity should be resolved in favor of the lessor to demand that a court require a clear and unambiguous expression of such contractual intention.¹⁸ No such expression can be found in the principal case.

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¹⁶ See note 13 supra.

¹⁷ See note 9 supra.

¹⁸ In referring to extensions of primary terms, the court said in *J. J. Fagan & Co. v. Burns*, 247 Mich. 674 at 681, 226 N.W. 653 (1929), "In fairness to lessors, extension provisions should be made plain."