

San Antonio Court of Appeals Addresses Shut-In Royalty Clause

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The San Antonio Court of Appeals issued an opinion yesterday addressing the scope and meaning of a shut-in royalty clause contained in an oil and gas lease. The case, *PNP Petroleum I, LP v. Taylor*, provides a good illustration of how shut-in royalty clauses work and how modifying just two words can significantly change the meaning of an oil and gas lease. [Review opinion: [http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=9360a5d4-d43a-4db5-ba6e-d437bb4adba6&MediaID=774b519f-b55f-4772-91c3-1b524268eace&coa="+this.CurrentWebState.CurrentCourt + "&DT=Opinion](http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=9360a5d4-d43a-4db5-ba6e-d437bb4adba6&MediaID=774b519f-b55f-4772-91c3-1b524268eace&coa=)].

Background

On June 1, 2009, Ms. Taylor and Ms. Herbst ("the mineral owners") entered into an oil and gas lease with PNP Petroleum. At the time the lease was signed, there were 13 non-producing wells on the property that were drilled by a prior lessee whose lease had expired. The lease between PNP and the mineral owners provided for a one year primary term and stated that it would continue "as long thereafter as oil and/or gas in paying quantities is produced from and sold from the land subject to this lease." Additionally, the lease contained a shut-in royalty clause that provided as follows:

SHUT-IN ROYALTY (Saving) If, at the expiration of the primary term there is located on the leased premises a well or wells not producing oil/gas in paying quantities, Lessee may pay as royalty a sum of money equal to \$20 per proration acre associated with each well not producing. The shut-in well royalty payment will extend the term of the lease for a period of 1 year....

As the primary term drew to a close, PNP wrote to the mineral owners stating that it intended to extend the lease term pursuant to the shut-in royalty clause and provided a check for the required amount of shut in royalty due under the clause. The mineral owners claimed that the shut-in royalty clause was inapplicable and that the lease was automatically terminated on June 1, 2010. PNP filed this lawsuit seeking a declaration that their payment of the shut-in royalties extended the lease term.

Parties' Arguments

PNP argued that because there were 13 existing wells on the property that were not producing oil and gas, the shut-in royalty clause extended the lease. Further, PNP offered a red-lined version of the lease agreement in which the language of the shut-in royalty clause was modified. Initially, the proposed shut-in royalty clause contained the words "capable of producing oil /gas in paying quantities" when discussing its application, but during the negotiations between PNP and the mineral owners, these words were stricken from the agreement. PNP argued that this was evidence the parties did not intend for the clause to apply only if there were wells capable of producing oil and gas (even though that is the standard understanding in the industry of a shut-in royalty clause), but instead to apply if there were any

non-producing wells on the property per the parties agreement, whether or not they were capable of producing.

The mineral owners, on the other hand, argued that under Texas law a shut-in royalty clause applies only when there was a lease *capable* of producing in paying quantities. They argued that this was the industry meaning of the term "shut-in royalty" and that the lease should be interpreted in accordance with the common use in the industry. Further, the mineral owners argued that the evidence of prior drafts of the lease and the negotiations was inadmissible under the rules of evidence.

The trial court sided with the mineral owners, finding that the shut-in royalty clause was inapplicable and that the lease terminated as of June 1, 2010. The trial judge also found that PNP's evidence of prior drafts of the lease agreement was inadmissible. PNP appealed to the San Antonio Court of Appeals.

Basic Law Regarding Interpretation of Oil and Gas Leases

Texas courts seek to determine the parties' intentions as expressed in a lease. *See Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 121 (Tex. 1996). Under Texas law, if a lease term has a generally accepted meaning in the oil and gas industry, that meaning is used by the court to construe the lease. *See BP Am. Prod. Co. v. Zaffirini*, 419 S.W.3d 495, (Tex. App. - San Antonio 2013) (pet. filed). These are the standard principles used by the Court of Appeals in reaching its decision.

Basic Law Regarding Shut in Royalties

Generally, a oil and gas lease is written such that it contains a primary and a secondary term. The primary term is generally a set number of years. In this case, for example, the primary term was for one year. The secondary term generally provides that the lease shall continue in effect at the conclusion of the primary term if oil and gas is being produced in paying quantities at the end of the primary term. There are, however, certain "savings clauses" common in oil and gas leases that allow an oil company to extend a lease beyond the primary term even if there is no production in paying quantities if certain conditions are met. One type of savings clause is a shut-in royalty clause.

"A shut-in royalty clause provides for a substitute contractual method of production, which will maintain the lease in force and effect when a gas well is drilled and for which no market exists. The shut-in royalty is considered constructive production and will maintain the lease if its terms are satisfied. However...for a well to be maintained by the payment of shut-in royalties, it must be *capable* of producing gas in paying quantities at the time it is shut-in. This is true even though the shut-in royalty clause makes no mention of capacity for paying production." *Hydrocarbon Mgmt, Inc. v. Tracker Exp., Inc.*, 861 S.W.2d 427, 432-33 (Tex. App. - Amarillo 1993).

Court of Appeals Decision

The court of appeals reversed the trial court. First, the court found that PNP's evidence of prior drafts of the lease agreement was admissible under the rules of evidence and should have been considered by the trial court. Next, the court reasoned that generally, a shut-in royalty clause would be interpreted in

accordance with the general principal quoted above and only applied to wells capable of production. In this case, however, the evidence that "capable of" producing in paying quantities was stricken from the lease by the parties, changed that general principal. The parties negotiations and agreed upon lease deviated from the general law that would have implied the "capable of" requirement in the lease because the parties expressly removed this agreement in the signed lease. In light of this, the court determined that it was not the parties intent to apply the generally accepted meaning of "shut-in royalty".

In light of this, because there were wells located on the leased premises that were not producing oil and gas at the end of the primary term as required by the parties' agreement, and because PNP paid the required shut in royalties, the lease continued on after the primary term.