Production in "Paying Quantities" - A Fresh Look

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I. INTRODUCTION

A. Preface

It is the purpose of this paper to review in some detail the requirement under Louisiana law that, in connection with the maintenance of mineral leases by production under the usual habendum clause, such production must be in "paying quantities." Although this doctrine has not been presented at this institute for about forty years, it has been examined in several fine papers to which the reader is referred. While this paper attempts to capture all significant Louisiana decisions on this topic, reference will also be made to certain decisions in other oil producing states, particularly Oklahoma and Texas. As noted in the Comment to Article 124 of the Mineral Code, Louisiana's current law on this subject is fashioned in large part on the pronouncements of the Texas Supreme Court in Clifton v. Koontz.

The notion that production must be of a certain quantity in order to maintain a mineral lease is as old as the industry itself. The earliest mineral lease in Louisiana jurisprudence contains an explicit requirement that production must be in "working quantity."
Although the requirement that production must be in "paying quantities" had been developed jurisprudentially, it is now codified in the Louisiana Mineral Code. As will be discussed, the Louisiana Mineral Code made significant changes to the scope of the inquiry as had been developed by the courts. Bringing Louisiana’s test in line with other jurisdictions, the issue of production in "paying quantities" essentially concerns itself with the operator’s motives in continuing production at the level being obtained.

B. Definition of Production in "Paying Quantities"

Before beginning the analysis, one should start with a few definitions. A "habendum" clause is that provision which dictates the duration of the mineral lease. The lease subsists during the "primary term" and "for so long thereafter as oil or gas is produced." The period of time after the "primary term" is sometimes called the "secondary term."

It is initially observed that, even where the habendum clause does not utilize the phrase "in paying quantities," the courts of Louisiana will nevertheless imply such a requirement. In an early case, the habendum clause did not state that production had to be in "paying quantities," on the basis of which omission the lessee "argued . . . that the quantity of oil produced has nothing to do with the continued life of the lease; that just so long as any oil at all is produced from the

after the conclusion of the Civil War. Id.

7. See infra Part IV.
8. The Louisiana Mineral Code requires a term for all mineral leases: The interest of a mineral lessee is not subject to the prescription of nonuse, but the lease must have a term. Except as provided in this Article, a lease shall not be continued for a period of more than ten years without drilling or mining operations or production. Except as provided in this Article, if a mineral lease permits continuance for a period greater than ten years without drilling or mining operations or production, the period is reduced to ten years.

9. Williams & Meyers defines the "secondary term" as the "period subsequent to the expiration of the primary term during which the lease . . . is continued in force by operation of the THEREAFTER CLAUSE of the lease . . . ." Howard R. Williams & Charles J. Meyers, Manual of Oil and Gas Terms 800 (6th ed. 1984).

10. Brown v. Sugar Creek Syndicate, 195 La. 865, 895, 197 So. 583, 593 (1940) (interpreting the customary habendum clause providing that the lease is to last "for a period of five years and as long thereafter as oil or gas, or either of them, is produced" to mean "producing oil and gas in paying quantities").
well the lease cannot be declared forfeited." The court rejected this contention, stating that it was "not prepared to give [their] approval to such a proposition." The court said:

A development that falls short of a reasonable production which would bring a net profit to the lessee and furnish an adequate consideration to the lessor for the continuance of the lease might well be said to be no development at all within the contemplation of the parties. To hold that any production, however small, and in less than paying quantities, gives to the lessee the right to continue the lease indefinitely and with no obligation to further development, would be contrary to the established rule of jurisprudence, and would be writing for the parties a contract which they never intended to make.

It was never contemplated that the lease under consideration should be continued for all time to come upon the mere production of oil in quantities not sufficient to compensate the lessee and totally inadequate as a consideration to the lessor for continuing the lease.

The supreme court's succinct treatment in Caldwell of the lessee's argument suggests that this requirement is a judicial articulation of the policy of this State which seeks to prohibit the lessee from speculating with mineral interests, or otherwise acting in a selfish manner, without regard to the interest of the lessor. This guard against speculation was explicitly stated as a reason for the rule by the Texas Supreme Court in Garcia v. King. There, the court observed that the "lessors should not be required to suffer a continuation of the lease after the expiration of the primary period merely for speculation purposes on the part of the lessees."

In Knight v. Blackwell Oil & Gas Co., the term "in paying quantities" was succinctly defined, as follows:

The words 'in paying quantities' can mean the production of oil or gas in such a quantity as will pay a small profit over operation costs of the well, although the expense of drilling and equipping the well may never be paid, and thus, the

12. Id.
13. Id. at 142-43, 108 So. at 315.
14. 164 S.W.2d 509 (1942).
15. Id. at 513.
operation as a whole might result in a loss to the lessee. Under such circumstances, the well might be operated by the lessee, in order to recoup some of the drilling and equipment costs.\textsuperscript{16}

The Louisiana Supreme Court has articulated a strict reading of the habendum clause, saying that mere "[d]iscovery of a well capable of producing minerals in paying quantities does not satisfy the requirement that oil, gas or some other mineral be \textit{produced} under the habendum clause in order to continue the lease in full force and effect beyond the primary term."\textsuperscript{17} Moreover, production under the habendum clause "should be understood to mean production in paying quantities in the absence of a stipulation that it should be production in paying quantities."\textsuperscript{18} A Texas court—faced with a lease wherein the words "whether or not in paying quantities" were stricken from the habendum clause—found that the lease nonetheless contemplated production in "paying quantities."\textsuperscript{19}

II. JURISPRUDENTIAL TEST

A. Historical Approach Developed by Jurisprudence

The jurisprudence of Louisiana had developed the test in connection with inquiries into whether production is in "paying quantities," that production must be such as to the interest of the lessor as well as with respect to the interest of the lessee. The two "prongs" of this test—first, as to the lessor, and second, as to the lessee—have been called the "objective" standard and the "subjective" standard.\textsuperscript{20}

B. First "Prong"—The Objective Standard

The first prong of the test—an examination of the relative worth or sufficiency to the lessor of the production royalties as compared to

\textsuperscript{16} 197 La. 237, 243, 1 So. 2d 89, 91 (1941) (emphasis added).
\textsuperscript{17} Landry v. Flaitz, 245 La. 223, 232, 157 So. 2d 892, 895 (1963) (emphasis added).
\textsuperscript{18} \textit{Id.} at 233, 157 So. 2d at 895.
\textsuperscript{19} Peacock v. Schroeder, 846 S.W.2d 905, 908 (Tex. Civ. App. 1993) ("Thus, we attach no significance to the striking of 'whether or not in paying quantities.' The lease requires production in paying quantities."). This holding is actually consistent with the principle of contractual interpretation which dictates that words which are obliterated or stricken are to be "deemed not written." See Patrick S. Ottinger, \textit{Principles of Contractual Interpretation}, 60 La. L. Rev. 765, 772-73 (2000).
\textsuperscript{20} Battle, \textit{supra} note 1, § 14.05.
the other payments contemplated by the lease terms—is a necessary corollary to the fact that, in Louisiana, royalties are characterized as "rent." The courts feel that, in order to sustain the validity of the lease, it is necessary to determine that the lessor is receiving "rent." The initial inquiry is a comparison of the production royalties paid to the lessor under the lease to other lease payments received by the lessor, e.g., the bonus, delay rentals, or shut-in gas payments. If the comparison is favorable to the lessor or, as the courts state it, if the royalties constitute a "serious consideration" to the lessor for the maintenance of the lease, the inquiry stops and any attack on the lease as not having been produced in "paying quantities" is foreclosed.

C. Second "Prong"—The Subjective Standard

If, on the other hand, the comparison of the royalty payments to the other monetary benefits inuring to the lessor under the lease is unfavorable, then the second prong in the test is reached. The essence of the inquiry at this point is whether the conduct of the lessee as manifested by the circumstances would indicate speculation on its part. That is to say, can the production secured, and being secured, be said to be in "paying quantities" with respect to the interest of the lessee?

If the lease is producing in quantities sufficient to meet current operating expenses and yield a small profit to the working interest owner, then the test is satisfied and, again, production is said to be commercial or in "paying quantities." It is appropriate to observe that, in the application of this phase of the jurisprudential test, one is not concerned with recovery of investment costs. As long as a small

21. Milling v. Collector of Revenue, 220 La. 773, 57 So. 2d 679, 1 Oil & Gas Rep. 587 (1952) ("Under this application of the law, it was inevitable that when the question arose as to the nature of royalty, it was held to be rent in the form of a portion of the produce of the land, . . . "). See La. Min. Code art. 123, La. R.S. 31:123 (2004) (". . . royalties paid to the lessor on production are rent.").
25. See Garcia v. King, 164 S.W.2d 509, 511 (1942) ("If a well pays a profit, even small, over operating expenses, it produces in paying quantities, though it may never repay its costs, and the enterprise as a whole may prove unprofitable."); see also Transport Oil Co. v. Exeter Oil Co., Ltd., 191 P.2d 129, 133 (Cal. Ct. App. 1948): By the great weight of authority, the term, 'paying quantities,' when used in the extension clause of an oil lease habendum means production in quantities sufficient to yield a return in excess of operating costs, even though drilling and equipment costs may never be repaid and the
profit (above and beyond current operating costs) is yielded, such profit is dedicated to recoupment of investment costs, and the well is deemed to be producing in "paying quantities."

As was hereinabove seen, the rule that production must be in "paying quantities" evolved so as to prevent speculation in mineral interests and, correspondingly, to deny a mineral lessee the right to effectively remove minerals from commerce. When, in applying the jurisprudential test to a particular factual situation, it becomes necessary to reach the second prong (for the reason that the comparison of royalties to other benefits of the lessor was unfavorable), then the courts are actually concerned with the status of development of the lease. That is, the courts will usually look favorably upon the past operational history of the lessee where the lessee has acted as a reasonable, prudent operator in the development of the leased premises. This is notwithstanding a less than favorable comparison of lessor's royalties to other benefits to the lessor. If the lessee has done all that could be done under the circumstances in terms of development of the lease, then the lease would be saved. The following cases seem to support this observation.

In Green v. Standard Oil Co. of Louisiana, the lessors sued the lessee for "the annulment of a gas and oil lease." The lessee had drilled one well. The court noted that such well "produced so little oil that it would have been abandoned, if the defendant company had not been in a position to have it attended to at no appreciable expense by the employees who attended to the other wells in the vicinity." The defendant resisted on the basis that "oil is being produced in paying quantities, since defendant company is getting some little of it from said well at practically no expense to itself and therefore in paying quantities." The supreme court held that the "defendant company having announced the intention not to develop, the lease must be annulled." Clearly, the lack of development motivated the court to disregard the fact that production was being obtained at little or no cost to the lessee.

In another case, Caldwell v. Alton Oil Company, the lessee failed the first prong of the test. The initial comparison was unfavorable ($33.33 in royalties in a year as compared to a $500 bonus). The court then considered the sufficiency of development of the leased premises. Observing that the lessee had assumed a drilling obligation which had not been satisfied, it was concluded that the lease had

undertaking considered as a whole may ultimately result in a loss.

26. 146 La. 935, 936, 84 So. 211, 211 (1920).
27. Id. at 937, 84 So. at 212.
28. Id.
29. Id. at 938, 84 So. at 212.
30. 161 La. 139, 108 So. 314 (1926).
expired by its terms, the implication being that the courts are not so deeply concerned with the comparison of royalties to other payments to the lessor in cases where there has been a reasonable development under the circumstances.\textsuperscript{31}.

In \textit{Smith v. Sun Oil Co., Inc.}, the lessor sued his lessee to declare the mineral lease to have terminated.\textsuperscript{32} It was admitted that “no oil whatever has been produced from the land since September, 1926, but it is contended that the land is still producing gas in paying quantities.”\textsuperscript{33} There existed on the land two shallow wells, capable of producing gas. “But [said the court] the fact is that there is no market for said gas, that the only gas used from said wells was a few thousand feet which were used by the driller of said well.”\textsuperscript{34} The court found that the lease had lapsed, stating:

\begin{quote}
We are of opinion that lease has now ceased to produce either oil or gas in paying quantities. Where the output of a gas well either cannot be, or in fact is not, disposed of, the well cannot be said to be a paying proposition either for the owner of the land or for the owner of the well; and, where a well has ceased to be a paying proposition for any one concerned, it has clearly ceased to produce gas in paying quantities. We think the lease has expired by its very terms.\textsuperscript{35}
\end{quote}

In \textit{Logan v. Tholl Oil Co., Inc.}, the lessor sued the lessee to declare a mineral lease to have been terminated because of failure to produce in “paying quantities.”\textsuperscript{36} Although the production from the lease was initially significant, it steadily declined “to such an extent that four wells were abandoned and the remaining four are small pumpers. The average production of these four wells during the fifteen months immediately preceding the filing of this suit was slightly over 1-1/3 barrels per day, or 1/3 of a barrel each, which yielded plaintiff as royalty slightly over $5 per month.”\textsuperscript{37} The court compared these amounts to the bonus and rental and found the production to be insufficient to continue the lease.\textsuperscript{38} The court had no occasion to reach the second prong of the test.

In \textit{Brown v. Sugar Creek Syndicate}, the lessor challenged a mineral lease on a variety of grounds.\textsuperscript{39} As to the contention that the

\begin{flushright}
31. \textit{Id.}
32. 172 La. 655, 135 So. 15 (1931).
33. \textit{Id.} at 656, 135 So. at 15.
34. \textit{Id.}
35. \textit{Id.}
36. 189 La. 645, 180 So. 473 (1938).
37. \textit{Id.} at 651, 180 So. at 475.
38. \textit{Id.}
39. 195 La. 865, 197 So. 583 (1940).
\end{flushright}
lease ceased to produce in "paying quantities," the court found that royalties paid to the lessors on gas amounted to $8,476.84 and on oil amounted to $100.00 per month for a six month period. Citing Logan, the court observed that "the well appears to have been a profitable commercial well bringing in a net profit to the lessees and furnishing an adequate consideration to the lessors for the continuance of the lease." The lessee was entitled to continue production.

This implication is given credence by a review of the decision in Vance v. Hurley. In Vance, the entire lease had been included in a compulsory unit. Although the first comparison was again unfavorable (52¢ per acre royalties vis-a-vis $10.00 per acre bonus), the court concluded that all possible development had occurred by virtue of unitization and the lease was upheld.

In Noel Estate, Inc. v. Murray, the plaintiff-lessee sought cancellation of a mineral lease. The lessee had obtained production on ten acres of a sixty-acre lease. The court held that production was in "paying quantities" as to both the lessor and lessee and, thus, upheld the lease. The test in determining if a lease is producing in "paying quantities," as to lessee, is "whether the producing well or wells involved would provide a net profit to the lessee," and, as to lessor, whether it will "furnish an adequate consideration to the lessor, the income of the latter from royalties being especially compared with the sums that he received in payment for the lease originally and for annual delay rentals." The court found it unnecessary to conduct a serious inquiry into the reasonableness of development inasmuch as the initial comparison was most favorable (royalties of $12 to $20 per acre as opposed to a $2.50 per acre bonus). The lease as to these ten acres was upheld on the basis of this favorable comparison.

Professor George W. Hardy, III, the Reporter for the Louisiana Mineral Code, was of the view that the initial comparison feature of the test is merely "an evidentiary signal." If favorable, the inquiry stops and the lease is maintained. If unfavorable, it becomes necessary to go further and review the question of adequacy of development under the circumstances. The conclusion to be reached after a review of the pre-Code jurisprudence in this area of the mineral law is well stated in the comment under Article 124 of the Louisiana Mineral Code, as follows:

40. Id. at 896, 197 So. at 593.
41. 215 La. 805, 41 So. 2d 724 (1949).
42. Id.
43. 223 La. 387, 65 So. 2d 886, 2 Oil & Gas Rep. 951 (1953).
44. Id. at 392, 65 So. 2d at 888.
45. Id. at 393–95, 65 So. 2d at 888–89.
Viewing the totality of the jurisprudence in this area, it appears that the thrust of the Louisiana cases is that (1) the lease must be producing in such manner as to yield a profit to the working interest over current operating expenses; and (2) the amount of the royalties being paid to the lessor must be sufficient to dispel any notion that the lessee has been holding the lease for speculative purposes and is doing all that might be reasonably expected to maximize his profit on his total investment or minimize any loss thereon.47

III. APPLICATION OF THE SECOND "PRONG" OF THE TEST

A. Introduction

Because the first prong is objective, monetary considerations accruing to the lessor either are, or they are not, serious. Additionally, this first prong has essentially been abandoned in Louisiana under the codal formulation and, therefore, merits little further discussion. It is appropriate, however, to give consideration to the jurisprudential treatment of the second, or subjective, prong. This is where the action is post-1975.

B. Contrary Interests of the Lessor and of the Lessee

The inquiry at this second prong involves a comparison of the "current operating costs"—usually called lifting costs48—with the revenue stream inuring to the entire working interest, that is, the portion of revenue remaining after deducting only the lessor’s royalty share.49 Because the revenue side of the ledger is determinable solely by reference to the lease contract itself (relevant revenue equals one hundred percent minus only the stipulated royalty), a production in "paying quantities" case focuses essentially on the expense side of the ledger.

In examining the costs which might be of a "current operating" nature, it is helpful at the outset to identify the contrary interests of the lessor and of the lessee in disputes over whether a lease is generating production in "paying quantities." The lessor would want

47. Id.
48. This term has reference to those costs incurred by the operator and which are "necessary to lift the oil from the ground." Stewart v. Amerada Hess Corp., 604 P.2d 854, 857 n.8, 65 Oil & Gas Rep. 530 (Okla. 1980).
49. See infra Part III.F.
to consider as many items of cost as possible so as to require a greater amount of production before it could be said that current operating costs were being met. Obviously, the lessor is well served to "load it up."

Conversely, from the point of view of the lessee, and so as to permit a smaller amount of production to satisfy the requirement of being in "paying quantities," it is necessary that fewer items of expense be considered. The less expenses considered, the less the production necessary to meet them on a current basis. Clearly, the lessee will challenge certain expenses as not being lifting costs, and, hence, will try to limit or minimize the relevant block of expenses to be measured against revenue. This tug of war is typically at the heart of a production in a "paying quantities" case.

In evaluating the production with respect to the working interest, it is necessary to give consideration to what expenses are considered as being current operating costs, what portion of the revenue stream is pertinent, and what qualifies as a "small profit" (assuming, of course, that relevant revenue exceeds qualifying costs). By their nature, production in paying quantities cases often turn on a characterization of items of expense and are usually expert-intensive. But first, it is appropriate to consider the question: from where is the relevant data to be obtained?

C. Source of Relevant Data

The lessor has the burden of proving its entitlement to lease cancellation as a consequence of the failure of production in "paying quantities." Except in the case where a sophisticated lessor has negotiated a lease clause which requires the lessee to afford the lessor the opportunity to review the lessee's books and records, the lessor has no effective means, prior to filing suit and availing itself of

50. Frazier v. Justiss Mears Oil Co., Inc., 391 So. 2d 485, 68 Oil & Gas Rep. 652 (La. App. 2d Cir.), writ denied 395 So. 2d 340 (La. 1980) ("In any event, the burden of proving grounds for the cancellation of a mineral lease is on the lessor.").

51. An example of such a clause, encountered by the author in a sophisticated mineral lease contract, is, as follows:

Lessor shall have the right, at all times, to inspect the books and records of Lessee, including without limitation, the gross production, the amounts saved, sold or used, the sales price thereof; the amounts and values of all other production, all sales contracts and all other data proper for the settlement of accounts between the parties hereto. Lessee shall make all of such records and data available to Lessor on request, at Lessee's principal office, for examination and copying, at all reasonable times, as well as all other records, contracts, receipts, invoices, documents, books, including title data, or papers in the possession or under the control of Lessee pertaining to the testing, exploration, development, operation, the production and disposition of such production therefrom.
discovery, to ascertain the expense and revenue data necessary to pursue a claim that the lease has lapsed because of a failure to produce in "paying quantities." Although the lessee is obligated to disclose certain revenue information on the check stub, there is no legal obligation to provide expense information.

It is obvious that a production in paying quantities case will involve close scrutiny of the books and records of the operator in order to determine what costs and expenses were incurred in the operation of the lease in question. Quite often, the manner in which an operator has characterized an item of cost or expense on its books and records will be used by the lessor against the operator. However, it is equally clear that the characterization of an item of cost or expense for purposes of the issue of lease maintenance may not accurately comport with the characterization of the same item for other purposes.

For example, a given item of cost or expense might be treated one way for purposes of joint interest billing under a joint operating agreement, and yet another way for purposes of filing tax returns, and still another way for purposes of financial accounting or reporting, and may or may not be considered in calculating a net profits interest (if such exists), and entirely differently for purposes of administration of the mineral lease within the lessor-lessee relationship. Context matters here.

There is nothing nefarious about the different treatment of the same item of cost or expense when viewed or examined in the context of different relationships. This fact was well stated by one commentator:

Since we are obliged to deal with the accounting facts of life, let's start out by frankly and intelligently recognizing that there is no stigma attached to "keeping two sets of books." The marvel would be if a sizeable company, in this day and age, could get by with only two sets. It is not at all unusual to find that the books kept by a company for the purpose of internal cost accounting will vary considerably from the books which Uncle Sam requires for income tax purposes. And, . . ., the accounting treatment in preparation of an F.P.C. cost case would certainly be different from the treatment on either the annual statement or the tax return. This is perfectly legitimate. In fact the difference in use of the figures requires different handling.

Therefore, it should come as no surprise if you find that an oil and gas operator keeps separate figures on the lifting

expense of his wells which do not resemble those on his F.P.C., tax, or annual report statements.

The most obvious example of this difference is in the handling of intangible drilling costs. Many operators have elected to "expense" these intangibles for the purpose of computing income taxes. Thus in the early life of a producing lease, where there is a lot of drilling, the "expense" of these intangible drilling costs may well exceed the proceeds from production for months or years. Yet by definition such well costs must be ignored in our determination of paying quantities under the habendum clause. You can readily see that such a lease may have current income far in excess of lifting expense and still show an operating loss on the tax books.

The paying quantities rule set up by the courts goes to the substance of the case and is not concerned with mere form. Thus it is necessary to look past the mere debit and credit book entries in every instance and inquire into the essential character of the particular transactions which gave rise to those entries.\(^5\)

This notion—that the absence of uniform, "one size fits all" accounting principles justifies (if not mandates) the different treatment of items of cost or expense for different purposes, in different contexts—has received judicial approbation. In Mason v. Ladd Petroleum Corporation, the Supreme Court of Oklahoma said,

> Neither can the determination of the issue rest with accounting practices, that is, how such expenses are carried on the books of the leasehold owner-operator. Until such time as accounting practices become standardized, generally accepted accounting practices may lead to one result, whereas equally accepted accounting practices, using acceptable but alternate methods and practices, can result in an opposite result.\(^4\)

For the reasons suggested by the foregoing passage, the fact that in the joint operating agreement between the parties working interest parties might characterize a certain item of cost or expense as chargeable is not dispositive of the issue. The Mason Court held that

> [t]he fact that operators under a joint operating agreement generally treat such expenses as chargeable inter se, does not, as plaintiff contends, establish a basis for including them as

\(^{53}\) Cage, supra note 1, at 68.

chargeable expenses in determining whether a well is a producer, both because no joint operating agreement was here involved, and because even if there were, such expenses would still be too indirectly and too remotely related to lifting costs.\textsuperscript{55}

In view of the foregoing, it is self-evident that an accountant or joint interest billing auditor is a necessary participant in the team of experts in a production in paying quantities case.\textsuperscript{56}

D. What Period of Time Is to be Considered?

Over what period of time is the issue of production in paying quantities to be determined? Production occurs daily, yet expenses to "lift" the product may be incurred daily, weekly, monthly or—taxes and insurance being examples—annually. The principle of amortization is obviously available, but the question is begged: Over what period of time should the expenses be spread? Clearly, a snapshot of one day's worth of production is not a reasonable measure of production as it is too susceptible to anomalies of the moment.

One commentator has stated, with respect to the "relevant period" to be considered:

Louisiana cases seem to have been inclined to consider relatively long periods and have not apparently laid down many limiting rules as to time; nor does there appear much discussion of the particular reasons for considering particular periods of time. Since in Louisiana the lessors [sic] royalties are considered as rent, the courts seem to take the view that a longer period, or perhaps the entire term of production, is peculiarly appropriate to consider in this connection.

...\textsuperscript{56}

It has been well suggested that the courts should consider only such period of past production as would shed light on the present status of production, and then only as one of the factors in determining that present status.\textsuperscript{57}

\textsuperscript{55} Id. at 1286. See also Hininger v. Kaiser, 738 P.2d 137, 141, 94 Oil & Gas Rep. 167 (Okla. 1987) ("It is, therefore, unnecessary to examine the terms of the Joint Operating Agreement because that agreement will have no effect on what expenses are, or are not to be, deducted as lifting costs.").


\textsuperscript{57} Wells, supra note 1, at 100.
Clifton v. Koontz instructs that profitability is to be determined over "a reasonable period of time under the circumstances." The Louisiana courts seem to consider "the quantity of minerals produced during the relevant period . . . rather than the quantity sold during such period." In any event, it is necessary to show the value of the production during the relevant period.

E. What Expenses Are to be Considered?

As to what constitutes a current operating expense, it seems that those expenditures incurred as a direct result of the leasehold operations would be considered, "the relevant concept being that the basic limitation on any expense to be considered is that it must be traceable to the actual expense of production of the well's product, once the capability of the well to produce is assured."

1. Capital Costs

First, we will begin by identifying that category of costs which are not to be considered. Costs incurred in seeking to find production are not operating costs and, hence, are not relevant. In accounting jargon, these are sometimes called "sunk costs."

Reworking expenses are not to be considered as lifting expenses. In Pshigoda v. Texaco, Inc., the Texas Court of Appeals stated that a "reworking expenditure is analogous, and closely related, to the initial drilling expenses. It is usually a one time, single expense item, that . . . is treated as a capital investment."

2. Labor, Equipment, and Material Costs

Labor, equipment and materials consumed, handling costs on well location and power utilized at the well site would qualify as costs to be considered. In Lege v. Lea Exploration, Inc., the lessors sued the

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59. Wells, supra note 1, at 99.
60. See, e.g., Stacy v. Midstates Oil Corp., 214 La. 173, 36 So. 2d 714 (1948) (case remanded where court was "unable to make an intelligent decision . . . without having the benefit of evidence as to the value of the oil produced" during the relevant period of time.).
61. Battle, supra note 1, §14.05(1)(c).
64. Reese Enters., Inc. v. Lawson, 553 P.2d 885, 898, 56 Oil & Gas Rep. 517 (1976) ("All direct costs encountered, whether paid or accrued, in operating the
lessees to declare a mineral lease to have terminated because of a failure to produce in "paying quantities." The lessors contended that certain identified costs and expenses were to be characterized as a lifting expense. The issue was stated by the court, as follows:

The heart of the dispute calls into question the legal classification of certain expenditures by the lessee. Allocation of these expenditures to the category of "operating expenses," which are deductible from a producing properties [sic] gross revenues, could result in our finding that the well did not consistently "produce in paying quantities" and a forfeiture of the lease at some point during the years 1981 through 1984; their classification as "repair and remedial" or "equipment" capital costs, on the other hand, would lead us to affirm the lower court's conclusion that the well never ceased to "produce in paying quantities."

The principal disputed item of expenditure was the cost incurred in converting an existing well to a saltwater disposal system. For a period of time, the lessees disposed of the saltwater by trucking it off of the leased premises, the cost of which would be treated as operating costs. The lessors argued that, by analogy, "so should be the expenditures which replace them." The court stated that they were "unable to accept the premise of plaintiff's position, that the nature of a lessee's cost is determined strictly by the substitution accomplished." Rather, the classification of a given item of expense as being "ordinary and recurring or extraordinary and largely non-recurring in nature" was determinative as to whether that expense item should be considered as a lifting expense. Since the disputed costs were treated as "extraordinary and largely non-recurring in nature," the costs were disregarded and the lease was maintained.

lease as a prudent operator are taken into account.

65. 93–605 (La. App. 3d Cir.), 631 So. 2d 716, 130 Oil & Gas Rep. 329, writ denied 94–0450 (La. 1994), 635 So. 2d 1112. In the interest of full disclosure, the author represented the operator in this case.

66. Id. at 717.
67. Id. at 718.
68. Id. at 719.
69. Id.
70. Id.
3. Depreciation

The cases treating the subject of depreciation as an eligible item of expense to be deducted are, to be kind, less than consistent. The better way to view this issue was explained by one commentator:

It is submitted that it is unquestionably proper to draw a line between the initial costs required to establish production and the costs of continuing to produce after production has been established. It is also submitted that the court is on sound ground in concluding that only lifting costs should be taken into account in determining whether or not the lease is producing in paying quantities for purposes of the habendum clause. It is also submitted, however, that the identification of lifting costs is made easier by first identifying and eliminating from consideration the costs of drilling and completion and other costs required to establish production in the first instance. This method avoids the difficulty of dealing with equipment that is required in drilling and completing the well and also required in operating the well. Accordingly, once it is determined that the costs of casing, tubing, and the Christmas tree are costs of completing the well and preparing it for production, such costs would be eliminated from consideration in determining paying quantities. Depreciation on such equipment should not be taken into account, because it is an accounting method of spreading the cost of equipment over its useful life that amounts to deducting costs of such equipment piecemeal.

In view of the foregoing, it seems logical that depreciation is not to be so included if the equipment to which it relates is a part of the drilling and completion expenses.

As to equipment and material not consumed, a Texas case permits consideration of the actual depreciation on these items. Or, as said

71. Compare Ross Explorations, Inc. v. Freedom Energy, Inc., 8 S.W.3d 511 (Ark. 2000) (Arkansas Supreme Court stated that the “better view” is to exclude depreciation as a cost of operation) with cases cited in footnote 74, infra.
by another court in Texas, "to show the depreciation allowed in the paying quantities calculation, landowners must show the cost of the particular equipment and its rate of depreciation."\footnote{75}

4. District Expenses

The propriety of including expenses of district offices—salaries and employees' fringe benefits—has been considered by the courts. Here, the question is, how high up the corporate chain of command can you go? Who is the highest corporate employee whose costs might, in part, be attributed to this particular well?

To frame this issue by way of illustration, it is only logical that if the lessee is a large, multi-national major, integrated oil and gas company, which operates and manages significant producing assets in many jurisdictions (domestic and foreign), a lessor would not be successful in attributing any expenses incurred above a rather low supervisory level in the corporate structure. That is the easy case.

If, however, the lessee is a small, one or two person operation—a so-called "mom and pop" shop—the probability is greater that some portion of all costs and expenses are in play, and this is all the more so if the company only operates one well.

If that small company operates two fields, one with seven wells and one with one well (the well in litigation), does one allocate one-half (one out of two fields) or one-eighth (one out of eight total wells) of district expenses? A court might find helpful the expert testimony of an accountant versed in the financial aspects of corporate structures or a human resources expert or an expert familiar with COPAS standards or custom in the industry.

Nevertheless, in \textit{Mason}, it was held that "district expenses" were "too indirectly and too remotely related to defendant's lifting or producing operations . . . to be included in determining whether the well operates at a profit."\footnote{76} The court also observed that the expense of a district office "relates to and is made necessary by reason of corporate convenience or necessity, and not by reason of anything necessary or convenient for the lifting operations of the well."\footnote{77}

76. \textit{Mason}, 630 P.2d at 1285.
77. \textit{Id.}}
One court held that, because “administrative and district expenses would continue whether or not [the well in question] was producing, then such expenses should not be considered as overhead.”

5. Administrative Overhead Expenses

Other expenses, although not directly and exclusively related to the operation of a particular well, such as overhead and administrative costs (including postage, office supplies, telephones, etc.), have been urged by landowners to be deductible. However, the Oklahoma Supreme Court—noting a “diversity of views within the oil industry”—has stated that, “in determining whether a well is a producer, such administrative overhead expenses should be excluded.” Nevertheless, legal expenses and insurance directly attributable to that particular lease could be considered.

6. Operator’s Overhead Expenses

In *Menoah Petroleum, Inc. v. McKinney*, plaintiff-lessee filed a suit to enjoin defendant-lessee from blocking plaintiff’s access to a well not located on defendant’s property, but located on property covered by a lease owned by plaintiff which lease included defendant’s property. Defendant asserted that plaintiff’s mineral lease had terminated for failure to produce in “paying quantities.” Additionally, defendant contended that the lease had also lapsed because of non-production for two months.

The trial court ruled for the defendant-lessee, denying the lessee’s application for injunctive relief and holding that the lease had lapsed. On appeal, the plaintiff-lessee complained that the trial court had placed on it the burden to show that the lease was in effect, rather than placing it on the lessor to prove that the lease had terminated. The court, in reliance upon *Frazier v. Justiss Mears Oil Company, Inc.*, agreed with the plaintiff and held that the “burden of proof was upon [lessor] to show that the lease affecting her property had lapsed due to failure to produce in paying quantities after expiration of the primary term.” The court then proceeded to “determine whether [the lessor] proved that [the lessee]’s lease lapsed due to failure to produce in paying quantities in 1986.”

80. 545 So. 2d 1216 (La. App. 2d Cir. 1989).
81. *Id.* at 1220.
82. *Id.*
The court reviewed the revenue and expenses and concluded that the lease ceased to produce in "paying quantities." In so doing, the court further stated that, where a unit is being operated by a third party other than the lessee, it is appropriate to consider overhead expenses as operating expenses for purposes of determining whether a well is producing in "paying quantities."

In the subsequent case of *Edmundson Brothers Partnership v. Montex Drilling Co.*, the defendant-lessee argued, in reliance on *Menoah*, that "the operator's overhead must be excluded from the calculation of whether the Edmundson No. 1 well produced in paying quantities." However, the court found that it need not reach "the question of whether operating expenses should be considered in connection with this issue," stating that, even excluding that expense, "the lease did not produce in paying quantities." This holding was made in the face of a finding that the "lease produced a profit of $139.00 per month for the eighteen-month period preceding the filing of the suit." Although the court did not explain why this "profit"—even if considered "small"—was not sufficient to uphold the lease, the court's ruling was probably motivated by its finding of a lack of development on the part of the lessee.

7. Marketing Expenses

An implication in *Hunter v. Booker* suggests that costs incurred by the lessee in treating the product so as to make it marketable is a relevant consideration. However, the court did not engage in extended discussion of this issue because "the cost of this operation is not mentioned in the testimony." The better view is that expenses incurred by the operator in rendering the product marketable should not be deductible. First, properly speaking, these expenses cannot be considered as lifting costs since they are incurred, if at all, only *after* the product has been "lifted" and thereby reduced to possession at the wellhead; they are incurred *after* the fact of production, not in connection with the obtaining of that production.

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83. 98–1564 (La. App. 3d Cir. 1999), 731 So. 2d 1049, 1058, 142 Oil & Gas Rep. 266.
84. *Id.*
85. *Id.*
86. 158 La. 690, 694, 104 So. 618, 620 (1925).
87. *Id.*
88. See *La. Min. Code art. 7, La. R.S. 31:7* (2004) (“Minerals are reduced to possession when they are under physical control that permits delivery to another.”).
Next, the lessee is under an implied covenant to prudently market the product and should not be penalized for taking those necessary and reasonable steps to discharge this duty. Absent bad faith, any tension between the lessee’s implied duty to market the product and the duty to prudently operate for the mutual benefit of the parties should ordinarily be resolved in favor of the operator.

Finally, in most instances, these expenses are borne proportionately by the royalty owner and the working interest owner. Since each party bears its own share of these expenses, it would be inequitable to effectively shift, for purposes of a “paying quantities” analysis, this burden to the operator by requiring it to deduct from its share of revenue the cost of marketing.

It should be noted, however, that Williams and Meyers, while observing that there “is some doubt concerning the question whether marketing expenses are to be included as costs of the operation,” then state that it “would seem that these are properly included in the calculation since unless the product is marketed there can be no paying production.” One might quarrel with this reasoning for, under that standard, drilling and completion costs likewise should be considered since unless the well is drilled and completed there can be no paying production.

8. Ad Valorem Taxes

Ad valorem taxes should be considered since “[t]hese annually recurring taxes are expenses which a prudent operator cannot ignore in an evaluation of whether to continue to operate the lease.”

F. What Revenue Is to be Considered?

It is irrelevant as to how the lessee might have distributed the net revenue interest attributable to the working interest. Thus, overriding royalty interests, production payments, or other burdens or interests created by the lessee would not be taken into account to the extent that the net revenue interest allocable to the working interest would be diminished thereby. The comparison to lifting costs is made to the full working interest stream, without regard to the various revenue burdens on that working interest. As stated in Clifton v. Koontz, “[t]he entire

under a shut-in royalty clause.”).

91. Howard R. Williams & Charles J. Meyers, Oil and Gas Law § 604.6(b).
income attributable to the contractual working interest created by the
original lease is to be considered.

To illustrate (with an admittedly extreme example), if a lease well
produces $4,000.00 per month in product sales (to the 8/8ths) and if the
lease provides for a one-fourth (1/4) royalty to the lessor, the lessee
receives three-fourths (3/4), or $3,000.00 per month in gross proceeds
(out of which all operating expenses are to be paid). If the well
produces excessive amounts of salt water which must be hauled off in
trucks, the lifting costs are $2,500.00 per month. Because the monthly
proceeds to the lessee ($3,000.00) exceed monthly lifting costs
($2,500.00), the lease is producing in "paying quantities." If the lease
is subject to a one-fourth (1/4) overriding royalty interest to a third
party, then the lessee's net interest in production (1/2) yields $2,000.00
per month, which is not sufficient to cover monthly lifting costs
($2,500.00). Nevertheless, the lease is producing in "paying quantities"
because expenses are, in the words of Article 124 of the Mineral Code,
to be measured against the "total original right of the lessee to share in
production under the lease," or three-fourths, rather than the lessee’s
actual net revenue interest (in this case, one-half).

In Leaderbrand and Hardy v. Shallow Oil Co., the sublessor of a
mineral lease stipulated that "the lease is paying in commercial
quantities to the landowner, lessor, and the defendant, sub-lessee.
Notwithstanding this admission, the sublessor sought to cancel the
sublease "on the ground that it was not producing in commercial
quantities." Upholding the sublease, the court stated:

Certainly this production could not be governed by the
amount received for the small overriding interest. The
plaintiffs seem to think that the consideration that they paid
for the sub-lease and overriding royalty, and the expenses
incurred by them such as book-keeping, taxes, and
depreciation, should be the determining factor of whether or
not these wells are producing in commercial quantities.

If it were to hold otherwise, said the court, "the rights of the lessor
and the operating sub-lessee could be easily destroyed.

1987) ("Overriding royalties, like costs of drilling, are part of the capital investment
instead of part of the lifting costs.").
94. 325 S.W.2d 684, 693, 10 Oil & Gas Rep. 1109 (1959).
96. 234 La. 796, 801, 101 So. 2d 673, 675, 9 Oil & Gas Rep. 475 (1958). See
also Vance v. Hurley, 215 La. 805, 41 So. 2d 724 (1949). A "stipulation" is a
"judicial confession" which "constitutes full proof against the party who made it.
97. Leaderbrand, 234 La. at 801, 101 So. 2d at 675.
98. Id. at 802, 101 So. 2d at 675.
99. Id.
G. How Much “Profit” Is Necessary?

As to what constitutes a profit within the meaning of the rule, the standard of evaluation again seems to be one of reasonableness. That is to say, is it reasonable to continue to operate this particular well under all relevant circumstances, when such production is yielding this particular profit? The leading court decision on this question—and the origin of Louisiana’s current codal formulation—seems to be a Texas Supreme Court case, where the court said:

[The standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated.

In determining paying quantities, in accordance with the above standard, the trial court necessarily must take into consideration all matters which would influence a reasonable and prudent operator. Some of the factors are: The depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes.

The term “paying quantities” involves not only the amount of production, but also the ability to market the product (gas) at a profit. . . . Whether there is a reasonable basis for the expectation of profitable returns from the well is the test. If the quantity be sufficient to warrant the use of the gas in the market, and the income therefrom is in excess of the actual marketing cost, and operating costs, the production satisfies the term ‘in paying quantities.’

IV. ENTER THE LOUISIANA MINERAL CODE

A. Introduction

Since 1975, the law relative to the sufficiency of the quantity of

production is contained in Articles 124 and 125 of the Louisiana Mineral Code, which read:

Art. 124. When a mineral lease is being maintained by production of oil or gas, the production must be in paying quantities. It is considered to be in paying quantities when production allocable to the total original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss.101

Art. 125. In applying Article 124, the amount of the royalties being paid may be considered only insofar as it may show the reasonableness of the lessee’s expectation in continuing production. The amount need not be a serious or adequate equivalent for continuance of the lease as compared with the amount of the bonus, rentals, or other sums paid to the lessor.102

The change which this legislation accomplishes to the area of mineral law under consideration is to suppress that phase of the test which required a comparison of the lessor’s benefits under the lease contract to the amount of production royalties then being paid to the lessor.

B. Retroactivity of Provisions of Louisiana Mineral Code

Some consideration must be given to the question as to whether the provisions on this subject which are contained in the Louisiana Mineral Code would apply to a mineral lease in existence on the effective date of the new Code, January 1, 1975.

Article 214 of the Louisiana Mineral Code provides, “The provisions of this Code shall apply to all mineral rights, including those existing on the effective date hereof; but no provision may be applied to divest already vested rights or to impair the obligation of contracts.”103

It might be argued that the changes effected by this new legislation with respect to the requirement that production be in “paying quantities” are substantive changes inasmuch as, depending upon the particular circumstances, their application to a given factual

situation could operate to make the responsibilities of the lessee more burdensome, or the rights of the lessor less favorable.

If such were determined to be the case by a court of law, the constitution would prohibit the application of this legislation to existing or vested rights. On the other hand, one might contend that the quoted article should be given literal application with the result that the provisions of the Louisiana Mineral Code are to be employed, and that the referenced constitutional provisions do not bar their application.

In a proper case, this might be a serious question which is not easily resolved. For present purposes, we pretermit further discussion on this issue.

C. Jurisprudence Under the Mineral Code

In *Smith v. West Virginia Oil & Gas Co.*, the court found that "there was no production and marketing of minerals from the leased premises in paying quantities" where the "lesser's royalty computed upon an annual total production of $593 would amount to only 21¢ per day for gas produced from the only well on the leased premises during the year 1977 and the maintenance of the well required the expenditure of $1,507.92."°6

In *CCH, Inc. v. Heard*, the lessee testified that "it cost about one-half barrel of oil a day to pay for the pumper or gauger, electricity and handling of the salt water, excluding the cost of repairs."°7 From this, the court determined "that the well had to produce 182 ½ barrels a year to pay for its own operation without yielding a profit."°8 The court found that the well "produced only 127.5 barrels of oil during the some 58 weeks of its operation," from which the court determined that "it is clear that this well was operated by the lessee for over a year at a considerable loss."°9 "Consequently, it is rather obvious that the production allocable to the lessee's working interest is not sufficient to induce a reasonably prudent operator to continue efforts

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104. La. Const. art. I, § 23 ("No . . . law impairing the obligation of contracts shall be enacted.").
107. 410 So. 2d 1283, 1286, 72 Oil & Gas Rep. 471 (La. App. 3d Cir. 1982).
108. *Id.*
109. *Id.*
to secure a return on his investment or to minimize his loss.” The lease was declared terminated. Other cases decided since the enactment of the Louisiana Mineral Code were noted above.

V. MISCELLANEOUS ISSUES

A. What Constitutes “Production” in the First Place?

In Champlin Petroleum Company v. Mingo Oil Producers, the lessee contended that the lease did not terminate “because of the ‘free flow’ of oil from some wells into the holding tanks which was sold at an alleged profit,” and that such oil constituted “production (in paying quantities) sufficient to extend the lease into the secondary term.” The court rejected this contention, stating that, “[i]n no way can it be said that merely allowing free flowing oil to accumulate for approximately two years could constitute production as contemplated by the parties in entering into the lease.”

B. “Freedom of Contract” to Abrogate or Modify Standard

Article 3 of the Mineral Code states that, “[u]nless expressly or impliedly prohibited from doing so, individuals may renounce or modify what is established in their favor by the provisions of this Code if the renunciation or modification does not affect the rights of others and is not contrary to the public good.” This article expressly makes applicable to mineral leases (and other mineral rights) the principle of freedom of contract which prevails generally under Louisiana law.

Does this liberality of contract permit parties to a mineral lease to totally dispense with the requirement that production must be in “paying quantities?” The short answer is, “No.”

Given the policy underlying the rule—a disapproval of a lessee operating in a speculative or selfish manner, without regard to the rights of the lessor whose land or minerals would be held hostage—it is unlikely that a court would allow, as stated the Louisiana Supreme Court a century ago, a mere “dribbling” of oil or gas to suffice to

110. Id.
113. Id.
maintain a lease.\textsuperscript{116} Support for this notion might be found in the early cases which implied the "paying quantities" requirement in a lease which did not even contain those precise words.\textsuperscript{117}

May the standard articulated in the Code be relaxed or altered? The short answer is, "Probably so." As long as the parties do not attempt to circumvent public policy by totally abrogating the "paying quantities" requirement, no harm to the public good occurs where parties stipulate what constitutes "paying quantities," particularly if the standard is heightened, such that the burden to the lessee is increased.

Therefore, the issue is where to place the line between the permissible contractual alteration of the standard of production and the impermissible abrogation of that requirement. Sooner or later, a contractual alteration of the test which so emasculates the underlying policy would not be allowed under the guise of a proper exercise of freedom of contract.

C. Is Production to be Evaluated on a Well or on a Lease Basis?

No Louisiana case has considered the issue of whether production in "paying quantities" is to be determined on a well-by-well basis, or on the basis of the lease as a whole. If there are a number of wells on the leased premises, some, but not all, of which are producing in "paying quantities," to what extent, if any, is the lease subject to termination?\textsuperscript{118}

The issue was considered in a dissenting opinion on a denial of rehearing in \textit{Gas Ridge, Inc. v. Suburban Agricultural Properties, Inc.}\textsuperscript{119} Although of dubious authority as precedent because of the procedural context in which the issue was discussed, the court observed that twelve oil wells were producing at a loss, whereas six gas wells were producing a profit. Based upon this, and in view of

\begin{itemize}
\item \textsuperscript{116} Anse LaButte (Le Danois) Oil & Minerals Co. v. Babb, 122 La. 415, 426, 47 So. 754, 757 (1908) (noting that the parties to the lease "must have had in mind something else than these dribblings of oil").
\item \textsuperscript{117} Caldwell v. Alton Oil Co., 161 La. 139, 108 So. 314 (1926).
\item \textsuperscript{118} A sophisticated, non-commercially printed lease form might require that the lessee allocate a defined amount of acreage to each producing well—sometimes called a "producing block"—thereby dividing the lease for lease maintenance purposes. In such cases, the lease itself will answer this question.
\item \textsuperscript{119} 150 F.2d 1020, 1021 (5th Cir. 1945) (Sibley, J., dissenting).
\end{itemize}
the terms of the habendum clause which would continue the lease "as long thereafter as oil or gas is produced [in 'paying quantities']," the dissenting judge stated that it may well be that the gas wells pay, and if so the lease is not at an end. . . . I do not see that [the lessee] injures the lessor by continuing to pump his unprofitable oil wells, even though he thus loses his profits on the gas. The lessor gets his royalties on both the gas and oil undiminished by the loss in producing the oil.120

A lessee's argument that, "so long as one well on a lease operates profitably, the condition for continuation of the lease is satisfied," was rejected by the fourth circuit in *Imperial Colliery Company v. Oxy USA, Inc.*21 The appellate court affirmed the finding that "the entire Imperial lease had to produce gas in paying quantities in order to survive automatic lease termination by operation of the habendum clause."122

Williams and Meyers argue that public policy should dictate that profitable wells be allowed to produce, and thereby hold the lease, even though unprofitable wells are also producing.123 Said another way, in South Louisiana terms, is not royalty on an unprofitable well "lagniappe," on top of royalty on a profitable well? In what manner is the lessor harmed by making a little bit more money, particularly if the lease would unquestionably be maintained if the production from the deficient well were disregarded?

*Union Gas & Oil Co. v. Adkins* rejected a lessee's claim that its well could "produce oil in paying quantities, if it is connected with other wells having like production, to a central pumping power."124 The court observed that the "provision in this lease is that oil shall be found in paying quantities on these premises, not on some other premises, and therefore the economy in operation that may be possible by pumping it in connection with wells on other premises is not controlling in the determination of that question."125

If production is being obtained from one zone, is it necessary to also obtain production from other zones in order to maintain the lease in effect?

In *Coyle v. North American Oil Consolidated*, lessor sued the lessee contending that the lease had lapsed as to a deeper zone or

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120. *Id.*
121. 912 F.2d 696, 705, 111 Oil & Gas Rep. 618 (4th Cir. 1990).
122. *Id.*
123. Williams & Meyers, *supra* note 92, § 6.04.6(g).
124. 278 F. 854, 858 (6th Cir. 1922).
125. *Id.*
stratum which the lessee was not producing and which, therefore, the
lessee contended that the lease had been "abandoned" by the lessee.\textsuperscript{126} The lessor argued that, "when there are two or more separate or distinct strata of oil-bearing sands in lands, each should be considered a separate and distinct oil field."\textsuperscript{127} The failure to produce or develop one of the strata, lessor contended, manifests an abandonment by the lessee. The court rejected this contention, saying:

Under the plain and unequivocal terms of the lease contracts, the leases are to remain in full force and effect as long as oil is produced. Oil is now being produced in paying quantities under the leases from the Lower Marine stratum. There is no language used in the lease contracts to indicate that it was ever intended that different strata or levels were to be considered separate oil fields. Undoubtedly these lease contracts contemplate that they shall remain in force and effect as long as oil is produced from the lands, irrespective from what level or stratum it is found.\textsuperscript{128}

Where multiple wells are producing and the operator maintains its accounting on a field basis, without distinction between wells, a court found no manifest error on the part of a jury which rejected the operator's testimony that the expenses should have been allocated on an "income basis, that is, if one well produces five times as much income as another it should be allocated five times as much expense."\textsuperscript{129}

In Arkansas, it has been held that a lease will be deemed to be producing in "paying quantities" where it is in a unit which is producing in "paying quantities," even if the lease itself, on a lease basis, is unprofitable.\textsuperscript{130} "The focus must be on whether the well is producing gas in paying quantities to the lessee, and that can only be determined by examining production from the unit as a whole."\textsuperscript{131}

\textbf{D. Market Conditions}

The courts have indicated that the economic state of the energy industry is relevant in a case wherein the lessor asserts that the lessee has failed to produce his lease in "paying quantities." In a case not

\begin{itemize}
  \item \textsuperscript{126} 201 La. 99, 9 So. 2d 473 (1942).
  \item \textsuperscript{127} \textit{Id.} at 104, 9 So. 2d at 475.
  \item \textsuperscript{128} \textit{Id.} at 115, 9 So. 2d at 479
  \item \textsuperscript{129} Sullivan and Garnett v. James, 308 S.W.2d 891, 893, 8 Oil & Gas Rep. 1141 (Tex. App.--San Antonio 1957) (writ refused n.r.e.).
  \item \textsuperscript{130} Perry v. Nicor Exploration, Inc., 738 S.W.2d 414, 97 Oil & Gas Rep. 494 (1987).
  \item \textsuperscript{131} \textit{Id.} at 416.
\end{itemize}
designated for publication, the appellate court noted that the "trial judge correctly pointed out that another valid factor to be considered in determining whether there has been production in paying quantities is the 'serious down flux of production during this period,' apparently referring to the state of the economy in the oil and gas industry during the period in which lessor claims there was failure to produce in paying quantities."\textsuperscript{132}

Moreover, in \textit{Denker v. Mid-Continent Petroleum Corp.}, the court stated:

Ever since the commencement of his action the oil industry has been and still is passing through a period of depression and many oil producing operations, due to the low price of crude oil, are being carried on at a loss, which under normal conditions would result in profit. We are of the opinion that the parties, when they used such phrase [viz., "production," construed herein as meaning "production in paying quantities"], contemplated normal conditions and not the unusual conditions to which we have referred, and intended that the question of whether the requirements thereof were being met should be determined in the light of such normal conditions; and that if the wells would produce a profit over operating expenses under normal conditions and the Petroleum Corporation is willing to continue to operate them at a loss believing in good faith that normal conditions will return and the wells will ultimately produce a profit over operating expenses, it cannot be said that the wells are not producing oil in paying quantities within the meaning of the lease.\textsuperscript{133}

In \textit{Barby v. Singer}, the court stated, "[t]he failure of the lease to produce a profit does not in and of itself terminate the lease. Compelling equitable considerations may rescue the lease from termination even when well operations are unprofitable."\textsuperscript{134}

\textbf{E. Temporary Cessation of Production}

The Texas Supreme Court has held that, even in a mineral lease which is silent as to the lessee's obligation to continuously maintain production or to restore production once it ceases, a "temporary

\begin{itemize}
\item 133. 56 F.2d 725, 727 (10th Cir. 1932).
\item 134. 648 P.2d 14, 73 Oil & Gas Rep. 344 (Okla. 1982) (upholding an otherwise unprofitable lease because of then pending legislation [NGPA] which, if passed, would result in increased gas prices).
\end{itemize}
cession" clause is "necessarily implied."  

To prevent the termination of the lease under an implied temporary cessation clause, (i) the cessation of production in the words of the courts must be "due to a sudden stoppage of the well or some mechanical breakdown of the equipment used in connection therewith, or the like," and (ii) the lessee must remedy the problem and resume production within a "reasonable time." The lessee has the burden of proving that the cause of the cessation is of a type or nature envisioned by the doctrine—"some mechanical breakdown . . . or the like." The doctrine was applied to maintain a lease in Cobb v. Natural Gas Pipeline Company of America.

In Natural Gas Pipeline Co. of America v. Pool, the Texas Supreme Court reversed the lower court's decision which had ruled that the leases at issue had terminated under the "temporary cessation of production" doctrine. The majority of the court chose not to reach the doctrine, basing its decision instead on its determination that, even assuming that the leases had lapsed, the lessees "thereafter acquired by adverse possession fee simple determinable interests in the mineral estates that are identical to those the lessees held under the leases."

Particularly comforting to the industry is the dissenting opinion, which deemed the majority opinion inappropriate to not reach the issue of lease termination under the "temporary cessation of production" doctrine, a question "which is undoubtedly important to the jurisprudence of the State." Defendants-appellants had argued that the "temporary cessation of production" doctrine and the production in "paying quantities" doctrine were harmonious. They thought it made no sense to come to a different result where a lease might produce a token volume (even 1 mcf) as opposed to being shut-in for a full month, based on a lack of a viable market for the production over a short period of time. Dissenting Justice Jefferson examined in some detail the prior jurisprudence on the subject and expressed the view that it was too limited or narrow to the extent that

135. Midwest Oil Corp. v. Winsauer, 323 S.W.2d 944, 946, 10 Oil & Gas Rep. 1123 (Tex. 1959).
136. Watson v. Rochmill, 155 S.W.2d 783, 784 (Tex. 1941).
138. 897 F.2d 1307, 1309 (5th Cir. 1990).
139. Natural Gas Pipeline Co. of America v. Pool, 124 S.W.3d 188 (Tex. 2003), (reversing 30 S.W.3d 618 (Tex. App.-Amarillo 2000) & 30 S.W.3d 639 (Tex. App.-Amarillo 2000)). Closely watched by the practicing oil and gas bar, Pool was argued on March 6, 2002, and was under deliberation for seventeen and a half months before the original decision was rendered.
140. Id. at 190.
141. Id. at 202 (Jefferson, J., dissenting).
Patrick S. Ottinger

it only allowed relief to the lessee when the temporary cessation is caused by "some mechanical breakdown." Noting that the "TCOP doctrine recognizes that lessors and lessees have a mutual interest in maintaining a lease that produces in paying quantities," Justice Jefferson stated that, if the issue were presented, he "would hold that the TCOP doctrine should be equally applicable to market-induced interruptions as it is to stoppages caused by mechanical or other physical events." Going further, the dissenting justice indicated that he "would reject the Watson v. Rochmill formulation to the extent it forces the automatic termination of leases, in which profitable production is not in dispute, when there is a temporary cessation of production that furthers the economic interests of both lessors and lessees." One thing that can certainly be said about this case is, "stay tuned."

Does the doctrine of "temporary cessation of production" exist in Louisiana law? No Louisiana case has addressed this issue in those precise terms, perhaps because most—if not virtually all—mineral leases contain an express clause addressing this issue. Because the lease contains an express provision regulating the term of the lease, the court would be without authority to imply a provision contrary to the express clause.

The "resumption of operations or production" clause is in the nature of an express resolutory condition. In Talley v. Lawhon, the Louisiana Supreme Court rejected a contention that the lessor must put the lessee in default as a prerequisite to a termination, stating:

There was nothing the said company could have been put in default about, as there was no obligation on its part to do

142. Id. at 206.
143. Id. at 209.
144. In George Hazlett, Effect of Temporary Cessation of Production on Leases and Term Royalties, 10 Inst. on Oil & Gas L. & Tax'n 201, 248 (1959), the author observed that the "cases above cited were decided on the basis of the habendum clause alone, as with only rare exceptions the leases . . . involved did not contain qualifying provisions such as the 'cessation' clause."
145. See Louisiana Gas Lands, Inc. v. Burrow, 197 La. 275, 289, 1 So. 2d 518, 521 (1941) (implied obligation "cannot be invoked so as to erase entirely from the contract those provisions which expressly declare that the lessee's rights shall continue so long as gas is produced in paying quantities."). Cf. Exxon Corp. v. Atlantic Richfield Co., 678 S.W.2d 944, 947, 83 Oil & Gas Rep. 623 (Tex. 1984) ("All parties agreed upon the termination clause. These clauses expressly and unambiguously set out the terms under which the contract could be terminated. There can be no implied covenant to the contrary.").
anything. There was only a right on its part to prolong the existence of the lease by doing a certain specified thing within a certain specified time, or let the lease run out by not doing that thing.\(^{147}\)

**F. Relevance of Revenue and Expenses After Suit Is Filed**

If a lessor files suit to seek the cancellation of a mineral lease which the lessor alleges has terminated because of the lack of production in "paying quantities," the lessee is generally not inclined to expend financial resources to improve or enhance production in the face of such a suit. A lessee would be imprudent to spend money when the lessor has contended that the lease has lapsed under these circumstances. This is particularly true in light of recent decisions holding that a producer ceases to be in good faith after a suit is filed and, consequently, that the operator is not entitled to recover its costs and expenses from that date.\(^{148}\)

If, as a consequence of the lessee withholding expenditures, production diminishes after suit is filed, can such post-petition revenue be considered in applying the second prong of the test? In *Noel v. Amoco Production Co.*, it was said that a "lessor is estopped from complaining about any alleged cessation of production in paying quantities that is the result of the lessee's failure to maintain and repair the wells during the pendency of the suit by the lessor."\(^{149}\) This is consistent with the line of cases which excuses performance by the lessee during the pendency of a suit to cancel the lease, provided that the lessee prevails.\(^{150}\)

However, in *Edmundson Brothers Partnership v. Montex Drilling Co.*, the court distinguished *Noel* on the basis that, in *Noel*, "the well

147. 150 La. 25, 28–29, 90 So. 427, 428 (1922).
148. *See Edmundson Bros. P'ship v. Montex Drilling Co.*, 98–1564 (La. App. 3d Cir. 1999), 731 So. 2d 1049, 142 Oil & Gas Rep. 266; *Lamson Petroleum Corp. v. Hallwood Petroleum, Inc.*, 2002–138 (La. App. 3d Cir.), 823 So. 2d 431, *writ granted*, 2002–1338 (La.), 832 So. 2d 975, *remanded to* 2001–1201 (La. App. 3d Cir. 2002), 843 So. 2d 424, *writ denied*, 2003–0333 (La. 2003); 841 So. 2d 796. The courts relied on Louisiana Civil Code article 487 ("For purposes of accession, a possessor is in good faith when he possesses by virtue of an act translative of ownership and does not know of any defects in his ownership. He ceases to be in good faith when these defects are made known to him or an action is instituted against him by the owner for the recovery of the thing.") (emphasis added).
150. *See, e.g.*, *Fomby v. Columbia County Dev. Co.*, 155 La. 705, 719, 99 So. 537, 542 (1924) ("By filing and prosecuting these suits, plaintiffs have made it utterly impracticable for the assignees of the lessee to exercise the rights granted by the leases. Having made it thus impracticable by their own acts, plaintiffs are not in position to contend that the leases have expired.").
was producing in paying quantities at the time suit was filed,” whereas, in *Edmundson*, the plaintiff had “averred from the inception of the suit that the . . . lease was not producing in paying quantities. There is nothing in the record which would tend to show that the production from the lease has been affected in any way by the suit.”

On the basis of this finding, the court in *Edmundson* found that “the receipts and expenses allocable to the lease since the suit was filed are relevant to the issue of whether production has been ‘sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss.’”

One might argue that this finding in *Edmundson* was *dictum* as the court ordered the lease cancelled on a finding of lack of development. In any event, it is submitted that it is unjust to essentially penalize a lessee for failing to take those steps which it might otherwise be willing to take but for the fact that its lessor is suing it to cancel the lease. If the lessor prevails on the suit which it brought on the basis of pre-suit facts, that is one thing, but, in the face of the cancellation suit which the lessee is defending, it is a bit of “having it both ways” to expect that the lessee will expend financial resources when the lessor is contending that the lessee no longer has a valid mineral lease. Post-suit production was allowed to be considered in the Oklahoma case of *Duerson v. Mills.*

**G. Necessity for Notice and Opportunity to Cure Default**

Having examined the cases dealing with the subject of production in “paying quantities,” some consideration should be devoted to the necessity of notice and the granting to the lessee of an additional time to respond in some manner in those cases where the lessor claims that production is not being secured in “paying quantities.” In the rare case that the mineral lease form under which the lessee operates contains no requirement of notice, the question is dependent upon general law. It is well settled that the habendum clause is a term concept or a resolutory condition. Furthermore, the Louisiana Civil Code provides that the “lease ceases of course, at the expiration of the time agreed on.” With particular references to mineral leases, the Mineral Code states that a “mineral lease terminates on the
expiration of the agreed term or upon the occurrence of an express resolutory condition."\textsuperscript{156}

In such instances, there is no necessity to put the lessee in default. Putting them in default would be inconsistent with a position that the lease had expired by its own terms, since a putting in default would constitute an acknowledgment that the lease was still viable.\textsuperscript{157}

Under the more prevalent lease forms in current use in Louisiana, there are particular provisions which require that the lessee be given notice of an alleged breach or non-compliance of the lease, and permitting it a period of time to obviate such breach, or to otherwise comply with the terms of the contract. For example, the clause contained in one popular lease form reads:

\begin{quote}
In the event that Lessor at any time considers that operations are not being conducted in compliance with the lease, Lessor shall notify Lessee in writing of the facts relied upon as constituting a breach hereof, and Lessee, if legally required to conduct operations in order to maintain the lease in force, shall have sixty (60) days after receipt of such notice in which to commence the necessary operations to comply with the requirements hereof.\textsuperscript{158}
\end{quote}

There are numerous Louisiana cases which consider the question as to whether the notice provision of mineral leases applies to certain aspects of lease maintenance, as opposed to others.\textsuperscript{159} In Smith v. Sun Oil Co., Inc.,\textsuperscript{160} the lessee argued that it was entitled to an opportunity to cure the default, relying on the "judicial ascertainment" clause. The court held that such clause did not apply to this case, "where the sole inquiry is whether or not the

\textsuperscript{157} See Murray v. Barnhart, 117 La. 1023, 1027, 42 So. 489, 493 (1906): To put in default is to call upon the debtor to perform . . . . But where the contract has been breached, and the resolutory condition thereby accomplished, and the creditor does not desire the performance of the contract, but the enforcement of the resolutory condition, he naturally does not call upon the debtor to perform, but brings suit for the enforcement of the resolutory condition.
\textsuperscript{158} Bath-Gram Form 42 CPM–New South Louisiana Revised Four (4)–Pooling Revised “B” ¶ 11.
\textsuperscript{160} 172 La. 655, 656, 135 So. 15, 16 (1931).
lease has expired and terminated by its own terms; no more, in fact, than if the lease had expired on a fixed date instead of an uncertain date.”\textsuperscript{161}

The court in \textit{Vance v. Hurley} indicated that the “judicial ascertainment” clause would be operative in cases where it is asserted by the lessor that production was not in “paying quantities.”\textsuperscript{162} The court had the following to say on the issue:

Furthermore, if the plaintiffs had entertained any doubt that the lease was being properly operated and developed in accordance with the contract and desired its cancellation for this purpose, they overlooked the provision in the contract that ‘In the event lessor considers that operations are not being conducted in compliance with this contract, lessee shall be notified in writing of the facts relied upon as constituting a breach hereof and lessee shall have sixty (60) days after receipt of such notice to comply with the obligations imposed by virtue of this instrument,’ as the record shows they failed to give such notice.\textsuperscript{163}

It must be stated, however, that the court engaged in this discussion after having concluded that the production was in fact in “paying quantities” for the reason that all possible development had been pursued. Thus, the comments as to the absence of notice were not necessary to the decision and were, it is submitted, \textit{obiter dictum}. That is, since the issue of notice was not essential to the determination and was not, therefore, before the court, any expression by the court on that issue was not necessary to its decision and thus should be disregarded.

It was argued in the \textit{Bouterie} case, at the court of appeal level, that such language was \textit{dicta}.\textsuperscript{164} In response to this argument, however, the \textit{Bouterie} court concluded that “an examination of that case [\textit{Vance v. Hurley}] does not lead this court to that conclusion.”\textsuperscript{165}

Notwithstanding the notice language addressed in these cases, it is submitted that the notice provision in a mineral lease would not be applicable in those instances where a mineral lessor seeks to establish that the production being secured under the lease is not commercial

\begin{itemize}
\item \textsuperscript{161} \textit{Id.} at 656–57, 135 So. at 16.
\item \textsuperscript{162} 215 La. 805, 41 So. 2d 724 (1949).
\item \textsuperscript{163} \textit{Id.} at 814, 41 So. 2d at 727.
\item \textsuperscript{164} \textit{Bouterie} v. Kleinpeter, 234 So. 2d 812 (La. App. 1st Cir. 1970).
\item \textsuperscript{165} \textit{Id.} at 818–19. \textit{See also} Bollinger v. Republic Petroleum Corp., 194 So. 2d 139 (La. App. 1st Cir. 1966), \textit{writ denied}, 250 La. 463, 196 So. 2d 276, 26 Oil & Gas Rep. 21 (1967) (involving a lease clause requiring pre-suit notice if lessor considers that the lessee “has failed to comply with one or more of its obligations hereunder, either expressed or implied.”) (emphasis added).
\end{itemize}
production; or in other words, that it is not in "paying quantities." Since production which is not in "paying quantities" is really no production at all for lease maintenance purposes, the resolutory condition embodied in the habendum clause would become operative when production ceases to be in "paying quantities" (assuming, of course, that the lease is not being otherwise maintained). Notice is immaterial inasmuch as the lease thereby expires ipso facto by its own terms. Indeed, it was so held in Bouterie v. Kleinpeter.

H. Bankruptcy as Force Majeure

In Webb v. The Hardage Corp., the court rejected the argument of a lessee who had filed for voluntary bankruptcy that such action was "beyond the control of the lessee," as required by the force majeure clause of its mineral lease.

In Champlin Petroleum Co. v. Mingo Oil Producers, the operator of a mineral lease was placed into involuntary bankruptcy. Seeking to maintain a mineral lease which the operator had not actively produced for some period of time, the lessee argued that the filing of the bankruptcy proceeding constituted a force majeure which "prevented the lessee or its assigns from producing or reworking any wells." The court rejected this argument, saying that, "while the bankruptcy proceedings were clearly outside the control of the lessee or its assigns, the very premise of such proceedings are inherently the result of financial problems."

These cases are consistent with the well-established proposition that the mere filing of bankruptcy does not, of itself, obviate the need for the lessee to take those actions necessary to avoid the termination of the lease. For example, it has been held that an "unless" form of mineral lease terminated under Texas law where the debtor-lessee failed to timely pay a delay rental, and that the lessee was not entitled to a further period of time to pay the delay rental under section 108 of the Bankruptcy Code. "The simple answer to any apparent

170. Id. at 560.
171. Id.
172. Good Hope Refineries, Inc. v. Benavides, 602 F.2d 998 (1st Cir. 1979). An "unless" form of mineral lease takes its name from the provision which states that it will expire at a stated time unless the lessee takes certain action to maintain the lease, such as commencing operations or paying a delay rental. As so stated, the clause is an express resolutory condition. La. Civ. Code arts. 1767 and 1768. See also La. Min. Code art. 133. It is to be distinguished from an "or" form of mineral
harshness of the result in this case is that a prudent man who plans to file a Chapter XI petition tomorrow uses a cashier’s check to make an important payment today.”

I. Production in “Paying Quantities” in Other Contexts

The issue of production in “paying quantities” may arise in contexts other than the continuation of a mineral lease under a habendum clause. A few of those other contexts are considered herein.

1. Implied Covenants.

For purposes of the implied covenants to which a lessee is bound, the elements of proof in a drainage case are, as follows:

In order for a landowner-lessee to recover damages from his lessee because of a breach of the lessee’s implied obligation to exercise reasonable diligence in preventing drainage, we think the lessor must allege and present facts which establish that oil and gas could have been produced from the same reservoir by offset wells drilled on the leased premises, and that it would have been economically feasible for the lessee to drill such offset wells. He must also allege and prove with some degree of certainty the quantity of oil or gas which would have been produced from the offset wells, and the value of the minerals which the landowner would have received from that production had the offset wells been timely drilled and completed.

In Breaux v. Magnolia Petroleum Co., it was intimated that the drastic remedy of cancellation may not be available in such instance if a second well could not produce oil in “paying quantities.” For purposes of this implied covenant, the requirement is that the well must be sufficient to pay, in addition to lifting costs, the costs of drilling the well. The reason for the difference is that, in the case of a habendum clause, the drilling costs have already been incurred and, provided that lifting costs are being met, the lessee is entitled to continue to produce the well in order to recoup those sunk costs. In lease, in which it is sated that the lessee should drill a well within a certain period of time “or” pay a rental.

173. Id. at 1003.
175. 121 So. 2d 280, 13 Oil & Gas Rep. 750 (La. App. 1st Cir. 1960).
the case of a well not yet drilled, the analysis requires that the expectation be that the drilling costs will be recouped, not just the lifting costs.


Another context in which the issue of production in “paying quantities” arises, was previously discussed by the author in a presentation on mineral servitudes, as follows:

In the context of interruption by use, the role of production in “paying quantities” is two-fold. Under Article 29 of the Mineral Code, one of the requirements for a use through drilling operations is that there must be a “reasonable expectation of discovering and producing minerals in paying quantities at a particular point or depth.” If a drilling operation is commenced with such expectation (and if the other requirements are met), the operation will serve to interrupt prescription even if unsuccessful; a dry hole is sufficient if it meets the “good faith” requirement. If production is obtained (even if obtained as a result of an operation not commenced with a “reasonable expectation of discovering and producing minerals in paying quantities at a particular point or depth”), such production itself— independent of the drilling operation (which had no bearing on prescription)—will interrupt prescription, regardless of whether it is in “paying quantities,” provided that production actually commences prior to the prescriptive date. “It is necessary only that minerals actually be produced in good faith with the intent of saving or otherwise using them for some beneficial purpose.” [Article 38, Mineral Code.] This codifies the jurisprudence which held that it “is unimportant whether this production was in paying quantities so long as there was some production or use of the servitude.” [Mays v. Hansbro, 222 La. 557, 64 So. 2d 232 (1953).]

Thus, for purposes of the interruption of prescription by production, production in fact is the standard. Whether or not production is in “paying quantities,” production in fact will interrupt prescription accruing against the mineral servitude so long as the minerals are produced “in good faith with the intent of saving or otherwise using them for some beneficial purpose.”

Production in “paying quantities” is defined in Article 124 of the Mineral Code. However, that definition is pertinent to mineral leases. [The article appears in Chapter 7 of the
Mineral Code entitled “The Mineral Lease,” Part 4 of which is entitled “The Obligations of the Lessee.”] The essential element of the codal definition is that production “is considered to be in paying quantities when production allocable to the total original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss.” Thus, if a mineral lease provides for a one-fifth (1/5) lessor’s royalty, “lifting costs” are measured against four-fifths (4/5) of total production (even if the lessee’s interest is burdened by an overriding royalty interest which would further reduce the net revenue interest attributable to the working interest). If no mineral lease exists, and the mineral servitude owner operates in its own right, it is entitled to five-fifths (5/5) of production, a higher amount of production against which operating costs are to be measured. Thus, assuming one could predict post-drilling “lifting costs” with sufficient certainty, it is apparent that more revenue accrues to the operator under the (unleased) servitude than to the hypothetical mineral lessee, against which the same amount of expenses are to be measured. In a proper case (depending upon the amount of the royalty reserved under a mineral lease), it might be that production would be found to be in “paying quantities” for purposes of the mineral servitude but not for purposes of a mineral lease. Again, the production in “paying quantities” issue is only relevant in determining if a dry hole was drilled “in good faith.” [If prescription is interrupted by production, it need not be in paying quantities. Article 38, Mineral Code.]\(^{176}\)

3. Mineral Royalties

A mineral royalty is a mineral right which, as in the case of the mineral servitude, is subject to a prescriptive period of ten years for non-user.\(^{177}\) However, unlike the mineral servitude, actual production is required to interrupt prescription; a dry hole or good faith operations which do not result in production will not suffice.\(^{178}\)

But, as with production from the mineral servitude, the production necessary to interrupt prescription accruing against a mineral royalty


\(^{177}\) La. Min. Code art. 85(1).

\(^{178}\) La. Min. Code art. 87.
need not be in "paying quantities." Rather, "[t]o interrupt prescription it is not necessary that minerals be produced in paying quantities but only that they actually by [sic] produced and saved."\(^{179}\)

In *Lee v. Goodwin*, a mineral royalty interest was created by deed dated March 2, 1945.\(^{180}\) The royalty interest burdened a sixty-acre tract of land. Although no well was drilled on the royalty tract, a well was drilled on an adjacent tract and later unitized with the royalty tract. The unit well was tested on July 14, 1952, and "it was determined that the well was capable of producing."\(^{181}\) It was then shut-in for a lack of market. Production did not begin until November of 1955, or more than ten years after the royalty was created.

The landowner contended that the mineral royalty interest prescribed. Citing *LeBlanc v. Haynesville Mercantile Co., Inc.*, the court held that the royalty did not prescribe. In the course of its discussion, the court made several references to the fact that the production was in "paying quantities."\(^{182}\) The court issued a supplemental opinion stating that it did "not intend that the language used in our original opinion relating to the facts of the instant case be construed as holding that a royalty interest is dependent upon production in paying quantities."\(^{183}\) The court declared:

> The inherent nature of a royalty interest is that of a right to share in any production, and it follows that production, regardless of whether it be in paying quantities or not, constitutes an interruption of prescription as against a royalty interest.

... We think it reasonable to conclude that the consistent reference to a royalty right as a right to share in production, which is so clearly indicated by the language noted in the above opinions, excludes any requirement that the production be established as profitable to the operator.\(^{184}\)

181. *Id.* at 652.
184. *Id.* at 655 (citing Mays v. Hansbro, 222 La. 557, 64 So. 2d 232 (1953); Union Sulphur Co., Inc. v. Lognion, 212 La. 632, 33 So. 2d 178 (1947); Union Sulphur Co., Inc. v. Andrau, 217 La. 662, 47 So. 2d 38 (1950)).
4. Shut-in Wells

The typical "shut-in clause" of a mineral lease allows the lessee to maintain leasehold rights, in the absence of actual drilling or production, by paying a "shut-in payment" if the lessee has completed a well capable of producing gas in "paying quantities," but which is not being produced for one of the reasons enumerated in the clause.\(^{185}\) Because, by definition, such a well is not producing, the issue arises as to how it is to be determined that the non-producing well is nevertheless "capable of producing gas in 'paying quantities,'" such condition being a necessary prerequisite to the right of the lessee to maintain leasehold rights by the payment of "shut-in payments."

In *Webb v. The Hardage Corp.*, the issue presented was whether or not the lessee had timely demonstrated the existence of shut-in conditions.\(^{186}\) The court stated, as follows:

Reading LSA–R.S. 31:124 [which defines 'production in paying quantities'] in conjunction with the terms of the leases, the shutting-in of the gas wells on the three leased properties could only extend the leases beyond their primary terms if the wells were capable of producing in paying quantities.\(^{187}\)

The court then noted that the lessor generally "has the burden of proving the propriety of cancellation of a mineral lease," but held that "the situation encountered in this case presents an exception to that general rule."\(^{188}\) The court further stated that:

A lessee cannot place the burden of proving the propriety of cancellation on the lessor by simply alleging that a well that has never been placed into actual production is capable of producing in paying quantities. Rather, the lessee must prove by a preponderance of the evidence that prior to the expiration of the primary term or the continuous drilling operations term a well was completed and surface tested to the extent that the well was at that time demonstratively capable of producing in paying quantities.

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185. Depending upon how characterized in the mineral lease, the "shut-in payment" might be in the nature of a delay rental or royalty. *Acquisitions, Inc. v. Frontier Explorations, Inc.*, 432 So. 2d 1095, 78 Oil & Gas Rep. 282 (La. App. 3d Cir. 1983).
187. *Id.* at 892 (citing *Taylor v. Kimbell*, 219 La. 731, 54 So. 2d 1 (1951)).
188. *Id.* The court relied on *Frazier v. Justiss Mears Oil Co., Inc.*, 391 So. 2d 485, 68 Oil & Gas Rep. 652 (La. App. 2d Cir. 1980), as support for the general rule.
Ordinarily, proof sufficient to carry this burden is a finding of commercial productivity resulting from the performing of the initial potential test required by the Department of Conservation. . . . While other kinds of evidence of production potential could also be considered, such as the results of logs and cores, the flaring of the wells for periods of time and the history of the wells in the same zone in the field, the importance of actual testing of surface production is obvious and is the most direct indication of production capability.\textsuperscript{189}

The court then noted, by way of analogy, that the "importance of surface testing is illustrated by the provisions of LSA–R.S. 31:34 and 31:90 which address the testing of shut-in wells in the context of interrupting prescription on mineral servitudes and mineral royalties respectively."\textsuperscript{190} The initial potential test, according to the court, "must be conducted during the primary term or the continuous operations term in order to continue a lease in effect beyond the primary and the continuous operations terms."\textsuperscript{191} "Without such surface testing, the status of the lease would ordinarily remain uncertain while the well is shut-in."\textsuperscript{192} "A lessee should not be able to rely on the shut-in clause to hold a lease beyond its primary term where the well’s capacity to produce in paying quantities cannot be determined until further testing and procedures are carried out at some later date."\textsuperscript{193}

VI. CONCLUSION

An inquiry into production in "paying quantities" involves a comparison of revenue to expenses. Because the eligible revenue is determinable solely on the face of the mineral lease, rarely does such a case involve significant dispute over that side of the ledger. Rather, the issue is most often determined by resolving disputes as to which items of cost or expense are relevant.

Litigation on the issue of production in "paying quantities" brings together a variety of disciplines—lawyers and landmen, petroleum engineers and geologists, auditors and accountants. For the most part, the courts have handled well the task of sorting through the accounting and engineering issues so as to effectuate the expectation of the parties to a mineral lease contract.

\textsuperscript{189} \textit{Id.} (citations omitted).
\textsuperscript{190} \textit{Id.}
\textsuperscript{191} \textit{Id.}
\textsuperscript{192} \textit{Id.}
\textsuperscript{193} \textit{Id.} at 893.