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Giving New Meaning to an Industry Term

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In May 2014, *PNP Petroleum I, LP, et al. v. Taylor et al.* 438 S.W.3d 723 (Tex.Civ.App.—San Antonio, May 21, 2014, pet. filed), PNP and Taylor entered into an oil and gas lease with a one-year primary term. The lease contained a shut-in royalty clause that read as follows:

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

This provision did not use the standard wording for shut-in royalty clauses—i.e., that it would apply only to wells capable of producing oil or gas. Instead it applies shut-in royalty treatment to any wells on the lease that are "not producing oil/gas in paying quantities." In the negotiations leading up to the execution of the lease PNP sent the following redline of the proposed shut-in clause:

> SHUT-IN ROYALTY (Saving) If, at the expiration of the primary term – or at any time thereafter, there is located on the leased premises a well or wells not ~~capable of~~ producing oil/gas in paying quantities or being used as a salt-water injection well(s), ~~and such gas is not otherwise produced and sold in paying quantities for lack of a suitable market and this lease is not otherwise being maintained in force and effect~~, Lessee may pay ....

When PNP acquired the lease there were 13 non-producing wells on the lease that had been drilled by a prior lessee whose lease had expired.

At the appropriate time, PNP sent Taylor a notice stating its intent to extend the lease pursuant to the shut-in clause and enclosing its payment. The Lessors rejected the payment contending that the shut-in clause could only apply to wells that were "capable of producing."

The Fourth Court of Appeals spent most of its opinion dealing with the issue of whether the redline draft of the lease and other related information could be introduced into evidence. Taylor argued that the draft was prohibited based on the exclusion of parol evidence to "vary, contradict, and/or create ambiguity" in an unambiguous lease. PNP argued that the draft should be admitted as "surrounding circumstances."

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Citing cases to the effect that the court may consider "surrounding circumstances as a construction aid to determine the parties' intentions as expressed in the plain language of the lease," the Court held that the parol evidence rule did not bar the introduction of the evidence of the deletions made to the lease drafts during the parties' negotiations.

Although the Court ultimately held that the proffered payment of shut-in royalties was effective to continue the lease, thereby reversing the trial court, it reached the result by first acknowledging that the term "shut-in royalty" has special meaning in the industry (i.e., it applies to wells capable of production) and then holding that the drafts exchanged by the parties could be admitted into evidence to show that the parties intended to forego the industry-standard "capable of production" test.

For the careful scrivener this case presents a bit of a conundrum. If you use a term that has a generally understood meaning in the industry, but alter its definition within the document, in the Fourth Court of Appeals, the court may not interpret the term the way you defined it in the document and may force you to jump through hoops to introduce previous drafts. Here the court accepted the revised definition of shut-in royalty but only after finding a way to show that "capable of producing" had been deleted in a prior draft. But what if there are no drafts showing the change; what if the first draft started with the modified term? Solutions might be to (i) avoid using the industry term but fully describe the concept; (ii) use the term and specifically reject its widely understood meaning; or (iii) use the term but modify its title such as "modified shut-in royalty."

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors:

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