# MEMORANDUM

DATE: July 3, 1996

TO: **Mr. Harry Pace**
3403 Boyd
Midland, Texas 79707

FROM: Patti Wier, Secretary to
David R. Vandiver
611 West Mahone, Suite E
Artesia, New Mexico 88210-2075

RE: Harrison W. Pace v. Jim Baca, Commissioner of Public Lands of the State of New Mexico; Appeal from the District Court of Chaves County, New Mexico, Cause No. CV-83-242; Supreme Court of the State of New Mexico, Cause No. 15,564

As requested, enclosed are the following:

1. Copy of Decision entered in the District Court on June 7, 1984;
2. Copy of Order of Judgment entered in the District Court;
3. Copy of Decision entered in the Supreme Court on January 7, 1986; and
4. Copy of Mandate of the Supreme Court dated January 22, 1986.

Let me know if you need anything else.

IN THE SUPREME COURT OF THE STATE OF NEW MEXICO

HARRISON W. PACE,
Plaintiff-Appellant,

vs. NO. 15,564

JIM BACA, Commissioner of Public Lands, State of New Mexico,

Defendant-Appellee.

APPEAL FROM THE DISTRICT COURT OF CHAVES COUNTY

Paul Snead, District Judge



DECISION

SOSA, Senior Justice.

Plaintiff applied to the trial court for an Order to Show Cause why the State Land Commissioner's decision that plaintiff's oil and gas lease automatically expired by its own terms should not be set aside. After a Show Cause hearing, the trial court sustained the Commissioner's decision. Plaintiff appeals and we affirm.

The facts relevant to disposition of this case, as set forth in the Stipulation entered into by the parties, are that on June 8, 1979, plaintiff Harrison Pace (Pace) acquired, by assignment, State Lease No. LG-0160 from the Shenandoah Oil Corporation (Shenandoah). The lease had been sold to Shenandoah by the State Land Commissioner on April 18, 1972 and was issued effective May 1, 1972.

The lease provided for primary and secondary terms of five years each. The secondary term of the lease ended on May 1, 1982; up until that time the lease was "valid and in effect according to its terms". The lease, however, could be extended beyond the secondary term under a provision contained in the lease which is the focus of this controversy. That provision reads:

> This lease shall not expire at the end of either the primary or secondary term hereof if there is a well capable of producing gas in paying quantities located upon some part of the lands embraced herein where such well is shut-in due to the inability of the lessee to obtain a pipeline connection or to market the gas therefrom; provided, however, the owner of this lease as to the lands upon which such well is located shall pay an annual royalty equal to the annual rental payable by such owner under the terms of this lease but not less than one hundred dollars ($100) per well per year, said royalty to be paid on or before the annual rental paying date next ensuing after the expiration of ninety days from the date said well was shut-in and on or before said rental date thereafter . . . .

There were two wells located on the leased property. Pat State No. 1 Well produced minimal amounts of oil between February 4, 1980 and July 31, 1982. Gulf State No. 1 Well, which had been abandoned, was re-entered and completed by "perforating and acidizing a prospective gas producing zone" in November of 1972. That well was shut-in on February 15, 1979 and there has been no actual production of gas from Gulf State No. 1 since that date. No shut-in royalty was tendered on or before May 1, 1980.

On February 28, 1983, the Commissioner of Public Lands notified plaintiff that his lease had automatically expired by its own terms on October 1, 1982, for failure to produce in its extended term. In response to this notice, plaintiff, on March 23, 1983, tendered to the State Land Office a check in the amount of $1,894.70, which represented all shut-in royalty and annual rentals due as of May 1, 1983. The check was placed in a suspense account, pursuant to NMSA 1978,

Section 19-10-39 (Repl.1985).

On April 27, 1983, Pace applied to the district court for an Order to Show Cause why the Commissioner's decision finding the lease automatically terminated should not be revoked. The court issued an Order to Show Cause to defendant on April 28, 1983. The district court heard the matter upon stipulated facts, documentary evidence and testimony and, thereafter, propounded Findings of Fact and Conclusions of Law. One of the Court's findings was that Gulf State No. 1 had been shut-in on February 15, 1979, due to lack of market, but that no shut-in royalty had been tendered before May 1, 1980. The Court concluded as a matter of law that "[b]y reason of the failure to pay shut-in royalties in a timely manner, the lease expired, and the decision of the Commissioner is correct".

On appeal plaintiff asks us to address the issue of whether the shut-in royalty clause is a covenant *requiring notice and opportunity to cure before* plaintiff's oil and gas lease can be cancelled or whether the lease is a special limitation, resulting in the automatic termination of the lease upon failure to pay shut-in royalty in a timely manner.

Plaintiff argues that the shut-in royalty provision, with its use of the phrase, "the owner of this lease . . . shall pay an annual royalty. . ." (emphasis added) creates an obligation on the part of the lessee, to pay shut-in royalty in order to extend the lease beyond the secondary term. "Shall" sets forth a mandate and not an option to pay shut-in royalty in order to extend the life of the lease, Pace asserts.

Plaintiff, then notes the general rule that imposing a duty to perform on the lessee constitutes a covenant arising under the lease, while granting to the lessee an option to perform constitutes a special limitaton on the lease. The lease provides that the lessor is required to give to the lessee notice and thirty days to

cure any breach of a covenant arising under the lease. Thus, Pace reasons that since the shut-in provision was a covenant, he was not afforded the requisite notice and opportunity to cure the breach of the covenant. He maintains that because his tender of the check to the Land Office was within thirty days of receipt of the Commissioner's notice of termination, it was a tender sufficient to continue the lease. We are unpersuaded by plaintiff's analysis of the issue and, instead, subscribe to that advanced by defendant.

As the Commissioner notes, resolution of the issue turns on the proper interpretation of the habendum clause and the effect of the shut-in royalty provision on operation of the habendum clause. The habendum clause of the oil and gas lease at issue grants the lease to plaintiff as follows:

> To have and to hold said land, and all the rights and privileges granted hereunder, to and unto the lessee for a primary term[1] of five years from the date hereof, and as long thereafter as oil and gas in paying quantities, or either of them is produced from said land by the lessee, subject to all of the terms and conditions as hereinafter set forth.

This is a typical habendum clause (see 3 H. Williams, Oil and Gas Law §601.4 (1985)), which grants to the lessee a lease of short, fixed duration, with that term to be extended "as long thereafter as" there is production of oil and/or gas in paying quantities. The phrase "as long thereafter as" has been construed by an overwhelming majority of courts to convey an interest subject to a special limitation. Id. at §604. This Court has previously held that the special limitation, as embodied in the "thereafter" provision of the habendum clause, results in automatic termination of the lease if oil or gas is not produced in paying quantities. Greer v. Sulmon, 82 N.M. 245, 249, 479 P.2d 294, 298 (1970). Under such circumstances, no notice is required to be given to the lessee.

The habendum clause of plaintiff's lease, however, by its own terms, is

subject to all of the conditions and qualifications which follow it. The shut-in royalty provision is one such clause which affects operation of the habendum clause. Whereas, normally, the lease expires automatically if there is no production of oil or gas at the end of the secondary term, the shut-in royalty clause acts to preserve the lease beyond the secondary term when a gas well is shut-in due to lack of market. Automatic termination of the lease is avoided because the shut-in royalty clause provides that the timely payment of shut-in royalty is a substitute for production. Thus, the production requirement of habendum clause is met.

We agree with the Commissioner that the shut-in royalty provision is, itself, a special limitation and, accordingly, Pace was under no duty to pay shut-in royalty to prevent termination of the lease. Rather, Pace could exercise the option to extend the lease by the timely payment of shut-in royalties. Our conclusion that payment of shut-in royalty was made optional rather than mandatory, is based upon a construction of the shut-in royalty provision in its entirety.

The provision, recited in full previously, states that the lease shall not expire where a gas well has been shut-in on the premises due to lack of market "provided, however, the owner of this lease as to lands upon which such well is located shall pay an annual royalty equal to the annual rental payment . . . ." As defendant correctly points out, the dependent clause beginning with "provided" is a proviso. Black's Law Dictionary 1388 (4th ed.1968). A proviso is properly used to "qualify what is affirmed in the body of the section preceding it . . . ." Id. at 1390. Thus, the lease is to be extended beyond its secondary term if Pace chooses to tender payment of the shut-in royalty in a timely fashion. If he does not do so, the special limitation of the habendum clause operates freely to effectuate

automatic termination of Pace's lease. "Shall pay", as it appears in the proviso, is not a mandate, imposing upon the lessee an obligation to pay. Within the context of the proviso, "shall pay" connotes that the lessee who wants to extend his lease may do so, provided he pays an annual shut-in royalty. "Shall pay", then, is used in the simple future tense (see Webster's Third New International Dictionary 2085 (1976)) to indicate that the lease continues in force, if shut-in royalties are paid. A phrase such as "the owner of this lease as to the lands upon which such well is located shall pay . . .", where not contained in a proviso, would impose upon the lessee an obligation to pay shut-in royalty, and would, therefore, be a covenant. See 3 H. Williams, Oil and Gas Law §632.8 at 435. Such is not the case here, when "shall pay" is read in context.

In conclusion, Pace's lease automatically expires under the special limitation contained in the habendum clause, should there be no production of oil or gas at the end of the secondary term. The shut-in royalty provision, however, acts as a savings clause to prevent automatic termination of the lease under the habendum clause because it equates the payment of shut-in royalty with production. The shut-in royalty provision, written as a special limitation on the habendum clause, is to be exercised at Pace's option. Should he not choose to pay shut-in royalty in a timely fashion, the shut-in royalty provision automatically fails to save the lease from expiration under the special limitation of the habendum clause, without the requirement that Pace be afforded notice and an opportunity to cure. Since Pace did not tender the shut-in royalty at the time specified in the shut-in royalty provision, the trial court was correct in sustaining the Commissioner's finding that Pace's lease terminated automatically.

This decision is not to be published nor cited as precedent.

IT IS SO ORDERED.

IVAN SOSA, Senior Justice

WE CONCUR:

WILLIAM RIORDAN, Chief Justice

HARRY E. STOWERS, JR., Justice

## FOOTNOTES

[1] Under the provisions of the lease, the lessee who has not discovered oil and gas during the primary term may continue the lease for an additional five-year term (secondary term) by payment of double rentals. In this manner, Pace continued his lease through a second term.

IN THE DISTRICT COURT OF THE FIFTH JUDICIAL DISTRICT

FOR THE COUNTY OF CHAVES, STATE OF NEW MEXICO

HARRISON W. PACE,

Plaintiff,

v. No. CV-83-0242

JIM BACA, Commissioner of Public Lands, State of New Mexico,

Defendant.

ORDER OF JUDGMENT

This action came on to be tried before the Court, and the evidence adduced by the parties having been heard, and the Court having made its findings of fact and conclusions of law, and having rendered its decision that the defendant Commissioner of Public Lands Jim Baca, has shown cause why his order that State Lease No. LG-0160 had expired by its own terms should not be set aside, it is hereby

ORDERED AND ADJUDGED:

1. That the Gulf State No. 1 well is capable of producing gas in paying quantities;

2. That the decision of the defendant Commissioner of Public Lands, Jim Baca, that State Lease No. LG-0160 expired by its own terms is correct; and

3. That the tender of shut-in royalty on the Gulf State No. 1 well by the plaintiff, Harrison W. Pace, was untimely and, therefore, ineffective to extend the term of State Lease No. LG-0160.

IT IS FURTHER ORDERED:

4. That the plaintiff, Harrison W. Pace, shall vacate the state lands formerly held under State Lease No. LG-0160;

5. That the defendant Commissioner of Public Lands, Jim Baca, shall refund to the plaintiff moneys tendered as shut-in royalty on the Gulf State No. 1 well; and

6. That each party shall bear its own costs and attorneys' fees on proceedings to date.

PAUL SNEAD
DISTRICT JUDGE

Approved:

Chad Dickerson
Attorney for Plaintiff
Harrison W. Pace

Arthur J. Waskey
Attorney for Defendant
Jim Baca, Commissioner of Public Lands

IN THE DISTRICT COURT

COUNTY OF CHAVES

STATE OF NEW MEXICO



HARRISON W. PACE,

Plaintiff,

vs.

CV-83-242

JIM BACA, Commissioner of Public Lands of the State of New Mexico,

Defendant.

DECISION

THIS CAUSE coming regularly to be heard by the Court, the parties having submitted Requested Findings of Fact and Conclusions of Law, the Court makes the following Findings and Conclusions as the decision in this case.

FINDINGS OF FACT

1. The State oil and gas lease identified as State Lease No. LG-0160 was sold to Shenandoah Oil Corporation by the Commissioner of Public Lands on or about April 18, 1972, and was issued effective May 1, 1972. On or about June 8, 1979, the Commissioner of Public Lands approved the assignment of said lease by Shenandoah Oil Corporation to Harrison W. Pace, plaintiff herein, and current record title holder.

2. Annual rentals on the lease were paid or tendered in timely manner to the time this litigation commenced. The lease was valid at least until May 1, 1982, when the "secondary term"

of the lease expired.

3. In November, 1978, a well within the leased acreage known as Gulf State No. 1 was re-entered, tested, and shut-in due to lack of market. Gulf State No. 1 is capable of producing gas in paying quantities. Date of shut-in was about February 15, 1979.

4. No shut-in royalty for Gulf State No. 1 was tendered before May 1, 1980.

5. The sole issue in this cause is whether the failure to pay shut-in royalties resulted in a lapse of the lease, or whether the shut-in provision of the lease preserved the lease, giving the State only an action for debt as to the unpaid shut-in royalties.

## CONCLUSIONS OF LAW

1. The shut-in royalty provision of the oil and gas lease in question permits the lessee to preserve a lease by shutting in a well capable of production when no market is available, and by paying the shut-in royalty.

2. By reason of the failure to pay shut-in royalties in a timely manner, the lease expired, and the decision of the Commissioner is correct.

Paul Snead

PAUL SNEAD
DISTRICT JUDGE

IN THE SUPREME COURT OF THE STATE OF NEW MEXICO

MANDATE NO. 15,564

THE STATE OF NEW MEXICO TO THE DISTRICT COURT sitting within and for the County of Chaves, GREETING:

WHEREAS, in a certain cause lately pending before you, numbered CV-83-0242 on your Civil Docket, wherein Harrison W. Pace was Plaintiff and Jim Baca, Commissioner of Public Lands was Defendant, by your consideration in that behalf judgment was entered against said Plaintiff; and

WHEREAS, said cause and judgment were afterwards brought into our Supreme Court for review by Plaintiff by appeal, whereupon such proceedings were had that on January 7, 1986, a Decision was entered by said Supreme Court affirming your judgment aforesaid, and remanding said cause to you.

NOW, THEREFORE, this cause is hereby remanded to you for such further proceedings therein as may be proper, if any, consistent and in conformity with the Decision of the Court.

WITNESS, The Hon. William Riordan, Chief Justice of the Supreme Court of the State of New Mexico, and the seal of said Court this 22nd day of January, 1986

(SEAL)

Rose Marie Aldrete
Clerk of the Supreme Court
of the State of New Mexico