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Pugh Clauses: A Primer

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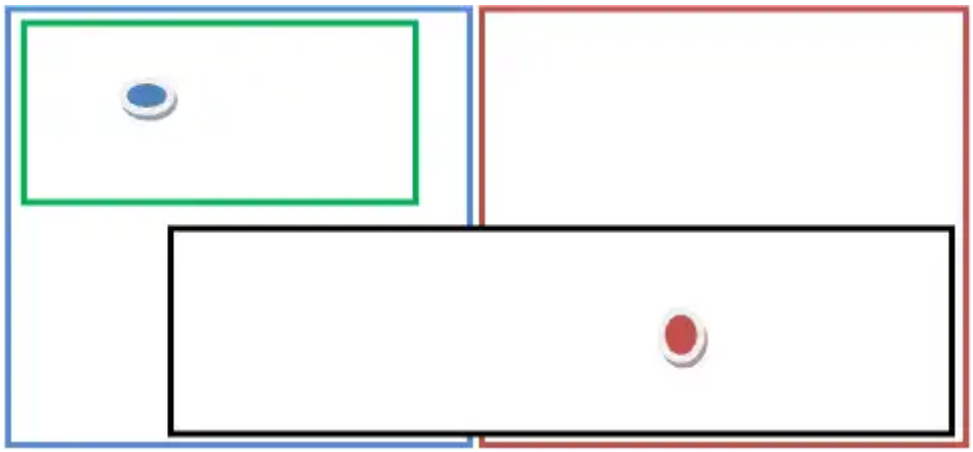
Most oil and gas leases throughout the country state that they are for a specific period of time (the "primary term"), but may be extended or renewed for additional time if there is active production or operations on the leased premises. In this manner, the entirety of the lease's acreage can be retained under the lease even by production on one small portion. But in many states, the regulators for such activities can create "compulsory" drilling and production units to cover multiple tracts of lands; with a compulsory unit, production anywhere within the unit area is treated as production from each of the tracts in the unit. Landowners and lessees also sometimes create "voluntary" unit or pooling agreements by which they contractually agree to combine adjoining tracts for drilling and production purposes. To this end, many leases provide that a lease is not only retained by production anywhere on the leased premises, but also by production on other land that is pooled or unitized with some portion of the leased premises. Thus, instances frequently arise where production from a pool or unit, but not on the tract subject to a lease, can maintain the entirety of that lease.

To limit such outcomes, lessors often employ Pugh clauses, named after the creative Louisiana lawyer Lawrence G. Pugh, who first used such a clause in 1947 to prevent the holding of non-pooled acreage in his client's lease while only certain portions of the lease acreage were being held under pooling agreements. In general, Pugh clauses state that activity attributable to a unitized portion of the lease will not save an entire lease's acreage, but rather only the portion of the leased premises within the pool or unit itself.

Consider the following picture:



Assume that the blue and red boxes represent separate leases; that the green and black boxes represent separate units or pooled areas; that the blue and red ovals represent productive wells; and that there are no other operations or production on either lease. In the absence of a Pugh clause, the blue and red wells would be sufficient to preserve the entirely of the Blue and Red Leases, respectively. Under a standard Pugh clause for each lease, (i) the blue well would be sufficient to retain only the portion of the Blue Lease that is within the green unit; (ii) the activity from the red well would preserve the portion of the Red Lease within the black unit, but not anything outside the black unit on the Red Lease; *but* (iii) the red oval would also preserve the portion of the Blue Lease that is within the black unit. Accordingly, under this scenario, the acreage on the Blue and Red Leases that was not within either the green or black unit would not be held under the leases.

But not all Pugh clauses are the same, and each one can be unique. The provision described above is known as a "horizontal" Pugh clause. But parties have also employed "vertical" Pugh clauses that follow the same principle but address preservation of a lease with regard to different drilling depths, as opposed to acreage. (See our recent post discussing Pugh clauses tied to strata)

Another intricacy that has developed over the years is between "snapshot" and "rolling" Pugh clauses. "Snapshot" Pugh clauses normally look at the state of production only once, at the end of the primary term. If there is production sufficient to preserve all or part of the lease at that one moment, the acreage is retained and not evaluated again. Conversely, under "rolling" Pugh clauses, "rolling determinations" following the primary term are to be made whenever any operations or production ceases. *See Apache Deepwater, LLC v. Double Eagle Dev., LLC*, 557 S.W.3d 650, 653-54 (Tex. App.- El Paso 2017).

Determining which Pugh clause you are dealing with is not always straightforward, and different states employ varying presumptions in construing these provisions. For instance, Texas courts have construed Pugh clauses to be "snapshot" unless specific language indicates that the lease contemplates continued determinations of production. *See id.* at 657. Conversely, in North Dakota, courts have been more apt to interpret such clauses as rolling so long as the text does not explicitly foreclose such an interpretation. *See Tank v. Citation Oil & Gas Corp.*, 848 N.W.2d 691 (N.D. 2014). The overall lesson is to review your state's jurisprudence before signing off on a Pugh clause, and make sure to be as specific as possible. No need to leave this up to litigation.

As with most contractual provisions, the parties are generally free to create the specific provisions they prefer to best accommodate the unique needs of their endeavor. The issues addressed in this short article and any other concerns that you would like your Pugh clause to address can likely be accommodated by some forethought and careful drafting.