JUST DON'T CALL IT A RULE—HOW THE COLORADO SUPREME COURT'S *CRESTONE PEAK* DECISION REACHED THE RIGHT OUTCOME WITH FLAWED REASONING

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I. Background and Lease Provisions

Despite the Colorado Supreme Court's purported rejection of the commercial discovery rule for Colorado oil and gas leases in its November 2023 decision in *Board of County Commissioners of Boulder County v. Crestone Peak Resources Operating LLC*, 2023 CO 58, 538 P.3d 745, the circuitous reasoning it seemed to use may have nonetheless accomplished the very result it sought to avoid.

Boulder County is the lessor under two oil and gas leases and three associated wells for which Crestone Peak—now part of Civitas Resources—is the lessee-operator. As is common, both leases' habendum clauses provide primary terms of a fixed number of years, followed by secondary terms of "as long thereafter" as oil or gas is "produced" from the premises. Both leases were signed in the 1980s and entered their secondary terms years ago.

Importantly, both leases also contain two similar provisions bearing on a lack of production during the secondary term. First, the leases include "cessation of production" clauses, which provide that if production ceases "from any cause" the lease "shall not terminate" if the lessee undertakes drilling or re-working operations within 60 or 90 days from that cessation. Second, the leases contain a fairly typical shut-in royalty clause: if a well is "capable of producing gas," but gas is not sold for a minimum period for whatever reason, then a shut-in royalty paid by the next lease anniversary date will hold the lease as producing.

II. Appellate Court's Reasoning and Decision

In 2014, Crestone's predecessor, Encana Oil & Gas (USA), Inc. (now Ovintiv USA Inc.), shut in the wells because Anadarko—the buyer of oil and gas from the wells—needed to repair its sales pipeline for four months. The wells remained commercially viable and, after repairs, Crestone Peak returned the wells to production. At the time, Boulder continued to accept royalty payments and did not claim termination. But Boulder sued in 2019 claiming termination, apparently in reaction to Crestone's attempt to expand operations under the two leases, and likely motivated by anti-extraction politics, which the Colorado Supreme Court specifically acknowledged.

After the district court granted Crestone's motions for summary judgment, Boulder appealed. The court of appeals' affirmance was not itself too surprising. The appellate court recognized it must "review oil and gas leases like any other contract," meaning each contract's terms "must be construed to give effect to the particular wording" and be interpreted "in its entirety" to "harmonize" all provisions.

Based on these black-letter principles, the appellate court harmonized "production" with the cessation of production and shut-in royalty clauses and found the shut in did not terminate the leases. According to the court, "production" under the lease is "functionally synonymous" with capability of production, a point supported by both the cessation of production and shut-in royalty clauses.

The cessation clause applies when "production" *permanently* ceases—i.e., when resuming production would require major drilling or reworking operations—as opposed to a temporary cessation (generally defined under common law). This is because a cessation clause typically specifies drilling or reworking as a remedy to the cessation, and, generally speaking, drilling or reworking are only required to "restore" production when the well is no longer capable of production.

The shut-in clause also supported "production" as synonymous with capability of production, according to the court of appeals. If production requires extraction, as Boulder argued, then the shut-in royalty clause would be a nullity—a four-month shut in would trigger termination, and the "lessee would never be able to utilize the shut-in royalties clause." But, said the court, if production means some capability of production, then the shut-in clause still has meaning.

If the court of appeals took a wrong step, perhaps it was labeling its reasoning "the commercial discovery rule," following an appellate panel's 1992 decision in *Davis v. Cramer*, 837 P.2d 218 (Colo. App. 1992). But *Davis* did not definitively adopt or apply that rule. Rather, responding to the trial court's finding that "marketing is not an essential part of production," *Davis* merely found neither the lease nor extant Colorado law required a different finding.

Arguably, the court of appeals need not have adopted, or even referred to, the commercial discovery rule. Instead, it could have simply begun with its later discussion of the leases' language and harmonizing the term "production" with the cessation and shut-in clauses. The outcome would have been the same.

III. Supreme Court's Analysis and Decision

Faced with Boulder's argument for a diametrically opposite rule—namely, the "actual production" rule, requiring extraction *and* production to hold the lease—the Colorado Supreme Court granted the County's certiorari petition on whether the court of appeals "erred in adopting and applying the 'commercial discovery rule.'"

The supreme court unanimously affirmed based on questionable reasoning. After criticizing the court of appeals for "focus[ing] exclusively on the word 'production'" (which mischaracterizes the lower court's lengthy analysis of the lease provisions) and for "'adopt[ing] the commercial discovery' rule to interpret that term," the court declined "to universally impose [a] definition of 'production' in every oil and gas lease, regardless of the context."

But the court's remaining analysis suggests that this is precisely what it did. Once the court gets to interpreting the lease language, its analysis closely tracks that of the court of appeals: the supreme court holds the cessation and shut-in royalty clauses inform a harmonious interpretation of "production" as "capable of producing."

If anything, the supreme court's rewrite only introduces more confusion. It mostly focused on the cessation clause, but, as the court found, that clause was not actually triggered by Encana's four-month shut in, because it only pertains to permanent cessations.

Temporary cessations, meanwhile, continue to be governed by the temporary cessation doctrine, considered in most states to be displaced in leases with cessation clauses, and not relied upon by the supreme court since *Hoff v. Girdler Corp.*, 88 P.2d 100 (Colo. 1939). Unfortunately, the supreme court's decision lacks guidance on distinguishing between temporary and permanent cessations, other than drilling or reworking are required in the latter but not the former. Thus, the

decision (1) considerably limited the scope of cessation clauses, (2) departed from most jurisdictions' established common law, and (3) provided limited guidance on application of its new rule.

Although the parties disputed whether the shut-in clauses were limited to gas-only wells, the court of appeals correctly observed the clauses were "most important" in that they cannot be reconciled with Boulder's position. Both courts should have led their analyses with the shut-in clauses; after all, those clauses clearly applied here, where Encana temporarily shut in due to causes unrelated to productivity. Yet the Supreme Court issued a convoluted opinion that may prompt lower courts to rely on the presence or absence of the cessation clause, not the dispositive shut-in royalty clause.

IV. Practical Implications for Practitioners and Operators

For practitioners and operators, several practical consequences are apparent. First, the decision postulates that, unlike most producing jurisdictions, the temporary cessation doctrine still applies even in the presence of a cessation clause. Such temporary cessation cases still require a fact-specific inquiry. Second, new leases should better define production, and include both cessation and shut-in clauses. Third, operators should commence and continue work on the premises during any cessation (as opposed to completely abandoning the well), following the timeframes in the lease, to show ongoing activity. Finally, of course, operators should not miss shut-in royalty payments, which have only increased in importance in the wake of *Crestone Peak*.