

Oil and Gas Leases

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Leasing Provisions

No standard or universal lease form is used by all the oil and gas industry.

- Industry normally uses some version of a Producers 88 Lease Form.

Three factors influence the negotiating power of the mineral owner (lessor).

- Amount of acreage the lessor controls.
- Proximity of the acreage to known production.
- Number of oil companies bidding for the lease.

Leasing Provisions (Continued)

If favorable terms are negotiated, they should be in writing/incorporated into the lease usually by three means.

- For minor modifications, strike the provision to be altered, insert the change and initial the margin of the page (by both parties) then insert the date next to the initials. Example - this process would be followed when changing the lease royalty from 1/8 to 1/6.
- For pronounced modifications, attach an addendum to the lease. The preface to the addendum begins, "Notwithstanding anything to the contrary in the foregoing Oil, Gas and Mineral Lease, the following terms and provisions control. . . ." The individual changes are then listed.
- If the addendum is extensive, and contains terms the lessee does not want to become public knowledge, a Memorandum Lease may be executed and recorded in its place.
 - The Memorandum Lease contains the minimum information necessary to give constructive notice of the lessee's lease.
 - It gives the name/address of both the lessor and lessee, the lease date, the length of the primary term and the legal description of the property.
- Third way to make changes to a lease and keep the changes from becoming public information is to enter a letter agreement.
 - Generally used to clear up minor problems with the lease prior to drilling operations.

Granting Clause

The opening paragraph of the lease - granting clause - outlines the purpose of the lease and describes the substances that can be explored and produced.

Typically, the clause will state that the lease is given for the purpose of exploring, drilling, and producing oil and gas and all other minerals, similar or dissimilar.

- Surface use problems arise under the Granting Clause.
- Among other things the granting clause gives the Lessee the right to reasonable use of the surface for purposes of developing the minerals.
- Lease often states: When there is a severance of the mineral and the surface estates (SE), the mineral estate (ME) is the dominant estate.
- The dominant estate rule means the surface estate has to serve the ME.
- The mineral owner (or his Lessee) has a right of ingress and egress as well as a right to use as much of the surface as is reasonably necessary to explore for and produce minerals.
- Because the ME is dominant, the Lessee is not obligated to pay for using the surface.
- He is not obligated to maintain or restore the surface in the absence of a statute or lease provisions requiring such restoration.

The Rule of Reasonable Use includes geophysical exploration, drilling, building roads, installing machinery and storage tanks, and using such water as is reasonably necessary.

- Limits the Lessee to no more of the surface than is reasonably necessary to develop the minerals. If it takes one acre to drill a well, the Lessee cannot use two acres.
- The Lessee's use has to be related to developing the minerals under the particular leased property. Lessee cannot use the surface to transport gas it has produced from a different piece of property to the pipeline.

If substances other than oil and gas are produced, two problems exist in Texas.

- If the substances sought lie near the surface or will substantially damage the surface when produced, the surface owner likely owns it.
- Leases should cover non-hydrocarbon substances.

Granting Clause (Continued)

- The legal description of the property covered by the lease is typically followed by a clause which reads as follows: "[T]he lease also covers adjacent or contiguous tracts owned or claimed by Lessor."
 - This is the "Mother Hubbard" (cover-all clause). The purpose of Mother Hubbard is to make inadvertent omissions of small strips due to improper descriptions, adverse possession, survey errors, easements, et cetera subject to the lease.
 - Does a large tract next to the leased property, owned by Lessor but not specifically described, become subject to the lease under Mother Hubbard?
 - The courts have said "No."

Granting Clause (Continued)

To avoid any disputes, specify that the extraction method used by the lessee can be through a borehole only

- Bars all strip mining and other methods that substantially destroy the surface.
- Substances lying beneath the surface do not necessarily belong to the mineral owner.
- Specify those included to the exclusion of all others, that is, all petroleum and natural gas and related hydrocarbons except coal, lignite and uranium (et cetera).

Another limitation is the Accommodation Doctrine (in Getty Oil v. Jones) which states.

- If the proposed use of the surface by the mineral owner will substantially impair existing surface uses and the mineral owner has reasonable alternatives available, the mineral owner must accommodate the surface owner.
- Getty Oil v. Jones illustrates both the application of and limitations under the Accommodation Doctrine.
- Getty installed a pump jack to produce oil from a well drilled on Jones' farm. The pump jack, which extended seventeen feet high, interfered with a seven-foot high rotating irrigator belonging to Jones. The court ordered Getty to sink the pump jack below the surface of the ground to avoid interference with the irrigator.
- The accommodation doctrine is not a weighing test - The rotating irrigator was an existing use and sinking the pump jack was a reasonable alternative.
- The legal standard is negligence.
- Many people falsely believe the standard is strict liability (a higher standard).
- Oil companies realize that they often lose these suits which are usually tried in the Lessor's home county with the Lessor's neighbors on the jury, hence they settle with the Lessor.

Granting Clause (Continued)

The reasonably necessary doctrine is usually expanded and explicitly permit a wide range of surface activities.

- Even if the lessee is liable for damages, the Lessor's inconvenience of unwarranted structures/entries may be avoided by.
- (The suggestions are also good for the Lessee's reputation).
 - Limit unrestricted underground disposal of salt water in abandoned wells on the property – require prior written consent of the lessor.
 - Lessee's routes of ingress/egress to existing roadways on the leased premises.
 - For deviations, require them from the nearest roadway.
 - Specify who removes roadways built by lessee when lease terminates.
 - Specify where cattleguards are required/who will maintain locked gates.
 - Specify erosion prevention techniques along roadways/around drill sites.
 - Do not permit wells within 200 feet (or some greater distance) of a dwelling.
 - Provide that all underground pipelines and telephone lines must be buried below plow depth.
- Mineral owners cultivating/grazing the land above pipelines should specify the double ditch method for laying pipe.
 - Method requires the top soil to be placed on one side of the trench and the subsoil on the other.
 - When backfilling, subsoil is replaced first, then the top soil.
- In Texas, the lessee has an implied right to use caliche on the leased premises free of charge for construction of drill sites and roads.
- Specify that the lessee's structures and equipment must be removed within a certain time after the lease or be forfeited.
- If the lessee must cut a fence to build a road or a pipeline, describe the methods for bracing the fence prior to its breach.

Duration of the Lease

Problems in lease termination disputes are controlled by the (1) the Habendum Clause, (2) the concept of production and (3) the relationship between the Habendum Clause, the Drilling and Delay Rental Clause and several Savings Clauses in the Lease Form.

The Habendum Clause (aka the Term Clause) fixes the ultimate duration of the lease (the longest possible time the lease may last).

The Drilling and Delay Rental Clause can cause the lease to terminate earlier.

Savings Clauses (the Operations Clause, the Shut-in Royalty Clause and the Force Majeure Clause) enable the lease to remain in effect by something other than production.

The Timeline — the Primary and Secondary Terms — is controlled by the Habendum and Drilling and Delay Rental Clauses which splits the term of the lease into two segments.

- The first period (primary term) sets a number of years during which drilling operations must begin or delay rentals must be paid.
- Generally if drilling operations are not being conducted within one year after the lease is entered, the lease terminates unless an agreed sum is paid to the lessor.
- This sum is a delay rental.
- Delay rentals must be paid on each subsequent anniversary date of the primary term whenever drilling operations or production are inactive.
- Failure to receive a required delay rental payment automatically terminates the lease whenever the word UNLESS is used to indicate the necessity of the payment.
- Some leases contain the word OR rather than unless, in which the lease will not terminate for a delinquent payment.
- Some leases have all the delay rentals paid in advance at the commencement of the lease (paid-up leases).

If production is not established by the end of the primary term, the lease will end.

- If production has been established, the lease will continue into its secondary term and last so long as substances covered by the lease continue to be produced.

Extension of the Primary and Secondary Terms

The primary and secondary terms of the lease may be extended via the shut-in provisions, dry-hole provisions and cessation-of-production provisions.

Extension of the Primary and Secondary Terms (Continued)

The shut-in royalty clause provides that when a well capable of producing gas is shut-in for lack of a market, the Lessee can hold the lease by paying shut-in royalties.

- These are usually a nominal amount.
- The Lessee must diligently work to find a market.
- The Lessee must find the market/sell the gas in a reasonable time.

Extension of the Primary and Secondary Terms (Continued)

The Operations Clause is the most complex of the savings clauses.

It covers three common contingencies that might occur in the course of developing an oil and gas lease – Operations, Dry Hole, and Cessation of Production.

It is designed to save the lease from lapsing in situations where it would lapse under the language of the Habendum Clause.

The operations clause provides that the lease won't expire while the Lessee is engaged in drilling or reworking operations.

Extension of the Primary and Secondary Terms (Continued)

The dry hole part of the clause covers a situation where Lessee drills a dry hole while the lease is in effect.

- Lessee gets information from the drill core that indicates if he moves the location xxx feet east, he may get production.
- The clause provides that the Lessee can keep the lease alive by starting to drill another well on the leased property within the stated time period (such as 90 days).
- If the primary term has not expired and more than 15 months still remain, the lessee has two options.
 - The lessee either can pay the next delay rental payment that comes due 90 days after the dry hole was drilled or commence drilling or reworking operations on or before the next anniversary date occurring 90 days after the dry hole.
 - If less than 15 months remain in the primary term, the lease will continue to the end of the primary term even though the lessee's operations remain idle and no delay rentals are paid.
 - Drilling or reworking operations must recommence on or before the end of the primary term to continue the lease.
 - If the lessee was in the process of drilling a well when the primary term ended, the lease will not terminate when the dry hole is discovered.

Extension of the Primary and Secondary Terms (Continued)

The cessation-of-production provisions.

- The premise is if the well ceases producing, the Lessee can keep the lease alive if the Lessee starts repairs within a stated time period.
- The Lessee does not have to achieve production within the stated time period (such as, 60 days).
- The Lessee must start working on the problem in good faith within the time period provided and diligently complete the work.

Royalty Clause

Royalty is paid to the Lessor by the Lessee as partial consideration for the lease.

- If production is obtained, royalty will likely be the main compensation received by the Lessor for the lease.
- Royalty is simply a share of the product payable in kind or in money free of the cost of production.
- The Lessor's fractional share of production, represented by his royalty, is negotiated between Lessor and Lessee.
- Today, royalty can be any amount that the parties negotiate which normally range between 1/8 and 1/4.
- Once a lease relationship is entered into and production obtained, there are two ways that a lessor can increase royalty income.
 - Increase the volume of production on which royalty is due; or
 - Increase the value of such production.
- The implied covenants — reasonable development and protection against drainage — are the lessors' primary tools for maximizing volume.

Royalty Clause (Continued)

Differences in the Way Oil and Gas are Marketed

- Producers seldom incur any costs subsequent to the production of oil.
- Crude oil is typically stored in tanks near the well.
- A refinery buys the crude oil and sends a truck to pick it up at the well head.
- This is the point of sale and subsequent costs are borne by the refinery.

Gas cannot be economically stored above ground or transported except through a pipeline.

- It must be transported into the pipeline as soon as it is produced.
- Gathering lines must be built and the gas must be compressed.
- The raw gas at the well head may contain impurities and need to be processed before it can be sold.

Royalty Clause (Continued)

Royalty Payments - Royalty is a share of production or production revenues free of the costs of production.

- Landowners Royalty is provided by the oil and gas lease royalty clause.
- Oil royalty clauses usually assumes that the oil royalty will be paid in kind and delivered to the lessor at the storage tanks.
- The gas royalty clause is drafted so that the lessee disposes of production and then compensates the lessor, usually by check.
- Royalty Basis.
 - If an oil and gas lease calls for payment of royalties computed on the basis of "market value at the well," this means market value at the time of production and delivery rather than when the sale contract regarding the gas was made.
 - Simple passage of title does not control whether gas is "sold at the well;" it is sold at the well only if the value has not been increased before sale by transportation or processing.
 - Thus royalty payments are based on the value or price of the gas before it is processed or transported.
- Texas Majority Rule: The *Vela Rule* - "market value" is a plain term that must be given its usual meaning; the price a willing buyer and seller would agree upon at the time of production. Market value is the value of gas when produced and sold.

Royalty Clause (Continued)

Royalty Payments (Continued).

- Difference between leases that refer to both market value and amount realized.
- By using both terms the lessee is hoping to establish the right to
 - (1) keep all benefits of any increase in value of the gas resulting from a sale off the premises rather than at the well and
 - (2) deduct from the lessor's royalty share costs subsequent to production, such as transportation and cleaning.
- If you use a lease that just refers to "proceeds" this will do away with market value ambiguity but may preclude the lessee from deducting costs subsequent to production.
- Use a lease clause that couches the obligation to pay royalties in terms of proceeds but spells out the lessee's right to deduct the lessor's share of costs subsequent to production.
- Market Value.
 - Actual sale at the well head
 - Sales comparable in.
 - Time
 - Quality (legal and physical)
 - Quantity
 - Availability of market.
- "Net Back" or "Work Back" method: Start where a dollar value can be placed on the transaction and work backwards.
- By using both terms the lessee is hoping to establish the right to (1) keep all benefits of any increase in value of the gas resulting from a sale off the premises rather than at the well and (2) deduct from the lessor's royalty share costs subsequent to production, such as transportation and cleaning.

Royalty Clause (Continued)

- Costs of Production and Costs Subsequent to Production (Part of Deductions in Calculating Royalty)
 - General Rule: The lessee is obligated to pay all costs of production, but the lessor shares proportionately in costs subsequent to production since they are incurred after production and increase the value of production.
 - Generally, all costs incurred on the leased land to bring o/g to the surface and make it ready for market are treated as costs of production.
 - Deductions from royalty are generally permitted for costs of cleaning, dehydration, transportation, and production and severance taxes
 - Costs incurred on the leased premises are likely to be classified as costs of production while costs incurred off the lease are likely to be treated as costs subsequent to production.

Implied Covenants

Implied Covenants - A promise in a lease (or other instrument) that is not written, but implied. May bind l'or and l'ee (quiet enjoyment) but it usually imposes duties upon lessee and gives lessors rights.

- **Common Implied Covenants.**

- To Test
- To protect against drainage
- To reasonably develop
- To further explore
- To market
- To operate diligently and prudently.

2. The Reasonable Prudent Operator (RPO)

- The reasonable prudent operator standard, like the reasonable man standard in contracts and torts, is a device for applying an objective standard to define the scope of the Lessee's duty.
- The reasonable prudent operator standard is higher than the standard of "good faith" which is imposed on every party to a contract. However, the reasonable prudent operator is not a fiduciary — not a person who acts primarily for the benefit of someone else.
- The reasonable prudent operator can do what is in his own self-interest, but he has to act.
 - in good faith;
 - competently;
 - with due regard for the interests of the Lessor.
- Good faith and competence have their usual common sense meaning and the absence thereof should be relatively easy to spot in a given situation.
- **Acting with due regard** means the reasonable prudent operator THE LAW OFFICE OF C. WILLIAM SMALLING, PC pursuing his own interest.

Implied Covenants

- Implied Covenant to Reasonably Develop
 - Rule: Under an oil lease which is silent as to the number of wells to be drilled, there is an implied covenant that the lessee shall reasonably develop the lands and reasonably protect the lines.
- Implied Covenant to Protect Against Drainage.
 - Rule 1: An oil and gas lessee must act as a reasonably prudent operator to protect the lessor against field-wide (and local) drainage. D had a duty of loyalty to P to refrain from self-dealing or to take a position that is adverse to the lessor's interests.
 - Rule 2: The BOP is on the lessor to prove (1) proof of substantial drainage (2) proof that a RPO would have acted to prevent substantial drainage (3) amount of damages.
 - The most the law should seek to do is require of the lessee the operations a reasonably prudent operator would undertake if he did not own the adjoining land.
 - Burden on Lessor to show
 - proof of substantial drainage
 - proof that the lessee's operations were the cause of the drainage
 - amount of damages.
 - D can avoid liability by proving that a protection well would not be profitable. Amoco wouldn't have to drill if drilling wouldn't have been profitable. This is a different profitability than the one meant by production. This means that you have chance of getting money back plus a profit.
 - Before a lessee's duty to drill an offset arises he must have reasonable notice of its necessity. This notice can be express from the lessor or constructive from surrounding circumstances. This can be dealt with in the lease.
 - Notice before forfeiture clause: Protects against forfeiture or termination by requiring lessor to give notice of alleged breaches and an opportunity to correct them.
 - Judicial Ascertainment Clause: gives even more protection to lessee. Lessor must first prove case in court before cancellation/forfeiture can proceed.

Implied Covenants

- Implied Covenant to Test: Since royalties are the primary consideration for the lease and no royalties can be paid unless the property is tested.
 - Lessee has an obligation to test the premises w/in a reasonable time
 - Disclaimed by the delay rental clause (expressly disclaimed by the payment of rentals)
- Implied covenant to further explore: imposes obligations on lessee only after initial development has taken place.
 - Although controversial, due to the RPO standard the law should recognize the implied covenant to explore further.
 - The RPO will act to maximize profits and this includes further exploration but only after careful consideration.
 - In Texas: once a lease is held by production, the lessee must reasonably develop it; lessor must show additional wells could be drilled profitably (50% probability), AND lessee has acted imprudently in failing to drill.
 - Burden on Lessor.
 - additional exploration can reasonably be expected to be successful
 - the lessor's operator is behaving imprudently by failing or refusing to further explore.
 - Notice required when demanding cancellation.
 - Retained Acreage Clause: used to split off producing acreage from non-producing acreage to avoid forfeiture of producing land for failure to produce, additional wells could be drilled profitably (50% probability), AND lessee has acted imprudently in failing to drill.
 - Burden on Lessor
 - additional exploration can reasonably be expected to be successful
 - the lessor's operator is behaving imprudently by failing or refusing to further explore.
 - Notice required when demanding cancellation.

Implied Covenants

- Implied Covenant to Operate Diligently and Properly.
 - Can substantially overlap other covenants.
 - broadest of six covenants - plaintiffs prefer tort claims over covenants because of punitive damages.
 - Most common complaints under diligence covenant.
 - lessee has damaged property;
 - lessee has prematurely abandoned a well capable of producing profitably;
 - lessee failed to use advanced production techniques;
 - lessee failed to protect the lessor by seeking favorable administrative action.

Warranty Clause

Warranty clause: a specific covenant of title from the lessor to the lessee.

- The language is not a general warranty.
- It creates only a covenant of warranty, a promise to defend the lessee against future lawful claims and demands.
- There is no breach until the lessee is physically or constructively ousted from the property.
- This permits the lessee to recover damages from lessor if there is a failure of title.
- Most states limit the liability to the actual damages up to the amount paid plus interest.
- The warranty clause may also protect a lessee by making available the doctrine of after acquired title.

Force Majeure Clause

Leases generally contain provisions that protect the oil companies from liability and loss of the lease whenever causes reasonably beyond their control suspend operations - known as the force majeure clause.

- The principle behind the force majeure clause excuses performance (or extends the time for performance) because of unforeseeable factors beyond the Lessee's control.
- These kinds of occurrences beyond the parties' control — called acts of force majeure — are specifically addressed under this clause and typically include acts of God, weather, labor shortages, government interference.
- A force majeure clause does not excuse performance every time something unexpected happens.
- The act of force majeure has to be identified in the lease and that event has to prevent performance.
- There has to be a nexus between the event and the nonperformance.
- Delays that are caused by strikes, ice storms, governmental regulations should indicate a force majeure issue.

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