Southern Methodist University

SMU Scholar

Faculty Journal Articles and Book Chapters

Faculty Scholarship

1978

Representing the Landowner in Oil and Gas Leasing Transactions

John S. Lowe
Southern Methodist University, Dedman School of Law

Recommended Citation

John S. Lowe, Representing the Landowner in Oil and Gas Leasing Transactions, 31 Okla. L. Rev. 257 (1978).

This document is brought to you for free and open access by the Faculty Scholarship at SMU Scholar. It has been accepted for inclusion in Faculty Journal Articles and Book Chapters by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.

OKLAHOMA LAW REVIEW

VOLUME 31 SPRING, 1978 NUMBER 2

REPRESENTING THE LANDOWNER IN OIL AND GAS LEASING TRANSACTIONS

JOHN S. LOWE*

The publicity attendant upon the "energy crisis" confronting the United States and increasing prices for oil and gas have induced growing percentages of landowners or mineral interest owners[1] and oil and gas operators negotiating oil and gas leasing transactions to seek legal counsel at some point in their negotiations. An oil and gas operator usually consults either staff legal counsel or a law firm which represents other oil and gas operators, so that as a general rule operators are served by legal counsel who are familiar with the problems involved in leasing transactions and with the particular characteristics of their client's business. In contrast, a landowner is likely to seek advice from his family attorney or from a lawyer whose office happens to be convenient to him. Frequently, those private practitioners are inexperienced in oil and gas law and in the practicalities of oil and gas operations, with the result that they may have difficulty in advising their clients as to what ought and ought not to be included in an oil and gas lease.

©1978 John S. Lowe. All Rights Reserved.

*B.A., Denison; LL.B., Harvard. Associate Professor of Law, The University of Toledo. Chairman, Ohio State Bar Association Special Committee on Oil and Gas Law.— *Ed.*

The author acknowledges with appreciation the assistance of Michael A. Cline, third-year student at the University of Toledo College of Law and an editor of the *University of Toledo Law Review*, in the research of this article, and of Ms. Linda Whalen in the preparation of the manuscript.

[1] For convenience, reference throughout the remainder of this article will be to "landowners," rather than to "landowners or mineral interest owners." If the mineral rights have been severed from the surface rights, oil and gas leasing negotiations will be between the mineral rights owner and the prospective lessee and will not ordinarily involve the surface owner. *Compare* Phillips Pet. Co. v. Cowden, 241 F.2d 586 (5th Cir. 1957). A broader range of problems is presented, however, where the surface owner also owns the mineral rights.

This article is directed to the particular problems of counseling landowners or mineral interest owners in oil and gas leasing transactions. It is not intended to be an exhaustive analysis of either oil and gas law or oil and gas leases,[2] but rather it seeks to identify those matters likely to be of importance to landowners and to suggest measures which may protect those interests. Particular attention is given to those aspects of oil and gas law which may be troublesome to counsel for a landowner, either because his experience and instinct are likely to be misleading in handling them, or because they are unique to oil and gas law.

The Oil and Gas Lease

Perhaps the most basic point to be made with respect to oil and gas leasing is that there is no such thing as a "standard" lease. In theory, every clause of an oil and gas lease is open to negotiation between the parties. In practice, however, some clauses are so well accepted by custom or are regarded as so important by oil and gas operators that deviations from the norm are extremely difficult to negotiate. Nevertheless, there is wide variation in terms from lease to lease. The so-called "Producers 88" form, which many landowners frequently request, is found in so many different versions that the caption is meaningless.[3]

Conceptually, the oil and gas lease is a simple transaction. The lessor grants to the lessee the right to search for and produce oil and gas for a primary term which may range from a few days or months to as many as twenty years.[4] The lessee's property interest is terminable as it may be cut short by his failure to pay periodic rents[5] which are paid to justify failure to drill a well during the primary term,[6] or by expiration of the primary term

[2] For an exhaustive treatment of oil and gas law in general, *see* the multi-volume treatises of H. WILLIAMS & C. MEYERS, OIL AND GAS LAW (1977); W. SUMMERS, OIL AND GAS (1954-68 & Supp. 1977); E. KUNTZ, OIL AND GAS (1962-77). For consideration of oil and gas leases in particular, *see* E. BROWN, OIL AND GAS LEASES (2d ed. 1973 & Supp. 1977).

[3] *See* Fagg v. Texas Co., 57 S.W.2d 87 (Tex. Ct. App. 1933), holding that a contract to execute a lease on a "Producers 88 Form" is too indefinite to be enforceable. The court found the form "as incapable of definite application as if the term 'oil and gas lease form' had been used instead." *Id.* at 89. For a history of lease forms including the origin of the "Producers 88 Form," *see* Moses, *The Evolution and Development of the Oil and Gas Lease*, 2d S.W. LEGAL FOUNDATION INST. ON OIL AND GAS LAW AND TAXATION. 1 (1951).

[4] The purpose of the primary term in an oil and gas lease is to provide the lessee an opportunity to explore the premises to determine the probability of the presence of commercial quantities of oil and gas. See the discussion accompanying note 77, *infra*. The more speculative it is that oil and gas will be found in commercial quantities, the more likely it is that the lessee will insist upon a long primary term.

[5] The periodic rents are called "delay rentals." See the discussion at H. WILLIAMS & C. MEYERS, MANUAL OF OIL & GAS TERMS 138 (4th ed. 1976).

[6] This is true only of the most common type of lease, the "unless" lease. See the discussion accompanying note 85, *infra*.

without the production of oil or gas from a well on the premises in quantities sufficient to satisfy the lease. However, the lease may be extended to a secondary term "for so long thereafter as oil and gas are produced"[7] by production of oil and gas and payment of a percentage of the gross production, free of the expenses of production, to the lessor.[8] Thus, in simple terms, the common elements of an oil and gas lease include a grant of exploratory rights for a stated term in exchange for payment of rentals, with the right of extension for the duration of the productive life of wells drilled on the property if development is successful, in exchange for a percentage of gross production to be paid to the landowner.[9]

The basic scheme of the oil and gas lease has been complicated over the years by the tendency of courts to interpret leases strictly against lessees,[10] often resulting in forfeiture or termination of the lessees' interests, and by countervailing attempts of lessees' lawyers to draft documents which will not subject their clients to economic disadvantage. Although the struggle continues, it is fair to say that the operators' legal

[7] A secondary term of indefinite duration is necessary because neither the lessor nor the lessee can know when the lease is given how long wells drilled on the property will produce. There are both practical and statutory limitations on the rate at which a given well or reservoir can be produced. *See generally*, INTERSTATE OIL COMPACT COMMISSION, A REPORT OF OIL AND GAS CONSERVATION ACTIVITIES (1964).

[8] The percentage of gross production paid to the lessor is called "royalty." *See* the discussion at WILLIAMS & MEYERS, MANUAL OF TERMS, *supra* note 5, at 511.

[9] Generally, in classifying the interest that a landowner possesses in the oil and gas under his land the courts have embraced either an ownership or nonownership theory. In an ownership theory state, the landowner is the owner of the oil and gas in place, subject to the correlative right of other landowners to capture it and bring it to the surface from wells drilled and bottomed on their own property. In a nonownership theory state, the landowner possesses an exploratory right akin to a *profit a prendre. E.g.*, Rich v. Doneghey, 71 Okla. 204, 177 P. 86 (1918). Under this latter theory ownership does not vest until the oil and gas is captured. Because conceptually a landowner can grant no greater rights than he himself has, a lessee in an ownership theory state may receive either ownership of the oil and gas or a *profit a prendre*, while a lessee operating in a nonownership state obtains only a *profit*. Occasionally, however, courts have not been constrained by such theoretical limitations. For the theory of ownership advanced in the various states and the consequences that result from the disparate theories, *see* 1 WILLIAMS & MEYERS, *supra* note 2, at §§ 203-204.9; 1 KUNTZ, *supra* note 2, at § 2.4; 1 SUMMERS, *supra* note 2, at § 62.

[10] *See, e.g.*, Stanolind Oil & Gas Co. v. Guertzgen, 100 F.2d 299 (9th Cir. 1938); Skelly Oil Co. v. Cities Serv. Oil Co., 160 Kan. 226, 160 P.2d 246 (1945); Magnolia Pet. Co. v. Vaughn, 195 Okla. 662, 161 P.2d 762 (1945). Real property leases are usually interpreted against the lessor. The most common explanation given of the courts' reversal of the thrust of interpretation is that oil and gas leases are usually prepared by the lessee and, therefore, any ambiguities ought to be resolved against him. Hinson v. Noble, 122 S.W.2d 1082 (Tex. Ct. App. 1938). To the extent that this is the rationale, the rule may not be relied upon if the landowner prepares the lease or actively negotiates its terms. Briggs v. Waggoner, 375 P.2d 896 (Okla. 1962); Lucky Thirteen Oil Syndicate v. Barrett, 158 Okla. 98, 12 P.2d 233 (1932). The tendency toward strict interpretation against the lessee may also be explained by the fact that disputes over oil and gas lease terms usually go to trial in the area in which the landowner lives, before judges residing in the area who may have to stand for election from time to time, and before juries composed of other landowners.

draftsmen have largely won the battle by the development of a multitude of long and complicated clauses.[11] Thus, most lease forms that will be presented as the basis for negotiation of the leasing transaction will be presented by operators and may be expected to be highly favorable to operators. Many of the clauses in such forms should be of concern to lawyers representing landowners. Some of these clauses should be substantially modified before acceptance, and a few rejected outright. Thus, the first step in effectively representing the landowner in a leasing transaction is to recognize that most of the lease forms in circulation are "operator's forms" which must be closely scrutinized.

The second and more difficult step for the landowner's lawyer is to identify his client's interests and then to evaluate the proposed lease form in light of those interests. While the interests of landowners will naturally differ somewhat among individuals, it is possible to generalize and to conclude that the landowner's major concerns may be categorized into one or more of three areas. First, the landowner will wish to protect himself against an unreasonable interference by oil and gas operations with existing or expected uses of his land. Second, insofar as possible, the landowner will wish to build into the agreement assurances of fair dealing by the operator. Finally, the landowner will seek to maximize his return from oil and gas operations on the land to be leased. Specific analysis will follow under these general headings. It should be noted that many of the particular topics could easily be discussed under more than one general heading; the classifications are not exclusive.

Protection Against Interference With Existing or Expected Uses of Land

The landowner engaged in negotiations for the granting of an oil and gas lease is often greatly excited by the possibility that he may be sitting upon a bonanza of oil and gas. Usually, however, there is a present or intended use of the land which is of economic benefit to him. Therefore, enticed as the landowner may be by the prospect of the development of oil and gas on his premises, he often is, or ought to be, worried about the possibility that oil and gas operations will adversely affect his present or intended use of the property.

In protecting the landowner's interest in use of the surface of the land, the first issue that must be addressed by the landowner's lawyer is whether the grant of the lease will conflict with the rights of others in the

[11] For an excellent and concise discussion of the development of the modern oil and gas lease, *see* H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §§ 600-602.6 (students' abridged ed. 1975). *See also* Moses, *supra* note 3.

property. The classic case arises when the owner and occupier of the surface does not own the oil and gas rights;[12] the full mineral interest may have been "severed" from the fee interest and the oil and gas rights be held as separate property.[13] Because oil and gas leases typically contain a warranty from the lessor to the lessee that the lessor owns the full mineral interest in the leased property,[14] and a proportionate reduction clause to the effect that the royalties and rentals provided for are to be reduced proportionately if the lessor does not own all of what he purports to lease,[15] the lessor's counsel ought to satisfy himself that his client does in fact own full rights to the oil and gas interest to be leased.[16] Because of the prevalence of casual practices in the conveyance of real property in many areas of the country, it is not unknown for the landowner's lawyer to discover that his client does not own all or any of the oil and gas rights to his property.[17]

Even where there has been no severance of the oil and gas interest from the surface rights, if the property has been previously mortgaged, the mortgage will take priority over the oil and gas lease.[18] Moreover, it is likely that the mortgage contains language to the effect that the property may not be leased without permission of the mortgagee and provides for the mortgagee's right either to accelerate the principal amount of the mortgage

[12] The problem may also arise where the landowner owns the oil and gas rights but is restricted in his use of them by equitable servitudes or zoning restrictions. *See* the discussion at 2 WILLIAMS & MEYERS, *supra* note 2, at § 517.

[13] Central Coal & Coke Co. v. Carseloway, 45 F.2d 744 (10th Cir. 1930); Dabney-Johnston Oil Corp. v. Walden, 4 Cal. 2d 637, 52 P.2d 237 (1935); Jilek v. Chicago, Wilmington & Franklin Coal Co., 382 Ill 241, 47 N.E.2d 96 (1943).

[14] For example, the following from a form frequently used in Ohio: "All covenants and conditions between the parties hereto shall extend to their heirs, executors, successors and assigns and the *Lessor hereby warrants and agrees to defend the title to the land herein described*; Lessor further agrees that the Lessee shall have the right at any time to redeem for Lessor, or otherwise acquire by payment, any mortgage or any other liens upon the above described lands which in any manner affect the Lessee's interest therein in the event of default of payment by Lessor and be subrogated in full to all the rights of the holder thereof the same as if Lessee were the original owner of said mortgage or lien." (Emphasis added.)

[15] For example, the following from a form used in Texas: "If said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided shall be paid the lessor only in the proportion which his interest bears to the whole and undivided fee; however, such rental shall be increased at the next succeeding rental anniversary after any reversion occurs to cover the interest so acquired."

[16] The problem of divided ownership may arise in many contexts, *e.g.*, concurrent ownership, life estates and remainder interests, property held in trust, and dower rights. *See* 2 WILLIAMS & MEYERS, *supra* note 2, at § 512-20.

[17] Back v. Ohio Fuel Gas Co., 160 Ohio St. 81, 113 N.E.2d 865 (1953); Oklahoma City v. Harper, 198 Okla. 493, 180 P.2d 162 (1947).

[18] *See* Ledbetter, *Mortgages on Land Affecting Subsequent Mineral Interests*, 32 TEX. L. REV. 740 (1954). *See also* 2 WILLIAMS & MEYERS, *supra* note 2, at § 518 and cases cited therein.

or to apply the proceeds of any oil and gas lease to the principal balance.[19] Thus, if the property is subject to a mortgage, it is advisable to obtain the mortgagee's subrogation to the lease. Subrogations are commonly freely given by lending institutions, at least if the use of the land upon which basis the mortgage was originally given will not be interfered with by oil and gas operations.[20]

A similar problem for the lawyer representing the landowner may arise when the property to be leased for oil and gas exploration and development is subject to an agricultural lease or to extensive utility or right of way easements. It has been asserted that the interest of an oil and gas lessee is subject to the rights of a prior agricultural lessee, so that the oil and gas lessee cannot interfere with the possession or use of the property by the surface lessee.[21] It is doubtful, however, that the few reported cases go beyond the principle that the oil and gas lessee is subject to an implied obligation not to interfere substantially with the senior agricultural lessee's use of the surface and may be held liable for damages incurred by the agricultural lessee from oil and gas operations, either by interference with

[19] For example, the mortgage form currently used by the Federal Land Bank of Louisville provides in relevant part: "The Mortgagor covenants and agrees:...

"(7) *that there are hereby specifically assigned to the Mortgagee all rents, revenues, damages and payments* of every kind at any time accruing under or becoming payable on account of the sale of any interest in any portion of said property and *on account of any and all oil, gas, mining and mineral leases, rights, or privileges of any kind now existing or that may hereafter come into existence covering the said property,* or on account of any condemnation proceeding or other seizure of all or part thereof under the proceeding or other seizure of all or part thereof under the right of eminent domain or otherwise, *and the Mortgagee, at his option, may collect and receive the same as the same become due and payable,* and all moneys received by the Mortgagee by reason of this assignment may be applied at the option of the Mortgagee, upon any unpaid amounts of principal and/or interest, whether or not the same shall be due and payable; provided that nothing herein shall be construed as a waiver of the priority of the lien of this mortgage over any such lease, rights or privileges granted subsequent to the date of this mortgage:...

"(10) that if the Mortgagor shall sell the premises, or *if the ownership of any portion thereof shall be changed* either by voluntary or involuntary transfer or by operation of law, or if the Mortgagor defaults in the payment of said indebtedness, or with respect to any warranty, covenant, or agreement herein contained, or if, in defending any action commenced to foreclose or enforce a lien on any portion of the mortgaged premises, the Mortgagee elects to cross-claim and foreclose the lien of this instrument, *then, at the Mortgagee's option, the entire indebtedness secured hereby shall forthwith become due and payable* and bear interest at the rate set out for defaulted payments in the promissory note secured hereby, and the Mortgagee shall have the right to enter upon and take possession of said premises and to foreclose this instrument;..."(Emphasis added.) La. F.L.B. 4-139; Ohio Revised 2-77. The specific reference to oil and gas leases in paragraph (7) gives rise to the inference that the granting of an oil and gas lease would not be considered to be a sale for the purposes of the acceleration provisions of paragraph (10). Conceptually, however, an oil and gas lease is a conveyance.

[20] For a subordination agreement form, *see* 6 SUMMERS, *supra* note 2, at § 1222.

[21] Republic Nat. Gas Co. v. Melson, 274 P.2d 543 (Okla. 1954). *See also* Keeton & Jones, *Tort Liability and the Oil and Gas Industry,* 35 TEX. L. REV. 1, 5 (1956).

the agricultural lessee's use of the surface or by destruction of his growing crops.[22] Nevertheless, if the oil and gas lease contains a broadly phrased warranty clause or proportionate reduction clause, the landowner may face liability if he executes the lease covering land already subject to an agricultural lease. More importantly, a dispute between the oil and gas lessee and a prior agricultural lessee may effectively bar development of the property for oil and gas production for the term of the agricultural lease. Consequently, if the property the landowner proposes to lease for oil and gas development is subject to an agricultural lease, it is advisable to obtain a subrogation from the agricultural lessee to permit oil and gas operations. It is generally possible to obtain the agreement of the agricultural lessee in exchange for agreement to compensate the agricultural lessee for any damages to his crops or interference with his operations by the mineral lessee. If it is necessary for the landowner to agree jointly with the operator to pay such compensation, he should secure an agreement of indemnification from the operator.[23] Where advance planning is possible, the problem can be effectively avoided by inserting a clause in agricultural leases making them specifically subject to future exercise of mineral rights.[24]

With respect to utility or access easements, the general principle of law is that the owner of the burdened property may use it in any way not inconsistent with the full enjoyment of the easement by its owner.[25] Many utility or access easements are so broadly worded as to bar expressly or by implication all or most uses of the surface for oil and gas operations. Operators are usually willing to work around such easements, however, because they are quite commonly encountered. Thus, the landowner can be protected simply by making the grant of the lease subject to existing easements and rights of way.

[22] As a general rule the mineral estate is regarded as dominant to the surface estate. *See* the discussion at McMahon, *Rights and Liabilities with Respect tu Surface Usage by Mineral Lessees,* 6th S.W. LEGAL FOUNDATION INST. ON OIL AND GAS LAW AND TAXATION 231, 232 (1955). Thus, unless the terms of the grant of an agricultural lease are so broad as to convey an exclusive right to the surface, the senior agricultural lessee's interest ought to be subservient to the right of the junior mineral interest lessee. It may be that the courts would interpret an agricultural lease this broadly where the facts were that the two uses were totally incompatible. In the absence of extreme facts, however, perhaps on the basis of the public policy in favor of energy development, one may expect that the courts will merely require the mineral lessee to compensate the agricultural lessee for damage suffered. *See* Republic Nat. Gas Co. v. Melson, 274 P.2d 543 (Okla. 1954); Magnolia Pet. Co. v. Price, 86 Okla. 105, 206 P. 1033 (1922). *See also* the discussion at 1 KUNTZ, *supra* note 2, at § 9.2 and 1 WILLIAMS & MEYERS, *supra* note 2, at § 218.3.

[23] Castleberry, *Protecting the Oil and Gas Lessor,* 30 ROCKY MT. L. REV. 441, 451 (1958).

[24] *Id.* Subrogation can be made more palatable for the agricultural lessee by providing that the landowner will pay over to the agricultural lessee any damages for injury to growing crops which are paid pursuant to a subsequent oil and gas lease.

[25] 3 R. POWELL & P. ROHAN, POWELL ON REAL PROPERTY ¶ 405 (1949).

The second problem which must be addressed in protecting the landowner against interference with use of his land relates to what rights are to be granted. Oil and gas development is the objective of the parties when the lease form is presented. Yet, lease forms often purport to grant the lessee rights to more than just the oil and gas under the premises. The additional phraseology may refer to specific by-products of oil or gas, such as asphaltum. Frequently, however, there will be general references to "other hydrocarbons" or "other minerals." One might expect that such inclusive language would be limited by the rule of *ejusdem generis* to substances which are similar in nature to oil and gas and likely to be produced in conjunction with oil and gas operations.

A variety of unreconcilable positions have been taken by courts in various jurisdictions with respect to the issue of what substances are included in a lease with such general references. Some apply the *ejusdem generis* as a rule of construction[26] or look to the "four corners" of the instrument to ascertain the intent of the parties.[27] Other courts reject the latter rule of construction and hold that the general reference is ambiguous and must be interpreted in light of all the extrinsic facts and circumstances that may be relevant in determining the intention of the parties at the time the lease was granted.[28] These courts will look to such factors as the nature of the lessee's business at the time the lease was given and the nature of mineral development activities in the area at that time.[29] Still others hold that there is no ambiguity and give the general reference literal effect; thus, coal would be included in the grant because it is an "other mineral."[30]

The division of authority becomes a problem, however, only where there is an ambiguity in the granting clause of the lease. Thus, the key to representing the landowner in this respect is to determine and specify what rights are to be granted. If the intention of the landowner is to limit the lease to oil and gas operations, then the granting clause should so indicate; a limitation to "oil, gas, and liquid and gaseous hydrocarbons, and other minerals produced with oil and gas," or similar language might be appropriate.

Closely related to the issue of what substances are to be produced under the lease is the question of what land is to be subject to its coverage. Because the commonly encountered metes and bounds descriptions of agricultural or grazing land are often imprecise, many lease forms offered

26 *See,e.g.*, Yunker's Co-Executors v. Mason, 284 S.W.2d 98 (Ky. 1955).

27 Vogel v. Cobb, 193 Okla. 64, 141 P.2d 276 (1943).

28 Besing v. Ohio Valley Coal Co., 155 Ind. App. 527, 293 N.E.2d 510 (1973).

29 For other factors that may be considered relevant, *see* the discussion at 1 WILLIAMS & MEYERS, *supra* note 2, at § 219.5.

30 Christman v. Emineth, 212 N.W.2d 543 (N.D. 1973).

by operators contain a "Mother Hubbard" or "cover all" clause designed to protect the lessee against a disparity between the description of the property in the lease and the actual boundaries of the tract.[31] The clause was developed to cure minor defects in legal descriptions by causing the inclusion within the lease description of small strips of land contiguous to the land leased which are owned by the landowner or to which the landowner has claims by adverse possession. Where the Mother Hubbard clause is broadly drafted and literally interpreted, however, it may be given the effect of including within the lease tracts of land or interests in land not contemplated by the landowner.[32]

In the absence of a specific clause formulation and a specific fact situation, it is difficult to suggest a modification of the Mother Hubbard clause to protect the landowner. Sometimes the Mother Hubbard clause may be deleted without detriment to the legitimate interest of the operator, particularly if the description used in the lease is in terms of well-established boundaries such as highways or tracts of land owned by other persons. On other occasions, it may be appropriate to modify the clause by limiting its application to tracts contiguous, adjacent to, or adjoining the described land or by adding specific reference to tracts owned by the landowner which are not intended to be covered by the lease.

Once the landowner's lawyer has established what substances and tracts of land are to be covered by the lease, his attention should turn to the scope of the lessee's right to use the surface of the land incident to his search for and development of oil and gas. It is well established that an oil and gas lease gives the lessee the right by implication to use so much of the surface of the land as is reasonably necessary for operations.[33] Typically,

[31] "A typical clause will follow the specific description of the land leased and will provide, 'It being intended to include herein all lands and interests therein contiguous to or appurtenant to said described lands owned or claimed by lessor'." WILLIAMS & MEYERS, MANUAL OF TERMS, *supra* note 5, at 96.

[32] *See, e.g.*, Holloway's Unknown Heirs v. Whatley, 133 Tex. 608, 610, 131 S.W.2d 89, 90 (1939), where the Mother Hubbard clause in a deed provided that, "If there is any other land owned by me in Liberty County, Texas, or any land, the title to which stands in my name, it is hereby conveyed, the intention of this instrument being to convey all land owned by me in said County," and was held to cause the conveyance of 1/2 interest in the minerals previously reserved by the grantor in other tracts of land in the same county. More generally, however, Mother Hubbard clauses are limited in language and disfavored by the courts. *See generally* McRae, *Granting Clauses in Oil and Gas Leases: Including Mother Hubbard Clauses*, 2d S.W. LEGAL FOUNDATION INST. ON OIL AND GAS LAW AND TAXATION 43 (1951).

[33] Otherwise, the owner of the mineral interest, the dominant estate, would be unable to enjoy his estate. Wilcox Oil Co. v. Lawson, 341 P.2d 591 (Okla. 1959). *See* 1 WILLIAMS & MEYERS, *supra* note 2, at § 218 and cases cited therein. *See also* 1 KUNTZ, *supra* note 2, at § 3.2 and cases cited therein.

[34] For example, a lease form commonly used in Ohio provides in relevant part: "That the said Lessor, in consideration of the sum of one dollar, the receipt of which is hereby acknowl-

however, the granting clause of the oil and gas lease specifies at some length surface uses permitted.[34] There is nothing objectionable about such clauses so long as they are related to uses of the surface necessary to development and marketing of the production from the leased land or units with which the leased land is combined for production purposes. However, the growth of "self-help" natural gas programs[35] in many states has led some independent operators to modify such clauses to provide that the leased lands may be used for pipelines to gather and transport gas without a restriction that the gas come from the leased land or from a drilling or operating unit which includes the leased land.[36] Such clauses are unsatisfactory from the viewpoint of both the landowner and the operator and should not be accepted by the landowner's lawyer. The operator under such a clause gets an easement that terminates with the lease when production from the leased land ceases, which is probably insufficient for his needs as wells on other lands may still be in production at that time. The landowner, on the other hand, receives no additional compensation for granting an easement unrelated to production from his land.

More generally, disputes between landowners and operators over use of the surface of the land center not upon the nature of the uses permitted but upon the location of those uses. It is in both parties' interest that the wells be drilled and produced on the lands covered by the lease, but wells drilled or equipment placed in the wrong location can substantially impede the landowner's use of the land for agricultural or business operations.

---

edged, and of the covenants and agreements hereinafter contained, does hereby grant unto the Lessee all of the oil and gas and/or the constituents of either, in and under the lands hereinafter described, together with the exclusive rights to drill for, produce and market oil and gas and their constituents and *also the right to enter thereon at all times for the purpose of drilling and operating for oil, gas and water, and for carrying on geophysical work, and to possess, use and occupy so much of said premises as is necessary and convenient in removing the above named products therefrom by pipe lines or otherwise* for a term of ten (10) years and so much longer thereafter as oil, gas, or their constituents are produced in paying quantities thereon, or operations are maintained on all of that certain tract of land...."(Emphasis added.)

[35] "Self-help" natural gas programs have been developed by public utilities commissions in several states to establish guidelines under which industrial natural gas users subjected to curtailments may develop resources within the state and transport gas through regulated pipelines to their industrial plants. *See, e.g.*, the orders of The Public Utilities Commission of Ohio, dated Oct. 18, 1973, Jan. 23, 1975, Oct. 31, 1975, Mar. 31, 1976, and Oct. 19, 1977. *In re* Development of the Supply of Natural Gas Within the State of Ohio, Case No. 73-761-G. For a description of the Ohio program, *see* Battaglia & Balthaser, *Ohio Public Utilities Commission's Self-Help Program—A Possible Solution to the Natural Gas Shortage Problem,* 50 OHIO ST. B.A. REP. No. 5 (Jan. 31, 1977). Frequently, self-help programs involve the gathering and transportation of gas from several properties through "feeder" pipelines to the public utility's metering station.

[36] For example: "The first party grants the...right of way over and across said premises together with the exclusive right to lay surface rights and pipes to operate this *as well as adjoining farms....*"(Emphasis added.)

From the landowner's perspective, the problem arises because the grant of the right to use the surface for oil and gas operations is generally held to carry with it the lessee's right to decide where to locate wells and associated equipment.[37] To the extent that the landowner is worried about interference with present or intended uses of his property from the location of surface uses in oil and gas operations, it is usually possible to negotiate a modification to the granting clause of the lease limiting the location of wells, equipment, access roads, and pipelines to specific areas or providing that they are to be determined by the operator with the reasonable consent of the landowner.[38] Further protection can be obtained by requiring that pipelines be buried below plow depth and that well sites and other equipment be fenced for the protection of livestock.[39]

The final concern of landowners with respect to interference from oil and gas operations with their use of the land pertains to the operator's right to use water in drilling or producing operations. The law as to the operator's right in this area is so vague that it is in the interest of both parties to the lease that the lease specifically address the subject.[40] However, it may be important to the landowner that the issue not be determined by "boiler plate" terms in the operator's lease form.[41] In areas where water is in short supply and must be relied upon for irrigation or other intensive use on the surface, it will be important for the landowner to limit the lessee's right to water. This can be accomplished either by providing that the lessee shall not use fresh water in such amounts as to interfere with the normal flow or supply of water for the lessor's use, or by reserving all fresh water to the lessor. Likewise, in arid areas it may be advisable to include in the lease a clause permitting the landowner to take over nonproducing oil or

[37] *See* 1 WILLIAMS & MEYERS, *supra* note 2, at § 218.8 and cases cited therein.

[38] For example: "Provided, however, that the lessor shall consent in writing to the location of any wells, equipment, access roads, pipelines or other structures placed upon the subject property, which consent shall not be unreasonably withheld." Note that it would probably be unwise to provide that "the location of any wells, equipment, access roads, pipelines or other structures placed upon the property shall be determined by mutual agreement of the lessor and lessee" because of the risk that a court might interpret such language as an unenforceable agreement to agree.

[39] For example: "The lessee shall bury below plow depth all pipelines used to conduct oil and gas to and off the premises. Lessee shall fence all pits, holes excavations and equipment locations sufficiently to safeguard livestock which may be on said land."

[40] *See generally* Losee, *Legal Problems of a Water Supply for the Oil and Gas Industry*, 20th S.W. LEGAL FOUNDATION INST. ON OIL AND GAS LAW AND TAXATION 55 (1969). *See also* 1 WILLIAMS & MEYERS, *supra* note 2, at § 219.6, which contains an excellent summary of Oklahoma cases dealing with this problem.

[41] For example, the provision that "The lessee shall have the right of using sufficient oil, gas and water for operating on the premises..." might make the landowner's right to water subordinate to the needs of the operator.

gas wells for conversion into water wells where water tables have been discovered in the course of drilling operations.[42]

In short, normally it is not difficult to protect the interest of the landowner adequately against interference with his use of the surface by the oil and gas lessee. The potential problems are often ignored by form leases, however, and it is the function of the landowner's lawyer to foresee and address those problems.

Insuring Fair Dealing By the Operator

The second major concern of the landowner negotiating an oil and gas lease transaction is that he be protected insofar as is possible against a lack of fair dealing by the lessee. Although an oil and gas lease does not create a legal partnership, the economic relationship between the lessor and his lessee approximates that of a partnership arrangement.[43] The primary benefit to be realized for both the landowner and the operator is from the exploration of the property and its development for production. Because they contribute different kinds and proportions of assets to the venture and because they have different shares in the profits of the venture, landowners' and lessees' interests are not always consistent. Moreover, because it is the lessee under the oil and gas lease who possesses within very broad limitations the right to decide if, when, where, and under what circumstances to drill and operate,[44] the position of the landowner is

[42] Professor Castleberry suggests the following clause to achieve this: "Lessee shall note on the log of any well drilled on said land all water-bearing strata, and shall immediately furnish Lessor with a copy of said well log. Lessee shall, before removing any casing or tubing from any non-producing well drilled on said land, notify Lessor in writing of his intention of doing so, and if Lessor shall, within fifteen days after the receipt of such letter inform Lessee in writing of Lessor's desire to convert such well into a water well, Lessee shall have in such well such amount of casing and tubing as Lessor may desire for such purpose, provided such procedure is lawful and will not violate any order or rule of any official, commission, agency, or authority then having jurisdiction in or over such matters, and provided further that Lessor shall pay to Lessee_____ _ (—%) per cent of the original cost of such casing and tubing when delivered to Lessee on the ground at the well site, such payment to be made within fifteen days after the receipt by Lessor of Lessee's statement therefor. Castleberry, *supra* note 22, at 449.

[43] Although the relationship between the lessor and lessee of an oil and gas lease has not traditionally been viewed as a fiduciary relationship, fiduciary principles have been frequently applied under the guise of implied covenants or equity. *E.g.*, Imes v. Globe Oil & Ref. Co., 184 Okla. 79, 84 P.2d 1106 (1938). *Cf.* Williams, *The Fiduciary Principle in the Law of Oil and Gas*, 13th S.W. LEGAL FOUNDATION INST. ON OIL AND GAS LAW AND TAXATION 201, 215-31 (1962).

[44] In all jurisdictions but Indiana and Kentucky, it is held that the lessee under an "unless" form lease has the sole discretion to determine if and when to drill a test well in the absence of offset drainage; no implied obligation to drill an initial well within the primary term is recognized. 2 SUMMERS, *supra* note 2, at § 397. As has been indicated above, location of wells and related equipment is also considered to be a decision for the lessee. See note 37 and accompanying text, *supra*. Likewise, once the property has been developed by the drilling of a test well, decisions as to how to

analogous to that of a partner owning a limited partnership interest; he shares the risk of the venture but has no voice in its management. Yet, the typical oil and gas lease is bereft of clauses protecting the landowner against a lack of fair dealing by the operator.[45]

A problem which frequently arises in this respect involves assignment of the lease. Sometimes oil and gas leases are obtained from landowners by an independent operator who intends to develop the property or, if the lease is granted to one of the large oil companies, by a "landman"[46] employed by the oil company. However, in areas with marginal or as yet unproven production, oil and gas leases often are taken by self-employed landmen who make a living by acquiring oil and gas leases and then assigning them to operating companies. The landman's anticipated profit may not be from operations but from a mark-up on the lease transferred or from an overriding royalty[47] reserved in the assignment of the lease. Deservedly or not, landmen have a reputation for veracity analogous to that of used car salesmen. Conventions of farm organizations abound with variations of the story of the landowner who granted an oil and gas lease under the distinct impression that his property would be developed by a specified oil company of sterling reputation, only to discover later that the lease had been assigned to some other operator.

Under the terms of a typical form lease, the landowner is not protected against assignment of the lease to an undesirable lessee; in fact lease forms usually specifically provide that the lessee may assign his interest.[48] Even in the absence of such a specific provision, the general rule of law is

---

operate existing wells and whether to drill additional wells are generally held within the operator's purview, unless it is shown that the operator is not acting as a reasonably prudent operator or with reasonable diligence.

[45] In part because of the "one-sided" leases prepared by lessees' counsel, the courts have developed various implied covenants to protect the lessors' interests. For a discussion of these implied covenants, see the text accompanying and the authorities cited at notes 63-67 and 102-103 *infra.* One able commentator, in critiquing the various views as to the basis of implied covenants, argues that implied covenants arise out of an attempt by the courts to promote their sense of justice and fair dealing by measuring the lessee's conduct against that of the hypothetical prudent operator. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27th S.W. LEGAL FOUNDATION INST. ON OIL AND GAS LAW AND TAXATION 177, 193-98 (1976).

[46] A landman is an employee of an oil company whose primary duties are the management of the company's relations with its landowners, including but not limited to the securing of oil and gas leases. *See* WILLIAMS & MEYERS. MANUAL OF TERMS, *supra* note 5, at 239.

[47] An overriding royalty is a share of the oil and gas produced, free of the expense of production. It is distinguished from the landowner's royalty in that it is carved out of the lessee's share of the oil and gas. *See* WILLIAMS & MEYERS, MANUAL OF TERMS, *supra* note 5, at 275.

[48] For example: "If the estate of either party hereto is assigned, and the privilege of assigning in whole or in part is expressly allowed, the covenants hereof shall extend to their heirs, executors, administrators, successors or assigns...."

that an assignment may be made unless it is specifically prohibited in the lease.[49] Moreover, the right to assign a lease is economically very important to operators as it substantially increases the liquidity of their assets and potentially enhances operating efficiency by permitting them to concentrate operations in a particular area. Despite the advantages to the lessee of free assignability, it may be possible for the lawyer representing the landowner to negotiate a modification of the assignment clause of the lease to provide that it shall not be assigned without permission of the landowner,[50] or by limiting the right of assignment to that necessary to secure development of the lease by the named lessee.[51] At the very least, counsel representing the landowner should insist that the lessee named in the lease be the person or company whom it has been represented will develop the lease, rather than the name of the individual who has negotiated its terms. Such insistence will either force the landman to divulge his intentions if he contemplates assignment to someone other than the operator whom it has been represented will develop the lease, or lay the ground for a claim of fraud in the inducement.[52]

Other problems relating to fair dealing between the parties usually do not arise until after development of the property under lease has begun. The most common of these is the issue of responsibility for damages to the premises and cleanup of drilling sites. Drilling for oil and gas is a messy and dirty business. Access roads have to be built and sites for the drilling and operating equipment have to be gouged out. Drilling operations in-

[49] The lessee's right of assignment is inherent, in the absence of express prohibition. 2 WILLIAMS & MEYERS, *supra* note 2, at § 402. Leases on federal, state, or Indian lands may not be assignable as a consequence of statutes governing their disposition and use. 3 SUMMERS, *supra* note 2, at § 541.

[50] Because of the danger that such a restriction would be held to authorize the landowner's refusal for any reason or no reason at all, this restriction is unlikely to be acceptable to a potential lessee, and probably need not be insisted upon by the landowner.

[51] *See, e.g.*, the clause upheld by the Supreme Court of Texas in Knight v. Chicago Corp., 144 Tex. 98, 188 S.W.2d 564 (1945), which modified the assignment provisions of the lease by providing that, "the lessee, its successors or assigns, shall not make any assignments of undivided interests, overriding royalties or oil payments without the written consent of the Lessors, save and except assignments to banks and oil well supply companies for the purpose of obtaining money, supplies, and equipment to operate and develop the leased premises." *Id.* at 565.

[52] If relied on by the lessor, a lessee's representation that he personally would develop the leasehold could form the basis for an action for rescission on the grounds of fraud. *See generally*, 8A G. THOMPSON, COMMENTARIES ON THE MODERN LAW OF REAL PROPERTY, § 4465 (repl. 1963). Such facts may be difficult to prove. *See* Lane v. Urbahn, 246 S.W. 1070 (Tex. Ct. App. 1922), *modified* 265 S.W. 1063 (Tex. Ct. App. 1924), *reh. denied*, 289 S.W. 173 (Tex. Ct. App. 1926) *judgment rendered*; Gillespie v. Fulton Oil & Gas Co. 236 Ill. 188, 86 N.E. 219 (1908). However, even if the cause of action were proved, as this fraud relates to the inducement rather than the execution of the lease, a bona fide assignee would be protected. *See* Parker v. King, 235 Miss. 80, 108 So. 2d 224 (1959).

evitably produce considerable dust, mud, and noise. Small amounts of oil are spilled in the course of operations. Although these problems are usually more of an irritant than an impediment to the use and enjoyment of the land, what the operator does or does not do to meet those problems is likely to color the landowner's perception of the whole leasing transaction.

While oil and gas leases typically provide for payment of damages to growing crops,[53] such a limited clause will not protect the landowner against financial loss which may result without the destruction of growing crops and which may continue from year to year, *e.g.*, if a well is located in the middle of a cultivated field, the well site and its access road will not be available to the landowner for cultivation for the life of the well. Although the use of well sites and access roads by the lessee is included in the grant of the lease either by implication or by specific provision,[54] it is common for operators voluntarily to pay "site damages" in a lump sum for damage to the terrain and loss of productive capacity. Obviously, however, it is preferable from the viewpoint of the landowner to make provision for such payments in the lease. Likewise, although most operators make a reasonable effort to clean up and restore the surface of the land after drilling and producing operations are completed, the common law generally recognizes no clear obligation to do so.[55] Although cleanup and restoration are required by statute in some states,[56] the landowner's case is strengthened if the requirement is included as a lease obligation of the operator. With an express provision, there can be no dispute as to the existence of the duty or to the right of the landowner to enforce it.

Another problem raising the issue of fair dealing is payment of royalties. A common suspicion among landowners is that their operators are holding back in the payment of royalties due, either by understating production or by overstating the expenses to which the landowner is sub-

[53] For example: "Lessee shall pay for damages caused by lessee's operations to growing crops on said land. Said damage, if not mutually agreed upon, is to be ascertained and determined by three disinterested persons, one thereof to be appointed by the lessor, one by the lessee, and a third by the two so appointed, and the award of such three persons shall be final and conclusive."

[54] See the discussion accompanying notes 33-34 *supra.*

[55] The common law restoration remedies that a landowner has available are basically an excessive use of a surface easement, nuisance, and negligence. *E.g.*, Lanahan v. Myers, 389 P.2d 92 (Okla. 1964) (holding a lessee liable for excessive use of the surface). The reported cases are few and contradictory, usually being decided on their facts. *See generally* 1 WILLIAMS & MEYERS, *supra* note 2, at §§ 218.8-.12; Annot., 65 A.L.R.2d 1356 (1959). It has also been proposed that there should be an implied obligation of restoration in oil and gas leases. *See* Smith v. Schuster, 66 So. 2d 430 (La. Ct. App. 1933). *See also* Note, *Oil and Gas: Does the Oil and Gas Lessee Have a Duty to Restore the Surface?*, 25 OKLA. L. REV. 572 (1972).

[56] *See, e.g.*, OHIO REV. CODE ANN. § 1509.072 (Page Supp. 1976).

ject.[57] The common law recognizes the right of the landowner to an accounting of production[58] and some states have statutes requiring the operator or companies purchasing the oil or gas to make available the information necessary for the landowner to evaluate the adequacy of the royalties received.[59] The procedures for enforcing either the common law or a statutory right, however, are likely to be more cumbersome than those for enforcing a lease clause and additionally a benefit is realized by putting the operator on notice during the lease negotiation that accurate accounting information will be required by the landowner. Therefore, a clause in the lease permitting the landowner and his agents reasonable access to the books and records of the operator is recommended.

Yet another post-development problem of fair dealing between the operator and landowner arises when a producing gas well which has been supplying gas to the landowner's residence and agricultural operations is determined by the operator to be no longer economically viable and plans are made to abandon it.[60] If such a well is the only producing well on the property, plugging it will cut off the landowner's source of gas. Although the well may not be capable of producing in paying quantities in that its production can no longer cover the operator's costs of operation, it may be capable of meeting the landowner's needs for many years. Furthermore, if the landowner loses the supply of gas from the well, he may be unable to secure another source because of public utility regulations barring the extension of new gas service.[61] This might seem a situation in which it would be logical for the lessor to buy out the interest of the lessee in the well so that the lessor might continue production himself. However, if there is a severe shortage of pipe and equipment, as is periodically the case, the

[57] Typically, oil and gas leases provide that the landowner's royalty is to be paid "at the wellhead" and "free of the cost of production," or other similar language. The royalty interest owner is obligated to pay his proportionate share of the costs incurred subsequent to production. For a discussion of what kinds of costs may be found to arise subsequent to production and, therefore, to be shared by the operator and the landowner, *see* 3 WILLIAMS & MEYERS, *supra* note 2, at §§ 645-645.3. *See also* 3 KUNTZ, *supra* note 2, at § 42.2.

[58] The courts have held that if the rent or royalty reserved in the leasing of mineral property is dependent upon the amount of mineral taken, a bill in equity will lie to compel an accounting by the operators or lessees. *See* Swearingen v. Stears, 49 W. Va. 312, 38 S.E. 510 (1901). *See also* Harleston v. West Louisiana Bank, 129 Miss. 111, 91 So. 423 (1922); Hurwitz v. Carolina Sand & Gravel Co., 189 N.C. 1, 126 S.E. 171 (1925); Withington v. Gypsy Oil Co., 68 Okla. 138, 172 P. 634 (1918).

[59] *See, e.g.*, OHIO REV. CODE ANN. § 1509.30 (Page Supp. 1976).

[60] Note, however, that there are limits upon the right of the operator to make such a determination. Where the well is clearly capable of paying production, the operator may not withdraw the casing and plug the well because that would destroy the well. Patton v. Rogers, 417 S.W.2d 470 (Tex. Ct. App. 1967).

[61] *See, e.g.*, Interim Supplemental Emergency Order of the Public Utilities Commission of Ohio, Case No. 71-757-G, June 23, 1972.

operator may be unwilling to sell the pipe and equipment at what the landowner regards as a reasonable price. Indeed, the operator may be unwilling to sell at any price; he may wish to use the equipment and casing in his own operations. Thus, if gas from producing wells on the landowner's land is likely to be important to the landowner's operations, counsel should include in the lease or in a separate agreement an option permitting the landowner to buy the equipment and pipe on wells drilled on his land at stated or formula-determined prices when the operator determines that those wells should be abandoned.[62]

Another, and final, matter relating to fair dealing between the operator and landowner concerns the obligation of the operator to comply with covenants implied in oil and gas leases. Oil and gas are fugacious, that is, they tend to migrate to areas of lesser pressure. Thus, oil and gas may be drawn from under one tract of land to a bore hole located on a nearby tract of land. All states recognize that the landowner's interest in the oil and gas under his property is subject to divestment if the oil or gas is first "captured" and produced by another.[63] To protect the landowner against such drainage, the law imposes an implied duty on the operator to drill an "offset" well[64] if the reasonable, prudent operator would do so.[65] In other words, if the landowner can show that it is more probable than not that a well drilled on his property to offset a well drilled on a separately owned adjacent tract would produce oil and/or gas in sufficient quantities to repay the cost of drilling, equipping and operating that well, and to pay a reasonable profit on those expenditures, then the law recognizes an obligation on the part of the operator to drill the offset well to protect the lessor's interest.[66] In addition, most courts recognize that the lessee, after drilling an initial well on the leased premises, has an obligation to continue ex-

[62] A clause drafted similarly to that set forth at note 42 *supra* would be appropriate.

[63] 1 KUNTZ, *supra* note 2, at § 4.2 and cases cited therein. *See also* 1 WILLIAMS & MEYERS, *supra* note 2, at § 204.4; 1 SUMMERS, *supra* note 2, at § 61.

[64] An offset well is a well drilled on one tract of land to prevent the drainage of oil or gas to an adjoining tract of land on which a well is being drilled or is already in production. WILLIAMS & MEYERS, MANUAL OF TERMS, *supra* note 5, at 383.

[65] North American Pet. Co. v. Knight, 321 P.2d 964 (Okla. 1958). The duty to drill an offset well is sometimes referred to as the implied covenant to protect the leased premises against drainage. *See* 1 BROWN, *supra* note 2, at § 16.02(5). *See also* 5 WILLIAMS & MEYERS, *supra* note 2, at §§ 821-26.3. Although there has been debate as to whether implied covenants are implied in fact or in law (*compare* Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399, 402-406 (1933), *with* M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 7,220 (2d ed. 1940), *and* Kuntz, *Professor Merrill's Contribution to Oil and Gas Law*, 25 OKLA. L. REV. 484 (1972)), there is substantial agreement that they are rooted in the contract principle of cooperation. 5 WILLIAMS & MEYERS, *supra* note 2, at § 802.1.

[66] North American Pet. Co. v. Knight, 321 P.2d 964 (Okla. 1958). *See also* 2 BROWN, *supra* note 2, at § 16.02(5)(d).

ploration and development if a prudent operator would do so.[67] Some operators seek to avoid these implied obligations by disclaiming the implied covenants in the lease.[68] From the landowner's standpoint, abrogation or limitation is unacceptable and may indicate that the operator intends to act in less than good faith toward him. Any lease form offered should be carefully scrutinized by the landowner's lawyer to insure that such disclaimers are not buried somewhere in the verbiage.

In summary, the steps which should be taken by the lessor's lawyer to insure that the lessee deals fairly with his client are primarily defensive in nature. Frequently, however, negotiation of such provisions in the lease will also have a prophylactic effect in that the discussion will reveal to the landowner the true character of the would-be lessee and the nature of his intentions toward the leased land. Moreover, a "quality" operator is unlikely to be offended by the suggestion that the lease be modified to protect the landowner, for he is being asked to do nothing he did not otherwise intend to do.

Maximizing the Landowner's Return

The third major concern of the landowner contemplating oil and gas leasing is that he maximize his return on the transaction. Because leasing is a business transaction, the landowner naturally feels that he ought to obtain "top dollar" for his lease or, at the least, that he should receive terms as favorable as those received by anyone else in the area. Counsel for landowners can promote profit maximization for their clients by flexibly negotiating the various lease clauses which may be of economic benefit to the landowner.

The most frequent complaint among landowners is that the royalty offered them is insufficient. By custom, the royalty, the share of the production reserved by the landowner for permitting another to develop his land for oil and gas, is 1/8 of the gross production, except in some western states where it may be 1/6.[69] With the rapid rise in wellhead prices of oil

67 Producers Pipe & Supply Co. v. James, 332 P.2d 958 (Okla. 1958); Fox Pet. v. Booker, 123 Okla. 276, 253 P. 33 (1926). *See also* 2 BROWN, *supra* note 2, at § 16.02(2); 5 WILLIAMS & MEYERS, *supra* note 2, at §§ 831-47.

68 If, as most courts have held, implied covenants are implied in fact, then they may be negated where that is the intention of the parties. Courts have tended to view disclaimers, particularly those tucked away in the "boilerplate" clauses, unfavorably and have construed them strictly. *See* the discussion at 5 WILLIAMS & MEYERS, *supra* note 2, at §§ 826-26.1, 835-35.3. Clauses specifically disclaiming one or all of the implied covenants would probably be given effect, however.

69 1 WILLIAMS & MEYERS, *supra* note 2, at § 304.11.

and gas over the past several years,[70] one might expect that the market would bear an increase in the customary royalty. Yet, no such trend is apparent. This may be attributable in part to the deep roots of the custom and the prevailing consensus among operators that oil and gas exploration and development is a risky business and that those engaged in it should receive the major portion of any increase in market price. Furthermore, in recent years there have been substantial increases in the costs of drilling and operating, although such costs have probably not increased as much as the market price for oil and gas produced.[71] Resistance to increases in royalty percentage may also be attributed to fear on the part of operators that by agreeing to a larger royalty in the lease (an agreement which will go on public record), they will open the floodgates with respect to royalties that must be paid on other leases which they must obtain or renew. For whatever reasons, the lawyer for the landowner is likely to find it difficult to negotiate more than the "standard" royalty for the area in which the land is located. This is not to say that the practitioner should not pursue such negotiations or that he will not succeed, but he should be prepared for strong resistance and ought to consider trading his demands for a higher royalty for a benefit of some other type.

The obvious trade-off is an increased bonus for granting the lease. Since 1975, it has not been permissible under federal tax law for landowners to claim percentage depletion treatment for lease bonus payments.[72] The lease bonus is cash in hand, however, and may be structured in the appropriate situation on an installment payment basis to minimize the impact of taxes.[73] If the land to be leased is located in an area evidencing a high probability of good commercial production, the operator will normally expect to pay some lease bonus, and it is probably fair to say that the frequency and size of lease bonuses has increased as the market price of oil and gas has risen.

[70] Between 1973 and 1976, domestic average crude oil prices increased from $3.89 per barrel of oil to $8.18 per barrel of oil. Committee on Energy and Natural Resources, United States Senate, "Regulation of Domestic Crude Oil Prices," 53 (Publication Number 95-8, Mar. 1977).

[71] The average cost per foot drilled in the United States increased from $20.76 per foot in 1972 to $28.93 per foot in 1974 (over 40%). Statistical Abstract of the United States, 1976, page 713.

[72] Proposed Treas. Reg. § 1.613A-7(f)(1). The lease bonus is, however, subject to cost depletion in those rare situations where the lessor has an identifiable cost basis attributable to the oil and gas in place. *See* Treas. Reg. § 1.612-3(a)(1) (1965), for the formula used in computing cost depletion on a lease bonus. However, royalty payments generally will qualify. *See* I.R.C. § 613A. Oil and gas taxation is a complex subject beyond the scope of this article. A good general source is C. BREEDING, F. BURKE & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES (1977).

[73] Securely establishing the right to installment reporting under I.R.C. § 453 is difficult. *See* the discussion at BREEDING, BURKE & BURTON, *supra* note 72, at ¶ 4.08. The statute and its regulation should be reviewed carefully before attempting such a transaction.

There are less obvious trade offs for the demand for increased royalties. One is the inclusion of a "free gas" clause if the lease offered does not contain one, or for a high or unlimited usage if the free gas clause is already included.[74] The free use of gas from wells on the premises is presently of substantial economic value to the landowner, and the value is increased by the fact that it is not generally treated as being subject to income taxation.[75] A free gas clause should be relatively easy to negotiate; operators will often agree even to provide and install the equipment and material to effect the hookup for delivery and use of the free gas. Another possibility for a trade-off in lieu of an increased royalty is a separate agreement providing for the payment of specified annual rentals for the use of sites for wells, tank batteries, and other equipment.[76] Alternatively, the landowner might be paid a fee for watching over well sites and equipment located on his land. Finally, a tradeoff may take the form of an indemnity against related liabilities or expenses; for example, the operator may agree to pay the landowner for any severance taxes or for increases in property taxes or insurance premiums that may result from development of the landowner's property for oil and gas production.

The point being made is that although operators are loathe to depart from the royalty "customary" in the area, there are many other features of the lease agreement that may be of significant economic value to the landowner which may be easier to negotiate than an increased royalty. This is particularly true if those agreements can be contained in an unrecorded document separate from the oil and gas lease so that they do not "haunt" the operator in negotiations with other landowners in the same area.

The landowner's second most common concern relating to maximizing his return under an oil and gas lease is the length of the term of the lease

[74] A typical "free gas" clause might provide that: "Lessor may lay a line to any gas well on said lands and take gas produced from said well for use for light and heat in one dwelling house on said land, at lessor's own risk, subject to the use and the right of abandonment of the well by the lessee. The first 200,000 cubic feet of gas taken in each year shall be free of cost, but all gas in excess of 200, 000 cubic feet of gas taken in each year shall be paid for at the current published rates in the town nearest the premises above described and the measurements and regulations shall be by meter and regulators set at lessor's cost at the tap on the line." Obviously, it would be to the landowner's advantage if the use of free gas were not limited to "one dwelling house" or to a maximum of 200,000 cubic feet per year.

[75] Gas used on the producing property for fuel does not represent a sale and, hence, does not result in any addition to gross income. The Roundup Coal Mining Co. v. Commissioner, 20 T.C. 388 (1953). However, if the gas is transported away from the producing property and is used for fuel or in a plant or refinery on another property belonging to the taxpayer, the value of the gas may be included in gross income for depletion purposes and, therefore, for tax purposes. Treas. Reg. § 1.613-3(a) (1977).

[76] Provision in the lease form for site rentals is likely to be the functional economic equivalent of the liquidated site damages discussed in the text accompanying note 55, *supra*. Therefore, one should not expect to be able to negotiate both for the landowner client.

and the circumstances which will cause the lease to terminate. Despite the attractiveness of lease bonuses and other financial devices, the primary economic advantage to be gained by the landowner from the development of his property for oil and gas is in the payment of royalties. Thus, the landowner is primarily concerned that the operator to whom he gives a lease develop the property promptly and, if development is not prompt, that the lease be terminated so that another lease can be granted to an operator who will perform.

The term of an oil and gas lease is set by the "habendum" or "term" clause,[77] and is divided into two parts. The first part, called the "primary term," is a stated period of time, *e.g.*, five, ten, or fifteen years. The primary term is sometimes referred to as the exploratory period and is designed to permit the lessee a reasonable time to conduct operations leading to the discovery of oil and gas. The primary term is modified by a rental clause which provides that "delay rentals"[78] are to be paid if an exploratory well is not drilled before the end of the first year of the lease. Thus, the operator is given an economic incentive to expedite exploratory operations thereby avoiding the payment of delay rentals. If, during the primary term, exploratory activity conducted by the operator indicates that oil or gas is not present beneath the leased tract in quantities sufficient to justify production, the lessee may allow the lease to terminate by failing to pay delay rentals or surrender the lease by executing a release.

As it is impossible to predict with precision the time span in which production from a given tract of land will be economically justified and because the operator needs protection for the substantial investment necessary to develop the premises, the secondary term of the habendum clause is of indefinite duration, for "so long thereafter as oil and gas is produced." Some courts considering the question have interpreted the word "produced" as shorthand for "produced in paying quantities to the lessee."[79] In such states, the effect of the "thereafter" part of the haben-

[77] The "habendum" or "term" clause of the lease sets forth the duration of the grantee's interest in the premises. The habendum clause in a typical "unless" lease form provides: "Subject to the other provisions herein contained, this lease shall be for a primary term of ..... years from this date and for as long thereafter as oil or gas is produced from the above described land or from land pooled with all or any part thereof."

[78] See the discussion accompanying notes 5-6, *supra*.

[79] McLeon v. Wells, 207 Ark. 303, 180 S.W.2d 325 (1944); Berthelote v. Loy Oil Co., 95 Mont. 434, 28 P.2d 187 (1933); Gypsy Oil Co. v. Marsh, 121 Okla. 135, 248 P. 329 (1926); Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959). The apparent reason for such a rule is that "the lessors should not be required to suffer a continuation of the lease after the expiration of the primary term merely for speculation purposes on the part of the lessee." Garcia v. King, 139 Tex. 578, 585, 164 S.W.2d 509, 513 (1942). The term "'paying quantities' when used in the extension clause of an oil lease habendum clause, means production in quantities sufficient to yield a return in excess of operating cost, even though drilling and equipment costs may never be repaid...."

dum clause is to extend the life of the lease to the limits of the economic viability of production to the lessee. In contrast, other courts, particularly those which first addressed the issue in the early part of the century, have held that maintaining the lease during the secondary term only requires production sufficient to generate a royalty adequate to compensate the lessor for occupancy and interference resulting from lease operations.[80] This has been applied so that the production required is less than "paying quantities."[81] Because the higher standard impedes speculation by the lessee,[82] it is recommended that counsel to the landowner add the words "in paying quantities to the lessee" if there is any question in the jurisdiction in which he practices as to the meaning of "produced" as used in the habendum clause.

Negotiations between landowners and operators as to the content of the habendum clause tend to focus on the length of the primary term.

Clifton v. Koontz, 160 Tex. at 91, 325 S.W.2d at 692. The lease does not terminate as soon as the well begins to operate at a loss:" there can be no limit as to time, whether it be days, weeks, or months to be taken into consideration...." *Id.* at 88, 325 S.W.2d at 690. "[T]he standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated." *Id.* at 89, 325 S.W.2d at 691.

[80] Gillespie v. Ohio Oil Co., 260 Ill. 169, 102 N.E. 1043 (1913); Enfield v. Woods, 198 Ky. 328, 248 S.W. 842 (1923); McGraw Oil & Gas Co. v. Kennedy, 65 W. Va. 595, 64 S. E. 1027 (1909).

[81] Enfield v. Woods, 198 Ky. 328, 248 S.W. 842 (1923). The action involved a suit to cancel an oil and gas lease because there was no production to extend the lease into the secondary term. The lease could be extended "as long thereafter as oil and gas, or either, is produced therefrom by the lessees, or either of them, their successors and assigns." The court interpreted this language and held for the lessor, but stated the principle that, "[i]t will be observed that the lessee is not required to produce oil in paying quantities, but he is required to produce oil or gas, one or the other, from the premises. This, of course, *means a production of oil or gas in such quantities as to be susceptible of division, so as to pay the landowner a royalty, even though small.* A mere showing of oil manifestly is not sufficient, even though produced. *The production must be tangible and substantial, but it need not be great.*" (Emphasis added.) *Id.* at 843. This rule was reaffirmed in United States v. 2,847.58 Acres of Land, More or Less, 529 F.2d 682 (6th Cir. 1976), which stated that the standard for production in "paying quantities" in Kentucky is that oil must be "produced in sufficient quantities to be susceptible of division and provide the lessor with royalties large enough to compensate for the inconvenience of the lessee's occupancy and operations." *Id.* at 690.

[82] The element of speculation referred to arises when the lessee wants to hold the lease, although diminished expectations on the partially developed tract result in an inability to justify substantial expenditures for reworking the existing wells or drilling new wells. In the short run of several years, it may be advantageous for the operator to continue operating the existing wells at a loss. If prices for oil and gas increase appreciably or if other development in the area changes the probability of drilling success, then the undrilled portion of the lease will be a part of the operator's inventory of well sites. If not, then the lease has been held in force without the expenditure of large amounts of money.

There is no standard duration. Operators typically prefer to make the primary term as long as the lessor will allow so as to provide themselves ample opportunity to decide whether to drill on the leased property and to make the necessary arrangements for financing and equipment. From the landowner's viewpoint, however, a short primary term is to be preferred in order to obviate the possibility that the operator will speculate on rising prices for the production; the landowner generally prefers to receive royalties now, rather than to await the possibility of a marginally higher royalty in the future. Obviously, compromise in the parties' positions is required.[83] In very active areas of production it is not unusual to see leases with terms of a few months to a year. More generally, however, primary terms of one to ten years are found.[84]

A secondary concern with the habendum clause relates to the timing of the lease termination during the primary term if the operator fails to live up to his obligations. Generally, there are two "polar" types of oil and gas leases in use in the United States. The more common is the so-called "unless" lease in which the primary term provided for by the habendum clause is modified by words to the effect that the lease will terminate one year after it is given *unless* a well is commenced prior to that time or delay rentals are paid for the privilege of deferring the commencement of operations.[85] Under an "unless" lease, if the operator fails to meet the requirements set for drilling or payment, the lease automatically terminates,[86] even though the failure of the operator may be due to clerical

[83] For example, the lessee may be willing to pay and the landowner willing to accept higher delay rentals or a larger bonus for a longer primary term. Delay rentals are treated as ordinary income to the landowner for the purpose of federal income taxation and are not entitled to the percentage depletion allowance. Treas. Reg. § 1.612-3(c)(2) (1965).

[84] *See* 3 WILLIAMS & MEYERS, *supra* note 2, at § 601.4; 2 SUMMERS, *supra* note 2, at § 292.

[85] A delay rental clause from a typical "unless" lease provides: "If operations for the drilling of a well for oil or gas are not commenced or if there is no oil or gas being produced on said land or on land pooled with all or any part thereof as hereinafter provided on or before one year from the date hereof, this lease shall terminate as to both parties, *unless* the lessee on or before that date shall pay or tender to the lessor or to the lessor's credit in the...... ...bank at ....., or its successors, which shall continue as the depository for rental regardless of changes in the ownership of said land, the sum of.......dollars ($.....) which shall operate as a rental and cover the privilege of deferring the commencement of operations for drilling of a well for twelve months from said date...." (Emphasis added.)

[86] In a few cases, where the failure to make the payment was due to the mistake of an independent agency rather than an agent or employee of the lessee, courts have refused to find automatic termination on equitable grounds. *See, e.g.*, Ballard v. Miller, 87 N.M. 86, 529 P.2d 752 (1974) (check timely tendered but lost in mail); Brazell v. Soucek, 130 Okla. 204, 266 P. 442 (1928) (cashier in depository bank failed to deposit); Oldfield v. Gypsy Oil & Gas Co., 123 Okla. 293, 253 P. 298 (1926) (postal clerk delivered to wrong bank although the draft was properly addressed).

error,[87] personal illness,[88] or good faith mistake as to the due date;[89] the language of the lease is literally interpreted by the courts.[90]

The second and less common type of lease is the "or" lease, which typically provides that the operator will drill within one year *or* do something else, such as pay rentals or surrender the lease.[91] Such a clause creates a leasehold interest which does not terminate automatically upon the operator's failure to perform; rather it gives the landowner the right to sue to recover past due delay rentals or to declare the lease forfeited (if the lease contains a forfeiture clause).[92] Thus, the basic difference between the "unless" lease and the "or" lease is whether the operator's failure to drill a well or pay delay rentals when due results in automatic forfeiture of his interest.[93]

The distinction between the "unless" lease form and the "or" lease form is blurred somewhat by the increasing use, at least in the midwestern states, of the "unless" form in conjunction with a notice requirement. Such clauses contain language to the effect that failure to pay the rental as required will not cause the lease to terminate until the operator has been given a specified period of notice in writing of the failure and payment has not been made within that period.[94] It may seem surprising that such

[87] Phillips Pet. Co. v. Curtis, 182 F.2d 122 (10th Cir. 1950) (applying Oklahoma law) (lessee's clerk misinterpreted records, believing the lease to be producing); Young v. Jones, 222 S.W. 691 (Tex. Ct. App. 1920) (lessee's tender was $2.96 short).

[88] Ford v. Barton, 224 S.W. 268 (Tex. Ct. App. 1920) (rentals tendered six days late due to lessee's absence because of serious illness in family).

[89] Greer v. Stanolind Oil & Gas Co., 200 F.2d 920 (10th Cir. 1952) (applying New Mexico law) (lessee's late tender due to mistaken belief that rentals due on anniversary of delivery of lease rather than execution of lease).

[90] Typically, the reasoning of the courts is that the "unless" lease form creates a determinable property interest so that termination of the lease is not a forfeiture subject to suspension on the basis of equitable principles, but the "automatic" ending of an estate. *See, e.g.*, Phillips Pet. Co. v. Curtis, 182 F.2d 122 (10th Cir. 1950).

[91] For example: "Lessees agree to commence a well on said premises within...years from the date hereof, or pay lessor...cents an acre per annum, payable quarterly in advance from the ...day of...,19.., until said well is commenced or this lease surrendered...." Broyles v. Gilman, 222 S.W. 685 (Tex. Ct. App. 1920) *error ref'd.*

[92] *See, e.g.*, Pure Oil Co. v. Sturm, 43 Ohio App. 105, 182 N.E. 875 (1930); Cohn v. Clark, 48 Okla. 500, 150 P. 467 (1915).

[93] The practical impact of the difference tends to be mitigated by the use of forfeiture clauses in "or" leases and by the need for landowners to clear title where an "unless" lease has been used. In either event, a formal act by the landowner is necessary before another lease can be given.

[94] For example, the following clause sometimes appears in leases used in Ohio: "Lessee to commence a well on said premises within...from this date *or* pay to Lessor... Dollars ($...) each year, payable quarterly thereafter until said well is commenced or this lease surrendered; but the completion of a well upon said lands unproductive of oil or gas in paying quantities shall be considered as the equivalent of and regarded as the tender of delay rentals for a period of one year thereafter. *This lease shall become null and void for failure to pay rental for any period when same*

language does not render the leases voidable for want of mutuality,[95] but the courts have generally upheld them.[96] From the landowner's point of view, this modified form of the "unless" lease presents the worst of both worlds. The landowner may well find himself in the position of periodically having to trace the operator in order to demand that delay rentals be paid. If the landowner omits to make the demand for a substantial period of time, or if he cannot locate the operator for a substantial period of time, the operator is placed in the enviable position of being able to choose with retroactive effect whether he wishes to continue the lease or not. If he chooses to pay the past due delay rentals, then the lease continues. If he elects not to pay them, then the lease is held to have terminated effective the date the rentals were due, leaving the landowner without compensation for the intervening time period. As a matter of principle, lawyers representing landowners should strenuously object to such modification of the habendum clauses in "unless" leases.

A variation of the problem being discussed is presented after the initial development of the lease when the operator fails to pay to the landowner the royalty provided for by the lease. Except in Louisiana,[97] courts have been reluctant to declare lease terminations for failure to pay royalties when due.[98] As a result, the landowner will usually find that his only prac-

---

becomes due and payable, provided however that lessee or his assigns is given 10 days written notice of his failure to pay said rentals and they are not paid within said 10 days." (Emphasis added.) The clause may have resulted from a suggestion made in McElroy, *Unless v. Or: An Appraisal*, 6 BAYLOR L. REV. 415, 427-28 (1954).

[95] If the performance of a promise is entirely optional with the promisor, the promise is said to be illusory, with the result that the entire agreement fails for want of consideration. *See* Corbin, *The Effect of Options on Consideration*, 34 YALE L.J. 571 (1925) and Patterson, *Illusory Promises and Promisors' Options*, 6 IOWA L. BULL. 129 (1920). Where courts have refused to give effect to language requiring notice of failure to pay delay rentals they have done so on the basis that the clauses are "inconsistent" and "repugnant" [Clovis v. Carson Oil & Gas Co., 11 F. Supp. 797, 798 (E.D. Mich. 1935)], "irreconcilable" [McDaniel v. Hager-Stevenson Oil Co., 75 Mont. 356, 368, 243 P. 582, 586 (1926)], or "in conflict" [Lewis v. Grininger, 198 Okla. 419, 420, 179 P.2d 463, 464 (1947)], rather than on the basis of failure of consideration.

[96] Wooley v. Standard Oil Co., 230 F.2d 97 (5th Cir. 1956); Dietrich v. Davis, —La.—,246 So. 2d 710 (Ct. App. 1971) (sand and gravel lease). *Cf.* Mossgrove v. All States Oil & Producing Co., 24 Ohio App. 2d 128, 265 N.E.2d 299 (1970) ("or" form lease). Professors Williams and Meyers conclude that a notice and demand provision specifically applicable to delay rentals should be given effect by the courts because of the parties' intent to contract against automatic termination. 4 WILLIAMS & MEYERS, *supra* note 2, at § 682.2

[97] *See, e.g.*, Bouterie v. Kleinpeter, 258 La. 605, 247 So. 2d 548 (Ct. App. 1971). The right of forfeiture does not arise in every case. See the discussion of "justifiable reasons" for which cancellation of the lease may be refused at 3 WILLIAMS & MEYERS, *supra* note 2, at § 656.3

[98] WILLIAMS & MEYERS, *supra* note 2, at § 656.3 Once the lessee has expended the time and money to develop a lease, a possibility of unjust enrichment arises if the remedy of cancellation is permitted. *See generally* Cannon v. Cassidy, 542 P.2d 514 (Okla. 1975); Morris v. First Nat'l Bank, 249 S.W.2d 269 (Tex. Ct. App. 1952); Castle Brook Carbon Black Co. v. Ferrell, 76 W. Va. 300, 85 S.E. 544 (1915).

tical recourse is to sue the operator for the past due royalties.[99] When one considers that financial difficulty is the most likely explanation for the failure to pay the royalties, the inadequacy of the remedy is apparent. A workable solution to the dilemma is for the lease to provide for termination at the landowner's option if a default in royalty payments continues for a stated period of time; *e.g.*, if royalties are payable monthly, the landowner may declare the lease forfeited if the default extends for three months.[100]

A third common problem confronted by the landowner concerned with maximizing his return in an oil and gas leasing transaction relates to the timing and extent of exploration and development of the leased land. The first aspect of this problem is a function of the number or size of tracts to be subjected to a given lease. Typically, the secondary term of the habendum clause is invoked by the drilling and putting into production of a single well. Thus, an oil and gas lease may be "held" without obligation to pay delay rentals by the drilling of a single well, no matter how large the area covered by the lease. Although the operator is still generally subject to the implied covenants of reasonable exploration and development, it is preferable, from the landowner's perspective, to lease separately each tract of land, thus imposing separate obligations upon the lessee to produce in order to extend each lease into its secondary term.[101] Although operators would prefer to lease all of a lessor's land on one lease form, separate leases for noncontiguous tracts of land are usually acceptable and advisable.

A more difficult situation arises when the tract to be leased is so large that a number of wells must be drilled in order to explore and develop it adequately. While oil and gas leases are subject to implied covenants of reasonable exploration and development,[102] the legal standard for es-

[99] Turner, *Remedies for Failure to Pay Royalties*, 14 ROCKY MT. MIN. L. INST. 407, 424 (1968). Failure to pay royalties when due may give rise to a statutory remedy of cancellation in North Dakota. *See* N.D. CENT. CODE § 47-16-39.1 (1961).

[100] For example: "If Lessee shall fail or refuse to make the payment of any sum due by the provisions of this lease as royalty on the production within three (3) months after same shall come due, this lease may be subject to forfeiture by Lessor by notice given in writing to Lessee at the address shown above or at such other address as Lessee shall request from time to time. Such notice shall recite the facts constituting the default and declare the forfeiture." Such forfeiture provisions will be strictly construed by the courts, no doubt because of the element of unjust enrichment to the landowner. *See, e.g.*, Headley v. Hoopengarner, 60 W. Va. 626, 55 S.E. 744 (1906).

[101] *See, e.g.*, Newell v. McMillan, 139 Kan. 94, 30 P.2d 126 (1934).

[102] There is a large body of literature on the subject of implied covenants. *See, e.g.*, Merrill, *Current Problems in the Law of Implied Covenants in Oil and Gas Leases*, 23 TEX. L. REV. 137 (1947); M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES (2d ed. 1940): Brown, *Covenants Implied in an Oil and Gas Lease*, A.B.A. Sect. M. and N.R.L. (1960); Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399, 401 (1933); E. BROWN, OIL AND GAS LEASES, § 16.01-05 (2d ed. 1973); Martin, *A Modern Look at*

tablishing a breach of either of these covenants is rigorous and the burden of proof is both difficult and expensive for the landowner to meet.[103] To avoid these difficulties, the landowner's counsel may consider negotiating a schedule for exploration or development drilling, *e.g.*, to require the drilling of the first well on the property within a short period of time with additional development or exploratory wells to follow at stated intervals.[104] However, provision for scheduled exploration and development in an oil and gas lease may negate the implied covenants, leaving the landowner no right to demand the drilling of wells other than those referred to in the drilling schedule.[105] Moreover, the difficulties of negotiating and drafting such schedules are substantial because of the necessity for precise definition of the terms used and consideration of numerous eventualities. This is particularly true when it is unknown at the time of leasing whether the tract leased will produce substantial oil or gas or from what geologic formations production may be obtained. Unless there is a high probability of finding oil and gas in substantial quantities, it may be preferable to rely upon the implied covenants rather than to attempt to negotiate and draft an exploration and development schedule.

Implied Covenants to Explore, Develop, and Market Under Mineral Leases, 21st S.W. LEGAL FOUNDATION INST. ON OIL AND GAS LAW AND TAXATION 177 (1976).

[103] As the Court said in Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905); "[N]o breach can occur [of the prudent operator standard] save where the absence of such diligence is both certain and substantial in view of the actual circumstances at the time, as distinguished from mere expectations on the part of the lessor and conjecture on the part of mining enthusiasts. The large expense incident to the work of exploration and development in the fact that the lessee must bear the loss if the operations are not successful, require that he proceed with due regard to his own interests, as well as those of the lessor. No obligation rests on him to carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor would result from them. It is only to the end that the oil and gas shall be extracted with benefit or profit to both that reasonable diligence is required. Whether or not in any particular instance such diligence is exercised depends upon a variety of circumstances such as the quantity of oil and gas capable of being produced from the premises, as indicated by prior exploration and development, the local market or demand therefor or the means of transporting them to market, the extent and result of the operations, if any, on adjacent lands, the character of the natural reservoir—whether such is to permit the drainage of a large area by each well—and the usages of the business. Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required." *Id.* at 814.

[104] Because the courts have expressed different theories as to the measure of damages for breach of such exploration and development schedule, caution suggests the schedule be accompanied by a lease clause providing for liquidated damages in the event of breach. Castleberry, *supra* note 22, at 445-46.

[105] Presumably the lessee still would have the obligation to act in good faith, but would not be held to the standard of the reasonably prudent operator. *See* Gulf Prod. Co. v. Kishi, 129 Tex. 487, 103 S.W.2d 965 (1937). *But see* Sinclair Oil & Gas Co. v. Masterson, 271 F.2d 310 (5th Cir. 1959), *cert. denied*, 362 U.S. 952 (1960). Some commentators have criticized the conclusion that including a drilling schedule in a lease is necessarily inconsistent with the implied covenants of reasonable exploration and development. *See, e.g.*, 5 WILLIAMS & MEYERS, *supra* note 2, at § 835.3.

A third and final aspect of this problem area relates to the presence of pooling and unitization clauses in oil and gas leases. Although the terms are frequently used interchangeably, "pooling" refers to putting together tracts or parts of tracts to form a drilling unit under well spacing rules.[106] "Unitization," on the other hand, refers to bringing together all or part of the well units over a producing reservoir under the direction of a single operator to maximize production from that reservoir.[107] In general, a pooling or unitization clause in an oil and gas lease will give the operator authority to pool or unitize all or parts of the tracts leased without the necessity of approval from the landowner.[108] Further, the clause will provide that production from a well drilled on land with which any part of the leased tract is pooled or unitized will be considered production from the leased tract for the purpose of satisfying the habendum clause's requirement of "production" to extend the lease to its secondary term. Thus, it is possible for an operator to use a pooling or unitization clause to extend the lease into its secondary term without drilling a well on the leased premises.[109] Likewise, it is the usual case that a landowner on whose pro-

[106] Texas Oil & Gas Corp. v. Rein, 534 P.2d 1277 (Okla. 1974); Whelan v. Manziel, 314 S.W.2d 126, 132 (Tex. Ct. App. 1958) (*err. ref'd n.r.e.*). *See also* King, *Pooling and Unitization of Oil and Gas Leases*, 46 MICH. L. REV. 311, 313 (1948).

[107] *E.g.*, Woody v. Corporation Comm'n, 265 P.2d 1102 (Okla. 1954). *See also* King, *supra* note 106.

[108] "Absent the express authority to do so, a lessee would have no right to pool the interests in the estate retained by the lessor with those of other lessors." Knight v. Chicago Corp., 144 Tex. 98, 104, 188 S.W.2d 564, 566 (1945). *See also* Long, *The Pooling Clause in an Oil and Gas Lease*, 11 OKLA. L. REV. 1 (1958).

[109] A typical oil and gas lease formulation illustrating the interrelationship of the term clause and the unitization clause provides:

"2. Subject to the other provisions herein contained, this lease shall be for a primary term of.........years from this date and for so long thereafter as oil or gas is produced from the above described land *or from land pooled with all or any part thereof.*

...

"5. Lessee, at its option, is hereby given the right and power to pool or combine the land covered by this lease, or any portion thereof, or formations thereunder, as to oil and gas, or either of them, either before or after production, any other land covered by this lease, and/or with any other land, lease or leases when in lessee's judgment it is necessary or advisable to do so in order to properly develop or operate said premises, and irrespective of whether authorities similar to this exist with respect to such other land, lease or leases, such pooling to be into a well or units not exceeding forty (40) acres, plus an acreage tolerance of 10 per cent (10%) of forty (40) acres, for oil, and not exceeding six hundred and forty (640) acres, plus an acreage tolerance of ten per cent (10%) of six hundred and forty (640) acres, for gas, except that larger units may be created to conform to any spacing or well unit pattern that may be prescribed by governmental authorities having jurisdiction. The pooling in one or more instances shall not exhaust the rights of the lessee hereunder to pool this lease or portions thereof, or formations thereunder, into other units. Lessee shall execute in writing and place of record an instrument or instruments identifying and describing the pooled acreage. *Production, drilling or reworking operations anywhere on a unit which includes all or a part of this lease shall be treated as if it were production, drilling or reworking*

perty a well is drilled pursuant to the exercise of a pooling or unitization clause in the lease will receive less than the full 1/8 royalty for production from that well.[110]

Generally, pooling and unitization are beneficial to the landowner; the former operates to protect his interest in rapid development with as many wells as possible being drilled to the reservoir under his property, while the latter operates to maximize the total production from the reservoir. Because pooling or unitization may be used by an unscrupulous operator to extend several leases into their secondary terms by the drilling of a single well,[111] it is preferable from the landowner's viewpoint that he decide whether to agree to a proposed pooling or unitization on a case-by-case basis. Therefore, counsel for the landowner should try to delete pooling and unitization clauses from proposed leases whenever possible. In many negotiating situations this is not difficult. If, for example, the lessee is an independent operator who expects to maintain close contact with his lessors, he may anticipate that he will be able to secure the necessary agreement without difficulty when he has a drilling venture at hand. With major operators, however, or with those who engage in "absentee management," it will be more difficult to obtain agreement to such a deletion.[112]

A final problem area related to maximizing the landowner's return on the oil and gas leasing transaction arises when the lease offered contains a gas storage clause. The critical shortages of natural gas experienced by many states in early 1977 have stirred new interest on the part of public utilities in expansion of their gas storage facilities. Thus, many operators have begun including clauses in their lease forms which permit the operator or his assigns to use the leased property for gas storage purposes.[113]

operations under this lease. In lieu of the royalties (excepting shut-in gas royalties) elsewhere herein specified, lessor shall receive from a unit so formed only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit or his royalty interest therein bears to the total acreage so pooled in the particular unit involved. In the absence of production lessee may terminate any unitized area by filing of record notice of termination." (Emphasis added.)

[110] Under a unitization clause, the landowner would also receive his pro rata share of the one-eighth royalty on production from other wells within the unit, although not drilled upon his property. *See* the discussion at 6 WILLIAMS & MEYERS, *supra* note 2, at § 951.

[111] In their treatise Professors Williams and Meyers discuss cases which indicate the development of an implied duty of fair dealing on the part of the operator toward the lessor in the exercise of the pooling or unitization power given by the lease. *See* 4 WILLIAMS & MEYERS, *supra* note 2, at § 670.2 As Williams and Meyers note, however, the character and scope of the duty remain poorly defined at present. *Id. See, e.g.*, Boone v. Kerr-McGee Oil Indus., Inc., 217 F.2d 63 (10th Cir. 1954); Southwest Gas Prod. Co. v. Seale, 191 So. 2d 115 (Miss. 1966).

[112] Should it prove impossible to delete the pooling or unitization clause, the landowner should require a site damage clause. Otherwise, the landowner may find himself in the unenviable situation of having all the drilling and its consequent damage located on his land, while he receives only his proportionate share of the royalty.

[113] For example:

"The Lessor, for and in consideration of the sum of One Dollar ($1.00) in hand paid by the

From the landowner's viewpoint, gas storage clauses are objectionable[114] for at least three reasons. First, the compensation provided for, typically $100 to $200 per year, is grossly inadequate in light of the potential interference with landowner's future use of the surface, *e.g.*, subdivision for residential purposes.[115] Second, at least where storage wells are drilled to reservoirs which have not been previously depleted, operation of gas storage wells will ultimately remove whatever gas was in place beneath the leased land as well as that injected for storage. Thus, the landowner's

---

Lessee, the receipt whereof is hereby acknowledged, and of the covenants and agreements hereinafter contained, does hereby lease and let unto the Lessee for the purpose of drilling, operating for, producing and removing oil and gas and all the constituents thereof on, from and under the following described lands, *and for the further purpose of injecting, storing and holding in storage, and removing gas, including gas lying thereunder, by pumping through wells or other means, into, in and from any sands, strata or formations underlying said lands, regardless of the source of such gas or the location of the wells or other means of so doing:*

...

"In full compensation for the use of the leased premises for the purposes of injecting, storing or holding in storage, and removing gas into, in and from any sands, strata or formations underlying the leased premises Lessee shall pay Lessor each year, quarterly in advance, (1) a storage rental equivalent to $200.00 for or on account of each well located on the leased premises and used for such purposes, or (2) if no wells shall be used on the leased premises for such purposes, a storage rental in the amount equivalent to the Delay Rental hereinbefore specified. The Lessee at any time may notify the Lessor in writing at the address of Lessor last known to Lessee, by registered or certified mail, of the Lessee's intention to use the leased premises, together with any well or wells located thereon, for any and all of the gas storage purposes hereinbefore specified of injecting, storing, or holding in storage, and removing gas into, in and from any sands, strata or formations underlying the leased premises, and upon the giving of such notice the Lessee may use the leased premises, together with any well or wells located thereon, for any or all of said gas storage purposes. Payment for storage use shall commence on the date such use begins, shall continue until the leased premises shall no longer be used for storage purposes, and shall be in lieu of all delay rentals or royalties for the right to produce and remove, and the production and removal of, gas from the sands, strata or formations in which gas is stored by the Lessee. The Lessee shall pay the Lessor for all damage to growing crops, trees and fences caused by the Lessee's operations under this lease, said damages, if not mutually agreed upon, to be ascertained and determined by three disinterested persons, one thereof to be appointed by the Lessor, one by the Lessee, and the third by the two so appointed, and the award of such three persons shall be final and conclusive." (Emphasis added.)

[114] It is not uncommon for owners of land subject to gas storage leases to be so incensed at the burden to which their land is subjected that they attempt to set aside the storage lease by litigation. The landowner in such a suit was successful in Rayl v. East Ohio Gas Co., 46 Ohio App. 2d 167, 348 N.E.2d 385 (1973), in which an Ohio court of appeals held that a gas storage agreement which was terminable after a ten-year primary period upon the failure of the "lessee" to produce, store, or withdraw gas from underground storage areas became a tenancy at will once the primary term expired and thus subject to termination upon reasonable notice by either party. However, this decision was effectively overruled by the Ohio Supreme Court in Myers v. East Ohio Gas Co., 51 Ohio St. 2d 121, 364 N.E.2d 1369 (1977), in which that court refused to follow the reasoning of the *Rayl* case on the grounds that that decision did not effect the intentions of the parties.

[115] See the discussion accompanying notes 33-42, *supra*.

gas may be produced without payment of a royalty.[116] Third, gas storage clauses are inconsistent with the landowner's basic goal of exploration for and development of the oil and gas in place under the premises. For these reasons, the landowner's lawyer should categorically refuse to accept a gas storage clause in an oil and gas lease. Use of the premises for gas storage should be the subject of separate negotiation and compensation.

As can be seen from the discussion above, the landowner's interest in maximizing his return requires consideration of much more than merely the amount of the royalty to be paid on production. The key to representing the landowner effectively is to review the lease to assure that the operator pays adequately for the rights that he receives and that the lease terms do not conceal grants of rights for which the operator has not paid.

Conclusion

The conscientious attorney who takes his landowner client through all of the analysis suggested in this article may find his client to be so impressed with the potential pitfalls that he will decide not to enter into a leasing transaction at all. It must be noted that there is danger in such a position. Because of the fugacious nature of oil and gas and the spacing rules most producing states have adopted to promote conservation,[117] the landowner who refuses to enter into an oil and gas lease may find that substantial portions of the oil and gas under his property have been removed by wells drilled on adjacent property. If the holdout landowner owns a tract too small to qualify for a well under the applicable spacing rules, he may find that he has effectively been frozen out of his rights to the oil and gas under his property by the development of adjacent property. Although most states make provision for the drilling of wells on "exception tracts," they usually require that production from these wells be prorationed in relation to the size of the tract upon which they are drilled to the size of the minimum drilling unit as set by law or rule.[118] Therefore, the drilling of an "exception tract" well may be economically unprofitable.

Practicality dictates that the landowner in an area being developed for oil and gas negotiate seriously to enter into an oil and gas lease. It is highly unlikely that counsel for the landowner will be able to negotiate an

[116] Note that the language quoted in note 113, *supra*, specifically grants the lessee the right to remove gas lying under the leased land without any compensation other than the storage royalty.

[117] *E.g.*, 52 OKLA. STAT. § 87.1 (Supp. 1977). For an overview of conservation laws and their impact, *see* the discussion at Emens & Lowe, *Ohio Oil and Gas Conservation Law—The First Ten Years (1965-1975)*, 37 OHIO ST. L.J. 31, 32 (1976).

[118] *See, e.g.*, OHIO REV. CODE § 1509.29 (Page Supp. 1977).

agreement containing all of the inclusions or deletions suggested in this article. It is probably not even desirable; in order to be workable, the lease must allow the operator reasonable flexibility.[119] However, an informed analysis of the landowner's interest in the transaction will permit choices to be made and priorities to be assigned so that those interests can be effectively advanced. Moreover, designation and discussion of potential problem areas in the course of negotiations is likely to have a prophylactic effect even where the negotiations do not result in modification of the lease form presented.

• • • • • •

In the months since the above article was written, two thoughts have occurred to me which I wish to add.

First, there is an addendum to the discussion in the text at notes 14 and 16 on the necessity for the landowner's lawyer to assure himself that his client has title to the minerals to be leased because of potential liability under the warranty clause. The problem noted can be avoided simply by striking the warranty and proportionate reduction clauses from the lease offered. That is difficult to negotiate in the midwest, because oil and gas leases are typically taken before a title search is run on the property and a lease without a warranty is seen by the lessee as a signal of a title problem. In areas in which title searches are run before the lease is taken, however, the lessee might have less objection to deletion of the warranty and proportionate reduction clauses.

Second, the discussion in the text at note 101 on maximizing the return of the landowner by limiting the number or size of tracts covered by a single lease could be expanded by noting that the geological formations or the horizons or zones subjected to the lease might be limited, as well. This is frequently done in parts of Louisiana and Texas. It may be accomplished either by limiting the granting clause of the lease to a particular formation, horizon, or zone, *e.g.*, "the Clinton formation" or the "T-Sand of the Frio formation located in McAllen Ranch Field, Hildalgo County, Texas" , or by adding a provision to the term clause to the effect that the lease will terminate at the end of the primary term as to any horizon or zone from which there is not then production in paying quantities. Either approach limits the lessee's ability to "hold" property from which oil and gas can be produced.

[119] An operator friend and sometime client of the author expressed his friendly disgust at the totality of suggestions of this article by saying, "The only operator who will give you [the lawyer representing the landowner] all of that list is one who will have no intention of complying with any of them." The point is well taken. This article is prompted by the author's concern that many oil and gas lease forms currently in use give the operator unfair advantages. A lease which incorporated all of the measures considered above might be so advantageous to the landowner as to hamstring the lessee's ability to operate.