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1985

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### Recommended Citation

John S. Lowe, Negotiating Oil and Gas Leases for the Lessee, 1 Nat. Resources & Env't. 6 (1985)

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# Negotiating Oil and Gas Leases for the Lessee

John S. Lowe

In the good old days, there was relatively little negotiation of oil and gas leases. Lessors did not understand the leasing transaction and so did not know enough to negotiate. And, at least in speculative areas, what was at stake when the lease was negotiated did not seem worth arguing about. Bonuses were modest, royalty percentages were a standard one-eighth, and oil and gas prices were low. As a result, the printed form oil and gas lease presented to the landowner by the oil company was usually executed without change.

Times have changed! The 1970s saw a great increase in oil and gas prices and, with them, a corresponding surge in the value of oil and gas leases. Lease negotiation is now the rule rather than the exception. The keys to guiding an oil company client effectively in negotiating leases are (1) appreciating the function of the lease, (2) understanding how essential lease clauses work and interrelate, and (3) avoiding interference between essential clauses and negotiated provisions.

## *The Function of a Lease*

An oil company has two fundamental goals when it takes an oil and gas lease: (1) it wants the right to search for and develop oil and gas upon the premises without accepting any obligation to do so; and (2) if oil and gas are located, it wants the right to maintain the lease for as long as it is profitable. Both goals are tied to the inherent uncertainty of oil and gas ventures.

The lessee generally does not know for certain that oil and gas are present under the property at the time the lease is taken. If they are present, they may be drained away by other operations in the area, or the price for which they can be sold may drop so precipitously that it is not worth taking the risk of drilling. Because of these risks, the oil and gas lessee is gen-

erally unwilling to commit to drill on the property.

The second purpose of the lease—the desire to keep it as long as it is profitable—is also related to economics. Oil companies are in business to make money, and they wish to maximize their profits when their risk taking results in production. Once production is obtained on a property, how long it will be profitable to maintain it is determined by economic factors that cannot be predicted when the lease is taken, e.g., the state of the technology available to produce oil and gas, the price for which production can be sold, and tax policy, to name just a few. That is the reason that modern oil and gas leases are drafted to extend “as long thereafter as oil and gas . . . are being produced. . . .”

## *Key Clauses*

The basic purposes of the modern-day oil and gas lease are accomplished in just three essential clauses: (1) the *granting clause*, which spells out what rights are granted from lessor to the lessee; (2) the *term clause*, which spells out the period of time for which the rights granted in the granting clause will extend; and (3) the *drilling-delay rental clause*, which makes it clear that the lease is an option agreement by negating any obligation to drill. It is particularly important that negotiated lease alterations not interfere with the functioning of these clauses.

In addition to the essential clauses, most oil and gas leases contain a group of important defensive clauses, including (1) an operations clause, (2) a *force majeure* clause, (3) a shut-in royalty clause, and (4) pooling and unitization clauses. These clauses are necessary because most states require actual production in paying quantities to maintain the lease beyond the primary term. Since that is often impractical or im-

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## for the Lessee *Continued from page 6*

possible, the defensive clauses modify the term clause to keep the lease alive until actual production can be obtained. Care must be taken that lease alterations not disrupt the operation of these defensive clauses.

In the pages that follow, I will discuss lease alterations frequently negotiated for by lessors and attempt to assess their importance to oil companies. My analysis will be clause by clause, though the discussion may occasionally overlap. Because of space limitations, it is also necessarily superficial. A more complete discussion can be found in J. Lowe, *Oil and Gas Law in a Nutshell* (West 1983) or one of the excellent treatises in the area.

### *The Granting Clause*

An oil and gas lease granting clause typically describes the parties to the lease, the land covered, and the interest conveyed. Usually, it provides in detail what rights the lessee has under the lease. Even in the absence of specific language, the courts have recognized an implied easement in the lease for such uses at such locations as are reasonably necessary to obtain the minerals. Because the express or implied rights given by the lease may interfere with the lessor's uses or expectations for the land, lease negotiations often focus upon granting clause limitations.

Restrictions on surface use, restoration requirements, and surface damages provisions are very common in negotiated oil and gas leases. Although they may present a substantial burden upon oil and gas operations, the industry generally is willing to accept the lessor's proposals. Do not assume, however, that all surface use clauses that you see do the same thing. Most oil companies are willing to pay substantial surface damages and to take reasonable steps toward restoration. However, there are limits both to the depth of the oil industry's pockets and to the technical skill of its production and reclamation experts. Be sure you understand the use limitations or restriction obligations proposed.

Perhaps the best example of an unacceptable surface use restriction is one that totally prohibits surface use. Consider, for example, the following:

The rights granted by this lease shall be exercised exclusively by wells and other facilities located upon adjacent or adjoining lands and lessee shall have no right to go upon or use the lands covered by such lease in any manner for the exer-

cise thereof, save only that directionally drilled wells . . . may penetrate the premises.

The quoted language could be easily tolerated if the tract of land were very small. However, if it were a large tract, the restriction might make it impossible to develop it even with expensive directional drilling. Perhaps the conflicting interests of the lessor and lessee where a ban on surface use is proposed can be balanced by an agreement specifying drill-site or equipment locations.

Landowners often guard their water rights jealously—particularly in the arid areas of the West. However, a complete prohibition on water use can effectively prevent drilling or, at best, subject your oil company client to financial burdens far beyond acceptable limits. It is reasonable and probably acceptable to bar water use for secondary recovery operations, but the industry needs the right to use it for drilling operations.

Lessors frequently seek to strike the warranty language. That is generally acceptable, at least where the lessee has conducted its own title search. However, be certain that the lesser interest clause and the subrogation clause, which are often found in the same paragraph, are not deleted also. Your client may be willing to risk failure of title, but it will want the right to reduce future payments proportionately and to protect and subrogate itself against future failures. In addition, be sure that the lease has a specific after-acquired title clause if the warranty clause is deleted. If the warranty clause is struck, the doctrine of after-acquired title will not operate.

### *The Term Clause*

The term clause of modern oil and gas leases really consists of two terms, the primary term and the secondary term. The primary term states the period of time for which the lessee may hold the lease without drilling. The secondary term provides for the indefinite extension of the lease "for so long thereafter as there is production from the premises."

The primary term of the lease is negotiable. Generally, it is from one to five years, though primary terms of ten years are still common in marginally producing or exploratory areas. Obviously, a longer primary term is preferable to your oil company client.

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*There are limits both to the depth of the oil industry's pockets and to the technical skill of its production and reclamation experts.*