Oil and Gas Leases: Structuring Key Provisions
Negotiating Scope of the Grant, Royalty Obligations, Implied Covenants, and More

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Key Lease Provisions

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A. Lessor/lessee relationship
B. Lease form
C. Scope of Grant and Permissible Operations
D. Royalty clause
E. Pooling and Pugh clauses
F. Continuous operations
G. Depth severance
H. Commencement of operations
I. Assignment
J. Indemnity
K. Surface damages
L. Access to information
M. Geophysical exploration
N. Express vs. implied covenants
O. Division Orders
The Lessor/Lessee Relationship

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A. Lessee’s Standard of Conduct

Throughout the United States, the standard to which lessee-operators are held is that of a reasonably prudent and capable operator, who takes into consideration both his own interests and those of the lessor. Even states with rules generally favorable to lessors have not imposed fiduciary duties or strict liability on lessees.

The leasing transaction is the foundation of the oil and gas industry. Countless leases have been used to grant oil companies the exclusive right to explore and exploit minerals on both private and public lands. It is this initial transaction that begins a chain of industry activity that runs from production through transportation, refining, and marketing.
This “prudent operator standard” establishes an objective test similar to the reasonable person concept found in tort law. Whether the lessee has acted properly with respect to operations on a lease must be measured by what a hypothetical operator of ordinary prudence would do under the facts and circumstances presented by the case.

The prudent operator standard requires that the lessee utilize the special knowledge and skills expected in the industry. Moreover, the standard ignores the circumstances and difficulties that are unique to the lessee and demands that the performance be evaluated in the context of the oil and gas lease in issue.
Lessee’s Standard of Conduct (Cont’d)

As stated in the previous section, the extent of a lessee's duty to fulfill implied contractual obligations is usually based upon a prudent operator standard, i.e., that which “would be reasonably expected of operators of ordinary prudence.” This standard is recognized by the Michigan courts. However, the courts of Oklahoma have held that a unit operator has a fiduciary duty to the members of the unit.

The fiduciary duty was first recognized by the Oklahoma Supreme Court in Young v. West Edmond Hunton Lime Unit. The Oklahoma Court held in Young that the “‘unit organization with its operator’ stands in a trustee-type position for all interested parties, be they lessees or royalty owners.” The governmentally formed, but privately controlled unit in Young, sold gas to the unit operator (in Young the two were separate entities) below the market price and was found liable for the difference between the sale price and the market price because of the potential conflict of interest between the unit operator as seller of production from the lessor's lands and the unit operator as potential purchaser of the same oil or gas.
Lessee’s Standard of Conduct (Cont’d)

Although subsequently criticized by other Texas Courts of Appeal, the Texas Court of Civil Appeals in Expando Production Company v. Marshall similarly held that “[t]here is no doubt that there is a fiduciary obligation on the part of the lessee to exercise the utmost good faith toward the lessor in exercising the power granted under a pooling provision.”

“The prudent operator is a reasonable man engaged in oil and gas operations. He is a hypothetical oil operator who does what he ought to do not what he ought not to do with respect to operations on the leasehold. Since the standard of conduct is objective, a defendant cannot justify his act or omission on personal grounds or by reference to his peculiar circumstances.” Howard R. Williams and Charles J. Meyers, Oil and Gas Law, §806.3 (2002).
B. Lease form

- "Producers’ 88"
- Use of "riders" or "addenda" to add landowner protection provisions
  - Disadvantages of riders
- Development of forms drafted for the mineral owner
  - TLMA Form
Scope of the Grant and Permissible Operations

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C. Scope of the Grant and Permissible Operations – What Rights are Granted to the Lessee?

A. Sources of Law Governing the Lessor and the Lessee Other than the Oil and Gas Lease

- Common Law Rights of Surface and Mineral Owners (Split Estates)
- Federal, State and Local Laws
- Federal, State and Local Regulations
- Permit Conditions Imposed by Government
- Other Private Contracts, such as Right of Way and Surface Use Agreements
Scope of the Grant and Permissible

B. Reasonable Accommodation—Due Regard for Each Other—Golden Rule—Share and Play Well with Others

- North Dakota - “The mineral estate is dominant in that the law implies, where it is not granted, a legitimate area within which mineral ownership of necessity carries with it inherent surface rights to find and develop the minerals, which rights must and do involve the surface estate. Without such rights the mineral estate would be meaningless and worthless. Thus, the surface estate is servient for those essential rights of the mineral estate. In the absence of other rights expressly granted or reserved, the rights of the owner of the mineral estate are limited to so much of the surface and use thereof as are reasonably necessary to explore, develop and transport the minerals.” Kartch v. EOG Resources, Inc., 845 F. Supp.2d 995, 1002 (D. N.D. 2012)(Emphasis Added; Analyzing Authority from Other States).
B. Reasonable Accommodation—Due Regard for Each Other—Golden Rule—Share and Play Well with Others (cont.)

- Colorado – “Although we have referred to the mineral estate as the dominant estate and the surface estate as the servient estate, our cases have consistently emphasized that both estates must exercise their rights in a manner consistent with each other. Hence, in a practical sense, both estates are mutually dominant and mutually servient because each is burdened with the rights of the other.” Gerrity Oil & Gas Corp. v. Magness, 946 P.2d 913, 927 n.8 (Colo. 1997).

C. State Surface Damages Statutes

Scope of the Grant and Permissible

C. State Surface Damages Statutes (cont.)

- Operator May Do What is Reasonable and Necessary to Explore and Produce But Must Minimize Intrusion Upon and Damage to the Land
- Must Use Alternatives to Minimize Intrusion Which Are Technologically Sound, Economically Practicable and Reasonably Available
- Statute Shall Not Abrogate Contracts Entered Into by the Parties (Surface Use Agreements or Leases)
- Creates a Cause of Action With Shifting Burdens of Proof
- Does Not Affect Local Authority
D. Granting Clauses

Example: “This agreement, entered into on January 1, 2013, between Lessor and Lessee, in consideration of $10.00 and the other covenants and agreements provided herein, hereby grants, leases and lets unto Lessee for the purposes of investigation, exploring, prospecting, drilling and producing oil, gas and all other minerals, constructing roads, laying pipelines, and building utility lines and other structures thereon to produce, save, take care of, treat and transport all such substances, and for housing its employees, the following described land in County X of State Y, described as follows [legal description] and containing 160 acres, more or less.”
Scope of the Grant and Permissible

- Key Elements of Granting Clause:
  - Effective Date of Lease and Identification of the Parties
  - Confirmation of Consideration and Bonus and Other Recitals
  - Present Words of Grant
  - Special Text for State or Federal Lands or Minerals
  - Special Text for Horizontal Wells—Use the Surface and Subsurface for the Well Pad and Nonproducing Portions of the Wellbore, Even for Production from an Adjoining Tract
  - Complete Legal Description
  - Warranty of Title
Key Elements of Granting Clause (cont.):

- **Depth and Formation Restrictions**—Subsurface Easement in Depths Not Leased
- **Cover-All “Mother Hubbard” Provision** (e.g., “the intent of Lessor to lease to Lessee all lands owned by Lessor in Section 4”). “Many leases include what is commonly called a ‘Mother Hubbard’ clause, which is intended to pick up accidently excluded small pieces of land contiguous to the lease premises. Inclusion of this common provision may have unintended effects if the landowner owns adjacent property that was purposefully excluded. The lessor and lessee should agree on the land to be included and consider if a provision to include ‘any and all other land’ owned by the lessor is overly broad.” Rachel L. Allen and Scotland M. Duncan, “The Standard Oil and Gas Lease—And Why It is Not,” 13 Duq. Bus. L.J. 155, 157 (Summer 2011).
- **Nonexclusive List of Additional Authorized Operations** (E.g., Facilities, Seismic, Water Disposal, Oil and Gas in Pipelines from Other Premises) and Required Surface and Subsurface Easements for all Operations
D. Royalty clause

- Royalty measured by “proceeds” or “market value.”
- Net-back method of measuring market value
- Post-Production Costs
  - “Market value at the well” vs. marketable condition rule
    - “net proceeds computed at the mouth of the well” – Heritage Resources v. Nationsbank, 939 S.W.2d 118 (Tex. 1996)
  - Sales to Lessee’s affiliate
  - Processed gas – royalty on natural gas liquids
D. Royalty clause

- Due dates of royalty
- Minimum royalties
- Remedies for non-payment
  - Interest
  - Security Interest
  - Right to terminate lease for non-payment
E. Pooling and Pugh clauses

- Benefits of pooling
- Relation between well spacing regulations and pooling
  - Field rules, proration units, pooled units and production units
- Restrictions on Pooling
  - Pugh Clauses
  - Restrictions on size of pooled units
  - Pooling for horizontal wells
- Forced Pooling
F. Continuous operations

- Maintenance of lease beyond primary term
  - No more than X days between completion of one well and commencement of the next well
  - Define “commencement” and “completion”
  - Accumulation of time

- Designation of “production units”
  - Size and configuration of production units

- Continuation of lease after designation of production units

- Production units for horizontal wells
Many oil and gas leases will contain a depth severance in the lease. The purpose of the clause is that the oil and gas lease will be released below the depth stated in the specially added clause.
Depth Severance

- There are several types of clauses, but they usually fall into one or more of the following categories:

  a) The lease is to be released below the total depth drilled;
  b) The lease is to be released below the deepest producing formation; or
  c) The lease is to be released below the deepest producing depth or perforated depth.
Depth Severance

- The lessor would prefer that the clause be the deepest perforation in the well from which it is producing.

- The lessee would also prefer that it be the total depth drilled plus 100 feet.
H. Commencement of Operations

A. Most Common Formulations in an Unless or Savings Clause: Commencing Drilling Operations or Commencing the Drilling of a Well. “[I]n general it appears that the courts have been ready to find the commencement of operations (or the pursuit of drilling operations) where only the most modest preparations for drilling have been made.” 3 Williams & Meyers Oil and Gas Law, 618.1 at 319-20 (2012). But “[t]he jurisprudence relating to how courts define the term ranges from ‘clear’ to ‘fuzzy’... As with other issues, it would be better for the parties to define what constitutes operations or commencement of drilling operations to avoid the kind of uncertainty that case law has provided.” Bruce M. Kramer, “Keeping Leases Alive in the Era of Horizontal Drilling and Hydraulic Fracturing: Are the Old Workhouses (Shut-In, Continuous Operations and Pooling Provisions) Up to the Task?, 49 Washburn L.J. 283, 296 (2010)(Collecting Authority).

H. Commencement of Operations

C. At What Point in Time Have OperationsCommenced—When “Preparations Have Begun,” the Location is Staked, the Permit Issues, “the First Material Is Placed on the Ground,” Equipment is On Site, the Well is Spud, When Work is Begun Downhole, Etc.?

D. “A mineral owner’s failure to define drilling operations as limited to those operations whereby appropriate equipment is onsite with the capability for physically drilling or reworking the well, not merely preparatory steps taken to demarcate the boundaries of the well or preliminary administrative steps like securing permits from the necessary agencies, can bolster the mineral owner’s argument that a lease has terminated. Defining the terms, such as drilling operations, in advance, leaves the mineral owner free to negotiate subsequent leases for more favorable terms rather than engaging in a protracted court battle should the mineral developer fail to continue the drilling operations pursuant to the lease.” Joshua A. Swanson, “The Fine Print Matters: Negotiating an Oil and Gas Lease in North Dakota,” 87 N.D. L. Rev. 703, 711-12 (2011).
I. Assignment

- Should Lessee have free right to assign interests in the lease?
- Possible restrictions on assignment:
  - No assignment without Lessor’s consent
    - Unreasonable restraint on alienation?
  - No change in operator without Lessor’s consent
  - No assignment that leaves original Lessee with less than X% interest in lease
I. Assignment

- Consequences of assignment:
  - Is original Lessee relieved of obligations under the lease?

- Consequences of failure to obtain consent

- Assignment of segregated portions of lease:
  - Is default by one Lessee default under entire lease?

- Joint and several liability of multiple lessees
  - Split-stream sales
J. Indemnity

- Should Lessee indemnify Lessor against claims that injury or damage was caused by Lessor’s negligence?
- “Express negligence” doctrine in Texas
- Backed by insurance naming Lessor an additional insured?
K. Surface Damages—Sources of Recovery Other Than Lease

A. Common Law Principles—Accommodation and Right of Reasonable Use
B. State Surface Damages or Surface Use Acts
C. Surface Use or Damages Agreements—May Be Incorporated Into a Lease
D. Other Agreements, Including Right of Way, Road Use, Pipeline, Facility, Disposal Well
E. Trespass and Other Tort Actions
Surface Use Agreements and Surface Use Provisions in Leases—Key Terms

- Contract Fundamentals
- Specification of Permitted Land Uses
  - Express Grant
  - Well and Pads
  - Supporting Infrastructure
- Compensation and Other Payment
  - One-Time or Annual
  - Flat Fee or Per Well, Facility, Pad, Rod, Etc.
  - Indemnification for Actual Damages
Surface Use Agreements and Surface Use Provisions in Leases—Key Terms

- Protection of the Land
  - Protection of Present Uses—Residences, Agriculture, Livestock, Hunting
  - Protection of Locations for Future Anticipated Surface Uses
  - Management of Hazardous Materials
  - Water Testing and Protection
  - Noise
  - Roads, Fences, Special Use Areas
  - Reclamation—Replacement of Top Soil, Contouring
- Advance Notice of Operations
- Insurance Requirements
- Term of the Agreement
- Confidentiality and Recording of Memo in Lieu of Lease
- Compliance with Laws—Contract Remedy for Violation
Surface Use Agreements and Surface Use Provisions in Leases—Key Terms

- Other Provisions
  - Releases
  - Indemnification and Defense Against Claims of Others Against Lessor or Surface Owner
  - Limitation of Damages
  - Force Majeure
  - Notice and Cure
  - Run with the Land
  - Successors and Assigns; Approval of New Operator

What Rights May Be Waived

- Unequal Bargaining Power
- No Consent
- Fraud
- Public Rights
L. Access to Information

- A Lessor May Ask a Lessee to Provide Copies of Maps, Permits and Other Regulatory Filings of Documents, Health and Safety Reports, Environmental Studies and Even Logs, Other Downhole Data Seismic or Geophysical Data.

- Downhole and Seismic Data often is proprietary and kept tight hole. “Information relevant to oil and gas exploration and production is frequently treated as a trade secret within the industry and at common law.” In re TXCO Resources, Inc., 475 B.R. 781, 805 (W.D. Tex. 2012); see also, e.g., In re Bass, 113 S.W.2d 735, 739-40 (Tex. 2003).

- Operator’s Drafting Objective: (1) Prevent the Disclosure of Trade Secret Data and, in Particular, Licensed Seismic or Other Data Which the Operator May Not have the Authority to Disclose Because it is Subject to License Agreements, Etc.; (2) Unambiguously Describe the Data to be Disclosed and the Timeframes and Manner for so Doing.

- Mineral or Surface Owner’s Drafting Objective: (1) Gain Timely Access to Records and Data Which Will Permit It to Better Monitor Oil and Gas Operations and Compliance with Lease Terms and Other Agreements; and (2) Gain Timely Access to Records and Data Which Will Permit It to Better Assess the Operator’s Compliance with Its Implied Duties as Well as the Value of the Mineral Estate.
M. Seismic Operations and Geophysical Exploration

- In Oklahoma and other states, the “law clearly permits the owners of mineral estates [and their lessees and other assignees] to grant access to the surface property in order to conduct seismic exploration” in a manner consistent with principles of reasonable accommodation. Kimzey v. Flamingo Seismic Solutions Inc., 696 F.3d 1045, 1048 (10th Cir. 2012) (construing Oklahoma law).

- Operator’s Drafting Objective: Seismic is a Short Term Operation Which Requires Certainty of Access; Confirmation of Rights in a Lease or Other Agreement promotes this Certainty and Ready Access, if Needed, to an Injunction to Enforce Contract Rights, if Needed. Cf. Trinity USA Operating, LLC v. Barker, 844 F. Supp.2d 781 (S.D. Miss. 2011) (Drilling Company Failed to Prove Irreparable Harm and Unlawful Interference by Surface Owner with Drilling Company’s Seismic Exploration).


- Model Provisions listed in 4 Williams & Meyers Oil and Gas Law, 693 at 494-96 (2012).
Colorado and Other States Recognize at Least Four Implied Covenants Associated with the Relationship between an Oil and Gas Lessor and Lessee: to Drill and Explore, to Develop after Discovery in Paying Quantities, to Protect against Drainage, and to Diligently and Prudently Operate Oil and Gas Facilities. E.g., Davis v. Cramer, 837 P.2d 218, 222 (Colo. App. 1992); James C. Wright, Brian J. Pulito and Cheryl L. Davis, “Implied Covenants in Oil and Gas Leases in the Appalachian Basin, 19 Tex. Wesleyan L. Rev. 121 (Fall 2012); Kenneth M. Klemm, “Implied Covenants: Recent Developments in Failure-to-Develop Cases and Other Implied Covenants Under Mineral Leases,” 57 Rocky Mtn. Min. L. Inst. 20.1 (2011)(Collecting Authority from Nine Western States).

“A lessee can avoid or limit its obligations under an implied covenant by negotiating for the lease to govern expressly and preclude the existence of an implied duty.” Keith B. Hall, “The Continuing Role of Implied Covenants in Developing Leased Lands,” 49 Washburn L.J. 313, 327 (Winter 2010)(Collecting Authority).

 “[T]he mineral owner should carefully review the lease to make sure that the mineral developer has not disclaimed any of the implied covenants.... These implied covenants exist in favor of the mineral owner unless they are expressly disclaimed by the mineral developer. The most frequently cited implied covenant is the implied covenant of reasonable development. The covenant is emerging as a popular tool for mineral owners in challenging mineral developers whom they feel have not done enough to develop their acreage.” Joshua A. Swanson, “The Fine Print Matters: Negotiating and Oil and Gas Lease in North Dakota, 87 N.D. L. Rev. 715 (2011).
O. Division Orders

- Purpose
- Binding until revoked
- Division orders as a condition to payment: Texas’ division order statute
- Effect on lease provisions