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UNDERSTANDING THE OIL AND GAS LEASE AND FACTORS AFFECTING TERMINATION OF THE OIL AND GAS LEASE RESULTING IN CANCELLATION
(or How I learned to love my Oil and Gas lease and treat it as a friend)

NATIONAL ASSOCIATION OF ROYALTY OWNERS ANNUAL CONVENTION
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GENERAL COMMENTS

The key to a successful relationship as a mineral owner with your Oil and Gas lessee is an understanding of the Oil and Gas lease. While understanding your Oil and Gas lease takes some work, the general concepts and principals can be understood by anyone. The Oil and Gas lease is nothing more than a contract. Yes, it is a very specialized type of contract, but a contract nonetheless. It is necessary to understand and read the document closely. Most Oil and Gas leases are fairly straight forward. Understanding certain sections depend on comprehension of terms used in the Oil and Gas business. You will have to learn these terms, but again that is not too difficult. Ultimately, if you realize that the Oil and Gas lease is your ally and not your enemy, you are on the road to protecting your legal rights.

THE SIGNIFICANCE OF THE OIL AND GAS LEASE

The fundamental contractual instrument that conveys the rights to develop oil and gas resources, as well as virtually every other type of mineral, is the lease. As such affects members of this organization, it is almost uniformly the Oil and Gas lease

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that defines the rights of the developer of the natural resource (the "lessee"), on one hand, and the rights of the owner of oil and gas ("the lessor"), on the other[3].

The conveyance or transfer of Oil and Gas rights can only be made in a writing. Oil and gas rights can never be conveyed by mere oral agreement. The real property involved must be specifically identified. While legally there exists no prohibition of the outright sale of oil and gas interests to those in the natural resources development community, such sales in this context are extremely rare, although by no means entirely non-existent.

Oil and Gas leases by their very nature can be drafted in a wide number of variations. Many are as short as a single page, while others can be voluminous. No matter the length, the thrust of this paper will include focus upon four basic subjects traditionally addressed in an Oil and Gas leases: 1) What legal rights are being conveyed by the lessor to the lessee? 2) For what period of time are development rights being granted? 3) How will the lessor be compensated for the granting of these rights, including the royalty? and, 4) Under what circumstances will the Oil and Gas Lease be cancelled?

OIL AND GAS LEASE ORGANIZATION

Most Oil and Gas leases at the beginning include what is referred to as the granting clause. There is considerable variation in granting clause language. It is thus very important that the specific language utilized in the granting clause be scrutinized very carefully. The granting clause in the Oil and Gas lease identifies the rights that are being transferred from the lessor to the lessee. The granting clause specifies the types of uses permitted and the specific substances addressed by the Oil and Gas lease.

A review of a Oil and Gas leases reveal that there are often other types of mineral and natural resources rights being conveyed beyond that of merely oil and gas. For the purposes of this paper, it is obviously important to make sure that your Oil and Gas lease contains both the terms "oil" and "gas." While this may appear to be very self-evident, the law in virtually every jurisdiction is that if rights to a given mineral or natural resource are not specifically conveyed, they remain with the lessor. Accordingly, if a type of mineral is reserved by the

[3] (The lessor is also referred to as the grantor and the lessee is often referred to as the grantee. For the sake of uniformity, this paper will utilize only lessor and lessee, although grantor and grantee are equally acceptable).

lessor (for instance, sand and gravel or gold), while the lessee under an Oil and Gas lease can still drill and otherwise develop the oil and gas resources, they cannot conduct exploration or extraction of any other minerals not specifically transferred. The granting clause thus identifies precisely what is being conveyed to the lessee.

OTHER SIGNIFICANCE OF GRANTING CLAUSE

However, the granting clause addresses more than merely what is being permitted to be developed. The granting clause typically also addresses the specific activities that can be conducted on the land in question. The granting clause will identify how resources can be developed, produced, and marketed. It is important to recall that with emerging technology and because of the potential duration of these leases there might be confusion. With the emergence of technology, resources that cannot be developed today might be subject to extraction in the future.

By way of one example only, in Colorado, Utah, and Wyoming shale oil resources and the conversion of shale into oil have been well known for well over a hundred years. In fact, oil has been already produced from shale for an extensive period of time. However, the cost of producing oil from shale has been so historically prohibitive that despite the abundance of oil shale, economics have made it unprofitable to produce oil from shale in a cost effective fashion. That is not to presume that in the immediate future as a result of development of improved technology it may be entirely possible to produce oil from shale in a cost effective and profitable fashion.

Accordingly, it is very important to pay close attention in drafting the language of the granting clause to consider the location, development, production, and marketing of the leased substances. The specific natural resources and minerals that we consider at the time of executing an Oil and Gas lease should include thoughtful consideration of events that may transpire in the future.

THE DOMINANT AND SUBSERVIENT ESTATE

Because the granting clause addresses the development of Oil and Gas interests, it is also important to note this development of Oil and Gas interests by its very nature involves consideration of what lawyers refer to as dominant and subservient estates of the land itself. This concept of land use is very counterintuitive. Many land owners incorrectly presume,

particularly in instances where real property has been used in a certain way for generations (for example: ranching), that it is the surface user and not the mineral owner that has priority pertaining to the use of the land. In fact, the surface user does not have the priority, also referred to as the dominate estate. It is the developer of the Oil and Gas resource that possesses the dominate estate and not the surface user. Hence, if there are two competing proposed uses of the same land between the surface owner and the mineral owner, the mineral owner (the lessee) prevails.

One may ask why the surface user has only the subservient estate. Although the answer is not exactly the same for every state, the simple answer is that the forefathers of virtually state placed a premium on the development of natural resources. In many states, severance taxes and other mineral related taxes were and even today are significant financial resources to the government. These oil and gas ventures also create a multitude of jobs. Particularly during the periods of time when our law was evolving through both the legislature writing laws and the judiciary interpreting the laws, the governmental priority has always emphasized creating a financial and legal environment whereby the development of natural resources would be encouraged. Through the course of time, it has always been the lessee developing the Oil and Gas interest that has received priority as to land use. Accordingly, although each state varies slightly in their interpretation of the law involving the use of property in developing Oil and Gas resources, it is almost universal that it is the lessee that has the ability to reasonably use the surface of property to develop of oil and gas. While it is true that the lessee in most instances will be required to pay for any damages caused by its operations (for instance, crop damage) it is almost always the case that it will be virtually impossible to stop the development of oil and gas on a given leased property.

RULES OF INTERPRETATION

It is also important to understand that there exist many rules of interpretation pertaining to contracts. An Oil and gas lease is merely a specific type of contract. One of the most significant rules of legal interpretation involves the emphasis that the law places on drafting documents in a clear and unambiguous fashion. All contracts are interpreted such that any ambiguity in a contract is interpreted against the person who drafted the contract. The question of who drafted the contract can often become a disputed issue of fact (as too the issue of whether a clause or term is ambiguous), but the reality is that the vast majority of all Oil and Gas leases are drafted by either landmen

representing oil and gas companies or their attorneys. It is very unusual and almost unheard of that a landman will come to a prospective lessor and ask the landowner to draft an Oil and Gas lease.

THE PRODUCER'S 88

In the southwestern and western United States, many Oil and Gas leases are a variation of what is referred to as a "Producer's 88 lease." The term "Producer's 88 Lease" actually refers to a vast number of variations an Oil and Gas lease that has been in place for well more than 50 years. The significance is that all of these "Producer's 88 Leases" tend to be organized almost identically and always are biased toward the benefit of oil and gas lessees, not lessors.

EXAMPLES OF AMBIGUITIES

What otherwise might appear to be a rather simple issue of interpreting the terms of a granting clause can become very complicated. An example of this includes even the term "Oil and Gas" itself. Does "oil" include "casing head gas" produced with the well? If so, is such a "gas" or is it an "oil." Does the term "gas" include "condensate" which is formed as the gas stream is brought to the surface of the land? If so, is this correctly categorized as a "gas" or an "oil"? Does the term "gas" include non-hydrocarbon gases that often have commercial value such as carbon dioxide or helium"? Does the term "gas" include non-hydrocarbon constituents of the gas stream, an example being sulfur? Does the term "gas" include methane gas produced from a coal seam?

The potential issues created in the interpretation of the granting clause are endless. One obvious way to address these issues of interpretation would be to specifically define every term in the Oil and Gas lease. Unfortunately, few, if any, Oil and Gas leases, define these terms. Further, the attempt at defining these terms often results in as much, if not more, confusion than in not providing definitions. Because defining terms in a contract often creates more disputes than drafting definitions in the Oil and Gas lease, these type of disputes as to interpretation are typically resolved by definitions commonly used in the given industry, statutory law (to the extent statutory definitions exists in any given state) or case law where judges define a term. In an imperfect world, the key is to not try to necessarily solve every possible drafting problem in advance, but rather to be aware of the potential problem areas so as to be proactive if a problem does ultimately arise.

IMPLIED TERMS AND COVENANTS

Ambiguity exists not only pertaining to the actual words used in an Oil and Gas lease, but also in interpreting entire sections of the lease itself. To minimize ambiguity as a result of omission, Oil and Gas leases contain not only explicit terms, but implied terms as well. There exist three broad covenants implied in an Oil and Gas lease: 1) the covenant to develop the premises; 2) the covenant to protect the leasehold; and 3) the covenant to manage and administer the lease. In addition, while it is the granting clause that typically addresses easements and related rights of the lessee as well as the resulting burdens of the lessor's land, it is often the case that an Oil and Gas lease will be silent as to these issues instead relying upon implied covenant as to the right to use the leased land.

Implied terms include the implied right to make reasonable use of the surface to explore, develop, and produce the granted minerals or natural resources. Unfortunately, "reasonable" is often in the eyes of the beholder. There are many land use conflicts that specifically involve what is and what is not reasonable. Reasonable use is easy to determine in obvious cases. Reasonable uses include activities necessary to explore, develop and operate oil and gas wells. Reasonable use includes the right to use substances associated with the surface to develop the mineral estate (for example, drilling for water).

As to uses that are not reasonable, it is never reasonable use to utilize more of the surface than necessary, to unnecessarily impair the use of the surface, to use the land in a manner that unnecessarily damage the surface, or use the land to support operations to develop other properties not part of that specific oil and gas lease. The placement of a well in the middle of a rancher’s prime grazing land may or may not be reasonable based upon other numerous criteria.

GEOPHYSICAL AND SEISMIC ACTIVITIES

There also exist a whole host of issues involving exploration activities including geophysical exploration and seismic activities. Often, the Oil and Gas lease in the granting clause does not establish whether or not these activities are permitted. It is frequently less than clear as to whether or not the lessee has the authority to conduct seismic operations on the leased land, whether the lessor retains the right to grant the authority to parties other than the lessee, whether the lessee has a right to transfer the rights to conduct such seismic or other geophysical operations and, if so, who actually "owns" the

resulting data. A well written granting clause typically will specifically permit all techniques to locate oil and gas, including seismic operations. However, as oil and gas exploration becomes more intensive, there exists an ongoing dispute as to whether or not a lessor independent of a specification in a Oil and Gas lease can contract with a third party to conduct seismic activities.

THE HABENDUM CLAUSE

It is the Habendum Clause that defines how long the interest granted to the lessee will extend. Most Oil and Gas leases provide for a primary term (the option period that establishes the period of time during which the lessee retains the right to explore, develop, and produce as to the leased property without further obligation to do so) and the secondary term (an indefinite period of time during which oil and gas is actually being produced in paying quantities). It is failure of the lessee to perform consistent with the deadlines in the habendum clause that often results in termination of the lease.

PAYMENT

Finally, issues often arise as to payment. The payment received at the time of the execution of the Oil and Gas lease is rarely an issue. The amount of royalties received can be a very contentious issue because unless the term cost is well defined, there can be significant issues as to whether the amount of money received in the royalty check by the lessee is consistent with that agreed to in the Oil and Gas lease. Even when the term cost is well defined, there can be a host of accounting and bookkeeping issues.

LEASE TERMINATION

A classic tension in Oil and Gas leases exists under circumstances where the primary term of the term has ended with no production, but the oil and gas lessee wants to keep the Oil and Gas lease in effect. It is common sense that what the lessor is ultimately looking for out of its contractual relationship is the production of either oil or natural gas so as to benefit from the royalties, which can be lucrative. On the other hand, lessees often have large inventories of other oil and gas properties and merely because the lessor has not successfully discovered oil and gas reserves on a given property during the primary term of the lease is not indicative in any fashion that the property is not valuable for future development. Development can be delayed because of time and effort being spent by the

lessee on other fields or projects. The lessee might be waiting for the development of natural gas pipeline infrastructure before drilling on the property in question. There is an endless list of causes of delay. One circumstance currently causing delay is the shortage of drilling rigs. While there is ample capital available for oil and gas drilling, a significant constraint currently delaying development is that there are more drilling projects than available drills.

EXPIRATION OF THE PRIMARY TERM

By and large, the most frequent cause for lease termination is the expiration of the primary term. If the primary term of the Oil and Gas lease as set forth in the habendum clause expires without any production in paying quantities and there are no operations being conducted as to the Oil and Gas lease in question at that time, the Oil and Gas lease terminates.

At times, this is a very confusing period because unlike the beginning of a contractual relationship when an Oil and Gas lease is signed and the commencement date is well memorialized, the expiration of the primary term often occurs with little fanfare or notoriety. As set forth below, if you believe that your Oil and Gas lease has terminated, write your lessee and request a recordable Release of Lease.

FAILURE TO PAY DELAY RENTAL

An Oil and Gas lease may also terminate as a result of a failure by the lessee to pay delay rentals or shut-in payments. A word of explanation is warranted. The objective of the lease drilling-delay rental clause is to clarify that the lessee has no affirmative obligation to drill or otherwise explore during the primary term. This clause eliminates any argument that there exists an implied obligation on the part of the lessee to test, let alone drill, upon the premises in question. Before drilling-delay rental clauses became commonly used in Oil and Gas leases, many courts held unless specifically referenced otherwise in an Oil and Gas lease, the lessee has an implied duty to drill a test well on the leased premises within a reasonable time after the execution of the Oil and Gas lease. The logic for this was that there existed an implied covenant to drill that constituted consideration for the signing of the Oil and Gas lease by the lessor and that there thus existed an affirmative expectation that the property would be tested within a reasonable time.

The utilization of the drilling-delay rental clause eliminated any implied covenant to drill a test well because such was now

specifically referenced otherwise. Hence, in lieu of actually drilling, or lessee can instead elect to pay delay rentals. Lessors do not generally resist drilling-delay rental clauses because, often, they enter into Oil and Gas leases expecting any development to occur, if ever, near the end of the primary term. Courts typically hold lessors to a standard of strict compliance pertaining to the payments of delay-rentals. Courts typically have held even minor shortages or delinquencies in payments of delay rentals to result in the termination of the Oil and Gas lease. Payments made late by mistake or not made fully made by mistake will result in termination.

THE SHUT-IN ROYALTY CLAUSE

Along similar lines, most modern Oil and Gas leases also contain a shut-in royalty clause. This provides that the Oil and Gas lease will be maintained if a well capable of production is "shut-in." Here, oil and gas has been discovered and successfully drilled, but is not being produced and is said to be “shut in”. A shut-in royalty clause provides for constructive production, typically in the form of a shut-in royalty payment. The effect of the shut-in royalty clause is to provide a substitute for actual production as otherwise provided under the habendum clause. Failure to make a full and complete shut-in royalty payment is likely to result in the termination of the lease, particularly in states that follow the majority rule that "production" (as that term is used in the habendum clause) requires actual production in paying quantities.

FAILURE TO PRODUCE IN PAYING QUANTITIES

A third significant area resulting in the termination Oil and Gas leases involves the failure of the lessee to produce in paying quantities. Oil and Gas leases require "production in paying quantities" for the Oil and Gas lease to continue to be in effect after the primary term expires. Continuous operations extend the life of the lease indefinitely after the conclusion of the primary term, but only to the extent that the production is in paying quantities. Often it is fairly easy to determine whether or not there is production in paying quantities. If as the lessor you continue to receive royalty checks, such is a strong indication that the condition of production in paying quantities is being satisfied. If you were once receiving royalty payments and royalty payments are suddenly not being received, such is an indication that this topic ought to be investigated immediately.

DOES FAILURE TO PAY CORRECT AMOUNT RESULT IN OIL AND GAS LEASE TERMINATION?

Often the question is asked as to whether or not the failure to pay all royalties due under an Oil and Gas lease will result in the termination of the Oil and Gas lease. It is often the case that money is being received by the lessor, but because there exists an issue as to what are legitimate costs subject to deduction there soon occurs a dispute as to whether full payment of royalties was tendered by the lessee. Depending upon one's theory of recovery, a breach of contract can result in the termination of the Oil and Gas lease. Overwhelmingly, the result is not termination, but damages. The remedy for default is damages defined by the actual amount due minus the amount paid, plus interest. Generally, Court's are reluctant to terminate leases for two reasons. Firstly, the structure of the Oil and Gas lease language typically does not lend itself to such interpretation. Secondly, the payment of the disputed monies plus interest makes the lessor whole. However, if your Oil and Gas lease contains terms that permit the termination of an Oil and Gas lease, such is a possible remedy.

DRY HOLE ISSUES

The final circumstance where an Oil and Gas lease may terminate is a failure to produce a well in paying quantities within a stated time after drilling of a dry hole. Typically, a lessee will be allowed to continue the Oil and Gas lease after the primary term has elapsed by conducting what is referred to as "continuous operations." If prior to the conclusion of the primary term drilling has commenced, the lessee will have an opportunity to continue to move forward with exploration even though there has not been any production at the time of the expiration of the primary term. If later drilling on the leased property is successful, then a lessor would be looking forward to the receipt of royalties in the immediate future. However, where drilling is commenced at the very end of the primary term and the primary term has already expired prior to the conclusion of drilling that results in a dry hole, the lessee will continue to maintain a grace period in which to commence drilling another well if the lessee wishes to keep the Oil and Gas lease in effect. Under virtually all interpretations of the Oil and Gas lease, the lessee can continue to drill wells indefinitely under the "continuous operations" term of the Oil and Gas lease.

Typically, one of two things happens when drilling continues after the primary term, one good and one bad. The best case scenario for all involved is that a well ultimately is successful

in producing paying quantities of oil and gas so the lessor receives the benefit of a royalty check. The other alternative is not so good. Under the latter alternative, either the lessee loses interest in the property or the lessee simply runs out of money. Either way, no well in producing paying quantities results.

In the second event, the Oil and Gas lease terminates. Whether the lessor will be successful in contracting with another future lessee willing to conduct other drilling exploration on the same property is, of course, unknown.

WHAT TO DO IF YOU BELIEVE YOUR LEASE TERMINATED

If you believe that your lease has terminated, write your lessee and request a recordable Release of Lease. (A form is attached hereto.) If you receive an executed Release of Lease signed by the lessee, immediately record that document in the county records where the minerals and the leased property are physically located. This recordation will provide notice to all third parties that the Oil and Gas lease in question has terminated and the property is in such a condition to lease your property again. Always make sure to send the request for a recordable Release of Lease by certified mail, return receipt requested, or some other form of delivery where you can maintain proof that the document was received (for example, UPS or Fed Ex). If you do not receive a response in approximately 15 days, document the same with follow-up type letters, also sending these by either certified mail, return receipt requested, or other form of delivery that can be proven. Keep copies of all documents sent or received. If you receive no response whatsoever, contact an attorney or independent landman versed in Oil and Gas law to make certain that the leased interests are officially terminated.

CONCLUSION

Production of oil and gas is a business. It is very important as the lessor of oil and gas interests to make sure that you are treating your economic interest with the same professionalism as your lessee. Although such might be obvious, it always bears repeating that the property owner should make certain that he knows where his Oil and Gas leases are. It is my recommendation that individuals place these documents with other important legal documents such as wills, real estate deeds, etc. We are often amazed at how frequently our clients do not even know where their oil and gas documents are located.

In addition, it is important to have a working understanding of

your Oil and Gas lease. Although not part of this presentation, it is also important to have a similar working understanding of any Surface Use Agreement. Our definition of a working understanding is not necessarily the same as the detailed understanding that one would expect of a lawyer who emphasizes oil and gas law in his or her practice. A working understanding would, however, be an understanding as to the basic terms and conditions of the most significant portions of your Oil and Gas lease. If specific issues arise, mastery of those details can be secured at that point in time. Every Oil and Gas lessor should at least be able to be conversant as to the general principals of their lease and should calendar the important deadlines and understand the computation of compensation to which they are entitled.