OIL AND GAS LEASES

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NATURE OF OIL AND GAS LEASES

The purpose of this article is to trace briefly the origins of the typical oil and gas lease using the Producers 88 as illustrative of oil and gas leases generally. Other contributions to this symposium will treat at length particular provisions of oil and gas leases and how they function in practice.

No oil and gas lease can be described as typical or even typical of a particular geographical area. What has been regarded as a standard Producers 88 and the Midcontinent Oil and Gas lease are neither standard nor typical as those terms are commonly understood. However, a review of various lease forms, both past and present, reveals some similarities running through all. Before examining these, however, we must survey the origin, history, and development of this vastly important natural resource.

Although oil has been known to man since antiquity, the commercial use of oil, apart from medicinal purposes, is a rather new development—a product of the past one hundred years. Kuntz traces the discovery of oil and gas in the United States back to 1629, although there appears to be ample evidence that oil and gas were known to the Indians, particularly in the eastern portion of the United States, before that date. Deposits of rock oil were recognized at least a hundred years prior to the first successful well, and, indeed, a number of maps both of Pennsylvania and Ohio indicated petroleum as early as 1755.[1] However, the late recognition of oil as a potentially valuable mineral resource influenced the type of lease form which was to be used in the first instances of commercial discovery.

Although drilling for oil and gas was an innovation of the post-Civil War period, use of crude oil as a nostrum preceded this by at least thirty years. Accounts indicate that as early as 1833, oil was collected and bottled for medicinal purposes under such headings as "American Oil" and "Seneca Oil."[2] Oil used as a part of folk medicine was invariably collected from an "oil spring" by the crudest methods and thereafter bottled, presumably with impurities.

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1 Kuntz, Oil and Gas § 1.3 (1962).

2 *Id.* § 1.4.

Since crude petroleum floats, the most common collection method was to skim a pond in which a significant amount of oil was present and strain the substance through one or more pieces of cloth, thereby reducing the number of impurities present. During this period the crude oil trade was not monopolized and anyone could collect whatever he needed.

In 1853 George H. Bissell apparently recognized the true value of a bottle of crude oil which was on display in a faculty office at Dartmouth College. Thereafter, Bissell formed the Pennsylvania Rock Oil Corporation in 1855 for the purpose of producing rock oil. Following the leasing of land on which an initial discovery was made, the company sent a former conductor for the New Haven Railroad to the site to commence drilling. Col. Drake and several associates proceeded to sink a shallow well which struck oil at a depth of 69½ feet. Thereafter, a number of wells were "spuded in." As might be expected, the price of petroleum fluctuated widely during the years 1861 through 1864 reaching a low of five dollars per barrel and a high of fourteen dollars per barrel.[3]

While natural gas had been known for some time, its value was not immediately recognized. In earlier times, gas was regarded as an unwanted by-product of crude petroleum, and lease forms contained little if any reference to the expectation of gas production. There are several accounts of natural gas being produced in Ohio, including an initial well near Kenyon College in Knox County. However, it was not until 1873, in the town of Fairview, Pennsylvania, that gas was first used for illumination.[4]

Although knowledge of mining and mining techniques were well advanced by 1890, a failure to appreciate the origins of oil and gas and the role which geology played in the accumulation of oil and gas led to much confusion as to whether oil and gas should be regarded as coming under the general theory of a "placer" deposit or a "lode" mining claim. This confusion was reflected in the federal government's policy of allowing the patenting of oil and gas mining claims in the Far West, particularly in the Little Buffalo Basin area of Wyoming. The "placer" claims were perfected as any other placer claim of this period by working at least annually to insure priority of claim. Although various theories were advanced in 1861 with respect to underground structures and their influence on the accumulation of oil, geology played little if any part in the role of shaping early oil and gas development. In the late 1800's practical observation tended to suggest that oil lay below the surface in dor-

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[3] *Id.* § 1.7.
[4] *Id.* § 1.10.

mant pools. Courts responded by recognizing a right in the fee owner to produce oil and gas as any other mineral resource.[5]

EARLY OIL AND GAS LEASES

Common sense dictated the coverage and terminology employed in early oil and gas leases in the United States. Since there was a perceivable difference between the production of minerals in place and oil and gas, mineral leases pertaining to lead, iron, and zinc were of little value as guidance. But the term "oil placer mining claim" was used in some leases, thus analogizing the lease of mineral rights in oil and gas to the artesian wells. In the case of the lease which purports to be the first oil and gas lease in the famous Oil Creek area of Pennsylvania we find:

> Agreed, this fourth day of July, 1853, with J. D. Angier, of Cherrytree township, in the county of Venango, Pa., that he shall repair up and keep in order, the old oil spring on land in said Cherrytree township, or dig and make new springs, and the expenses to be deducted out of the proceeds of the oil, and the balance, if any to be equally divided, the one-half to J. D. Angier and the other half to Brewer, Watson & Co., for the full term of five years from this date. If profitable.[6]

Still later we find the following lease, dated December, 1857:

> "to bore, dig, mine, search for and obtain" oil, salt-water, coal and all materials existing in and upon said lands, and take, remove and sell such, etc., for their own exclusive use and benefit, for the term of 15 years, with the privilege of renewal for same term. Rental, one-eighth of all oil as collected from the springs in barrels. . . . Lessees agree to prosecute operations as early in the spring of 1858 as the season will permit, and if they fail to work the property for an unreasonable length of time, or fail to pay rent for more than sixty days, the lease to be null and void.[7]

Still another lease form reads as follows:

> This agreement made and entered into at San Augustine, Texas this 12th day of August A.D., 1866, by and between M. Cartwright, of the first part, and B. T. Kavanaugh, of the second part, . [Witness:]
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> That the party of the first part for the consideration hereinafter expressed, leases and doth hereby lease to said party of

[5] Merrill, "The Evolution of Oil and Gas Law," 13 Miss. L.J. 281, 283-84 (1941).
[6] File, "The Oil & Gas Lease in the Midwest," 1959 U. Ill. L.F. 461, 482.
[7] *Ibid.*

> the second part, the privilege of mining for petroleum or rock-oil, on a certain tract of land in Jefferson County, Texas, known as follows....
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> The said lease is given under the following terms and conditions: The said Kavanaugh is to go upon the land and prospect for oil. If he finds prospects sufficiently encouraging to justifying boring he is to continue to enjoy the privilege until it is determined whether there is oil to be found there or not. If it is found in sufficient quantities to justifying boring, he is to continue to enjoy the privilege until it is determined whether there is oil to be found there or not. If it is to be found in sufficient quantities to justify working, the lease is to continue for twenty years with the privilege of using all necessary timber and material for carrying on the oil business. If no oil is found then this lease expires and is thereafter to be null and void. Should oil be found and the well worked, the said Cartwright is to receive one-tenth part of the oil, he furnishing the barrels for this portion to be delivered at the well. The said Kavanaugh is to proceed without delay to explore the land and if satisfactory prospects are found he is to commence boring as soon as it is in his power to do so and to prosecute the boring until oil is found, or it is known that it cannot be found (the work is to be so conducted as to determine within two months whether this lease is to be continued or not). In testimony whereof the parties have hereunto subscribed their names, this date written above.
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> M. Cartwright
> B. T. Kavanaugh[8]

Looking at these lease forms, one notices such terms as "rock-oil," which today would raise the question of whether or not the various hydrocarbons might be recovered and divided according to the lease-term itself. While the lease provided no specific time for prospecting to begin, the language "to go upon the land and prospect for oil" probably included a right to the reasonable use of the land for exploratory purposes. Note that the lease itself provided "with the privilege of using all necessary timber and material for carrying on the oil business." This provision was probably adequate when one recalls that a detailed geologic study was not used until the twenties and extensive electronic geophysical prospecting became possible only after World War II. The term "sufficiently encouraging" is used to enlarge on the privilege of continuing exploration and seems to us today very indefinite. However, it is to be remembered that the lessee probably had no interest in the land, at least there were very few who did, with the result that lessors in the past were somewhat more generous than they are today. Today, we use the term "paying quantities" rather than the more ambiguous term

8 Brown, Oil and Gas Leases 1 (1958).

employed in this lease, "sufficient quantities." Once oil was found in sufficient quantities, the lease ran for a fixed period of twenty years with a renewal provision based on the length of time in which oil and gas were produced. This latter expression is in widespread use today throughout the United States. The royalties provided under these leases were one-tenth of the oil found, with the lessor obligated to furnish his own containers and take his royalty in kind.

It was not until 1916 that the first real standardization of oil and gas leases came about in the Southwest. This was the so-called "Producers 88 Lease," a product of the Kansas City Blueprint Co. Although subsequent revisions of this lease caused it to be designated by various names, including "Producers 88—Special" and "Producers 88—Revised," many of the land-owners in the Far West were at best only semiliterate, and it is easy to appreciate why one well-known leaseform became widely accepted for leasing purposes. In many instances, lessors would look for the caption "Producers 88—Kansas Blueprint Co." as something of a hallmark.

Private Ownership of Oil and Gas

As mentioned earlier, it was not until the early part of the 1900's that geologists introduced into the oil and gas community the formation of hydrocarbons, the mechanics by which oil is trapped, and the forces which cause oil and gas to migrate. The fact that land owners and even the oil and gas industry had little knowledge of oil and gas in place added confusion to leasing procedures. Thus, in contrast with the mining entrepreneur, the oil and gas lessee did not have practical insight based on a knowledge of the resource itself. Lode mining of necessity entailed underground exploration. If the vein pinched out or expanded at any time, this could easily be recorded and plotted on maps. This was not possible in the case of oil exploration since the prospector remained on the surface and resorted to boring for information with respect to underground strata. Further, there is a fundamental difference between the subsurface topography found in the oil and gas producing areas and that topography which is involved in hard-rock mining. Oil and gas deposits are found in sand and limestone, largely soft-rock deposits; in contrast, nonferrous minerals are generally found in mineral veins in the form of sulphides and oxides.

In the beginning of the oil industry no single company dominated leasing activities. Such activities developed regionally and in ignorance of the nature of oil and gas with many early prospectors believing that the resource might be self-regenerating.[9] For example,

[9] Wood County Petroleum Co. v. West Virginia Transit Co., 28 W. Va. 210 (1886), cited in Merrill, *supra* note 5, at 282.

an oil well which dwindled in production might pick up after it was driven further or allowed to remain unused for a period of time. Some analogized the search for oil to that for water, insisting that only a prior claim had to be perfected in order for the claimant to get prior rights in the production from the pool.[10] Others saw the right to explore for oil and gas as related to dominion over the land, that is, the substance was regarded as *ferae naturae.*

These approaches and others led the courts to regard an oil and gas lease as a deed, land-lease, sale, license, an estate in land, or an estate in the substance. Real property terms such as servitude, chattel, and an interest in land were also used.[11]

Naturally, the rights of the lessee are clouded by varying legal theories as to the nature of an oil and gas lease. For example, the Ohio Supreme Court has held that a lessee was not entitled to sublease the surface to his employees for garden purposes.[12] Since federal and state regulations on the production of oil and gas were not developed until the latter part of the twenties and early thirties, it is understandable why these disputes raged and why there was such a discrepancy among courts in the treatment of what today might be regarded as a typical business instrument. One dominant theme, however, did persist during that period: The owner of the fee simple absolute held some sort of title or prior claim to that which lay beneath his particular property. This, coupled with the realization that control of surface was essential to the development of an oil and gas claim, led to the standardization of base forms, at least in terms of coverage.

As the Producers 88 lease and the Standard Mid-Continent lease have evolved through redrafting and judicial definition, the lessor is entitled to three particular benefits in a lessor-lessee relationship. These include: (1) a cash bonus, which is an inducement to enter into the lease contract; (2) delay rentals, under which the lessee holds the lease during its primary term without drilling; and (3) a royalty, generally expressed in the terms of a fraction—typically one-eighth of all oil and gas produced at the wellhead. Since the holder of a mineral interest, or fraction thereof, is entitled to all three benefits, his status is somewhat different from one who holds only a royalty interest.

WHO MAY LEASE?

Before discussing the various covenants contained in the typical oil and gas lease as it has evolved over the years, some thought

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[10] Kelley v. Ohio Oil Co., 57 Ohio St. 317, 49 N.E. 399 (1897).

[11] 1A Summers, Oil and Gas § 152, at 369-75 (perm. ed. 1954).

[12] Fowler v. Delaplain, 79 Ohio St. 279, 87 N.E. 260 (1909).

should be given to who may make a lease. The majority of the cases construing oil and gas leases have held that the individual must have a statutory capacity to enter into an agreement.[13] What constitutes statutory capacity, of course, varies from state to state; the general test being that the individual should have that capacity necessary to enter into the execution of a conveyance of real property.[14] Disability based on age varies from state to state, particularly with reference to married infants. Generally, a lease for oil and gas agreements of any sort entered into by an infant is voidable at his election upon reaching majority.[15] However, acceptance of contract benefits, such as rentals or royalties, upon attaining majority has generally been regarded as ratification of the instrument.[16] It is preferable when possible under the state statutes to have the agreement signed by a duly appointed guardian or parent and avoid the question of minority.[17]

In community property states such as Texas a married woman cannot convey real estate or an interest therein without being joined by her husband. The majority of states, however, require the wife to be joined with the husband in any lease or conveyance of the homestead.[18] It is preferable in all instances to have husband and wife join in the execution of leases, homestead or not, for a title examiner or any individual rendering a "division order" does not always know what property is a part of the homestead.

With the exception of a few states in the Southwest, an executor or administrator of an estate is powerless to lease property for oil and gas purposes during the period of administration.[19] Thus, for mineral lease purposes, every will should be carefully scrutinized to see what powers are expressly given to the executor or administrator.

If real property is owned by two or more individuals as tenants in common, most states allow one of the tenants to lease his or her interest with the lessee becoming a tenant in common with the other owners, at least as to the rights granted by the agreement. Although there does not appear to be a majority or minority rule on this point, one appears safe in observing that a co-tenant generally has the right to drill for oil or gas.[20] Should he realize

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13 Brown, *op. cit. supra* note 8, § 2.02.

14 *Ibid.*

15 2 Summers, Oil and Gas § 212 (perm. ed. 1959).

16 Shipman v. Conrad, 97 Okla. 216, 223 Pac. 183 (1924).

17 2 Summers, *op. cit. supra* note 15, § 214.

18 Masterson, "Marital Property Problems from an Oil and Gas Lessee's Standpoint," 4 Sw. L.J. 151, 152 (1950).

19 Brown, *op. cit. supra* note 8, § 2.06; 2 Summers, *op. cit. supra* note 15, § 215.

20 1 Kuntz, *op. cit. supra* note 1, § 5.3.

production, he must account to the co-tenant for the value of the co-tenant's share in production less costs of exploration and production. However, if he is unsuccessful in his venture, he does not have a right of reimbursement against the nonjoining co-tenants.[21]

The rights of the life tenant and remainderman with respect to the use of real property for the exploration and production of oil and gas are somewhat clouded. The common law provides that the life-tenants shall not commit waste, but shall be allowed to use the premises in a reasonable manner. Thus it has been advanced that the life tenant has a right to receive an interest in the proceeds from oil and gas produced on the premises and a right to exclude others from the premises. However, he does not have a right to drill or develop the estate where exploration is not under way when he comes into his estate.[22] By the same token, there are jurisdictions which hold that the remainderman has no right to grant an oil and gas lease on the theory that he cannot give a present interest in the property.[23] Thus, it is preferable to have both the life tenants and remaindermen join in the execution. In such instances, the lessee may pay into court bonus considerations and rentals and allow the parties to make their own arrangements as to the division of the amount paid.

An attorney-in-fact may enter into a valid oil and gas lease providing his power of attorney spells out his right to lease for oil and gas specifically. It should be recalled, however, that a power of attorney is revoked by the death of the grantor, consequently, proof should be obtained that the party owning the interest is alive at the time the attorney-in-fact executed the agreement.

Where a lease is granted by a corporation, one must be certain that the proper officers have executed the instrument. Normally the president executes the lease on behalf of the corporation and his signature is attested to by the secretary with the corporate seal attached. If a lesser officer executes the agreement, a title examiner may wish specific evidence of the authority of this individual to so act. Evidence, of course, may be obtained from the corporate bylaws, from a resolution by the board of directors, or from the statutes of the state in which the land is located or of the state of incorporation or both. Where corporate dissolution is pending, it is important for the person obtaining the lease to understand the affairs of the corporation. In some states title to the assets of a defunct corporation pass immediately to the stockholders, while in

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[21] *Id.* § 5.6.

[22] Kenton Gas & Elec. Co. v. Dorney, 9 Ohio C.C. Dec. 604 (1898) ; 2 Summers, *op. cit. supra* note 15, § 223.

[23] 2 Summers, *op. cit. supra* note 15, § 224.

others the equitable owners of the corporation have only beneficial title in the assets of the corporation.

Leases granted by municipal and charitable bodies present difficulties for state and local bodies can and often do lease property for oil and gas purposes. A title examiner for an oil or oil pipeline company will, in all likelihood, wish to examine the deed by which the municipal subdivision obtained title. Most conveyances to cities, at least in the Midwest, carry with them the mineral rights, including the right to prospect for oil and gas. A more difficult question is presented where the municipality is located on a seashore and there is a question as to the ownership of the tidelands.[24]

In general, a religious institution has a right to lease its property for the purposes of producing oil and gas. Courts have acknowledged the need of spiritual organizations for financial support and have construed "church purposes" broadly when the gift would fail should the church no longer use the property for religious purposes. However, the majority viewpoint seems to be that a church may not lease a cemetery site for geophysical exploration purposes or production activity.[25] In general, the owner of a cemetery lot or an individual who has a loved one buried there has a right to appropriate equitable relief. It would appear that production derived from pools beneath cemetery tracts may be accomplished by directional drilling with the institution receiving a pro rata share of the oil and gas produced.

Evolution of Delay Rentals

Since most early leases were entered into in contemplation of an immediate plan of exploration and drilling, the oil and gas lease which evolved reflects this early approach. However, by the early 1900's, the desirability of acquiring and holding large blocks of acreage to facilitate conducting a field exploratory program became clear. This, of course, was contrary to the purpose of the early leases, even those which did not contain express covenants with respect to development at an early date. Further, many courts construed agreements which were silent as containing an implied covenant to commence operations as soon as feasible. To offset this implied covenant with respect to early exploration, a number of lease forms were modified to provide for an annual rental in lieu of im-

[24] See Reclamation Dist. No. 108 v. Gibson, 63 Cal. App. 2d 311, 147 P.2d 80 (Dist. Ct. App. 1944); Stone v. City of Los Angeles, 114 Cal. App. 192, 299 Pac. 838 (Dist. Ct. App. 1931).

[25] Houston Oil Co. v. Williams, 57 S.W.2d 380 (Tex. Civ. App. 1933); Cochran v. Hill, 255 S.W. 768 (Tex. Civ. App. 1923).

mediate development activities. Initially, no-term agreements were not enforced against the lessor in a number of jurisdictions; notable among this group was Indiana.[26] Around 1800 two types of delayed rental provisions appeared: One was termed "drill or pay," the other, "unless."[27] The widely-used drill or pay lease, was for a fixed term—usually ten years—and as long thereafter as production continued. During the fixed or primary term the lessee agreed to pay a stipulated annual rental until development was commenced. After the courts held that the lessor might sue either to cancel or to recover rents, lessees added a surrender clause providing that the lessee might at any time release the lease and avoid any obligation to pay rentals. Lessees, of course, took a very dim view of being obligated to pay delay rentals after the leasehold had been condemned as a dry hole. Some surrender clauses required a cash consideration to be paid at the time of surrender, while others did not.

Following *Brown v. Wilson*,[28] in 1916, there was great concern as to whether or not a lease with a surrender clause became terminable at the will of either party following the first year, for the court considered the bonus payment as support only for the first year and not for the entire primary term of ten years. Out of *Brown* came a movement on the part of Oklahoma attorneys to redraft the "unless" clause and add a down-payment clause which, in effect, would provide sufficient consideration for the option to pay delay rentals. Their efforts prevailed and today most lease forms may be traced to this original redraft of the earlier drill-or-pay clause. When *Brown v. Wilson* was overruled two years later, the new "unless" clause had already gained widespread acceptance.[29] New requirements of the industry have seen the addition of pooling clauses, shut-in-gas clauses, authorization of seismic activities, and other additions to the form, but the basic approach has not changed.

Clauses Found in the Typical Midwestern Lease

The typical lease form is captioned "Oil and Gas Lease" with perhaps the term "Producers 88—Rocky Mountain" in the upper left-hand corner. Thereafter one finds introductory recitations with respect to the date in which the lease is signed, the parties involved, and sometimes, although not generally, the place at which the lease was executed. In contrast, a typical deed of mineral interests gener-

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[26] File, "The Oil and Gas Lease in the Midwest," 1959 U. Ill. L.F. 461, 463.

[27] *Id.* at 463-64.

[28] 58 Okla. 392, 160 Pac. 94 (1916). *Brown v. Wilson* was later overruled in part by Rich v. Doneghey, 71 Okla. 204, 177 Pac. 86 (1918).

[29] File, *supra* note 26, at 464.

ally starts out with a recitation of the grantor, the place, and the consideration—a more abbreviated form. Generally there follows a number of covenants concerning the mode and manner of oil and gas production. The name of the lessor should appear in the body of the lease and he should be sufficiently described to make identification clear. Although this is the better view, in practice, for reasons unknown to this author and commented upon by others,[30] the contracting party is usually identified by his name only.

The date, which is generally given in the introductory recitation, is also important. While the lease is not effective until delivery, the initial date given sets forth the period for performance and duration of the lease. This is particularly important since it controls the running of the primary period, whereby the lessee will be held by delay rentals should no production be obtained. However, if the lease is undated it will still be valid and the term will commence upon the date of delivery.[31]

Granting Clause

Early leases were generally silent as to any rights which a lessee might enjoy beyond the right to explore for and produce oil. Today, however, the granting clause does provide for additional rights and powers. A typical clause states:

> the exclusive right of mining, exploring by geophysical and other methods and obtaining for and producing therefrom oil and all gas of whatsoever nature or kind, and the laying of pipeline, telephone and telegraph lines, housing and boarding of employees, building tanks, power stations, gasoline plants, ponds, roadways, and structures thereon to produce, save, market and take care of said products and the exclusive surface and sub-surface rights and privileges relating in any manner to any and all such operations and any and all such other rights and privileges necessary, incident to, or convenient for the economical operation alone or upon jointly with neighboring tracts for such purposes . . . .[32]

Sixty years ago, however, the phrase "the right to mine and produce oil and gas" was sufficient. It contemplated the lessee's moving on the premises and attempting to bore for oil and gas with little or no exploratory work. Counsel for lessees generally sought to broaden the traditional grant of power by adding language to

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[30] Barnsdall v. Boley, 119 Fed. 191 (C.C.N.D.W. Va. 1902); 2 Kuntz, Oil and Gas § 22.2 (1964).

[31] 2 Kuntz, *op. cit. supra* note 30, § 22.27, at 115.

[32] See Moses, "The Evolution and Development of the Oil and Gas Lease," Second Annual Institute on Oil & Gas Law and Taxation, Southwest Legal Foundation 1 (1951), for the history of the lease.

the effect that the rights granted included the rights to perform geophysical and other types of exploratory work prior to attempting recovery of oil and gas from the leasehold estate. By the same token, draftsmen of the newer leases added additional rights with respect to the production and storage of oil and gas once it was produced, including the right to install pipelines; the right to use the leasehold estate in connection with adjacent tracts of land for pipeline gathering systems; and the right to install communication lines, such as telephone and telegraph lines.

With the discovery of uranium in commercial quantities in the Rocky Mountain area in the early fifties, a number of oil and gas producers decided to expand the granting clause to include the right to prospect for and mine fusible source materials. It was conceded that the typical Producers 88—Rocky Mountain form did not include the right to produce uranium from property leased exclusively for oil and gas purposes.[33] It is difficult to determine with any accuracy the extent to which this particular lease form variation is used.

If other minerals are to be included in addition to oil and gas, the caption should state: ". . . for oil, gas, and other minerals." The draftsman should include additional references and perhaps an elaboration of these mineral rights in the lease itself. These rights might be mentioned in the granting clause or in the habendum and rental clauses. The rental clause should refer to the percentage of royalty which shall be paid on minerals produced and where the percentage shall be paid. These references become important when one understands that the royalty owner under an oil and gas lease normally obtains the value of the product extracted from his leasehold estate at the wellhead. He generally takes the current field value of the product. In the case of uranium, where the market has been altered by the fluctuations of government use, it would be wise to specify whether the royalty shall be in kind or at an established price and whether it should be at the mine site or at the nearest reduction facilities. At least one state, North Dakota, has a statute specifically stating that uranium, cobalt, clay, and gravel must be specifically mentioned if they are to pass either by mineral deed or lease.[34]

The importance of spelling out these terms becomes particularly important when one considers the three traditional types of granting clauses. The exclusive-right type has traditionally been worded in these terms: hereby grants to the lessee his heirs and assigns, the *exclusive right* to mine and produce from the following described

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[33] See Symposium on Uranium Mining Law, 27 Rocky Mt. L. Rev. 373 (1955).

[34] N.D. Cent. Code § 47-10-24 (1960).

land, *petroleum and natural gas* with possession of so much of such land as may be necessary for such purpose. The second type is the lessor-let type which provides that the lessor grants to the lessee the *right to enter* upon the land for the purpose of mining and operating oil, gas, and other minerals. The third is the conveyance-of-title-in-place type, whereby the lessor purports to convey to the lessee all oil and gas in and under the particular premises. The second type, the lessor-let type, raises a number of questions as to the lessee's right to explore for minerals other than oil and gas, while the third type, the conveyance-of-title-in-place type, is by its language more exclusive and therefore might well preclude coverage with respect to hard and soft rock deposits other than oil and gas.

While the nature of the estate created is important, and the words by which the grant is made are in many instances controlling as to whether or not the lease shall be solely for the purpose of exploring for and producing oil and gas, the description of the estate conveyed in the granting clause is of equal importance. In general, the law relating to descriptions in deeds is applied to oil and gas leases. Since the exploration for oil and gas is pursued in remote areas and under generally unfavorable conditions, a Mother Hubbard clause has been added to the typical lease. This clause is designed to pick up any small adjacent tracts of land owned by the grantor, but perhaps inadvertently left out of the grant due to improper descriptions. Included under the Mother Hubbard clause would be unnamed lanes, roadways, survey errors, and fenced in roads (by adverse possession). With the advent of state conservation laws and of field-wide producing units the importance of the Mother Hubbard clause has been somewhat diminished. However, at one time it was possible for a stranger to acquire the narrow strips of land which had been left out of leases and to then drill a number of wells on these pieces of property, thus milking the supply. Presumably, the Mother Hubbard clause would pick up property which had previously been under water, such as abandoned river beds and lake beds where there had been a prior conveyance by the owner of all lands up to a particular body of water. Today, the Mother Hubbard clause is an accepted adjunct to the granting clause and provokes few if any problems.

The Habendum or Term Clause

Unlike many portions of the lease form, the habendum clause was one of the earliest requirements. In many leases, it reads as follows: It is agreed that this lease shall remain in force for a term of —— years from this date, and as long thereafter as oil or gas, or either of them is produced from said lands by the lessee. Wording such as this is typical throughout the United States today.

After some experimentation the typical long definite term was uniformly abandoned in favor of a shorter flexible term: twenty to twenty-five years and as long thereafter as oil and gas is produced from the leasehold estate. Lessors, by and large, did not even care for a term of this length; consequently it was shortened to a term of five to ten years. Some of the earlier leases provided that the lessee was to commence drilling as early as possible or within a certain specified time and continue the development of the acreage until success or abandonment. This proved to be a difficult provision for lessees with the result that there was eventually devised the term "drill or pay" which evolved into the "unless" clause.[35]

It is to be recalled that the granting clause fixes the nature of the estate granted; the term clause, its duration. Since the term clause defines and terminates the estate, equitable consideration should not extend the lease beyond the date fixed by the lease for expiration. By and large, the courts have strictly enforced this particular clause in the oil and gas lease.[36] However, some courts have granted relief where no production was available to sustain the lease, but where the lessee was diligent in his drilling operation at the date of expiration.[37] In an attempt to avoid the harshness of this particular clause, a provision has sometimes been added which provides for continuation of the lease if the drilling operation is being diligently pursued on the last day that the lease is in force.

The picture is further complicated by a rather typical clause which provides for extension of the lease for as long as drilling operations are in progress or production is continuing. This leaves open the question of whether or not reworking, deepening, or other operations will support a lease and avoid termination. A number of writers have pointed out that even with a provision for sustaining the lease through drilling operations, a dry hole would work a hardship on a producer where it causes the expiration of a primary term and not allow a second try even where information obtained from the first well would require a prudent operator to do additional work.[38] Further, some lease forms provided for continuation of the primary term only if oil and gas is produced in paying quantities. Other lease forms require that there actually be drilling on the last day of the term if the lease is to be held, as opposed to an operation

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35 See text accompanying *supra* note 27.

36 See Veasey, "The Law of Oil and Gas, IV," 19 Mich. L. Rev. 161 (1920); Walker, "The Nature of the Property Interests Created by an Oil and Gas Lease in Texas," 8 Texas L. Rev. 483 (1930).

37 File, *supra* note 26, at 467.

38 Brown, Oil and Gas Leases § 5.02 (1958); 2 Summers, Oil and Gas § 300.1 (perm. ed. 1959).

preparatory to drilling. It would appear that under the Producers 88, the commencement of a drilling operation, the movement of equipment to the drilling site, or work on the erection of a derrick is sufficient to sustain the leasehold estate.

A problem that has plagued the courts is the construction of an habendum clause which provides for a primary term followed by a provision extending the term if oil and gas is discovered, and so long thereafter as such substances are produced in paying quantities. By and large courts have held that the terms "produced" and "discovered" are not synonymous and that although only the term "discovered" is used, basic fairness requires that the lessee have a reasonable length of time for development.[39]

Another interesting variation of the language of the habendum clause is found where a short primary term is followed by "or said premises developed or operated." Here one court found that the wording was such as to support a construction which would allow a primary term to be extended until a well, which was being drilled at the date of expiration of the primary term, is completed.[40] The construction of the term "in paying quantities" is complicated by two situations: First, when the tender of the royalty check follows what is regarded as a reasonable time; and, second, where there is no market for the particular product such as gas and the well is shut-in awaiting market. The latter situation can easily be handled by a shut-in-royalty clause in the lease. This clause will be considered later.

A more interesting question is presented where the lessee encounters oil and gas in producible quantities during the course of the drilling operation, but elects to drill to a deeper depth to test other areas before electing to produce from a particular pay zone. While different rules apply in different jurisdictions a reasonably prudent operator in this situation would obtain a release from his lessor in order to protect himself. Somewhat akin to this problem is where there has been a temporary shut-down of a drilling operation or a temporary cessation of production through circumstances outside the control of the lessee. In general, the courts appear reluctant to forfeit a lease in such a situation. For example, the Supreme Court of Arkansas has held that where production was discontinued because of the infiltration of salt water, forfeiture would not be allowed in view of the fact that the lessee was spending large sums of money in the hope of protecting what he considered to be a valuable lease.[41] In general, courts seem to hold that unless

39 2 Summers, *op cit. supra* note 38, § 300.

40 Prowant v. Sealy, 77 Okla. 244, 187 Pac. 235 (1919).

41 Reynolds v. McNeill, 218 Ark. 453, 236 S.W.2d 723 (1951).

there is a willful abandonment of the lease, temporary cessation of either development, operation, or production will not render a forfeiture.

The Royalty Clause

Perhaps the most important clause in the standard oil and gas lease from the lessor's point of view is the royalty clause. Literally, royalty refers to the payment which the crown could demand for a specific portion of the minerals discovered under a grant from the crown to explore. Since it was the common practice in Europe for minerals to be reserved for the crown, the crown alone might grant a concession to mine for mineral substances. As used in the common gas and oil glossaries, the term "royalty" is defined as the share in the fruits of the enterprise which go to the owner of the land or the mineral interest owner and which represent a payment to him for the right to develop the property for oil and gas. Generally, the term does not include delay rentals or bonuses. It has been regarded by some courts as synonymous with mineral rights.

Historically, the amount which was payable to the lessor for the right to drill upon property varied from one-half to one-fourth of the oil produced. However, the one-eighth fraction has now become standard. This amount affords the operator the prospect of a reasonable profit and at the same time encourages exploration.

A typical Producers 88 lease contains three references to royalty:

(1) To deliver to the credit of the lessor free of cost, in the pipelines or tanks in which he may connect his wells, the equal one-eighth part of oil produced and saved from said leased premises.
(2) And where gas only is found one-eighth of the value of all raw gas at the mouth of well, while said gas is being used or sold off the premises, payment for gas so used or sold to be made monthly.
(3) To pay the lessor for gas produced from any oil well and used off the premises one-eighth the value of the raw gas at the mouth of the well, payment for gas so used or sold to be made quarterly.

In general, there has been little change in the way in which the royalty interests have been expressed over the years. Usually the lessee agrees to supply the lessor with his royalty in kind. Since few lessors would have any use for crude-petroleum products, the lessee usually sells the lessor's royalty-interest oil either to the lessee's company or to a crude oil purchasing company through a device known as a division order. A division order is similar to a title. An

attorney examines the title to establish the rights of the respective parties in the product which is obtained in the leasehold estate. The division order also reflects all variations of ownership in the oil and gas produced in the leasehold estate, including interests which may be burdened. Lessors seldom take their royalty oil in kind and courts have generally upheld contracts requiring the lessor to sell his royalty oil at the prevailing market price to the lessee or a subsidiary of the lessee.[42]

The majority view obligates the lessee to market the lessor's oil, unless the lessee is otherwise directed to dispose of it. In a sense then, there is an implied duty on the part of the lessee with respect to the marketing of the lessor's royalty oil.[43] Since earlier forms were silent as to the responsibility of the lessor to treat royalty oil in order to make it a marketable grade, the later contracts expressly included a solution. Although the authorities are divided, it appears that the better view requires the lessor to bear his proportionate share of the cost of preparing the oil for market.[44]

An additional problem is presented where the field is new or remote and the lessee cannot abate gas production. The leading case in this area is *Molter v. Lewis*.[45] The court held that it was the duty of the lessee to provide transportation for the oil without cost to the lessor, contingent upon a failure to have pipelines connected from the producing wells to a purchaser. Failing to provide such connections, the lessee was obligated to make a reasonable effort to transport the oil by truck to a place where it could be received. However, the lessor was required to pay the reasonable charges for such transportation out of his one-eighth share of the oil. Similarly, a Wyoming case held that the lessor was entitled to the value of gas where it entered the pipeline and not where it emerged from a privately constructed pipeline some ninety miles in length.[46]

Gas Royalty Clause

Since natural gas has only recently acquired economic value, it is not unusual to run across an older lease which provides for a flat annual royalty of from fifty to one hundred dollars per gas well in lieu of a fractional percentage of gas produced at the wellhead. Since Northern markets have developed, gas is no longer regarded as a nuisance and has assumed considerable importance to the oil

[42] See Sullivan, Oil and Gas Law 124-49 (1955), for a full discussion of the distribution of royalty.

[43] 2 Summers, *op. cit. supra* note 38 § 400.

[44] 3A Summers, Oil and Gas § 590, at 144-45 (perm. ed. 1958). *Contra,* Merrill, Covenants Implied in Oil and Gas Leases 214-19 (2d ed. 1940).

[45] 156 Kan. 544, 134 P.2d 404 (1943).

[46] Kretni Development Co. v. Consolidated Oil Corp., 74 F.2d 497 (10th Cir. 1934).

and gas industry. Because the percentage of crude petroleum granted as a royalty is seldom the subject of serious negotiation; parties have tended—with the increase in value of natural gas—to fix the royalty on gas as one-eighth of all natural gas produced in lieu of an increase in the flat payment. This provision is sometimes modified with royalty being expressed as one-eighth of the amount realized from the sale of the gas.

Wet Gas

A more difficult problem is encountered when wet gas is produced from a leasehold estate. Wet gas is a hydrocarbon-saturated form of natural gas which requires processing prior to its introduction into the gas lines. What is extracted from wet gas is a form of gasoline and the plants which clean the gas are called scrubbing plants. If the royalty is expressed as one-eighth of the price received by the lessee for the gas from a particular well, then difficulty is encountered where the lessee has erected a gasoline plant, cleaned the gas, and marketed the liquid hydrocarbons. Is the lessor entitled to one-eighth of the value of the gas prior to or after scrubbing and if a sale of the residual hydrocarbons results, is the lessee entitled to a percentage of the proceeds? In *Armstrong v. Skelly Oil Co.*,[47] the court held in favor of the lessee on both issues finding that the lessor was entitled only to the value of the gas at the well and not the value of the gasoline extracted in the plant erected by the lessee, and that the lessor was not entitled to one-eighth of the value of the residual gas.

In *Armstrong* the lessee sold the residual gas to a carbon-black plant in exchange for one-half of the returns from the sale of carbon black. Lessee in turn distributed one-eighth of its fifty per cent to the lessor. Some cases are not in accord, however, with this particular interpretation.[48]

Further, one state has held that where the lease is silent as to royalties on casing-head gas, lessor has no interest in that gas.[49] As a consequence, it is not unusual to find the lessor entering into specific contracts with respect to the production and marketing of products derived from casing-head gas. Other distinctions have been made on the basis of whether or not the casing-head gas is a product of the oil well or the product of a gas well. This is a tenuous distinction and the preferable way to handle this is to provide for a specific royalty in the lease itself. Thus, the following provision may be included in the lease: for casing-head gas when

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[47] 55 F.2d 1066 (5th Cir. 1932).

[48] See, *e.g.*, Coyle v. Louisiana Gas & Fuel Co., 175 La. 990, 144 So. 737 (1932).

[49] Ludey v. Pure Oil Co., 157 Okla. 1, 11 P.2d 102 (1931); Mullendore v. Minnehoma Oil Co., 114 Okla. 251, 246 Pac. 837 (1926).

sold or used off the premises 25 dollars per year for each well, payment for gas to be quarterly in advance.[50]

A further question is raised with respect to the nature of distillate, which is a liquid produced from gas wells and which has generally been thought to be a product of a temperature change. Since distillate differs in chemical composition it has presented some problems with respect to the royalty clauses of the lease form. Part of the confusion stems from whether or not distillate exists in a liquid or a gaseous state below ground.

The preferred way to draft a lease for a well wherein distillate may be recovered is to provide specifically in the gas royalty clause that this royalty embrace "gasoline, whether recovered by drips, absorption or otherwise," [51] and an agreed payment which does not mention how the product is to be recovered. If the parties wish to go further, they may provide for termination of the one-eighth royalty on all gass produced (including all component parts); and provide that upon the use of gas or its sale off premises "such royalty shall cease, and instead, the lessor shall be paid one-half of one cent (½ of 1¢) per thousand cubic feet of such gas production, including gasoline, whether recovered by drips, absorption plant or otherwise, corrected to two pounds (2 lbs.) above atmospheric pressure.[52]

Shut-in Gas Royalty Clause

Where there is no market for the product of a gas well or where a state conservation commission has ordered it shut-in, a lease may be held under the appropriate clause by the tender of a shut-in royalty. Such a clause constructively presupposes that gas is being produced from the leasehold estate in paying quantities so as to meet the requirements of the habendum or term clause of the lease. Actually, there have been few cases interpreting this particular provision for its intent is clear and consistent with public policy.

The Drilling and Delay Rental Clause

In the early days the oil and gas lease forms did not specifically provide for the payment of "rentals" as the term is used today. Consequently the lessee was obligated to develop the property as soon as feasible or forfeit his lease.[53] Thus, prior to the inclusion of delay

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[50] Magnolia Petroleum Co. v. Connellee, 11 S.W.2d 158, 159 (Tex. Civ. App. 1928).

[51] Sullivan, Oil and Gas Law 138 (1955).

[52] File, *supra* note 26, at 469.

[53] Roy v. Arkansas-Louisiana Gas Co., 200 La. 233, 7 So. 2d 895 (1942).

rentals a lessee could not accumulate acreage to justify a field-wide drilling campaign, but had to explore for oil and gas following the signing of the lease.

Although the lessor has an obligation to enter the leasehold estate and explore for oil and gas, he might defer doing this by the addition of a clause which allowed him to pay a consideration for the right to defer exploratory operations. This provision became known as the "delay rental" clause, although it was not rental per se. The provision is not for the purpose of using the property but for the privilege of deferring exploratory operation.

Following the introduction of the delay rental clause, there appeared in common use a lease form which provided that the lessee should drill or pay a rental within a certain period of time. Unfortunately, this form did not provide expressly for forfeiture in the event of failure to drill or pay, and the courts were reluctant to impose such a forfeiture.[54] This, of course, left the terms of the lease uncertain.

Following *Brown v. Wilson*[55] this form of lease fell into disuse and this in turn led to the adoption of the "unless" provision in the lease form. Since the "unless" clause is one of limitation, there is an automatic termination of the leasehold estate upon failure to drill unless there has been a tender of delay rentals. This means that each year an oil and gas producer has three alternatives available to him: He may drill, pay delay rentals, or abstain from either and allow forfeiture of the lease. Despite our rather complete knowledge of the history of early oil and gas lease forms and what led to their development, little has been uncovered as to why a lessee under an oil and gas lease would hold himself so strictly accountable for the payment of rental. Unless delay in payment is a result of a failure of closing a depository, loss of a payment in the mail, or death of the lessor, the leasehold estate will fail for non-payment of a delay rental.

Perhaps the most important aspect of the "unless" clause is the determination of when a well has been commenced. Under the "or" clause, the determination is simple: The required drilling is measured by the requirement that the well be completed on or before a particular date. If a majority rule can be advanced, actual drilling is unnecessary provided substantial preparatory operations are in progress making clear a commitment to drill at a particular site. Thus, if a producer were ready to "spud-in" a well, had cleared the location, and had delivered all the equipment to the well site,

[54] Brown, Oil and Gas Leases § 7.02 (1958).

[55] 58 Okla. 392, 160 Pac. 94 (1916), which was later overruled by Rich v. Doneghey, 71 Okla. 204, 177 Pac. 86 (1918).

then this would probably constitute the commencement of a well under the "unless" clause. Sufficient financial means and present ability to pursue the work would usually continue the lease if preparatory operations existed.[56] However, Ohio has held "too little too late" will not hold a lease beyond the primary term.[57]

Inadvertent underpayment raises the question as to whether or not the leasehold estate is preserved. Generally, where the lessor accepts payment and then holds it even though it is slightly less than the correct amount, the lease is not forfeited.[58]

Dry Hole Clause

The delay rental clause provides for the holding of the lease in the absence of drilling; the dry hole clause provides for the holding of the lease if drilling has come to an unsuccessful completion. A prudent operator may avoid any uncertainty as to forfeiture by tendering rental payments upon completion of the dry hole during the primary term of the lease. Such a tender, if received by the lessor, would place the parties back in the position which they were in prior to the commencement of the dry hole. However, some clarity is desirable and modern lease forms tend rather uniformly to provide a reactivation of rentals on the anniversary of the rental date fixed in the lease, which date in most instances is the same date the lease was dated and signed. The "unless" clause provides some uncertainty since the obligation is to either pay rentals or continue further drilling operations, unless the lease terminates by its own terms.

The picture is further complicated where exploration pursued during the first year of the primary term results in a dry hole. The question is whether or not the dry hole requires payment of the first-year rentals. Although the better view would seem to be that it should not, prudence again would dictate the tender of the first-year rental. Since producers typically try to defer drilling until the end of the primary term, draftsmen may insert the following provision: If a dry hole is completed and abandoned at any time during the latter part of the primary term no rental payment nor operations are necessary in order to keep the lease in force during the remainder of the primary term.[59]

If an oil and gas operator ceases production during the primary term, owing to failure of the well to produce, or if the lessee is

[56] McCallister v. Texas Co., 223 S.W. 859 (Tex. Civ. App. 1920).

[57] Hanna v. Shorts, 163 Ohio St. 44, 125 N.E.2d 338 (1955); Gisinger v. Hart, 115 Ohio App. 115, 184 N.E.2d 240 (1961).

[58] Woolley v. Standard Oil Co., 230 F.2d 97 (5th Cir. 1956); Buchanan v. Sinclair Oil & Gas Co., 218 F.2d 436 (5th Cir. 1955).

[59] Colby v. Sun Oil Co., 288 S.W.2d 221 (Tex. Civ. App. 1956).

required to plug a producing well as a result of a conservation order, the prudent operator will in all likelihood elect to commence rental payments in order for the lease to be held through the primary term pending the further exploration for oil and gas.

Lesser Interest Clause

Over the years prudent operators have included a clause which governs where the lessor owns less than a full fee simple estate in the property leased. Since leasing activities, generally under the direction of a division land department, take place well in advance of exploration for oil and gas, the company may not have an opportunity to examine title to the property. In its simplest form, the clause provides for an automatic downward adjustment in payments if the lessor owns less than he purports to convey.

The following clause has proved satisfactory in meeting this possibility:

> If this lease covers a lesser interest in the oil and gas right in all or any part of the leased premises than the entire and undivided fee simple estate herein (whether the lessor's interest is herein specified or not) or no interest therein, then the royalties, rentals and other monies accruing from any part of such full interest, shall be paid only in the proportion which the interest therein, if any, covered by this lease, bears to the whole or undivided fee simple estate therein.

The Entirety Clause

The entirety or so-called pro-rate clause is often confused with the lesser interest clause. An analysis of these two clauses will quickly show that they are designed to cover two different contingencies. The former covers the contingency where two individuals with adjacent tracts of property join in a single instrument purporting to convey the right to explore and produce oil and gas on the property as if it were a single tract of land. Such a clause governs where the original lessor, subsequent to leasing, subdivides his holding. In such a case the entirety clause would allow payment to the original lessor only if the producing well were located on his tract of land, or only to the extent of his interest in the tract upon which the well was located.

A typical clause is as follows:

> If the leased premises shall hereafter be owned in tracts, the premises, nevertheless, shall be developed and operated as one lease, and all royalties accruing hereunder shall be treated as an entirety, and shall be divided among and paid to such separate owners in the proportion that the acreage owned by each such separate owner bears to the entire leased acreage. There shall be no obliga-

> tion on the part of the lessee to offset wells on separate tracts into which the land covered by this lease may be hereafter divided by sale, devise or otherwise, or to furnish separate measuring or receiving tanks . . . .[60]

Since gathering and measuring facilities are expensive, no lessee is interested in setting up separate facilities if it can be avoided. Originally, the clause most frequently employed was the unrestricted pro-rate clause. This simply provided that each separate owner under the lease was to receive a fractional portion of the total royalty computed on surface acreage. Claims of abuses led to a revision of this clause with the result that the more typical clause today is the restricted pro-rate clause, which makes the clause applicable separately to each nonabutting tract. Tracts which have a common corner are to be regarded as abutting under this particular clause.

Problems arising under the unrestricted pro-rate clause tend to be problems exclusively of the lessee as opposed to the lessor since a full examination of title is required. Problems may also arise where a portion of the lease terminates. This clause should not be included in the average lease unless the situation dictates its inclusion.[61]

The Assignment Clause

A typical assignment clause contained in a Producers 88 lease starts out with an affirmation of full freedom to transfer with all subsequent takers being bound by the terms, both expressed and implied, contained in the lease. However, when the lease is assigned or a sublease is effected, the initial or assigning party, *i.e.*, the party executing the lease, is relieved of all secondary liability arising out of the default of the party acquiring the leasehold estate. Presumably, this would be important where there is an obligation to pay rentals, in the absence of a forfeiture clause. Uusally, there is a sentence or two early in the clause discussing the contingency of a sale by the lessor and the fact that such sale does not increase the obligation of the lessee with respect to maintaining separate measuring tanks. Although this is normally covered in the entirety clause, most draftsmen include the language also in the assignment clause. Some, but not all of the common clauses, contain express language with respect to the gathering system and measuring facilities. However, others rely solely on the statement that the lessee's obligation will not be enlarged by a subsequent sale.

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[60] Brown, *op. cit. supra* note 54, § 12.01, at 218.

[61] See Thomas Gilcrease Foundation v. Stanolind Oil & Gas Co., 153 Tex. 197, 266 S.W.2d 850 (1954).

Ordinarily, these initial sentences are followed by a sentence or two indicating that no change in ownership shall be binding upon the lessee until thirty days have elapsed following receipt by the lessee of such documents and instruments as he believes to be necessary in order to effect a change of ownership. This thirty-day period allowance undoubtedly stems from the fact that oil payments are many times initiated from the home office of an oil company, which may be thousands of miles away from the site of drilling and production. Such a clause also alleviates the necessity of paying a second rental in many instances.

The last sentence of the typical lease form reads as follows:

> If this lease is assigned or sublet in so far as it covers only a part of the acreage embraced in said lease premises, the delay rentals herein above provided for shall be apportioned to the separate parts, according to the surface acreage of each, and failure of the leasehold owner or a sublessee of any separate part of the above described land to make the rental payment with respect to such part shall in no event operate to terminate or effect this lease insofar as it covers any other part thereof.

This provision of course applies in place of other provisions which, in effect, state that drilling on any one part or separate tract insures to the benefit of all other tracts or parts. There would seem to be no conflict between these provisions since we are interested not in reducing obligations which the lessee may have either expressed or implied, but in the preservation of interest in a particular lease or portion thereof.

It is interesting to note that conflicts between this provision and the term clause have not caused any serious litigation. Perhaps the most interesting aspect of this particular clause is pointed out by Brown in *Oil and Gas Leases*, wherein he states:

> An interesting angle of rental divisibility was presented in the Texas case of *Young v. Jones* [222 S.W. 691 (Tex. Civ. App. 1920)]. There it was held that where a lessee assigned his interest in an oil and gas lease as to different . . . persons, who in turn assigned their interests to the same person, such person, holding title to all the lessee's interest, could not validly pay the rental on only a portion of the acreage covered in the lease and continue the lease in force as to that portion. The court said: "The fair and reasonable construction of this portion of the contract is that the option to pay rental upon only a portion of the land arose when the lessee had assigned to different persons different portions of the land in severalty . . . ." The court then proceeded to hold that the failure to pay the full amount of the rental terminated the entire contract. Although the court didn't specifically say so, it held in effect that a "merger" of interest was created by the delivery and acceptance of all the assignments and thereafter the

common assignee held directly under the lease contract itself rather than under each assignment.[62]

The distinction between the terms "assignment" and "sublease" in oil and gas leases is not clear. Part of this difficulty stems from the very nature of the financing of exploratory operations. However, an assignment contemplates a transfer of the entire leasehold estate, while a sublease contemplates that the original lessee may retain an interest in the leasehold estate. The court in *Robertson v. Pioneer Gas Co.*,[63] held that the reservation of an overriding royalty interest, *i.e.*, a royalty interest unburdened by the expense of development constitutes the transfer of a sublease and not an assignment. The *Robertson* court held that the transfer of the lease subject to an overriding royalty characterized the transaction as a sublease in this respect: Under Louisiana law, payment of a royalty is in the nature of a rent payment and not a payment for a conveyance. Since an overriding royalty interest is profit which a leasehound may obtain for his activities, little light is cast on the situation by looking at the nature of the transaction. Overriding royalty interests generally are found only in areas which have increased in value and where production is assured.

Most of the difficulty encountered with respect to this particular provision stems from reservations in the lease whereby an individual reserves the right of re-entry upon failure of performance by his sublessee. This tends to characterize the transaction as a sublease rather than an assignment, since in practice, the overriding desire for royalty allows producers to purchase acreage from leasehounds without paying cash. Thus, it is doubtful whether such a provision in the transfer should be construed as a sublease rather than an assignment.

The Pooling Clause

With the advent of field-wide conservation measures in the thirties, the adoption of a pooling clause became a necessity. This clause gives the lessee the right to pool all or a portion of his share of the lease with other lands, without the necessity of approaching the lessor or his assigns. The pooling of acreage does, however, have a material effect on many of the lessor's interests, *e.g.*, the right to receive royalty, the term of the lease, the terms of the delay rental and dry hole clauses. Perhaps the most important aspect of the right to pool is the fact that the lessee no longer finds it necessary

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[62] Brown, *op. cit. supra* note 54, § 11.03, at 202-03.

[63] 173 La. 313, 137 So. 46 (1931).

to pay delay rentals on one tract if this tract is pooled with acreage which is already producing or upon which a well has been started.

Although the lessor's interests have usually been protected by the courts under such clauses, abuses have and do continue to exist. The typical clause reads as follows:

> The lessee is hereby granted the right to pool or unitize this lease, the land covered by it or any part thereof with any other lands, leases, mineral estates, or other parts thereof, for the production of oil, liquid hydrocarbons and all gases and their respective constituent products or any of them.

Some safeguards, however, are generally attached to the pooling provision: (a) the acreage pool must be contiguous or involve a particular structure; (b) all units of forty acres, are subject, of course, to state and federal conservation measures; and (c) the unit may not be abandoned by the lessee when the unit is producing oil or drilling operations are in progress. With the advent of field-wide exploratory and producing units (both the divided and undivided type), the use of this clause has increased materially over the past twenty years.

The right to pool does not apparently violate the Rule Against Perpetuities. The question was raised in *Phillips Petroleum Co. v. Peterson*[64] wherein the court held that if the pooling were accomplished within a reasonable time, the clause was not invalid for remoteness. Lessors, particularly those who are receiving royalties, are justifiably reluctant to enter into pooling agreements whereby their interest or return will be diminished by the addition of those with unproven acreage or less productive acreage. This is why a number of draftsmen modify the standard pooling clause so that pooling for secondary recovery purposes may not be accomplished without the expressed permission of the lessor.

The most important aspect of the pooling clause is the effect on the term of the lease. By analogy, it would seem that if the lessor accepts a portion of production from the pooled area all of his lease should remain in effect, although no drilling activity has been commenced on the lease during the primary term.

In general, it would appear that the courts assiduously support pooling clauses under the theory that they effect a common good. The court in *Phillips* expressly stated that there is no cross transfer of interest among the royalty owners when the acreage is pooled. Rather, there is a relinquishment of certain rights in exchange for benefits received by the parties. Noting that title to each tract remained in the lessors and that they had merely entered into an

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64 218 F.2d 926 (10th Cir. 1954).

agreement with respect to the allocation of production, the court stated:

> Finally, there being no time fixed within which unitization was to be effected, it must be implied that the parties intended it to take place within a reasonable time, and a reasonable time, under the facts and circumstances, would be well within the limitation of the rule against perpetuities. Hence, had there been cross-assignments, the rule against perpetuities would not have been violated.[65]

While a number of oil and gas producers would have preferred a stronger opinion in the *Phillips* case, it is apparent that what is involved in a pooling agreement is a postponement of an enjoyment in an estate and not a cross transfer of royalty interest.[66]

Operational Rights and Restrictions Clause

Of considerable importance to the lessee is the provision contained in the standard lease which deals with the additional rights which the producer has with respect to the surface and certain resources used on the premises itself. Traditionally, this clause contains a statement that the lessee "shall have the right to use free of cost, gas, oil and water produced on said lands for its operations thereon, except water from the wells of the lessor." [67]

This provision was probably adequate prior to the advent of secondary-recovery operations on a field-wide basis. Today, gas and water are used on the premises in substantial quantities for the recycling operation and for water drives on oil reservoirs.

In the case of gas produced on the premises, the test would seem to be one of good faith and good judgment in its utilization, either for repressuring or for cycling activities. However, in the use of water, courts have indicated more stringent requirements to protect the lessor.[68] In general, the lessee is not permitted to take from stock ponds or other artificial reservoirs erected by the lessor. Except for the purpose of the drilling operation, the lessee must resort to water drawn from his own wells. As long as the use

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[65] *Id.* at 931.

[66] Jones, "The Rule Against Perpetuities as it Affects California Oil and Gas Interest," 7 U.C.L.A.L. Rev. 261 (1960); Kuntz, "The Rule Against Perpetuities and Mineral Interest," 8 Okla. L. Rev. 183 (1955); Lentz, "Some Problems Concerning Oil and Gas Leases and the Rule Against Perpetuities," 26 Dicta 341 (1949); Meyers, "The Effect of the Rule Against Perpetuities on Perpetual Non-Participating Royalty and Kindred Interests," 32 Texas L. Rev. 369 (1954); Morris, "Future Interests in Oil and Gas Law," Third Annual Rocky Mountain Mineral Law Institute 597, 630 (1954).

[67] Armstrong v. Skelly Oil Co., 55 F.2d 1066, 1067 (5th Cir. 1932).

[68] Brown & Myers, "Some Legal Aspects of Water Flooding," 24 Texas L. Rev. 456, 467 (1946).

is reasonable and the consumption takes place on the leasehold premises, the courts seem in accord that the lessee is entitled to use as much water as necessary for the drilling activities.

Clause Permitting Lessee to Remove Property

In addition to the clause which provides for free use of fuel, the lease form usually contains a clause covering the rights of the lessee to remove his property from a leasehold estate at any time during the lease or for a reasonable period thereafter. A typical provision would state that lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by the lessee on said land, including the right to draw and remove all casing.

In general, few if any problems are encountered with respect to the actual drilling equipment and casing; the rule is that this equipment is the property of the lessee and he has a right to remove it during the existence of the pending lease or within a reasonable time thereafter.[69]

Additional Covenants Which Benefit the Lessor

A common practice in the oil industry, particularly in the Southwest, requires the inclusion of three clauses favoring the lessor.

In the first of these covenants, the lessor requires the lessee to bury all pipelines below plough depth which is twelve inches. Some feel that there is no obligation to bury pipes below that depth. Though there have been few holdings on this point, such a provision is important, particularly in that new fields, such as those located in Ohio, are being drilled in areas in which the soil was being cultivated as opposed to areas in which there was little cultivation and the property was being used largely for grazing.[70]

The second covenant protecting the lessor deals with damage to growing crops. This provision is particularly important in Ohio since most land currently being leased has been under cultivation. Growing crops are defined as those crops which are a result of cultivation, planting, and labor.[71] Since tenant farming is not

[69] See Moses, "The Right of a Lessee Under an Oil, Gas and Mineral Lease to Remove Casing from an Abandoned Well," 19 Tul. L. Rev. 229 (1944); Note, 3 Okla. L. Rev. 111 (1950).

[70] See Cranston v. Miller, 208 Ark. 156, 185 S.W.2d 920 (1945), which did not apply the provision to shackle rods connecting a remote well with a powerhouse.

[71] Kennedy v. Spalding, 143 Kan. 76, 53 P.2d 804 (1936); Bernard v. Board of Supervisors, 216 Miss. 387, 62 So. 2d 576 (1953); Czerner v. Kerby, 53 N.M. 311, 207 P.2d 531 (1949); Moore v. Hope Natural Gas Co., 76 W. Va. 649, 86 S.E. 564 (1915).

generally practiced in the Midwest, less conflicts of interest among the surface owners, the exploration conductors, and the oil and gas producers arise than in other areas. In general, the surface lessee must recover from the produced for his damages rather than from the owner of the fee.

A typical third protective covenant in favor of the lessor reads as follows: "No well shall be drilled within two hundred (200) feet of any residence or barn now on said land without the lessor's consent."[72] As the wording suggests, this particular provision applies only to structures then in existence and, in general, the structures must be the principal dwelling place of the farm owner or tenant. The extent to which the lessee may use the premises for purposes which are related to oil and gas production without incurring liability appears to be an open question. Generally, if the lessee intends to use property adjacent to farm buildings for storage or for operations conducted off the leasehold estate, he should enter into a separate lease agreement with the owner of the fee or the surface lessee.

Another provision may provide that the lessor may use gas produced on the premises for the purpose of heating and lighting. This may be handled by a simple statement to the effect that the lessor shall have the privilege at his risk and expense of using gas from any gas well on said land for stoves and inside lights in the principal dwelling, out of any surplus gas not in use for operations.

Although a line of cases define what constitutes a principal-dwelling house under the lease,[73] few lessors use surplus gas to either illuminate or heat their dwelling houses.

Warranty Clause

Traditionally, warranty clauses vary widely in the scope of their coverage, even under the Producers 88 form. Perhaps the most expeditious clause is as follows:

> The lessor hereby warrants and agrees to defend the title to the lands herein described, but if the interest of the lessor covered by this lease is expressly stated to be less than the entire fee or mineral estate, lessor's warranty shall be limited to the interest so stated. Lessee may purchase or lease the rights of any party claiming any interest in said land and exercise such rights as may

[72] Clauses of this type are only limitations on the lessee's right to drill and not reservation of the mineral estate. See Westmoreland & Cambria Natural Gas Co. v. DeWitt, 130 Pa. 235, 18 Atl. 724 (1889).

[73] See Pittsburgh & W. Va. Gas Co. v. Richardson, 84 W. Va. 413, 100 S.E. 220 (1919); Harbert v. Hope Natural Gas Co., 76 W. Va. 207, 84 S.E. 770 (1915); Hall v. Philadelphia Co., 72 W. Va. 573, 78 S.E. 755 (1913).

> be obtained thereby but lessee shall not suffer any forfeiture nor incur any liability to lessor by reason thereof. Lessee shall have the right at any time to pay for lessor, any mortgage, taxes or other lien on said lands, in the event of default of payment by lessor, and be subrogated to the rights of the holder thereof, and any such payments made by lessee for lessor may be deducted from any amounts of money which may become due lessor under this lease.[74]

The most important function of the warranty clause is to include after-acquired interests into the terms of the lease—should the lessor at execution own less than a full estate in the mineral interest. This means that the lessor, if he receives a warranty or quitclaim deed, would later have further title rights inure to the benefit of the lessee. This is particularly important when there is a cloud on the title, for prudence dictates that the producer clear title prior to the expenditure of any large sums of money on the lease. The second portion of the warranty clause affords a lessee the right to correct any defects in the title without forfeiting the lease.

One variation of the Producers 88 form places the burden on the lessor, if at execution of the lease he owned less than a full estate, to inform the lessee in writing of any after-acquired interest in the property. The clause states:

> In case said lessor owns a less interest in the above described lands then the entire and undivided fee simple estate therein, then the royalties and rentals therein provided for shall be paid the said lessor only in the proportion that his interest bears to the whole undivided fee; however, such rentals shall be increased at the next succeeding rental anniversary after any reversion occurs to cover the interest so acquired, and lessor agrees to notify lessee in writing upon acquisition on any reversionary interest.[75]

This clause is also effective when the lease provides for a lump sum rental as opposed to a per-acre basis for computation and where the lessor purports to lease the entire mineral interest in the land. Here the lessee is entitled to reduce his payments to the extent that the payments reflect the lesser interest which the lessor in fact conveyed.

Many lease forms contain one additional provision: Should any one or more of the parties named above as lessors fail to execute this lease, it shall nevertheless be binding upon the party or parties

[74] 7 Summers, Oil and Gas § 1156, at 50-51 (Supp. 1965).

[75] The variation is also known as a proportional reduction clause. Where the producer is only obligated to pay on a per-acre basis, all he need pay is for the actual acreage leased by the lessor. Warfield Natural Gas Co. v. Cassady, 260 Ky. 548, 86 S.W.2d 276 (1935).

executing the same. Here the lessee is attempting to protect himself from the common law doctrine which, in effect, holds that where less than all parties sign an agreement, consideration fails since the court assumes the lessors are signing in reliance on the signing of all others.

One additional provision allows the lessee to surrender a portion of the lease to avoid rental payments for the surrendered premises. Needless to say, this particular clause is not always acceptable to lessors. This provision states:

> lessee, and lessee's successors and assigns shall have the right at anytime to surrender this lease, in whole or in part, to lessor or his heirs or assigns by delivering or mailing a release thereof of record in the county in which said land is situated; thereupon lessee shall be relieved from all obligations, express or implied, of this agreement as to the acreage surrendered, and thereafter the rental payable thereunder shall be reduced in proportion that the acreage covered hereby is reduced by said release or releases.[76]

Force Majeure Clause

The force majeure or governmental orders clause is relatively new, not having been anticipated by the earlier lease forms. In its simplest form, it provides that the lessee shall not be liable for delay or stoppage when such delay is occasioned by an act of God. This particular clause has been enlarged by judicial interpretation to include other contingencies which are beyond the control of the lessee. A provision relieving the lessee of any liability with respect to express or implied covenants where the cause of nonperformance is due to state or federal regulation has also been included in many lease forms. A typical expression in this connection would be the following:

> All express and implied covenants of this lease shall be subject to all applicable laws, governmental orders, rules and regulations. This lease shall not be terminated in whole or in part, nor lessee held liable in damages, because of a temporary cessation of production or of drilling operations due to breakdown of equipment or due to the repairing of a well or wells, or because of failure to comply with any of the express or implied covenants of this lease if such failure is a result of the exercise of governmental authority, war, lack of market, act of God, strike, fire, explosion, flood, or any other cause reasonably beyond the control of the lessee.[77]

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[76] See Young v. Jones, 222 S.W. 691 (Tex. Civ. App. 1920), with respect to "merger" of assigned acreage and the obligation to pay rentals.

[77] 7 Summers, Oil and Gas § 1156, at 51 (Supp. 1965).

Undoubtedly, wartime experience and the requirement of special permits to purchase pipe occasioned the adoption of this particular paragraph.

Haby v. Stanolind Oil & Gas Co.[78] suggests that draftsmen should require that the obligations of the lessee shall be temporarily terminated where there is an exercise of governmental regulatory authority. In *Haby*, the Texas Railroad Commission ordered a lease shut-in since the casing-head gas was being flared and thereby wasted. Stanolind, along with others in the field, was at the time engaged in the erection of a gasoline plant to utilize the casing-head gas. However, as a result of the order the lease was shut-in for a period of nine months after the expiration of the primary term without an effort by Stanolind to start a new well. The lease itself provided that should production cease for any cause, the lessee was obligated to commence a well or rework it within sixty days. The court noted that the starting of a well was not impossible and thereby found that the lessee had failed to perform by virtue of the lease language.

Since the acts of regulatory bodies are made without consideration for the obligations of the private parties to a lease, a broad force majeure clause would seem to be preferable. This position is probably reinforced by the rapid organization of employees of the oil and gas areas in the Far West with realization that labor difficulties may be forthcoming. It would appear that the force majeure clause does not recognize failure to perform based on economic impracticability.

Concluding or Catchall Clause

Today's lease form generally concludes with one or more clauses covering waiver of homestead and restating that the conveyance is not personal and is binding upon successors and assigns. What impact, if any, these two clauses have on existing practices remains doubtful. Their inclusion certainly would appear to be worthwhile and the language does not appear to provoke litigation. A typical clause reads as follows:

> This lease and all provisions thereof shall be applicable to and binding upon the parties and their respective successors and assigns. Reference here to the lessor and lessee shall include reference to their respective successors and assigns. Should any one or more of the parties named above as lessors not execute this lease, it shall nevertheless be binding upon the party or parties executing the same. Lessor hereby surrenders and releases

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[78] 228 F.2d 298 (5th Cir. 1955).

> all rights under and by virtue of the homestead-exemption laws of the state wherein the above lands are located insofar as the same may in any way affect the purpose for which this lease is made.[79]

In community property states both husband and wife should sign the lease regardless of whether or not the property is homestead property. In other states it is desirable to have both parties join in the lease although the acreage involved does not constitute a homestead since the property could possibly be later considered as homestead property. Joinder of husband and wife in an execution of a lease further assists the oil companies in rendering division-order opinions and in examining titles. Since oil and gas properties particularly in the Far West involve areas remote to the division land office, joinder of husband and wife is preferable in view of the fact that it may be expensive to send out a landman to determine whether or not there is a homestead building located on the property involved.

Another reason for having the wife join the husband in the lease is that the lease is an instrument of potentially undefined duration and may include after-acquired interests. In a situation in which the wife's interest increases following the execution of the lease by a husband, it would be desirable to have had her join in the execution of the lease and, therefore, bind all of her potential interest.

Execution and Acknowledgment of the Oil and Gas Lease

Since an oil and gas lease is both a contract and a conveyance it should be executed with the same formality as any deed to real property. Since it has uniformly been held that an oil and gas lease comes within the purview of the Statute of Frauds it must be in writing and signed by the party against whom it is to be charged.[80] Any subsequent modification of it must likewise be in writing. This does not mean, however, that an oral understanding between the parties which is contemporaneous with the execution of the lease may not be binding, providing it does not contradict the written agreement. Further, a contract to execute or assign an oil and gas lease must be signed by the party to be charged.

Conclusion

This article has provided only a summary treatment of the history of the oil and gas lease, how particular clauses have evolved, and finally, examples of the usual or typical clauses found in leases

79 7 Summers, Oil and Gas § 1156, at 51 (Supp. 1965).
80 See generally 2 Summers, Oil and Gas §§ 226-27 (perm. ed. 1959).

utilized in the Midwest.[81] Other articles in this issue will treat in greater detail specific provisions of the oil and gas lease such as implied covenants. While a number of excellent treatises are available covering specific points, an over-view is helpful, particularly where the area is new to the practitioner. What prognostication can be made for the future, if any? In all likelihood more detailed provisions will be included in the leases of the future with respect to secondary recovery techniques and an extension of the force majeure clause to cover expressly the possibility of labor difficulties and civil disobedience. However, all will agree that the oil and gas lease form device has remained remarkably stable over the past hundred years.

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[81] The sections and provisions provided herein have been hypothetical or drawn from Summers' model forms contained in his treatise on Oil and Gas.