

Chapter 6 - Leasing the Available Lands

Once a company has geologic data and begins to put together a drilling prospect or drilling area, they must acquire the right to access the minerals in the prospect. Those rights are acquired through the acquisition of oil and gas leases. These leases will be taken from those who own mineral rights within the drilling prospect.

The oil and gas lease is, without question, the foundation of every oil and gas exploration and production company. It can be said with a great deal of certainty, that these simple pieces of paper are, indeed, the greatest assets a company can own.

An oil and gas lease can be defined as a written agreement between two parties for the purpose of exploration and development of the oil and gas estate. Both parties, the *Lessor* (mineral owner) and the *Lessee* (the oil company) come together in this legal document to form a relationship for such a purpose.

There is a similar construction to most modern leases

The oil and gas lease has evolved over the years. The first leases taken in the 1850's were drafted from salt water leases, and although they bear some resemblance to modern leases, many issues addressed today were unknown 150 years ago.

Early leases contained only a fixed primary term. There was no secondary term mentioned even in light of production, nor did these leases provide for any type of renewal or right to extend the lease.

As the industry evolved, lessor and lessee alike began to see the need for a more mature oil and gas lease.

Over the years, as the industry and technology grew, more complex clauses were added to leases and old language was changed as problems reared their heads. Many language revisions took place as the result of court rulings. As the industry matured, so did the oil and gas lease.

Today, there is no real standard oil and gas lease because every lease can be modified. However, today's modern leases contain a similar construction. People often refer to what has been known as the Producer's 88 oil and gas lease form; however, these words, which might appear at the top of a lease, are meaningless. The wording, *Producer's 88* originated from a printing company that placed the term at the top of the oil and gas lease as a way of identifying the print job.

Leases designated as Producer's 88 might contain a multitude of different lease language. Depending on specific needs, company landmen and/or attorneys will change the wording or strike entire clauses on the lease. However, there is a basic structure and design in our modern oil and gas leases that can be broken down into a grouping of a handful of lease clauses. They are:

1. The Granting Portion of the Lease
2. The Habendum Clause or Term Clause
3. The Royalty Clause of the Lease
4. The Termination Clauses of the Lease
5. The Pooling Clause of the Lease
6. The Damage Clause
7. The Assignment Clause
8. The Surrender Clause
9. The Warranty Clause
10. The Force Majeure Clause
11. The Legal Effect Clause

The Granting Clause- Contains several vital aspects to the oil and gas lease including the lease date, parties entering the lease agreement, consideration wording, establishes what substances are being granted, the lessee's surface rights, mother Hubbard language, depth limitations, and the legal description.

The date - an undated lease is not void but generally takes effect when it is executed and delivered.

The Parties - a lease must name all the parties involved in the agreement. Some states (e.g. Louisiana) requires indication of the parties' marital status

Although the legal description describes a surface location the oil & gas lease covers only the subsurface minerals of that description.

The intention of the mother Hubbard clause is to include any small tracts of land that are contiguous with or join the lands as described on the lease.

The Habendum Clause or Term Clause sets out the length of time the lease will remain valid and establishes two different term periods, (1) the primary term and (2) the secondary term.

The Royalty Clause establishes the percentage of production that is to be paid to the royalty owner. This is generally a negotiated amount.

The Shut-in Royalty Clause allows the lessee to hold the lease when gas wells are shut-in until a market for the gas has been established or a pipeline becomes available to transport the gas to the market place.

FORM 88-394 (Prod. Pooling)
Rev. 5-60, No. 2

OIL, GAS AND MINERAL LEASE

AGREEMENT, Made and entered into the 1st day of May 2005, by and between James McDougal and Martha McDougal, husband and wife hereinafter called Lessors (whether one or more). And Your Oil Company, HEREINAFTER CALLED Lessee, whose post office address is 123 Main Street, Tulsa, Oklahoma.

WITNESSETH, That the said lessor, for and in consideration of ~~*****~~Ten and More~~*****~~ DOLLARS, cash in hand paid, receipt of which is hereby acknowledged and of the covenants and agreements hereinafter contained on the part of lessee to be paid, kept and performed, has granted, demised, leased and let and by these presents does grant, demise, lease and let unto the said lessee, for the sole and only purpose of exploring by geophysical and other methods, mining and operating for oil (including but not limited to distillate and condensate), gas (including casinghead gas and all other constituents), and all other hydrocarbons, and for laying pipe lines, and building tanks, power stations and structures thereon, to produce, save and take care of said products, all that certain tract of land, together with any reversionary rights therein, situated in the County of Dewey, State of Montana, described as follows, to-wit:

Township 16 South, Range 16 West
Section 14: SW1/4NW1/4, W1/2SW1/4

of Section 14, Township 16 South, Range 16 West, and containing 120.00 acres, more or less.

together with all strips, parcels of land, accretion and riparian rights adjoining or contiguous to the above described tract of land, attaching to and forming a part of said land whether properly or specifically described or not and owned or claimed by Lessor.

It is agreed that this lease shall remain in force for a period of 5 years (herein called primary term) and as long thereafter as oil or gas, or either of them, is produced from said land by the lessee.

In consideration of the premises the said lessee covenants and agrees:

1st. To deliver to the credit of lessor free of cost, in the pipe line to which it may connect its wells, the one-eighth (1/8) part of all oil produced and saved from the leased premises.

2nd. On gas including casinghead gas or other gaseous substance, produced from said land and sold or used in the manufacture of products therefrom the market value at the well of three-sixteenths (3/16) of the gas so sold or used, such proceeds to be less severance and other excise taxes, said payments to be made monthly.

During any period (whether before or after expiration of the primary term hereof) when gas from any well or wells on the premises capable of producing gas in commercial quantities is not sold or used and the well or wells are shut in and there is no current production of oil or operations on said leased premises sufficient to keep this lease in force, lessee shall pay or tender a royalty of One Dollar (\$1.00) per year per net royalty acre retained hereunder, such payment or tender to be made, on or before the anniversary date of this lease next ensuing after the expiration of ninety (90) days from the date such well is shut in and thereafter on the anniversary date of this lease during the period such well is shut in, to the royalty owners. When such payment or tender is made it will be considered that gas is being produced within the meaning of the entire lease.

The Delay Rental Clause creates an obligation on the part of the lessee, during the primary term, that requires an annual rental payment when drilling operations are absent. Unless this payment is rendered or operations have begun the lease will automatically terminate.

Dry Hole, Cessation of Production, and Continuous Drilling Clause: When production ceases to occur or a well is a dry hole, the lease provides for non-termination if, during a set out period of time, drilling operations or reworking of a current well begins.

The Pooling Clause gives the lessee the right to combine the lands on the oil and gas lease with other lands and leases in the vicinity in order to form an area large enough to meet spacing regulations. The spacing size will vary from state to state and from one field to the next.

This lease shall terminate on May 1st 20 06 unless on or before said date the Lessee either (1) commences operations for the drilling of a well on the land, or on acreage pooled therewith, in search of oil, gas or other minerals and thereafter continues such operation and drilling to completion or abandonment; or (2) pays to the lessor a rental of One Dollars (\$ 1.00) per acre for all or that part of the land which Lessee elects to continue to hold hereunder, which payment shall maintain Lessee's right in effect as to such land without drilling operations for one year from the date last above mentioned; and Lessee may continue to maintain the right granted without drilling operations for successive twelve month's periods (during the primary term) by paying Lessor, on or before the beginning of such respective periods One Dollars (\$ 1.00) per acre for all or that part of the land held hereunder. If the lessee shall commence to drill a well or commence reworking operations on an existing well within the term of this lease or any extension thereof, or on acreage pooled therewith, the lessee shall have the right to drill such well to completion or complete reworking operations with reasonable diligence and dispatch, and if oil or gas, or either of them, be found in paying quantities, this lease shall continue and be in force with like effect as if such well had been completed within the term of years first mentioned.

After the discovery and production of oil, gas or any other minerals in paying quantities, either on the leased premises or on lands pooled therewith, the rights granted shall be maintained in effect during and after the primary term and without the payment of the rentals hereinabove provided for so long as oil, gas or some other mineral is being produced in paying quantities, or Lessee is carrying on operations with reasonable diligence looking for the production thereof. It is provided, however, that if, after the discovery and production of oil, gas or other minerals in paying quantities, the production thereof should cease from any cause this lease shall terminate unless Lessee resumes or restores such production, or commences additional drilling, reworking or mining operations within ninety (90) days thereafter and continues such operations without the lapse of more than ninety (90) days between abandonment of work on one well and commencement of reworking operations or operations for the drilling of another, in an effort to restore production of oil, gas or other minerals, or (if during the primary term) resumes the payment of rentals in the manner hereinabove provided for in connection with the abandonment of wells drilled.

Lessee is hereby granted the right at any time and from time to time to unitize the leased premises or any portion or portions thereof, as to all strata or any stratum or strata, with any other lands as to all strata or any stratum or strata, for the production primarily of oil or primarily of gas with or without distillate. However, no unit for the production primarily of oil shall embrace more than 80 acres, or for the production primarily of gas with or without distillate more than 320 acres; provided that if any governmental regulation shall prescribe a spacing pattern for the development of the field or allocate a producing allowable based on acreage per well, then any such unit may embrace as much additional acreage as may be so prescribed or as may be used in such allocation of allowable. Lessee shall file written unit designations in the county in which the leased premises are located. Operations upon and production from the unit shall be treated as if such operations were upon or such production were from the leased premises whether or not the well or wells are located thereon. The entire acreage within a unit shall be treated for all purposes as if it were covered by and included in this lease except that the royalty on production from the unit shall be as below provided, and except that in calculating the amount of any shut in gas royalties, only the part of the acreage originally leased and then actually embraced by this lease shall be counted. In respect to production from the unit, Lessee shall pay Lessor, in lieu of other royalties thereon, only such proportion of the royalties stipulated herein as the amount of his acreage placed in the unit, or his royalty interest therein on an acreage basis bears to the total acreage in the unit.

The Proportionate Reduction Clause allows the lessee to pay the lessor his or her full royalty amount based on the owner's proportionate share of the tract of land under lease.

The Damage Clause sets out the lessee's liability to the surface owner for damages to those items listed in the clause. Some leases will include items such as trees, pasture or other items the lessor wishes to protect.

The Assignment Clause allows the lessor and lessee to assign the lease, usually without the other parties consent. This language usually says that these assignments are not binding on the other party without notice first being given.

The Surrender Clause establishes that the lessee can voluntarily surrender either all or part of the lease.

The Warranty Clause guarantees that the lessor is leasing clear title to the lands being leased.

The Force Majeure Clause protects the lessee from lease obligations if certain types of events occur. These events generally are catastrophic in nature and are beyond the control of the lessee.

The Legal Effect Clause binds the parties to the contract and declares the lease as being effective and valid.

If said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties herein provided shall be paid to the lessor only in the proportion which his interest bears to the whole and undivided fee.

Lessee shall have the right to use, free of cost, gas, oil and water produced on said land for its operations thereon, except water from wells of lessor.

When requested by the lessor, lessee shall bury his pipelines below plow depth.

No well shall be drilled nearer than 200 feet to the house or barn now on said premises, without the written consent of the lessor.

Lessee shall pay for all damages caused by its operations to growing crops on said land.

Lessee shall have the right at any time to remove all machinery and fixtures placed on said premises, including the right to draw and remove casing. During the term of this lease, Lessee shall have the exclusive right to conduct exploration by geophysical or other methods upon the lands covered hereby.

If the estate of either party hereto is assigned, and the privilege of assigning in whole or in part is expressly allowed, the covenants hereof shall extend to their heirs, executors, administrators, successors or assigns. However, no change or division in ownership of the land or royalties shall enlarge the obligations or diminish the rights of Lessee. No change in the ownership of the land or royalties shall be binding on the lessee until after the lessee has been furnished with a written transfer or assignment or a true copy thereof. In case lessee assigns this lease, in whole or in part, lessee shall be relieved of all obligations with respect to the assigned portion or portions arising subsequent to the date of assignment.

Lessee may at any time execute and deliver to lessor or place of record a release or releases covering any portion or portions of the above described premises and thereby surrender this lease as to such portion or portions and be relieved of all obligations as to the acreage surrendered.

Lessor hereby warrants and agrees to defend the title to the lands herein described, and agrees that the lessee shall have the right at any time to redeem for lessor by payment any mortgages, taxes or other liens on the above described lands, in the event of default of payment by lessor, and be subrogated to the rights of the holder thereof. If Lessor owns less than the entire undivided interest in all or any portion of the lands or mineral rights relating thereto (whether such interest is herein specified or not) rentals and royalties as to the land in which an interest is outstanding in others shall be reduced proportionately to the interest of the Lessor therein, but the failure of Lessee to reduce rentals shall not affect Lessee's right to reduce royalties; and all outstanding royalty rights shall be deducted from the royalties herein provided for.

All express or implied covenants of this lease shall be subject to all Federal and State Laws, Executive Orders, Rules and Regulations, and this lease shall not be terminated, in whole or in part, nor lessee held liable in damages, for failure to comply therewith, if compliance is prevented by, or such failure is the result of any such Law, Order, Rule or Regulation or acts of God.

This lease shall be effective as to each lessor on execution hereof as to his or her interest and shall be binding on those signing, notwithstanding some of the lessor's above named may not join in the execution hereof. The word "Lessor" as used in this lease means the party or parties who execute this lease as Lessor, although not named above.

IN TESTIMONY WHEREOF, we sign this the _____ day of _____, 2005.

X _____
James McDougal

X _____
Martha McDougal

The Oil and Gas lease creates a conveyance

Most states view the oil and gas lease as both a contract between the lessor and lessee and a conveyance of mineral rights. Louisiana is an exception to this rule and holds that the "mineral lease is a contract by which the lessee is granted the right to explore for and produce minerals...". Donald L. Hansen, Jr., "Elements of the Lease," National Association of Lease and Title Analysts Certification Review Manual, (July, 2005), page 6-2.

The state of Texas has established the oil and gas lease as a conveyance whereby the lease creates an "estate in fee simple determinable in the oil and gas in place." Donald L. Hansen, Jr., "Elements of the Lease," National Association of Lease and Title Analysts Certification Review Manual, (July, 2005), page 6-2.

Mineral owner's concerns

Land professionals, attempting to lease minerals, will often experience the following three main concerns of the mineral owner:

1. The signing bonus
2. The royalty
3. The term of a lease

Although these concerns can be considerable, the land professional may also experience a number of other issues that are important to the mineral owner.

The Signing Bonus

In order for the lease agreement to be a valid contract, what is known as "valuable consideration" must exchange hands from the lessee and the lessor. In other words, the lessor (mineral owner) is handing over something that could be of extreme value to the lessee (oil company). In exchange, the lessee must give the lessor something of value (valuable consideration) and will come in the form of a signing bonus.

This signing bonus is a dollar amount based on two numbers:

1. The per dollar "going rate" being paid per acre in the area
2. The number of net mineral acres the mineral owner is leasing

If the going rate per acre is \$75 and the lessor is leasing 105.34 net mineral acres, the signing bonus would be $\$75 \times 105.34 = \$7,900.50$.

The exact amount of the signing bonus is not displayed anywhere on the lease. Instead the contract simply says that the lessor for "ten or more valuable dollars has..."

The Royalty

Prior to signing an oil and gas lease, the mineral owner has the right to capture and benefit 100% of the minerals underlying their land. However, in order for this to take place, the mineral owner must drill their own well (at their own expense).

Most mineral owners do not have the knowledge, money or desire to accomplish this task. This function, in most all cases, rests in the hands of the oil company. Since oil and gas exploration is extremely risky and expensive and since all of the risk and expense is borne by the oil company, they must be entitled to the majority share of the revenue generated from production.

The royalty clause in the oil and gas lease will determine what percent of production revenue the oil company will receive and what percent of production revenue the mineral owner will be able to keep.

This lease clause sets out the fractional amount of production due the lessor. This can also be referred to as "leasehold royalty".

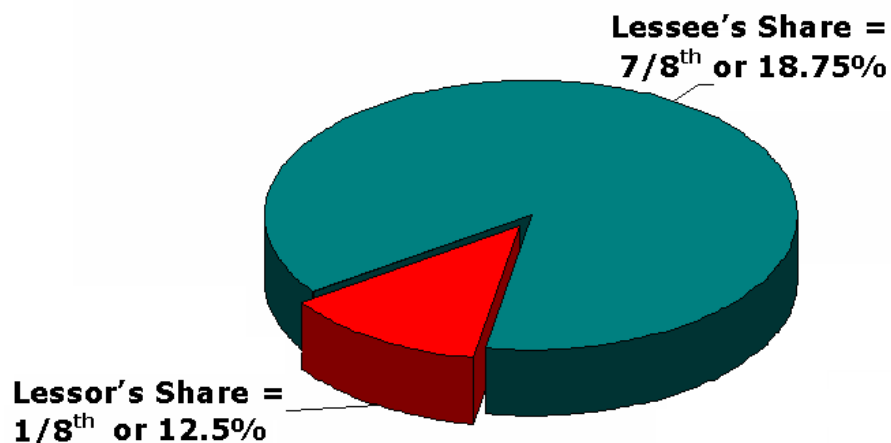
In this case, the lessor has agreed to receive $1/8^{\text{th}}$ part of all oil or gas production. The lessee's share of production would then be $7/8^{\text{ths}}$ of all production.

Royalty Clause

In consideration of the premises the said lessee covenants and agrees:

1st. To deliver to the credit of lessor free of cost, in the pipe line to which it may connect its wells, the one-eighth (1/8) part of all oil (including but not limited to condensate and distillate) produced and saved from the leased premises.

2nd. On gas including casinghead gas or other gaseous substance, produced from said land and sold or used in the manufacture of products therefrom the market value at the well of one-eighth (1/8) of the gas so sold or used, such proceeds to be less severance and other excise taxes, said payments to be made monthly.



The Term of the Lease (Habendum Clause)

The habendum clause or term clause of the lease follows the legal description clause and is that part of the contract which sets out the period of time for which the grant is extended.

The word *habendum* is Latin in origin and is derived from the phrase "*habendum et tenendum*", meaning "to have and to hold." Oil and gas leases contain *special limiting language*.

Habendum Clause or Term Clause

It is agreed that this lease shall remain in force for a term of five years from date (herein called the primary term) and as long thereafter as oil or gas, or either of them, is produced from said land by the lessee.

Primary Term and Secondary Terms

The language in this lease limits the grant for a period of five years (primary term) unless certain conditions are met. If these conditions are met the lease is automatically extended into what is known as the secondary term. If these conditions are not met the lease will automatically expire at the end of the primary term (five years from the date of the lease).

The primary term of the lease can be a major concern to many mineral owners. They know that the oil company's desire is to have as long of a primary term as possible. On the other hand, the mineral owner wants the shortest term possible. For most, the sooner the well is drilled the better. On the other hand, the oil company may not be ready to begin operations within the first, second or third year of the lease.

EXERCISE 12:

Several oil and gas companies have begun a leasing program in the Tucker Gap area. Assume that you work for Sunrise Oil and Gas. Using the lease form that follows, negotiate a hypothetical lease with one of the mineral owners in Section 11 (as seen of following plat).

Next, calculate how much signing bonus you should pay the mineral owner based on the "going rate" of \$75 per net mineral acre.

Finally, fill out the lease **A.** date of lease, **B.** name of lessor, **C.** name and address of lessee, **D.** County and State, **E.** Legal Description, **F.** Royalty percentage for oil and gas.

OIL, GAS AND MINERAL LEASE

AGREEMENT, Made and entered into the **A.** 1st day of May, 2005, by and between **B.** James McDo l a d art a eDo a. us nd d wife hereinafter called Lessors (whether one or more). And **C.** Y u i f Compa, HEREINAFTER CALLED Lessee, whose post office address is 12 M I Str t, I sa, Kl oma.

WITNESSETH, That the said lessor, for and in consideration of ****Ten and More***** DOLLARS, cash in hand paid, receipt of which is hereby acknowledged and of the covenants and agreements hereinafter contained on the part of lessee to be paid, kept and performed, has granted, demised, leased and let and by these presents does grant, demise, lease and let unto the said lessee, for the sole and only purpose of exploring by geophysical and other methods, mining and operating for oil (including but not limited to distillate and condensate), gas (including casinghead gas and all other constituents), and all other hydrocarbons, and for laying pipe lines, and building tanks, power stations and structures thereon, to produce, save and take care of said products, all that certain tract of land, together with any reversionary rights therein, situated in the County of **D.** Dewey, State of Montana, described as follows, to-wit:

E. Township 16 South, Range 16 West
Section 11

and containing _____ acres, more or less.

In consideration of the premises the said lessee covenants and agrees:

1st. To deliver to the credit of lessor free of cost, in the pipe line to which it may connect its wells, **F.** _____ part of all oil produced and saved from the leased premises.

2nd. On gas including casinghead gas or other gaseous substance, produced from said land and sold or used in the manufacture of products therefrom the market value at the well of **F.** _____ of the gas so sold or used, such proceeds to be less severance and other excise taxes, said payments to be made monthly.

Tucker Gap Prospect



**B.J. & Ruth Potter,
husband and wife**



**Ben & Tom
Smith 75/25**

11



**Sam, Jim & John Roth
33/33/33**



**Bea Booth,
a widow**



**Steve
Bent, deal-
ing with
sole and
separate
property**



Ben & Jan Topper, h&w

**Township 18 North, Range 16 West
Grant County, Oklahoma**

Types of Leases

Annual Delay Rental Lease

Today's delay rental leases are segregated into equal annual periods. Each of these periods begins on the anniversary date of the lease. During each of the annual periods, the oil company has the right, but not the obligation to begin the drilling of a well.

In those cases where operations have not begun, a delay rental payment must be made to the lessor either on or before the anniversary date of the lease. This payment is the only vehicle that can perpetuate the lease into the next annual period. This payment also allows the company another year in which they have the right but not the obligation to begin drilling.

Assume that the oil company used an *annual delay rental* lease form and was able to negotiate a 5-year primary term. The company really only acquired a lease for 12-months with the option to extend the lease into 4 additional 12 month periods by making a rental payment to the lessor on or before the anniversary date of the lease.

Delay Rental Clause

This lease shall terminate on July 1st 20 07 unless on or before said date the Lessee either (a) commences operations for the drilling of a well on the land, or on acreage pooled therewith, in search of oil, gas or other minerals and thereafter continues such operation and drilling to completion or abandonment; or (b) pays to the lessor a rental of One Dollars (\$ 1.00) per acre for all or that part of the land which Lessee elects to continue to hold hereunder, which payment shall maintain Lessee's right in effect as to such land without drilling operations for one year from the date last above mentioned; and Lessee may continue to maintain the right granted without drilling operations for successive twelve month's periods (during the primary term) by paying Lessor, on or before the beginning of such respective periods One Dollars (\$ 1.00) per acre for all or that part of the land held hereunder. If the lessee shall commence to drill a well or commence reworking operations on an existing well within the term of this lease or any extension thereof, or on acreage pooled therewith, the lessee shall have the right to drill such well to completion or complete reworking operations with reasonable diligence and dispatch, and if oil or gas, or either of them, be found in paying quantities, this lease shall continue and be in force with like effect as if such well had been completed within the term of years first mentioned.

Since these are annual rental payments and are to be made prior to the next ensuing 12-month period, the first annual rental is made to the lessor at the time the lease is signed and is usually incorporated into the bonus payment.

There are two types of annual delay rental clauses used today. One is called the "unless" clause and the other is the "or" clause. The delay rental lease form, used in our example, uses the *unless* clause. Simply put, when this language is used the lease will terminate on the anniversary date of the lease *unless* one of the following things has taken place:

Delay Rental Clause

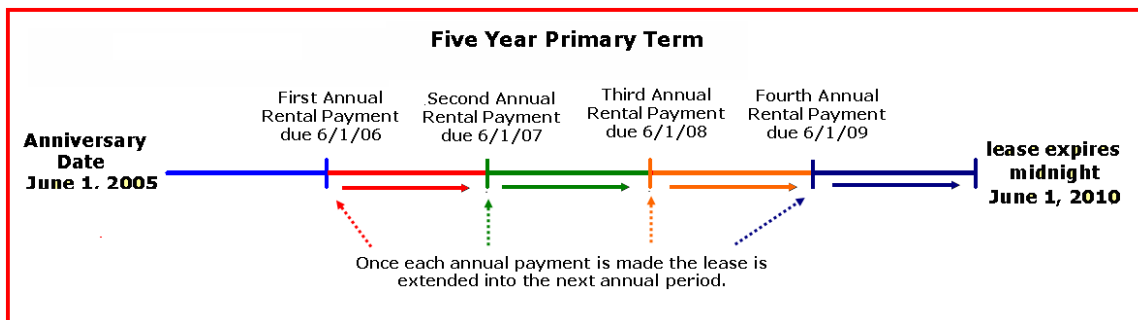
Notice the word, "Terminate"

Notice the word, "unless"

This lease shall **terminate** on July 1st 20 07 **unless** on or before said date the Lessee either (a) commences operations for the drilling of a well on the land, or on acreage pooled therewith, in search of oil, gas or other minerals and thereafter continues such operation and drilling to completion or abandonment; or (b) pays to the lessor a rental of One Dollars (\$ 1.00) per acre for all or that part of the land which Lessee elects to continue to hold hereunder, which payment shall maintain Lessee's right in effect as to such land without drilling operations for one year from the date last above mentioned; ...

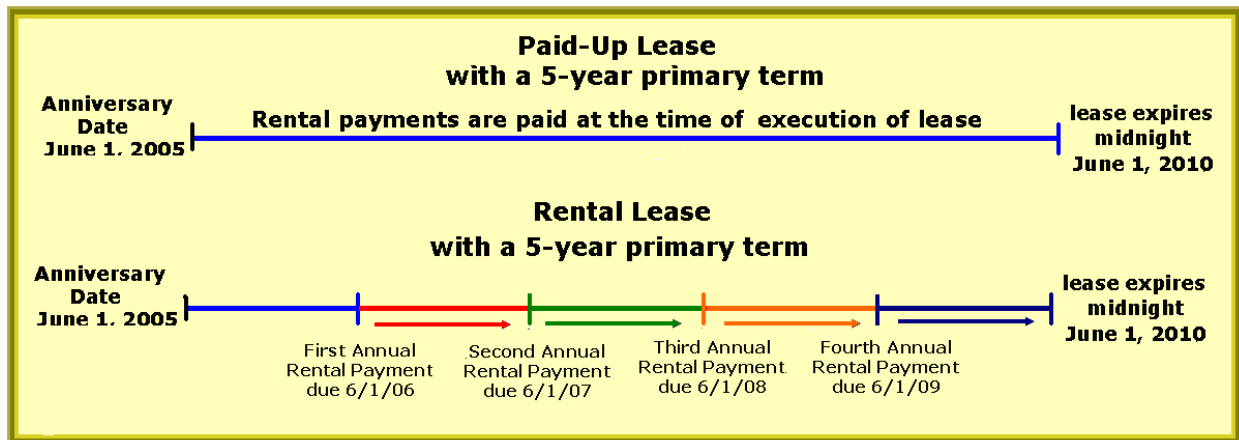
- a. Operations have commenced
- b. A delay rental payment has been tendered to the lessor

The words, as set out in this clause, create what is known as a *condition of title*. A condition of title simply means that in order for the lease to be maintained into the next annual period of the lease, certain *conditions* must have been met. Most states hold that such language is to be strictly interpreted and unless the lessee has complied with the terms, the lease will terminate automatically by its own terms.



Paid-up Leases

Many companies prefer to use a lease form that has done away with the need to make annual delay rental payments. The necessity for these payments has not gone away because they actually become part of the bonus payment offered to the lessor and are made all at once - at the time the lease is taken. This type of lease, called a *paid-up lease*, ensures that the lease will not be terminated because of any rental payment oversight.



Meeting the Condition of Commencing Operations

The question is often asked, "What does commencing operations really mean?" If a company simply staked a location, filed a permit to drill a well or had someone on the premises digging a hole with a shovel, would that qualify as commencing operations?

Or is drilling the only way to satisfy this condition?

Although some leases define operations as actual drilling with a rig capable of drilling to total depth, apart from this language, generally, courts have found that commencing operations can be something less than actual drilling. Moving dirt in order to build a road or a location or some sort of physical operations *would* qualify as commencing operations. Whatever the activity, it must be demonstrated that the company has an *irrevocable commitment* to finish the task of drilling the well.

Some leases actually define operations. In these cases, the definition must be literally followed and the lessee becomes limited in their interpretation of "operations". If the definition is limited in its scope, the constraints placed on the lessee are also limited. Leases that do not attempt to define operations are more liberally upheld in the favor of the lessee.

A lease using the term "commence a well" is much different than a lease using the term, "commence operations to drill a well" or "commence operations". It is very important to properly identify the language in the lease. The language of the lease will determine what activity needs to take place on the specified date.

Example:

Read the following language and determine what activity needs to take place on the specified date.

This lease shall terminate on July 1, 2008, unless on or before said date Lessee completes drilling operations for the drilling of a well on the land, or on acreage pooled therewith, in search of oil, gas or other minerals.

In this example, the lessee has limited operations to not only mean drilling, but also the *completion* of the drilling operations either on or before July 1, 2008.

Meeting the Condition of Paying a Delay Rental

If the commencement of drilling is not achieved, the lessee must make delay rental payments in order to keep the lease active.

Most states would enforce a stringent compliance with the paying of delay rentals. States will permit few excuses, if any, and will not allow "honest" mistakes or an inadvertent error made on the part of the lessee. Because the language in the lease has created a *condition*, the condition must be met or the lease terminates. An Oklahoma District Court in *Latham v. Continental Oil Co.*, 558 F. Supp. 731 (W.D. Okla. 1980), stated, "Intention, good faith, or a mistake on the part of the lessee generally are not material and will not excuse the lessee's failure to strictly comply with said lease condition."

Excuses that are not allowed and will cause the termination of the lease:

1. A rental payment made after the due date
2. A rental payment made with less than the full amount due
3. A rental payment sent to the wrong payee

Options to Lease

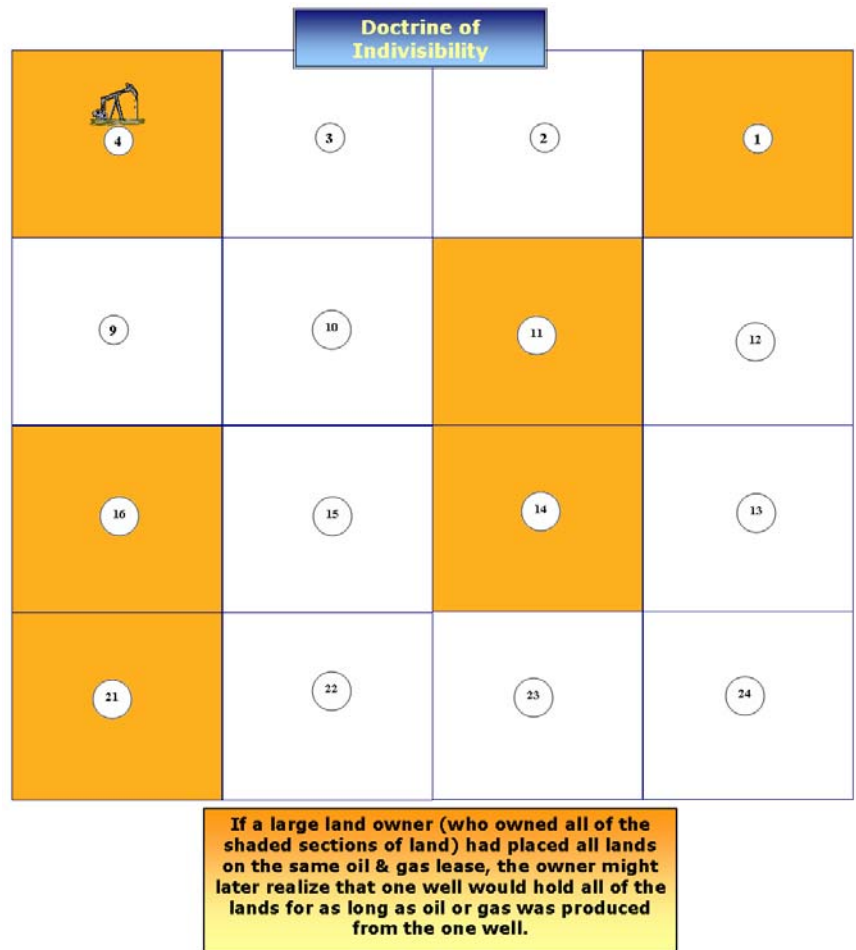
There are times when a company has a particular interest in an area in which they do not own any leases or only own a few leases. Instead of investing in any more lease costs, they might first want to evaluate the area further through seismic studies.

In order to conduct these studies, the company must obtain the shooting rights on the property. Once the seismic is complete and evaluated, the company may or may not wish to lease the mineral lands in question. Prior to evaluating this data and in order to protect their interest, the company will often obtain an *option to lease* the lands at the same time they obtain the shooting rights. This option to lease is made available to the company for a period of time and guarantees that the company will be able to lease the mineral lands during this time period and for a pre-determined price set out in the option.

The Doctrine of Indivisibility

Indivisible simply means not-divisible or not divided and states that a single well, which is capable of producing in commercial quantities, will continue to hold the entire leased lands into the secondary term. In other words, unless the lease itself contains a provision for dividing the lands, they remain whole (indivisible) during the secondary term.

The doctrine holds that what the lessee does on one tract of land is as if it has been done on all tracts of land.



Not too many years ago, lessors who owned large tracts of land, might lease their entire ranch or farm on the same lease. Under the doctrine of indivisibility, a single well, capable of commercial production, would hold the entire acreage by production (HBP). This concept became more than an irritant to many land owners who unknowingly placed these large tracts of land on the same lease.

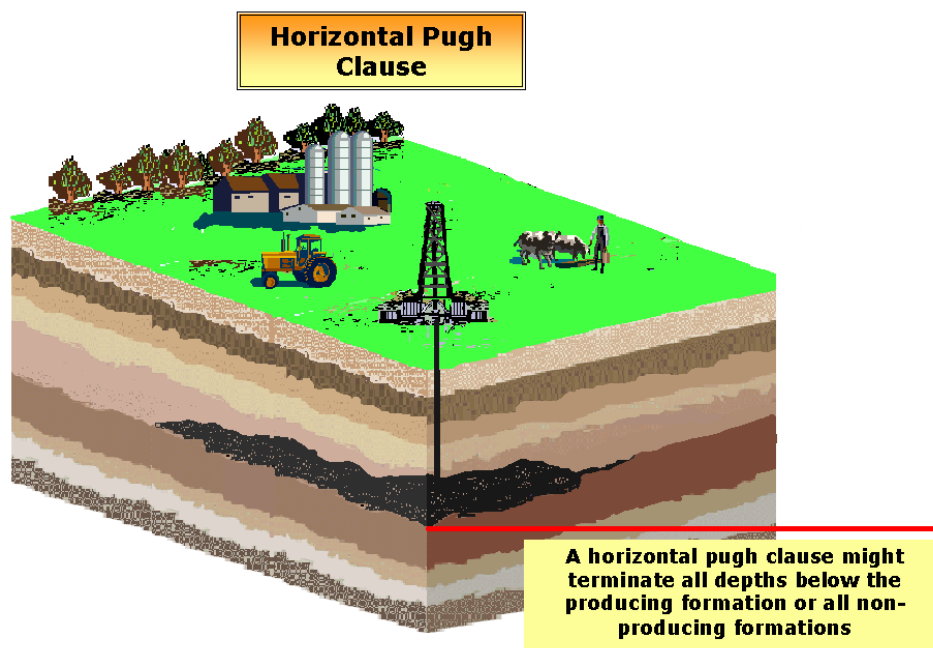
Pugh Clause

During the latter part of the twentieth century and into the twenty-first century, the oil and gas industry witnessed a vast increase in leases containing *divisible* language. As land owners broadened their knowledge, more and more leases contained added language requiring a partial termination (Pugh Clause) of lands located outside a formed unit. Such added language might provide for either a *horizontal* or *vertical* termination or severance of the lands.

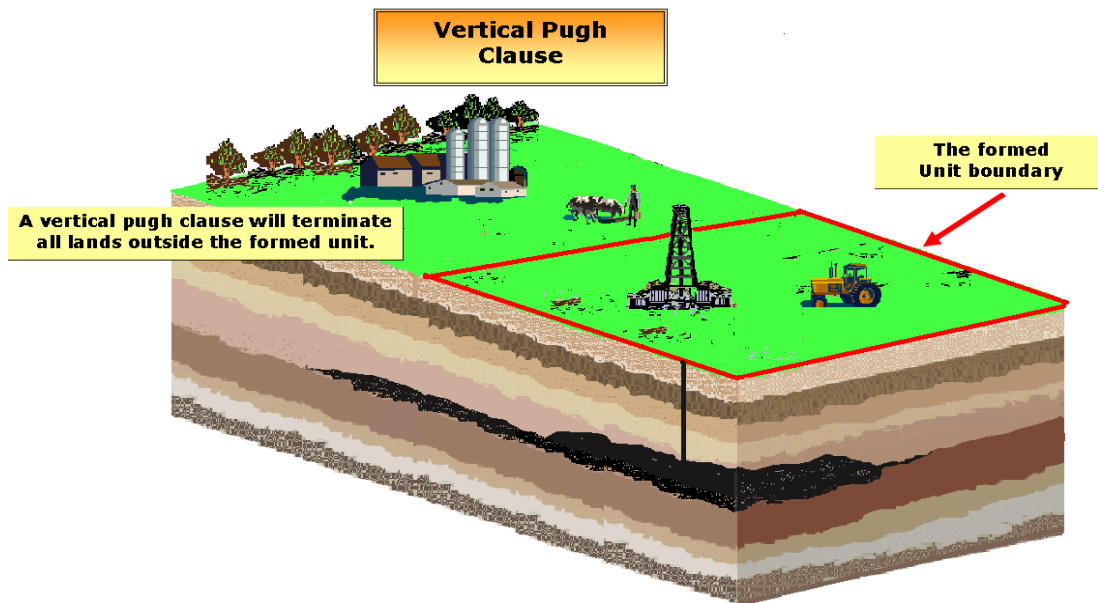
Today, there is some confusion over the definition of either a horizontal or a vertical pugh clause or severance. It appears that various organizations in the industry define these differently.

The following illustrations have been adapted from the definitions as set out by the National Association of Royalty Owners and the Schlumberger Oilfield Glossary.

- Horizontal Pugh Clause – refers to depths, geologic horizons or structures beneath the surface of the earth that will be terminated. A horizontal severance happens between two subsurface strata.



- Vertical Pugh Clause – refers to a defined portion of land located outside a formed unit, such as the Northwest quarter of the lease or any of the lands that are outside of the producing unit boundary.



A typical Pugh clause might read:

"If, . . . a drilling and/or production unit be created and established, pooling and combining a portion of the lands covered by this lease with other lands, lease or leases in the vicinity thereof, then drilling operations . . . shall continue this lease in force and effect during or after the primary term only as to the lands covered hereby which are included in such unit, . . . it being expressly agreed that drilling operations . . . shall not maintain this lease . . . as to any of the land covered hereby which are not included in such unit."

Statutory Pugh Clause

A few states, including Oklahoma, North Dakota, Mississippi and Arkansas, have established what is known as *statutory pugh clause* rulings.

- The Oklahoma statutory pugh clause applies to leases that were executed after May 25, 1977 and only apply to leases that have been included in a spacing unit containing 160 acres or more. In such a case, those lands falling outside the drilling and spacing unit will, by state statute, automatically expire 90 days after the primary term of the lease.

- The North Dakota statutory pugh clause applies to leases that have been committed to a compulsory unit that has lands inside the unit boundary and lands outside the unit boundary. "After two years from the effective date of the order of the commission creating and approving the unit or the expiration of the primary term of the lease, whichever is the later date...lands outside the unit area may be maintained in force and effect only in accordance with the terms and provisions contained in the lease."
- Mississippi provides that if an oil and gas lease contains lands partially within and partly outside a compulsory field-wide unit, production from the unit shall not hold the lands outside the unit. The exception to the rule applies if the lessee commences drilling activities on the land outside the unit within one year from the date of the determination of the unit or before the end of the primary term of the lease, whichever is a longer period of time.
- The Arkansas pugh clause statute applies to oil and gas leases that were executed on or after July 4, 1983. Drilling operations or production from lands falling within a pooled unit shall maintain the lease only as to the lands where the production occurs. Those leased lands falling outside the sections or pooling unit will not be extended into the secondary term of the lease. There is an exception to this rule also. The rule does "not apply when drilling operations have commenced on any part or lands in sections or pooling units under the lease within one year after the expiration of the primary term, or within one year after the completion of a well on any part of lands in sections or pooling units under the lease."

Louisiana does not have a statutory pugh clause. However, they do require that all state leases, which have been executed after August 1, 1991, contain a type of pugh clause. The language in this clause permits the lessee to maintain lands outside a unit for two additional years past the primary term of the lease, if the lessee submits rental payments during the two year term.

Leasing Federal Mineral Lands

Nearly one-half of all minerals in the United States must be leased from either state or federal agencies. Prior to 1920, if an oil company wanted to lease federal oil and gas mineral lands, they could do so under the laws that already existed under the Mineral Leasing Act of 1920. This act was primarily enacted for mining purposes and was administrated by the Department of Interior.

The Mineral Leasing Act of 1920 was amended to include not only oil and gas, but several other minerals. Excluded were the subsurface minerals in national parks, monuments, and Indian lands. Then in 1947, a law was passed that authorized oil & gas leases to be issued for Acquired Lands that were subject to the same laws as leases that were issued for Public Lands.

Today, the Bureau of Land Management is the agency that issues and maintains federal oil and gas leases. There are some limitations, however, when it comes to obtaining oil and gas leases on public lands. No one company or individual is allowed to lease more than 246,080 acres in any one state. In Alaska the maximum amount of leased lands per company is no more than 300,000 acres in two leasing districts.

Competitive & Non-Competitive Leases

There are two general classifications of federal leases:

1. *Competitive*
2. *Noncompetitive*

Competitive leases have a primary term of ten (10) years and so long as oil or gas is produced in paying quantities. The maximum amount of acreage that can be included on a competitive lease is 2,560 acres for lands within the lower 48 states and 5,760 acres for lands in Alaska.

Noncompetitive federal leases also have a primary term of ten (10) years and so long as oil or gas is produced in paying quantities. The maximum acreage size for these leases is the same as for competitive leases.

Competitive lease sales occur quarterly if lands are available for leasing. Notices of such available lands will contain the royalty rate of the lease as well as the rental amount. A company wanting to acquire a competitive lease may only do so by bidding on the lease at a public auction of lands. The minimum dollar amount required for such bidding is \$2.00 per acre which is calculated on the gross acres in the tract of land not the net acres owned by the Federal government. An authorized officer from the BLM will accept bids from companies and has the right to reject any and all bids. The lease will be acquired by the company who has offered the highest bonus amount and must submit a payment that includes a \$75 administrative fee, the first year's rental of \$1.50 per acre (calculated on the gross acreage in the parcel), and the bonus amount (calculated on the gross acreage of the parcel).

Noncompetitive leases are a little different. The only parcels available for noncompetitive leasing are those lands that received no bids during the competitive lease sale. These leases become available for leasing the first business day after the competitive sale and are available to be leased,

unless withdrawn by the BLM, for a period of two years.

Once oil or gas has been discovered on the leased lands in paying quantities, a minimum royalty payment is due at the expiration of each lease year unless the lease has been unitized. Then the minimum royalty payments will be made only on participating acreage at a rate of \$1.00 per acre.

Leasing State Mineral Lands

Most states have a process in place whereby notices about state lease sales are either advertised or posted. Montana is one of those states and will post notices on their website, in local newspapers and through the mail.

Generally, states conduct oil and gas oral auctions whereby companies interested in acquiring any of the lands must send a representative in order to bid.

As an example, Wyoming only conducts oral bidding auctions. The lease forms used by the state are approved by the Wyoming Board of Land Commissioners. The primary term is 5 years with a delay rental of \$1.00 per acre. The royalty rate can vary. Depending on the rate established by the Board for a given tract of land, the rate might be 16.6666% or might be 12.5%.

The minimum acceptable bid in Wyoming is an advance rental of \$1.00 per acre with an additional bonus consideration of at least \$1.00 per acre.

If a company wins the bid on a tract of land, the payment of the minimum bid, plus a \$25.00 filing fee, the advance rental, the bonus consideration, and a pro-rata share of the cost of advertising which would not exceed \$0.12 per acre, must be paid on the day of the sale. The balance must be paid in full within ten (10) business days after the date of the sale.