



The Essence of a Contract

According to the American Law Institute and their restatement of the Law of Contracts, a contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.

Contracts are legally enforceable agreements between two or more parties that contain specific actions and/or promises that must be fulfilled or actions and/or promises that must remain undone. The failure to perform any such duty is referred to as a breach of the contract and the law provides remedies for such a breach.

Contracts can be either written or oral, but oral contracts are more difficult to prove thus the old saying, "An oral contract is not worth the paper it is written upon!" All states require contracts that involve the sale or transfer of real property to be in writing and be signed by the grantor.

The law has established that contracts are only valid if the parties involved have the "legal capacity" to enter into the agreement. Individuals that would not fall within the *legal capacity* range would be:

1. Minor children
2. The insane
3. Those who are mentally ill or senile at the time of entering into a contract
4. Those under the influence of alcohol or drugs at the time of entering into a contract
5. Deceased parties

Since contracts lie at the heart and soul of most oil and gas business activities, almost all items found in the land professional's inbox is connected directly with or indirectly with some sort of a contract. It is; therefore, imperative that contract law and the contracts themselves be studied by the land professional.



The Six Components of a Contract

Generally, in order for any contract to be binding and enforceable by a court of law, six components must be present. If two or more parties enter into an agreement that contains less than all six of these components it may not be enforceable, as a contract, under a court of law. In such a case, the parties have entered into an agreement rather than a contract.

Although there is a technical difference between a *contract* and an *agreement*, for the land professional, the terms are often indistinguishable whereby *contracts* are called *agreements*.

Mutual Consent



Mutual Consent is an important ingredient in determining the viability of a contract and is based upon the understanding or intent of both parties. Courts will often attempt to determine if there was, in fact, a “meeting of the minds”.

Assume the seller of a horse listed the animal on Craig’s List as follows: *“Older Mustang for sale. Years of life still left. \$1,000 or best offer.”* A potential buyer, thinking the ad concerned a Ford Mustang, made an offer of \$750. The deal was struck. The money was paid and the horse was delivered to the buyer a week later.

In such a case, since there was no “meeting of the minds”, courts would generally, not consider the deal enforceable.

Offer and Acceptance



In order for mutual consent to exist the second ingredient of a contract must take place which is the offer and acceptance.

The offer must clearly set forth the fundamental terms of the contract including: bonus to be paid, term of the contract, names of parties involved and the conditions or provisions of the contract.

Acceptance is also a key point. Contract law establishes that an acceptance must take place without any revisions, amendments or modifications. If the

party receiving the offer makes a counteroffer, acceptance has not taken place and the original offer becomes null and void. The counter offer becomes the new offer."

Assume, that an oil company, wishing to lease a tract of land, offered the mineral owner a 3-year term lease, with a 16% royalty and a bonus of \$200 per acre.

The mineral owner countered with a 1 year term lease, a royalty of 18.75% and a bonus of \$400 per acre.

The oil company refused to agree to the terms of the counteroffer and walked away from the deal. Twelve months later, the mineral owner signed the original lease and returned it to the oil company. A note attached to the lease said, "Please remit a signing bonus of \$200 per acre at your earliest convenience."

In a case like this, even though the original offer has now been accepted, it had previously been rejected and would now be considered dead. The oil company would not be bound to accept the original lease.



Consideration

For a contract to be valid consideration is required, must be offered by both parties and must contain something of value.

Although the consideration must be mutual (must be offered by both parties) the value of the consideration is not

required to be of equal value.

Assume an oil company leased a 40-acre tract of land from a mineral owner. The consideration paid to the mineral owner was \$200 per mineral acre or \$8,000. The lessor would also receive future consideration based on royalty from a producing well.

In this case, the question could be asked, "What consideration has the mineral owner given to the oil company?" Seismic studies might condemn the tract of land revealing that drilling should never take place and the lease would become nothing more than a valueless piece of paper. Since consideration must be of real value but does not have to be paid in money, the lessor, at the time of signing the lease, did offer something of real value. Prior to the seismic studies, the lease contained a potential value of unlimited resources.

Since both parties of a contract agree to give up something of value to the other party, consideration can act as a catalyst for *good faith* negotiations. In other words, assume an oil company offered to lease a tract of land but

was not willing to tell the mineral owner how much they were offering in bonus payment until the rest of the terms of the lease had been finalized. In this case, it is clear that the oil company is not acting in good faith.

On the other hand, assume a mineral owner signed a lease and received a bonus payment of \$50 per acre. Later, the mineral owner heard that his neighbor had received \$200 per acre for his lease. Under contract law, the mineral owner could not escape the consequences of his poor negotiations by simply telling the oil company that he had changed his mind.



Performance or Delivery

Generally, contracts will set forth the actions required by either/or both parties. These actions will often create conditions that, if not met, will cause either termination of the contract or recourse by the other party.

Assume that a couple wishes to purchase a king size bedroom set. They find the perfect set on Craig's List. The price is too good to be true.

Because of this, they are concerned about being scammed, that what they will receive is not the same as is shown in the pictures. They contact the seller who immediately prepares and mails a contract to the buyers. The contract reads, "Once payment has been received, the furniture will be shipped".

The buyers sign the contract and return it to the seller with the enclosed payment. In this case, the buyers performed their duties as outlined in the contract and delivery of the bedroom set is enforceable.

However, assume that the buyers send the signed contract back to the seller with the following note: "Please find enclosed a check covering only half of the price of the bedroom set. Because we have not been able to see the furniture first hand and because of our concerns over potential fraud, we will remit the other half of the payment upon the furniture's arrival and inspection." In this case, the duties of the buyers as outlined in the contract have not been fulfilled and the delivery of the bedroom set is not enforceable.

This same concept holds true for Oil and Gas leases. Leases will set forth actions that are required by the lessee. For instance, a Delay Rental Lease can create a very limiting condition for rental payments. If the lessee fails to meet this condition, unless provided for in other lease language, termination of the lease will ensue.



Good Faith

In order for any contract to be binding and legally enforceable contract law requires that both parties act in good faith. In cases where it can be established that one of the parties acted in bad faith, courts may very well deem the contract void.

Assume that an oil company was leasing in a very competitive area. They recently found out that their primary drilling location was leased to a competitor company who had not yet recorded their lease. The oil company immediately sent an agent to the mineral owner in an attempt to acquire a second lease from the owner. They told the agent, "Do whatever is necessary to get that lease!"

When the mineral owner objected stating that the lands were already under lease, the agent lied telling the owner that the other company was not reputable; was never going to drill a well; had paid the owner far less than the going rate and that the new lease, if recorded first, would become the valid lease.

Good faith is a very important aspect of contract law and those who negotiate in bad faith place the contract in peril.



Lawful Purpose

Contracts also become voidable if their purpose deals with an unlawful or illegal purpose or if their intent violates public policy.

Assume that two parties have entered into a written contract to distribute illegal drugs to elementary children. Assume the contract had mutual consent between the parties, had a valid offer and acceptance, contained a consideration clause from both parties, had clear performance and delivery, and had been negotiated in good faith. Because its intent was for unlawful purposes and violated "public policy", the contract is voidable.



The Rules for Contract Interpretation

When courts become involved in contract disputes, they are called upon to determine the validity of either certain terms of the contract or the validity of the contract itself. Certain principles will guide the courts in their ultimate determination. They are:

1. The Statute of Frauds
2. The Four Corners Rule
3. The Parol Evidence Rule
4. Breach of the Contract



The Statute of Frauds

In 1920 William Payson Richardson professor at the Brooklyn Law School, St. Lawrence University authored the "Principles of Law of Contract." Herein he wrote, "The most important statute every promulgated, either in England or in this country, is the celebrated Statute of Frauds." The statute originated in England in 1677 and was originally entitled "An act for Prevention of Frauds and Perjuries."

The purpose of the statute was to prevent loss caused from fraudulent behavior, particularly associated with false testimony (perjury) regarding the sale or transfer of lands or property wherein no written deed was ever secured. In an attempt to reduce this type of fraud, England enacted a statute that required certain contracts be in writing.

Because of the propensity for this type of abuse, all fifty states adopted the Statute of Frauds in one form or another.

Many land professionals have answered their phones only to hear the caller say something like this:

"My mother just passed away and I would like for you to transfer her mineral interest into my name. My mother promised me her mineral interest before she died. I have an older sister but she is an alcoholic and my younger brother never took care of my mom when she got sick. As a matter of fact he might call you and say that mom promised those minerals to him. But he is a liar..."

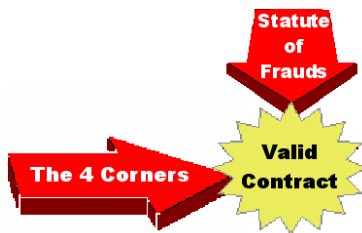
Because of the predisposition of certain people to use fraud and deceit for

personal gain, the statute of frauds requires all contracts involving the sale or transfer of real property be in writing and be signed by the grantor.

Generally, the statute requires the following:

1. The contract must identify the parties involved.
2. The contract must detail the provisions, terms and conditions of the agreement.
3. The contract must adequately state the purposes and subject matter of the agreement.
4. The contract must have a legally sufficient legal description.

Additionally, oil and gas contracts that involve the transfer of real property must be in writing or they may be voidable. This would include Oil and Gas Leases, Farmouts, Joint Venture Agreements, Assignments, Purchase and Sale Agreements, AMI's and the like.



The Four Corners Rule

If a court is called upon to determine the validity or meaning of certain terms or conditions in a contract, they will refer to the "four corners rule." In other words, they will examine the entire contract (the four corners) in an attempt

to understand the meaning and outcome of a particular term or condition.

It is as if the entire written agreement were contained in a square box. The meaning of certain conditions that appear in one corner of the box will be influenced by statements and conditions contained in other corners of the box.

Additionally, if it is determined that, on its face, the contract is complete no external evidence can influence the meaning of the condition. Courts are required to interpret the meaning and conditions of a provision based solely on the overall meaning and intention of the entire agreement.

Assume that the Habendum Clause of an oil and gas lease contained the following 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.

This is standard language found in many leases. According to the terms and conditions of this language, most courts have found that *actual production must be in place* by the end of the primary term in order for the secondary term of the lease to take place. If a well were commenced during the primary term but not *produced* until after the primary term, the lease would expire at the end of the primary term.

An Oklahoma court ruled as follows:

"This court has steadfastly held to the rule that an oil and gas mining lease having a definite and fixed term limited with a 'thereafter' clause 'as long as oil or gas or either of them is produced upon said lease by the lessee' terminates not by forfeiture, but by its own terms, at the end of the fixed period unless oil or gas is found or produced there from, in the absence of the lessee having specifically provided against such contingency by an appropriate term in his lease contract."

In other words, by using the four corner rule, the court will examine the entire lease contract in an attempt to interpret the conditions as set out in the Term Clause.

Thankfully, most all leases contain additional language in other clauses that will allow the company to begin drilling during the primary term and continue drilling past the expiration date until the well is completed.



The Parol Evidence Rule

One of the basic rules of contract law is that if the court is attempting to determine the meaning and effect of a contract they must restrict themselves to the document itself. If it is determined that the contract was indeed a clear and complete statement of the terms and conditions as between the parties, the restriction does not allow the court to look at other extrinsic evidence

such as prior agreements, side agreements, or verbal interactions either before or after the creation of the contract.

During the negotiation period of a contract, both parties will often make statements or promises that do not ultimately end up in the written contract. The “parol evidence rule” may exclude these oral statements as evidence that would have the effect of adding to or taking away from the terms of the written contract.

If terms or conditions in the contract appear to be clear and unambiguous, the court must accept the “plain meaning” of the terms and will not be influenced by outside evidence.

Assume a newly hired lease administrator had the responsibility of making a rental payment on a delay rental oil and gas lease. The rental terms of the lease state,

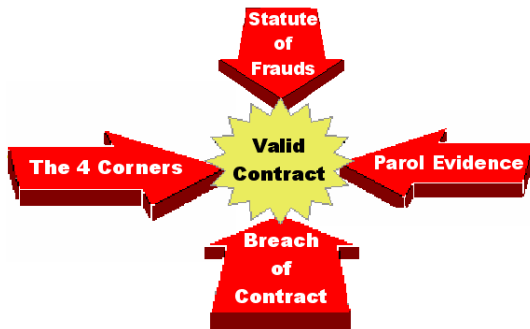
**Delay Rental
Clause**

“This lease shall terminate on March 15, 2010 unless on or before said date Lessee either (a) commences operations for the drilling of a well on the land, or (b) pays the lessor a rental payment of \$10 per acre for all or that part of the land the Lessee elects to continue to hold hereunder...”

On January 15, 2010 the lease administrator realized that the payment was due and requested a check in the correct amount. On February 15, 2010 the lease administrator called the lessor and explained that the payment was being mailed on that day. Immediately after the call, the lease administrator gathered up the rental payment along with several of her personal bills and drove them to the post office. While in her car, the rental payment fell unnoticed beneath the passenger seat of the car. It was never mailed. On March 17, 2010 the lessor, having not received the rental payment, believed the oil company was in breach of the lease contract and demanded a release of the lease.

Since most states enforce a stringent compliance with the contract language of the lease, they would permit few excuses, if any for this lease to be saved. They would not allow “honest” mistakes or an inadvertent error made on the part of the lease administrator. Because the language in this lease contract created a *condition*, the condition must be met or the lease would terminate. No amount of parol evidence, testimony concerning the phone call or explanations over the events would cause the court to deviate from the clear and concise terms of the written contract.

When contract language is ambiguous or has more than one meaning, circumstantial evidence will be allowed; however, such circumstantial evidence would not be admissible in order to contradict the clear terms of the contract.



Breach of Contract

Under contract law, parties to a contract must fulfill and perform their specific duties and conditions as set out in the contract.

These conditions, terms and duties can be modified if all parties agree to the change, or if the conflicting actions of the one party are completely accepted by the actions or non-actions of the other party.

Failure, without having a legal excuse, to meet specific duties or terms of an agreement when the other party refuses to accept that failure of performance would constitute a breach of the contract.

Assume a homeowner contracted with a builder to have his kitchen remodeled. The contract specifically called for copper pipes; however, the builder used sub-par, non-copper pipes. If the homeowner could prove a breach of the contract, recovering the cost of correcting the breach may be determined.

A breach would also occur if one party to the contract would make it impossible for the other party to perform their specific conditions.

Assume that two oil companies entered into an Area of Mutual Interest Contract (AMI). According to the terms of the AMI, the smaller company would receive a 25% interest in all leasehold and wells and the larger company would receive a 75% interest. The larger company was obligated, under the contract, to begin drilling the initial well within seven months of the effective date of the agreement.

After the contract was in place, the smaller company felt they had been taken advantage of by the larger company ... so, six months into the contract, they secretly placed a locked gate across the access road to the first drilling location. Late every evening, they would change the lock on the gate, in an attempt to stall operations.

In this case, if the initial well were not commenced prior to the seventh month, the larger company would be in breach. The breach; however, would occur because of the fault of the smaller company not the larger.

It could also be said, in this case, that the breach took place because the smaller company acted against the intent of the contract.

The Result of a Breach of Contract

The ordinary effect for breach of contract would be damages assessed against the defaulting party and in favor of the non-defaulting party. Courts; however, may terminate the contract upon a breach.

Many contracts spell out any such consequences. In the example of the delay rental lease as seen earlier, the contract specifically stated that the "lease would *terminate* on March 15, 2010 unless..." the lessee either began operations or tendered a rental payment.

A Material Breach vs. an Immaterial Breach

Not all contracts would become void upon a breach of contract. The breach as cited in the AMI agreement would be considered a material breach. Many other breaches would be considered "immaterial" meaning they would not be serious enough to make any real difference in the intended result of the contract. When an immaterial breach occurs, the default can be excused and/or ignored. Additionally, the default can be addressed by the defaulting party and then fixed.

In the case of the kitchen remodel, as cited earlier, the breach may be considered immaterial and the homeowner might refuse to make any more payments to the builder until the sub-par pipe is removed and replaced or the homeowner could fix the problem himself and then deduct the cost from the final bill.