

# The Practice of Drafting and Interpreting Oil and Gas Leases: Common Problems from Experienced Oil and Gas States

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## I. Introduction

Proponents of drilling the recently found natural gas shale in North Carolina frequently point to the economic benefits that hydraulic fracturing will bring to the state and to job seekers.<sup>1</sup> There are two other parties, but certainly many more,<sup>2</sup> that could also benefit economically from the drilling of natural gas: the operator and company making the profit, and the person or persons who own the surface under which the shale lies.<sup>3</sup> The company drilling (the “lessee” or “operator”) benefits economically from actually and potentially capturing and marketing the mineral. The lessor benefits economically from royalties paid by the operator when the operator markets the mineral. The lessor also benefits when the operator pays any fees to keep the lease alive before production is possible or in the event of any necessary halt in production during the lease.<sup>4</sup> Clauses within the typical oil and gas lease are written by drafters and interpreted by courts in ways designed to equitably protect the economic interests of both parties.<sup>5</sup> In this endeavor, the common law of different states evolves with different methods of interpretations of those clauses.<sup>6</sup>

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<sup>1</sup> Dan Way, *GOP Works to Override Governor’s Veto of Energy Jobs Bill*, THE CAROLINA JOURNAL (Oct. 10, 2011), [http://www.carolinajournal.com/exclusives/display\\_exclusive.html?id=8341](http://www.carolinajournal.com/exclusives/display_exclusive.html?id=8341).

<sup>2</sup> See Keith B. Hall, *Hydraulic fracturing: What are the 3 Big Benefits*, STONE PIGMAN WALTHER WITTMAN L.L.C. (April 01, 2011) <http://www.oilgaslawbrief.com/hydraulic-fracturing/hydraulic-fracturing-what-are-the-3-big-benefits/>.

<sup>3</sup> See Bruce M. Kramer, *Keeping Leases Alive in the Era of Horizontal Drilling and Hydraulic Fracturing: Are the Old Workhouses (Shut-in, Continuous Operations, and Pooling Provisions) Up to the Task?*, 49 Washburn L.J. 283, 283 (2010).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> See Ashleigh L. Boggs, *Anadarko Petroleum Corp. v. Thompson: Interpretation of Oil and Gas Lease Habendum Clauses in Texas and Why Oklahoma Should Maintain Its Divergent Approach to Keep Leases Alive*, 61 OKLA. L. REV. 341, 341 (2008).

Oil and gas leases, though commonly used, contain debated language and costly gaps in terms. These gaps and subjective terms lead to conflicts that can frequently only be settled by litigation. There is no agreed upon standard form for oil and gas leases, only a standard format, generally referred to as “Producer’s 88.”<sup>7</sup> Even well drafted leases create points of disagreement between communities, operators, and individual land lessors.<sup>8</sup> Regardless of efforts over the past few decades to solve common issues and create law to preempt problems, litigation continues at a persistent rate.<sup>9</sup> This paper briefly explains relevant property law in the context of mineral rights, and discusses clauses commonly found in an oil and gas lease that have been the source of disagreement between interested parties.<sup>10</sup>

## II. How the Law Defines Mineral Rights

Defining the boundaries of a lessee’s mineral rights is a challenging effort. Oil and gas, like water or other flowing resources, are not simply contained in one area. These resources can flow between properties. Mineral law attempts to redefine property concepts, such as “trespass,” to deal with the fluidity of oil and gas.<sup>11</sup> Defining the surface boundaries of land under which a lessee has mineral rights is important when determining where the lessee can place equipment and carry out necessary function of production, including to what minerals the lessee has a right.<sup>12</sup> Thus an oil and gas lease must not only define the surface area to which a lessee has access, it must attempt to conceptually define the subsurface resources that the lessee owns.<sup>13</sup>

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<sup>7</sup> Leslie Moses, *The Evolution and Development of the Oil and Gas Lease*, 2 OIL & GAS INST. 1, 33 (Matthew Bender 1951).

<sup>8</sup> See William D. Wood & Jaworski L.L.P., 59-3 CAIL Annual Institute on Oil & Gas Law § 3.04 (2008).

<sup>9</sup> Kramer, *supra* note 3, at 283.

<sup>10</sup> Theodore R. Borrego & Randall Hill, *Energy Transactions and Business Planning*, in 2 ENERGY LAW AND TRANSACTIONS 20.2 (David J. Muchow ed., 2011).

<sup>11</sup> *Id.*

<sup>12</sup> Borrego, *supra* note 10.

<sup>13</sup> *Id.*

Defining the boundaries of the surface area is important for determining the amount of land on which royalties are paid, what surface areas the operators can use, and what mineral the lessee has a right to capture.<sup>14</sup> The rule of capture is a concept recognizing, because of the fluidity of certain resources like water and gas, that no one is the owner of that resource until the person has obtained the resource.<sup>15</sup> This principle is slowly being overruled by state statutes such as those in Mississippi, Kansas, and Oklahoma.<sup>16</sup> These statutes aim to protect the mineral right owners of adjacent lands that might otherwise lose the ability to recover resources because of the rule of capture.<sup>17</sup> In Texas, for example, a lessor cannot recover for the loss of oil from his tract due to a fracturing operation from another property because “a mineral rights owner [has] title to the oil and gas produced from a lawful well bottomed on the property, even if the oil and gas flowed to the well from beneath another’s tract.”<sup>18</sup>

### III. Keeping Economic Interests Alive without a Termination Clause

An oil and gas lease has an initial term, or primary term, and a secondary term.<sup>19</sup> The primary term is a period of time of usually between five and ten years in which the lessee has exclusive rights to exploration of the leased premises.<sup>20</sup> Once the primary term expires, the lease will continue into the second term if the exploration results in the discovery of hydrocarbons.<sup>21</sup> The presence of hydrocarbons is an indication that oil or gas might have formed.<sup>22</sup> Therefore, during exploration, the finding of hydrocarbons in an accessible formation suggests the ability to

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<sup>14</sup> *Id.*

<sup>15</sup> George A. Bibikos & Jeffrey C. King, *A Primer on Oil and Gas Law in the Marcellus Shale States*, 4 TEX. J. OIL GAS & ENERGY L. 155, 158 (2009).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> Richard F. Brown, *Oil, Gas, and Mineral Law*, 62 SMU L. REV. 1317, 1328-1329 (2009).

<sup>19</sup> HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW, MANUAL OF OIL AND GAS TERMS 948, 1125 (1993).

<sup>20</sup> *Id.*

<sup>21</sup> Boggs, *supra* note 6, at 341.

<sup>22</sup> COLORADO GEOLOGICAL SURVEY, *Excerpts for Rock Talk Vol 7 No.2*, <http://www.geotech.org/survey/geotech/Oil.pdf>.

find oil and gas, but it does not guarantee any drilling for oil or gas will be able to produce either in profitable amounts.<sup>23</sup> In order to protect the lessee's mineral rights and the economic interests of both parties, clauses in an oil and gas lease allow for the continuation of the lease into and during the secondary term, as long as the lessee satisfies conditions specified by each clause.<sup>24</sup> Although in theory economic interests of both parties are best served by allowing the lease to continue indefinitely, this is not always the case, and conflict will arise.<sup>25</sup> Three clauses, the habendum clause, the shut-in royalty clause, and the cessation clause, are frequently the basis for some of these conflicts.<sup>26</sup>

#### A. Habendum Clause

The habendum clause is one of the more controversial clauses in the lease because it determines the duration of the lease.<sup>27</sup> The habendum clause states the time length of the primary term of the lease, divides the primary and secondary term, and defines the situation where a lease would terminate at the end of the primary term or at some point during the secondary term.<sup>28</sup> A lease extends indefinitely during the secondary term while the lessee maintains the drilling operations and produces in a manner that satisfies the habendum clause.<sup>29</sup> Habendum clauses may specify what actions are required of the lessee, such as production of natural gas and marketing of the product, but different court systems interpret the commonly used terms such as "production" and "marketing" differently.<sup>30</sup> When one party, usually the lessor, wants to terminate the lease by enforcing the habendum clause, these interpretations become critical to

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<sup>23</sup> *Id.*

<sup>24</sup> Boggs, *supra* note 6, at 341.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> Lisa S. McCalmont, *Vanishing Rights of the Mineral Lessor: The Pack v. Santa Fe Minerals Ruling*, 30 TULSA L.J. 695, 699 (1995).

<sup>28</sup> Boggs, *supra* note 6, at 341.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

resolving disputes.<sup>31</sup> Two examples of disparate interpretations come from courts in Texas and Oklahoma.<sup>32</sup>

The Oklahoma Supreme Court requires only that the lessee be able to produce hydrocarbons and use due diligence to market the product.<sup>33</sup> Due diligence is so “liberally interpreted” in Oklahoma that a lease can be upheld if there is even an *intention* to market the product.<sup>34</sup> Courts have upheld a lease even where there has been some violation of the express terms of the lease.<sup>35</sup> The Oklahoma Supreme Court, by liberally interpreting due diligence, removed the lessor’s ability to have any power over termination, even in the presence of clear termination terms stated in the contract.<sup>36</sup> In reaching its liberal interpretation of the habendum clause, the Oklahoma Supreme Court applied what is known as the “discovery” rule.<sup>37</sup> Texas courts, in contrast, interpret leases more literally.<sup>38</sup> In Texas, for the Habendum Clause to be in effect, the product must be in physical production and it must be marketed<sup>39</sup>—“for a gas well to be ‘capable of producing gas;’ the gas must be able to flow.”<sup>40</sup>

While it may be fair to give such advantage to the lessee given the amount of investment required to explore and make a drilled well produce, the Oklahoma rule also allows for interpretation of express terms of the agreement instead of reading the plain language of the terms.<sup>41</sup> If hydraulic fracturing becomes legal in North Carolina, the drafter of leases should explicitly describe phrases like “production,” “capable,” and “market,” in order to avoid lengthy

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<sup>31</sup> See *Pack v. Santa Fe Minerals*, 869 P.2d 323, 331 (Okla. 1994).

<sup>32</sup> *McCalmont*, *supra* note 29, at 696.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Pack v. Santa Fe Minerals*, 869 P.2d 323, 331 (Okla. 1994).

<sup>36</sup> *Id.*

<sup>37</sup> *Kramer*, *supra* note 3, at 284.

<sup>38</sup> *Boggs*, *supra* note 6, at 341.

<sup>39</sup> *Id.*

<sup>40</sup> Richard F. Brown, *Family Law: Oil, Gas and Mineral Law*, 62 SMU L. Rev. 1317, 1326 (2009).

<sup>41</sup> *McCalmont*, *supra* note 29, at 732.

litigation and equitably inform the lessor.<sup>42</sup> The interpretation of the habendum clause in Oklahoma tends to favor the economic interests of the operator, whereas the interpretation of the habendum clause in Texas is more favorable to the economic interests of the lessor.<sup>43</sup>

## B. The Royalty Clause

The Royalty Clause addresses the proceeds of sale or production of material that both parties agree will be given to the lessor.<sup>44</sup> Traditionally, as negotiated under the Royalty Clause, lessees have been required to give one eighth of royalty amounts to the lessor.<sup>45</sup> These amounts are increasing, and in some cases, the lessee has given half of all royalty to the lessor.<sup>46</sup> Because of ambiguities in the terms of oil and gas leases, conflicts have arisen as to what amount of royalty might have actually been agreed upon.<sup>47</sup> For example, if natural gas is sold “off the lease,” or at “market value,” it has to go through further production off site, increasing the operator’s investment in the production and marketing of the natural gas.<sup>48</sup> State law varies as to whether this off site production is deductible from the off-lease sales price.<sup>49</sup> For example, in Texas, lease forms specify that costs of transportation must be deducted from the royalty payments to the lessor.<sup>50</sup>

## C. Pooling

Pooling is the concept that the lessee may combine the mineral rights of one lessor’s land with the mineral rights of adjacent lessors’ land in exploration and drilling without the further

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<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> Borrego, *supra* note 10.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> Jefferson D. Stewart, *Post-Production Charges to Royalty Interests: What Does the Contract Say and When is it Ignored?* 70 MISS. L.J. 625, 635 (2000).

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> E. Kuntz, THE LAW OF OIL AND GAS § 47.2(a)(2) (1964); Williams & Meyers, OIL AND GAS LAW § 612 (2004).

consent of each lessee.<sup>51</sup> In Texas, pooling can only be done through voluntary agreement of all parties in the lease.<sup>52</sup> In contrast, Louisiana oil and gas leases presume pooling will take place, removing the ability of the surface owner to object.<sup>53</sup> Regardless of state law, a broad pooling clause is arguably necessary given the likelihood that surface property changes hands over the course of drilling operations.<sup>54</sup> However, courts tend to require strict compliance with express terms used in the pooling clauses.<sup>55</sup>

Conflict arises between lessee and adjacent surface owners when pooling is mandated in order to protect mineral rights, especially in urban areas.<sup>56</sup> Pooling becomes necessary in urban areas because numerous, small lots must be pooled in order for any drilling to be practically and economically feasible.<sup>57</sup> Some states that allow for voluntary pooling agreements, however, have laws that might obligate the owner of a small, urban plot to enter the pooling in order to protect mineral interests.<sup>58</sup> For example, Texas created the Texas Mineral Interest Pooling Act (“TMIPA”) in recognition of the need to protect mineral interests in urban areas using pooling.<sup>59</sup> TMIPA allows the Texas Railroad Commission (“the Commission”) to pool lands on a “reasonable” basis over the objection of neighboring would-be lessors.<sup>60</sup> However, the TMIPA also raises the obvious question of whether forced pooling will be unfair and unreasonable and encroach on the economic interests of the lessor.<sup>61</sup> Recently in Fort Worth Texas, all but 5.9% of

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<sup>51</sup> Kramer, *supra* note 3, at 286.

<sup>52</sup> Borrego, *supra* note 10.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> Kramer, *supra* at note 3, at 286.

<sup>56</sup> Maxwell, *Texas Tug of War: A Survey of Urban Drilling and the Issues an Operator Will Face*, 4 TEX. J. OIL GAS & ENERGY L. 337, 357 (2009).

<sup>57</sup> *Id.*

<sup>58</sup> Maxwell, *supra* note 59, at 357.

<sup>59</sup> Kramer & Martin, THE LAW OF POOLING AND UNITIZATION, Matthew Bender 3d ed. 1989.

<sup>60</sup> TEX. NAT. RES. CODE ANN. § 102.011 (Vernon 2007); Tex. Nat. Res. Code Ann. § 102.001 *et seq.*

<sup>61</sup> Maxwell, *supra* note 59, at 357.

desired acreage within a neighborhood had been pooled.<sup>62</sup> The lessee used the TMIPA to pool the remaining units in order to protect the lessee's interests. While there was community objection, the Commission upheld the ability to pool.<sup>63</sup> The TMIPA serves as a way to protect mineral interests in urban areas, but can lead to conflict between land owner and mineral lessees because of the state's tendency to give higher importance to mineral interests over surface interests.<sup>64</sup>

#### IV. Conclusion

Conflicts not only arise from the language of the lease concerning land use and royalty payments, but may also arise after drilling and production.<sup>65</sup> Clear and precise language can help alleviate the need for judicial intervention,<sup>66</sup> but inevitably States will produce bodies of law that influence how unclear language must be interpreted.<sup>67</sup> For states with undeveloped oil and gas law, it is in the best interest of parties not to rely on commonly used terms such as "production," and "royalties" but to make explicit the parties' common understanding of what these terms mean.<sup>68</sup> Initial court cases concerning these disagreements will define the way a state protects and promotes economic interests of both parties.<sup>69</sup>

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<sup>62</sup> *Id.*

<sup>63</sup> H. Philip Whitworth, *State Regulatory Impacts Upon Horizontal Drilling in Urban Areas*, Tex. J. Oil, Gas, & Energy L. Symposium (Jan. 23, 2009) at 12-13, available at [http://www.tjogel.org/symposium\\_2009/symposium\\_2009\\_documents.html](http://www.tjogel.org/symposium_2009/symposium_2009_documents.html).

<sup>64</sup> Maxwell, *supra* note 59.

<sup>65</sup> William D. Wood & Jaworski L.L.P., *supra* note 8.

<sup>66</sup> Rick D. Davis, Jr. Chris Aycock Cotton, Bledsoe, Tighe & Dawson, P.C., 60-4 CAIL Annual Institute on Oil & Gas Law § 3.04 (2011).

<sup>67</sup> McCalmont, *supra* note 29, at 725.

<sup>68</sup> Boggs, *supra* note 6, at 341.

<sup>69</sup> *Id.*