FOCAL POINTS OF OIL & GAS LEASE NEGOTIATIONS – LESSEE PERSPECTIVE

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CHAPTER 1

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I. INTRODUCTION

For onshore oil and gas exploration and development, the oil and gas lease is the single most important and longest enduring document. Because the majority of lands in Texas are held under private ownership, the oil and gas lease is usually negotiated specifically between mineral owners acting in their capacity as property or asset managers and oil and gas companies acting with a singular focus towards a complete development of the minerals. Unfortunately, almost all of the initial negotiations for a lease purchase are made while the prospect is still at its infancy. Consequently, the type of drilling and completion techniques to be employed, along with knowledge of the actual reservoir dynamics that may be encountered, are likely unknown or minimally understood at best.

These development "unknowns" tied with the rapid changes in various technologies, including horizontal completion and fracturing, in addition to the continued shift to shale formations, have completely changed the manner in which oil and gas drilling and exploration is conducted—changes that can and have continued to occur between signing of the initial lease and actual drilling. Each oil and gas lease negotiation is an attempt to reach a mutual agreement on a plethora of issues, all of which may or may not be relevant in the future, and many of which will be based on the oil and gas companies' success relating to actual production from the property. The lessee's mission, then, is to have an oil and gas lease that retains the operator's flexibility to adapt to new patterns of development and all the while preserving the value of the leasehold working interest investment made, not just through the bonus but through the actual drill bit and developing of reserves.

II. COMMON COMPONENTS OF AN OIL AND GAS LEASE

Understanding the major components of an oil and gas lease is the first step to being able to fully and accurately respond to the intricacies relating to a fair and enforceable lease in the lessee's hands. The most common components are:

A. Granting Clause.

The purpose of the granting clause is to describe the rights that the mineral interest owner grants to the lessee. These rights include searching, developing and producing oil and gas from the leased land without any obligation to do so. To ensure the granting clause is valid, it must specify the size of the interest granted, what substances are covered by the lease, what land is covered by the lease, and in most circumstances, it must also specify the permitted uses.

B. Habendum Clause.

The habendum clause sets the period of time for which the rights in the granting clause will extend. The majority of leases contain a primary and secondary term, whereby the primary term is a fixed number of years during which the lessee may, without any obligation, operate on the premises. In contrast, the secondary term is the additional extended period of time in which the rights extend after production. Normally, production means that the oil and/or gas is produced and marketed (i.e. sold) with an amount in paying quantities (meaning that production is profitable).

C. Delay Rental Clause.

The delay rental clause ensures that a lessee has no obligation to drill during the primary term, as drilling a test well within a reasonable time after leasing was an implied covenant in years past. These clauses have now become standard in oil and gas leases and many lessors generally do not resist them. Recently, the paid-up oil and gas lease has been used more frequently because it essentially pays any delay rentals in advance—thereby eliminating the chance for a lease to terminate during the primary term for lack of payment.

D. Dry-Hole Clause.

Dry-hole clauses clarify the obligation to pay delay rentals after a lessee has drilled a dry hole during the primary term. By placing this clause in the lease, the lessee is assured that even after drilling a dry hole, the lease will continue by either commencing additional drilling or re-working operations within the primary term or by making timely delay rental payments.

E. Operations Clause.

The operations clause protects the lessee against the expiration of the primary term while drilling operations are active. This clause essentially satisfies the production requirement in the habendum clause and is more constructive production than actual production. Therefore, even if there is no actual production or the capability of production (which is normally required), this clause saves the lessee's lease.

F. Pooling Clause.

Pooling is the process of combining fractional mineral interests of various small tracts in order to drill a single well on a particular spacing unit. A pooling provision allowing a lessee to pool his or her interests gives the lessee the ability to extend into the secondary term by drilling anywhere within the pooled unit, not just within the original leased land. For a lessee, a pooling agreement is necessary to ensure that proper allocation of the lease royalty to the lessor is proportionate to the total interests of all pooled lands. Otherwise, lessee would be responsible to lessor for the full lease royalty on production from the well. Pooling clauses are very important when the lease covers a small tract, especially tracts that are of a size less than required for a drilling unit.

G. Pugh Clause.

A Pugh clause is a mechanism in which the lessee and lessor agree to modify the usual pooling language by providing that drilling or production from a pooled unit will not necessarily preserve the entire lease. The lessor's royalty is proportionate to the amount of land within the pooled unit. Essentially, this reduces the ability for lessees to hold large tracts of land by creating smaller, multi-leased units.

H. Shut-in Royalty Clause.

Shut-in royalty clauses are used to solve any issues with the normal requirement that once production occurs, the product must be marketed to maintain the lease. These clauses provide that the lease will be maintained when a well that is capable of producing is shut in. This constructive production normally takes the form of shut-in royalty payments and therefore is a substitute for production as required in the habendum clause.

I. Temporary Cessation of Production Clause.

Temporary cessation of production clauses provide a solution for instances when a well stops producing, for various uncontrollable reasons. The critical distinction with this type of clause is differentiating "temporary" cessation from "permanent" cessation. When a lessee is diligent to reestablish production or where circumstances excuse the inability to produce, even longer time periods of inactivity may be classified as temporary. The usual mechanism in this lease clause is for the lessor and lessee to agree upon a fixed period of time, usually between sixty and ninety days.

J. Lease Royalty Clause.

When production is obtained, a lessor normally receives a percentage of production as payment. The lease contains multiple payments, such as the bonus payment (for granting the lease), delay rental payments (see above), and royalty payments (a percentage of production or value of sale, free of production costs). Lease royalties are generally fixed percentage amounts, negotiated by both parties based on probability and quantity of production, and payable if, as and when production is secured.

K. Force Majeure Clause.

Incorporating a force majeure clause into the lease is a necessity because it excuses or extends the time for performance due to unforeseeable circumstances (or specific circumstances negotiated by the parties) beyond either party's control. Usually these consist of so called "acts of God", such as weather and governmental strictures. When negotiating this portion of the lease, lessee/operators should carefully read what is an excusable event and focus on any possible events, not just probable events, that may cause issues in fulfilling their contractual obligations.

III. KEY ELEMENTS OF LEASE NEGOTIATION

Oil and gas companies, as lessees, are increasingly confronted with surface and mineral owners who prepare special custom forms that resemble a standard lease, but operate as more of a license, allowing the oil and gas company to merely enter the land. Other lessors attempt to arrange more of a development agreement that contains almost every potential contingency with all remedies in favor of the mineral owner. Thus, in negotiating an oil and gas lease from the lessee/operator's perspective, a lawyer must be cognizant of the significant potential capital that may be put into the ground balanced with the potential value stemming from a producing well. Standard forms, such as the Producers-88, are available for lessee/operators, and all contain the major components discussed above. However, there are instances when a person may be confronted with a landowner's lease and the attorney must understand which portions of the lease to focus on and negotiate. In summary, there are a number of key focal points that should remain at the top of a negotiator's list when assisting the lessee.

A. The Granting Clause.

Generally, the lessee/operator wants to secure two important components out of the granting clause: (1) securing the <u>exclusive</u> rights of exploration and development to oil and gas and the stated hydrocarbons and (2) acquiring <u>all</u> of the named lessor's rights in the same property. When a lessee is granted exclusive exploration rights, the lessor cannot grant any rights to third parties, nor conduct exploration on his or her own. *Wilson v. Texas Co.*, 237 S.W.2d 649, 650 (Tex. Civ. App.—Fort Worth 1951, writ ref'd n.r.e.). In short, a lessee/operator should be cognizant of the language in the granting clause and ensure that exclusivity language is written in to the lease, otherwise he or she may be subject to the general rule that the valuable property right of exploration stays vested in the leasehold owner until it has been exclusively granted. For a more detailed explanation of the exclusivity issue see N. Suzanne Lomenick, *The Oil and Gas Lessee's Right to Geophysical Exploration: Incidental or Exclusive?*, 20 TULSA L.J. 97, 106–07 (1984).

The second component in the granting clause is to clearly gather all of lessor's rights in the property. There should be no ambiguity that all rights into the development of the oil and gas estate are acquired by the lease document. Provisions seeking to state or limit the quantum of mineral rights passed should be strenuously avoided and the lease should cover all or the full fee simple absolute interest in the property.

B. The Delay Rental vs. Paid-Up Feature.

Almost all leasing has gone from payment of annual delay rentals to paid-up primary terms of three, four or five years. Lessees and operators must be cautious when using lease forms with addendums, printed forms or the like that make reference to delay rentals. These leases must be meticulously scrutinized and scrubbed to remove delay rental components and language that cause the lease to terminate by failure to drill or pay rentals ("unless" form oil and gas leases). Courts tend to construe these clauses strictly and if a lessee/operator is not careful a lease can terminate by a multitude of mechanisms such as underpayment, late payment, payment to the wrong person or payment in the wrong proportions. *See Humble Oil & Refining Co. v. Harrison*, 146 Tex. 216, 205 S.W.2d 355 (1947), *citing Young v. Jones*, 222 S.W. 691 (Tex. Civ. App.—El Paso 1920). A lessee should include specific language relating to the primary term clarifying that to the extent there is any other language in the lease to the contrary, the primary term is paid-up, and no other actions, such as drilling, production, operations, or additional payments, are required during the initial stated primary term.

C. Lease Perpetuation Beyond the Primary Term.

Two questions that all lessee/operators should ask and be aware of are "what types of activities are sufficient to perpetuate a lease across and beyond the primary term, and are producing the only way to retain the working interest rights beyond the primary term?" There are many different lease savings clauses that act as substitutes for production. Principally, the lessor and lessee understand that as long as the operator is attempting to secure oil and gas through good faith drilling or operations, the lease continues, and any payments made to perpetuate the lease are additionally classified as a substitute for operations. Therefore, a lessee should ensure that a comprehensive list and definition of all manners of development activities will perpetuate the lease. Activities sufficient to perpetuate the lease should include more than production in paying quantities—obviously, drilling operations are contemplated by almost every lease and most land owners and lessees understand that drilling operations usually means drilling with a rig by a drill bit that is making a hole. The other activities that should be included in the definition of operations are:

(i) reworking operations to secure, restore and prove production by downhole mechanical means;
(ii) chemical treatment or swabbing;
(iii) drilling by virtue of a drill rig;
(iv) work over rig or coil tubing apparatus activities;
(v) running pipe;
(vi) circulating cement;
(vii) installing production casing;
(viii) installing surface metering and valve equipment;
(ix) planning for, locating and staging fracture stimulation equipment and supplies; and
(x) undertaking fracture stimulation and flow back of injected water and fracture stimulation fluids.

D. Royalty Payments – Valuation.

Another major lease component that continues to cause angst for lessees and operators is the lengthy and sometimes complicated multi-step royalty clause that attempts to secure a stated royalty percentage under various sales, processing and disposition arrangements. Royalty clauses frequently provide for the use of market indices, area indices, posted prices or the like, regardless of the contracts actually made for the disposition of oil and gas from the lease by the lessee. Lessees/operators need to be aware that certain landowners incorporate language into their leases skewed highly in their favor, especially with regard to royalty valuation. Some landowners may not want to pay for any costs associated with production *and* any subsequent costs; therefore, a lessee needs to look for language seeming to indicate that lessor is not liable for any post-production costs, no matter what, such as for compression, marketing and transportation. A different issue that arises is how the royalty payment is valued or received. Landowners may put language in the lease tending to use the "market price" method, which is essentially the price at the well, but with additional language such as a formula, to determine how the market price or value is to be established. Lessees must be cognizant of the specifics of the language, especially when dealing with valuation of the oil and gas. Additionally, landowners may include language giving themselves an extra royalty, such as an overriding royalty, in addition to the normal royalty interest. Without thoroughly reading the lease, an unsuspecting lessee/operator may not receive the level of net revenue interest they initially anticipated. Inevitably, these provisions tend to run on for many pages and lessees may want some protection against the potential disputes and continued future litigation about the valuation of oil and gas, including royalty claims for the value far beyond what the operators themselves realized by selling the product. At a bare minimum, all operators want the ability to pay based on a percentage of the proceeds that they receive, regardless of how those proceeds stack up against the market, the field price or even what other lessees are securing in a similar area. For that reason, and in an attempt to avoid numerous revisions to a landowner's royalty paragraphs, operators generally prefer a "notwithstanding" royalty clause that more closely resembles the standard oil royalty clause which calls for 22.5% of the amount realized by the lessee from the sale of oil and gas at its place or use. This is the "bottom-line" threshold that lessees should negotiate in order to satisfy all royalty conditions within the lease. Although negotiations on this topic may be difficult, some suggested language a lessee/operator may push to add in to the lease may look something like this:

"Notwithstanding anything to the contrary, in accounting for the royalty payable to lessor, the value of any oil or gas produced from the leased premises shall never be more than or less than the total gross proceeds received by lessee by reason of the sale of such oil or gas provided such sale is made to a third party in an arm's length transaction. It is the intention of the parties hereto that lessor's royalty be free of the costs delineated in the lease; however, notwithstanding anything to the contrary, in accounting for the royalty, if the gross proceeds received by Lessee incorporates such expenses, lessor shall proportionately participate in such contract adjustments to the extent that, and only to the extent that, such settlement terms respecting production are in excess of that necessary to put the oil and gas in a marketable state at the first available gathering point or point of sale."

E. Royalty Payments – Lease Terminating Events.

a. With regard to royalties, operators must be extremely cautious to avoid the non-payment or underpayment of royalties becoming a lease terminating event. Particularly, the failure to pay the exact amount the lessor is entitled could result in a termination of the lease. These types of provisions are often found in the royalty clauses specifically, and allow the lessor (royalty owner) to terminate the lease at a specific date in the event royalties are incorrectly paid. Disputes can easily arise when dealing with the proper payment of royalties, either with the time period, the total amount, a misstatement of quantity, deductions in payment or other disputes regarding valuation, sale proceeds or tax deductions. Ideally, lessee/operators and lessors should negotiate the specifics of these provisions, but at a minimum, they should arrive at a comfortable area to address these important items when a dispute or mistake arises. First, to the extent that a default by improper payments occurs and results in termination, the termination should only occur with respect to the specific wells and the specific amount of acreage associated with those wells. In *Hitzelberger v. Samedan Oil Corp.*, 948 S.W.2d 497 (Tex. App.—Waco 1997), a lease was terminated based on an untimely royalty payment because the lease habendum clause consisted of language providing that the secondary term would continue as long as there was production *and royalties were paid as provided.* Courts generally disfavor termination of a lease based on non-payment or underpayment of royalties because the lessor has a viable legal remedy in the form of a contract claim. However, courts do have the power to terminate a lease and may do so in situations where a lessee knowingly refuses payment for speculative purposes. In most instances, as long as there is a legitimate reason for non-payment, or a mere accounting mistake or other unintentional underpayment, courts tend to avoid canceling a lease. But, when a specific contractual remedy is negotiated between the lessor and lessee as to language regarding underpayment or non-payment of royalties, these clauses are strictly construed, and termination of the lease will occur.

The second item relates to the ability to suspend or otherwise dispute payments based on title examination issues, a third party claim, a simple misunderstanding about production or some other payment mishap. In these cases, the defaulting provision should be abated as long as the operator has made a good faith attempt to address and fix the problem, or provide another suitable remedy. Frequently, an escrow account, payment to a bank trust account or a similar placement of funds can be used. For both of these ambiguous royalty termination features that landowners seek, the following language or provisions are recommended to at least put some reasonableness in the termination remedy:

1. Only terminating as to a specific well on the lease:

a. Suppose landowner leases 10,000 acres to lessee, on which lessee drills five (5) producing wells. Assume that lessee fails to make proper royalty payments on one (1) well. Should the entire lease covering the 10,000 acres terminate, or just as to the land subject to the well? Landowners would prefer for the entire lease to terminate and therefore, to shield this from occurring, lessees should incorporate into their leases language similar to this:

"Should Lessee at any time fail to make royalty payments to Lessor in compliance with the applicable provisions of this lease, Lessor may, at Lessor's election, cancel this lease as to such well and said lands ascribed to such well as a retained acreage unit which is subject to such royalty payments by giving Lessee thirty (30) days advanced written notice of such cancellation."

2. What size/type of discrepancy is sufficient?

Suppose an oil and gas lease requires lessee to pay to lessor royalties equating to $100,000.00. What happens if disputes arise as to ownership of all of this amount and lessee pays only a fraction of the $100,000.00—an amount that lessee believes he is responsible for? In this scenario, lessee would not want to have the lease terminate based on a dispute as to payment which could be either large or small. To ensure this event does not happen, lessee should insert a provision into the lease that reads:

"In the event Lessee reasonably determines that a bona fide question of title or ownership exists as to all or any portion of the royalties payable hereunder, Lessee shall deposit such disputed royalties into an escrow account at the depository bank designated by Lessor until such dispute is resolved. Lessee shall instruct such depository bank to maintain such escrow account at the highest interest rate allowable therefore. To the extent that Lessee makes each deposit into such escrow account and requests the highest interest rate thereon, Lessee shall be relieved of any liability for such disputed royalties and interest accruing thereon. As to any and all proceeds of production paid into escrow under this paragraph, the party or parties which prevail in the title dispute shall be entitled to receive all such disputed proceeds together with the interest that may have accrued on such suspended sum."

F. Royalty Payments – Burdens.

Another issue that plays an important role in lease negotiations is the amount of royalty that lessors are obligated to pay. As we are aware, most tracts of land, especially where there has been traditional oil and gas activity, have been segregated with the occasional creation of non-participating royalties. These non-participating royalties are entitled to a fixed or variable percentage production if, and when it occurs. This percentage is sometimes tied to the lease royalty clause, while other times it is tied to a fixed percentage of the total production. Generally, a non-participating royalty interest is created when a mineral interest owner sells his or her rights, entitling them to a percentage of either the production or leasehold royalty. These types of royalties can be perpetual or limited, and interestingly, they do not relate to a particular lease and therefore do not end when the lease ends. Note that the standard royalty found in most producer's leases provides that "royalties to be paid by Lessee are as follows: on oil, 1/8 of that produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipe line to which the wells may be connected." Lessees should be careful to ensure that the lease includes a provision providing that "all royalty payable out of the land covered by the lease shall be payable out of the royalty herein provided." *See Gibson v. Turner*, 156 Tex. 289, 294 S.W.2d 781, 788 (1956) (finding that because there were no words in the lease that modified the royalty language as to production from "said land", the royalty was to be paid out of the full royalty interest, not proportionately reduced based on their actual interest ownership). Without this express language, a lessee may be at risk for potential excess royalty payments that were unanticipated at the time the lease was signed. Without the proportionate reduction language, a landowner could argue that the non-participating royalties cannot reduce the fixed net revenue percentage that he or she has secured in the lease. Because lessee/operators do not want to pay the royalty interest *plus* a non-participating royalty interest they assume should be paid out of the royalty interest, special attention must be given to these portions of the lease. Therefore, a person should carefully review a lease to ensure that it has both proportionate reduction clauses and provisions providing that all royalties payable on the lease are to be paid out of the "royalty herein stipulated."

G. Liens on Royalties – How Big is Too Big?

Continuing with the royalty discussion, another major concern that arose out of the bankruptcy issues of the 1980s and the recent stresses of the recession starting in 2008 is the ability of the royalty owner to secure payment of royalties. Generally, payment of royalty interests is a contractual matter within the terms of the lease and in Texas, non-payment of royalties does not terminate an oil and gas lease, absent specific language. *Morris v. First Nat'l Bank*, 249 S.W.2d 269, 279 (Tex. Civ. App.—San Antonio 1952, writ ref'd n.r.e.). Because of this, in bankruptcy proceedings, royalty payments were generally disregarded and payment avoided, while the lease continued. This frustration among royalty owners resulted in numerous states, including Texas, to pass royalty owner super lien statutes that minimally created an automatically perfected security interest in the lease production. The relevant Texas statute grants a security interest in favor of "interest owners" who sell hydrocarbons to a first purchaser. TEX. BUS. & COM. CODE § 9.343(a). That statute further defines an "interest owner" as a person "owning an entire or factional interest of any kind or nature in oil or gas production at the time of severance, or a person who has an express, implied, or constructive right to receive a monetary payment determined by the value of oil or gas production or by the amount of production." *Id.* § 9.343(r)(2). Clearly, a royalty owner falls under the purview of an "interest owner" according to this definition and therefore, would be afforded the protection the statute provides. However, a distinction should be made between oil royalties and gas royalties because the former allows for payment "in kind", whereas the latter normally results in monetary payments only. When the statute was first enacted, this was a critical distinction because if the royalty owner had no personal property in the gas (or oil depending on the lease terms), then he would not have been protected under the statute and would have only been able to collect delinquent royalty payments as a contractual obligation. However, in 1987, the Texas Legislature amended the statute to include language that protected royalty owners, even those who typically have royalties paid in funds rather than in kind. *See In re Tri-Union Development Corp.*, 253 B.R. 808, 812 (Bankr. S.D. Tex. 2000).

As a practical point, courts have typically construed the lien from this statute to attach to only the royalty interest owner's proportionate share of the proceeds. However, more and more frequently, lessors are inserting language into lease royalty provisions that essentially provide for a lien on <u>all</u> proceeds from production, without reference to the lessor's proportionate share. For lessees and operators, overlooking this language can be a vital mistake and care must be taken when reviewing these leases. As a lessee, inserting language that "a lien attaches on lessor's proportionate share of production proceeds" would help cure this potential problem.

The key to success when negotiating leases on behalf of an operator is to never overlook what are now common provisions in leases—especially those that incorporate the Texas statutory liens, along with various other state liens. One attempt by landowners to expand these additions is to try and secure a lien on *all* production. Operators should be careful to structure the terminology in the lien in a manner that limits the lien on proceeds from the royalty share provided in the lease (i.e. 22.5%). Without this limitation, all of the production itself, known as "as extracted collateral" while it is stored in the tanks or until sold, together with the proceeds of the sale, will be encumbered by a first lien. These proceeds then go to the first purchaser who also has a lien on it. This type of situation generally hinders the operator's ability to obtain traditional bank financing on its working interest in gas and oil. Note the differences between the two examples below regarding what interest is burdened by the lien:

1. All Production.

Lessor retains a security interest *in all of*: (i) the oil and gas produced from said lands pursuant to this lease; (ii) all proceeds of sale of such oil and gas and all accounts arising therefrom; and (iii) all as-extracted collateral (the "Collateral"), to secure Lessee's payment of royalties and compliance with the other terms and provisions of this lease. In addition to any other remedies provided in this lease, Lessor, as a secured party, may in an event of Lessee's, as a debtor, default in any obligation of Lessee under this lease proceed under the Texas Uniform Commercial Code (the "Code") as to the Collateral, in any manner permitted by the Code. In the event of default by Lessee, Lessor shall have the right to take possession of the Collateral, and to receive the proceeds attributable thereto and to hold same as security for Lessee's obligations or to apply it on the amounts owing to Lessor hereunder. The Collateral includes minerals to be financed at the well head of the wells and accounts from the sale thereof.

2. Royalty.

Lessor retains a security interest *equal to its royalty percentage retained pursuant to this Lease in*: (i) the oil and gas produced from said lands pursuant to this lease; (ii) all proceeds of sale of such oil and gas and all accounts arising therefrom; and (iii) all as-extracted collateral (the "Collateral"), to secure Lessee's payment of royalties and compliance with the other terms and provisions of this lease. In addition to any other remedies provided in this lease, Lessor, as a secured party, may in an event of Lessee's, as a debtor, default in any obligation of Lessee under this lease proceed under the Texas Uniform Commercial Code (the "Code") as to the Collateral, in any manner permitted by the Code. In the event of default by Lessee, Lessor shall have the right to take possession of the Collateral, and to receive the proceeds attributable thereto and to hold same as security for Lessee's obligations or to apply it on the amounts owing to Lessor hereunder. The Collateral includes minerals to be financed at the well head of the wells and accounts from the sale thereof.

IV. MODERN DRILLING AND COMPLETION ACTIVITIES AND TIMELINES

Traditionally, oil and gas leases of all sizes contain a retained acreage clause that limits the amount of acreage around a well that can be kept by the lessee, allowing any undeveloped additional acreage to essentially drop off. In contrast, another provision called a continuous development clause allows the lessee to retain all of the acreage after the primary term, so long as they drill wells on a certain timetable, usually sometime between the completion of one well and the subsequent commencement of another. The continued use of horizontal well drilling, along with fracture stimulation completion technologies has made such concepts problematic in older form leases proposed by landowners. Operators should be careful to review and adjust their leases to account for these new realities.

A. Time Between Drilling and Completion.

At one time, a drilling and completion attempt would both be made relatively at the same time—generally when a rig was still on station. Today, oil and gas wells are drilled by a drilling rig, leaving a cased hole in place; whereas completion is done by a fracture stimulation procedure, where production tubing and equipment are installed at a much later date. Because each of these processes are provided by unique service companies, a lag time may develop between drilling and completion, sometimes from just a few days to even months. In some instances, the operator may secure a rig to drill across a leasehold or a number of leaseholds with the intention of bringing in a completion crew when all drilling is finished. Consequently, oil and gas lessees must ensure that the lease clauses dealing with continuous development "timelines" account for a possible large lapse between the end of drilling and completion of the well, so long as the operator is diligent in returning to complete the well. The time period should continue as though the well itself was being continuously operated on. An example of this provision is as follows:

"A well shall be deemed to be commenced under the terms of this lease on the date the drill bit enters the earth for the drilling of a validly permitted well with a rig capable of reaching the intended objective. . . . A well shall be deemed to be completed under the provisions of this lease on the later of ten (10) days after the end of all fracture stimulation operations and flow back of produced fluids; provided however, that such fracture stimulation operations commence within a reasonable time after the release of the drilling rig."

B. Retained Acreage.

The biggest negotiating point between lessors and lessees on retained acreage is simply the amount of acreage that can be held once a well begins producing. Lessors obviously want to negotiate for the smallest amount of retention in order to get the greatest amount of potential development, or even the ability to lease the acreage again. The lessee/operator's perspective differs somewhat, and goes against the notion that more acreage is better. Operators clearly have an interest in protecting the acreage that is actually drained by a wellbore and with the continued use of horizontal wells with longer and longer laterals, the simple fact remains that a larger unit is required. It is impossible then, without an agreed upon formula, for a lessor and lessee to accurately state the amount of acreage that can be retained if a horizontal wellbore is located on a unit. Likewise, even if a formula is agreed upon, it may not be applicable to certain types of formations. A quick review of the Texas Railroad Commission's Special Field Rules for calcium carbonate, as opposed to shale reservoirs, clearly indicates that the differences in drainage patterns may be substantial. Even current publicly available information related to the Eagle Ford, Barnett or Fayetteville Shales show that the acreage physically drained may be very limited in some cases. Nevertheless, an operator should secure flexibility with regard to these clauses in order to form units that will allow them to successfully operate the well under any of the proration rules, especially to protect the well within a box, rectangle, or the like—ensuring that all points are at a legal location. In order to achieve this flexibility, operators should be sure that retained acreage units can be formed as per either the state wide general field rules or special field rules, when applicable. Sample language relating to this flexibility can be drafted as follows:

"Notwithstanding the above (relating to unit size and retained acreage), in the event any governmental authority having jurisdiction should hereafter either *prescribe* more acreage to locate a well at legal spacing or density distances or *permit* a spacing pattern of a greater number of acres around oil and gas wells for fully allowable purposes than the number of acres specified above, then lessee may retain around each oil well and gas well such number of acres *as prescribed or permitted* by such governmental authority."

C. Warranty of Title.

Landowners are becoming increasingly sophisticated by granting no warranty, or in essence, quitclaim leases. Although the standard practice among oil and gas operators is to readily accept these, one issue particularly bothersome to operators deals with the obligation to carry burdens, primarily burdens on production in certain cases. Additionally, operators must ensure that all payments stipulated in the lease are paid prorata. In essence, the operator does not want to be liable for paying double for shut-in royalty payments, delay rental payments or any surface payments. Operators need to be very cautious when accepting multiple leases covering the subject lands and would have to ensure that all leases they accepted contained, at least, proportionate reduction clauses. A normal proportionate reduction clause reads, "without impairment of lessee's rights under the warranty in event of failure of title, it is agreed that if lessor owns an interest in the oil, gas and other minerals on, in or under said land *less* than the entire free simple estate, then the royalties, rentals or other payments provided for herein to be paid lessor shall be reduced proportionately." An important issue to remember when reviewing this portion of the lease is to look at what interest the lessor claims to have in the lands. If the lessor asserts fee title, then any proportionate reduction clause will cause a reduction of payment; however, if the lessor asserts only a fractional interest and still has the proportionate reduction interest, the lease is read as to have already reduced payments and therefore, the lessee should pay the full amount agreed upon in the lease. *See Texas Co. v. Parks*, 247 S.W.2d 179 (Tex. Civ. App.—Fort Worth 1952, writ ref'd n.r.e.).

D. Hunting Moratorium.

Finally, increasingly comprehensive surface use agreements, either from the landowner who owns the land in fee or from a landowner who owns the surface only, continue to complicate the actual conduct of oil and gas operations. Lessee/operators in certain areas should be cognizant of any possible moratoriums based on hunting or areas that are not drillable because of lack of access or other happenings in the drilling phase, and place in their leases the ability to abate or toll any matter that would otherwise terminate the lease. Here, a short provision is recommended to ensure that the operator can invoke something akin to a force majeure, by which they notify the mineral owner that they would have engaged in a lease saving operation, such as drilling or reworking a new well, but for the uncontrollable event. This provision may provide that:

"The term of this lease may be extended during any year to compensate for Lessee's lost time of the primary term or the continuous drilling period of this lease resulting from provisions contained in a surface use agreement covering said lands that restricts drilling operations, seismic operations, pipeline construction, or other than normal production activities ("prohibited operations") during the posted White Tail Deer season. This extension provision will be invoked in accordance with the following criteria:

(i) Lessee must give notice to Lessor and Surface Owner of its intent to drill a well or conduct other such prohibited operations during the deer hunting season.

(ii) If Surface Owner refuses to allow the drilling or other such prohibited operations to occur, and if such refusal occurs during the primary term of this lease, then the number of days from the date of Lessee's proposed "move in date" to the end of the deer season shall be added to the primary term of this lease.

(iii) If Surface Owner refuses to allow the drilling of a well during the White Tail Deer Season, and if such refusal occurs after the end of the primary term of this lease but while Lessee is conducting continuous development, and if the last day for commencing such well in order to keep this lease in continuous development would occur during the White Tail Deer Season, then the due date for commencing such well shall be extended until thirty (30) days after the end of the White Tail Deer Season.

(iv) If during the posted White Tail Deer Season, Surface Owner refuses to allow drilling or other such prohibited operations to occur, and if such refusal occurs after continuous development have ceased, then the time during which Lessee is prohibited from conducting the proposed operation shall be considered a force majeure event, and this lease shall be extended as to the lands included in the retained acreage unit upon which the proposed operation is to be conducted while and so long as Lessee is prevented from conducting operations on or from producing oil or gas from the retained acreage unit, and for thirty (30) days thereafter. If Surface Owner agrees to allow such drilling or other such prohibited operations to occur then Lessee shall have the right to drill such well or conduct other such prohibited operations."

V. CONCLUSION

As we have covered, the basic construct of an oil and gas lease remains the same and the essential elements that have been present for over 100 years must be honored and utilized. A practitioner helping a lessee or operator acquire a new oil and gas lease must carefully ensure that the key elements are present so that the traditional lease is complete and the operator has a leasehold that is actually subject to development. With the advent of horizontal drilling technology, statutory liens and the increasingly complicated valuation and payment of royalties, operators must be careful to take leases under which they can comply and for which they will not be subject to termination by a mere miscalculation in some aspect of the lease or disagreements as to how the lease promises are to be enforced.