

CHECKLIST FOR NEGOTIATING AN OIL AND GAS LEASE

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for the Texas Land & Mineral Owners Association
Annual Meeting, October 5, 2006

1. *Check out the lessee.*

Some leases are acquired in the name of landmen or agents for the true lessee. Insist on knowing the identity of the company acquiring the lease, and that the ultimate lessee be the named lessee in the lease. Inquire about the experience of the company in the area. Learn to use the Texas Railroad Commission website to investigate operator history. Ask other landowners who have dealt with the company. If the company is small and/or owned by one person, consider asking the principal for a guaranty of the lease.

2. *Agree on Deal Terms First.*

The "deal terms" of a lease are typically:

- bonus,
- primary term,
- royalty fraction,
- delay rental (if any)
- shut-in royalty

Reach agreement on these terms before negotiating the form of lease. Additional "deal" terms may include:

- an option to extend the lease primary term,
- a commitment to drill a well during the primary term, or pay an agreed amount as liquidated damages.
- a promise to pool lands into a unit for a well to be drilled,
- an increased royalty after "payout" of a well,
- a minimum annual royalty.

3. *The Lease Form.*

Once "deal terms" are agreed, decide whose lease form to start with in negotiations. If possible, use your attorney's form or the TLMA form as the beginning of negotiations. The TLMA form addresses many of the issues described in this checklist.

4. Negotiate.

Remember: all lease terms are negotiable. The landman acquiring the lease may not have authority to negotiate those terms, but someone does. Don't be timid.

5. Bargaining Position

Your bargaining power in negotiating lease terms depends on

- The size of your tract and what minerals you own in the tract;
- the proximity of your tract to known production;
- whether multiple companies are competing to acquire leases in your area; and
- "going rates" for bonus and royalty in your area.

Often an oil company will designate an area in which it wants to acquire leases, and hires a landman to get as many leases in that area as he can at a set bonus and royalty rate. Once the company has acquired all leases it can at those rates, it may then be willing to negotiate better terms for the owners in the area who have held out for higher rates. Never be bashful about negotiating bonus and royalty rates – it never hurts to ask.

6. Description of Leased Premises

Be sure there is a complete legal description. If there is more than one non-contiguous tract to be leased, provide a separate lease for each tract.

Delete the "mother hubbard" clause in printed forms following the lease description ("This lease also covers any lands of lessor adjacent or contiguous to the above-described lands")

7. Limit the lease to oil and gas.

Most printed form leases cover "oil, gas and other minerals." Limit the lease to petroleum and natural gas and related hydrocarbons produced in association with oil and gas.

8. The Royalty Clause

Prohibit or limit deductons of post-production costs – transportation, dehydration, compression, treating and marketing costs.

Beware of the *Heritage v. NationsBank* trap. Provide that royalties are based on the higher of market value or gross proceeds received by lessee *at the point of sale*, not net proceeds at the well.

Address the sale of production to affiliates of the lessee. If there is an affiliate sale, the royalty should be based on the higher of gross proceeds or market value at the point of sale.

Detail the time, place and frequency of payment of royalties.

Provide for interest on royalties not paid when due, at an above-market interest rate.

Include the right to terminate the lease for failure to pay royalties, after a period of written notice and opportunity to cure.

Include a security interest provision to secure payment of royalties.

Provide for the right to inspect, copy and audit books and records to assure correct royalty payment.

Consider a minimum annual royalty clause of \$25/\$50/acre/year.

9. Define "Operations."

Clearly define what is necessary to constitute drilling operations, and when drilling operations are completed.

Define what "operations" will maintain the lease in effect beyond the primary term absent actual production.

10. Pooling and Pugh Clauses

Consider whether to grant the lessee the right to pool. If the tract is large enough to develop without pooling with other lands, try to delete the clause entirely.

If a pooling clause is needed, negotiate a maximum size for pooled units.

Consider requiring that a minimum part of the leased premises be put in any pooled unit. If the lease covers 40 acres or less, require that all of the leased premises be included in the pooled unit.

Insist in a "Pugh clause", providing that production from a pooled unit will not hold that portion of the lease not included in the unit.

11. Continuous Operations Clauses

The importance of these provisions depends largely on the size of the tract being leased. If the tract is relatively small (less than 200 acres),

such a provision is probably not necessary. For larger tracts, a continuous operations clause requires the lessee to release portions of the leased premises not included within "production units" designated around producing wells, at some time after the end of the primary term. Thereafter, each production unit stands on its own as a separate lease, and production from each well holds under lease only that part of the leased premises within its production unit. Specify maximum unit sizes, and the maximum time between completion of one well and commencement of the next well in order to keep the lease in force as to all lands beyond the end of the primary term (90 or 120 days).

12. *Depth Severance*

Require the lessee to release all depths below the deepest producing perforation at the end of the primary term. If possible, avoid use of the term "stratigraphic equivalent."

13. *Assignment*

Consider whether to require lessor's consent to any assignment by the lessee.

Require notice and copy of any assignment.

Provide that no assignment by lessee will relieve lessee of any liability, before or after the assignment, and that any assignee is jointly and severally liable with lessee for all lease obligations.

14. *Delete the warranty of title.*

15. *Limit the effect of the force majeure clause.*

Require the lessee to give notice in writing of a force majeure event, and provide a maximum number of days beyond the end of the primary term that a force majeure clause can keep the lease in force.

15. *Provide a broad indemnity clause that satisfies the "express negligence" rule.*

16. *Address the use of division orders.*

If possible, provide that lessor is not required to sign a division order in order to receive payment. Provide that no division order will operate to amend any provision of the lease.

17. *Protection of Surface*

If the lessor owns the surface estate, consider what provisions need to be included to protect the surface estate. These provisions will vary greatly with the type of land involved and its current and prospective uses.

Provide that surface owner will be compensated for all uses of and damages to the surface estate for all operations by lessee.

Consider providing agreed liquidated amounts for specific uses: Agreed amounts for well locations, roads, pipeline easements, tank batteries, etc.

Consider liquidated damages provisions for breaches of particular covenants: \$ ___ each time the lessee fails to close a gate, \$ ___ each time the lessee fails to provide a copy of an assignment.

Remember that a lease may remain in effect for decades. Therefore, if liquidated amounts are specified, provide that those amounts will be adjusted annually based on changes in the Consumer Price Index, to account for inflation.

Provide that employees and agents of lessee may be excluded from the property if they violate restrictions on surface use.

Provide that lessee must consult with lessor in the location of all roads and other facilities, and locate same so as to minimize interference with use of the surface.

If the land is under grazing or farming lease, provide that lessee must separately compensate the surface lessee for all damages caused to such party's leasehold interest and property.

An oil and gas lease carries with it the right of lessee to use subsurface and subsurface water, to use caliche found on the property for construction of roads. Prohibit lessee from using water from lessor's wells or tanks, and provide that subsurface fresh water may be used only for drilling operations, and not for secondary recovery operations.

Require lessee to tender any water well it has drilled to the surface owner when the lessee has no further use for the well.

Require pipelines to be buried below 36 inches, and require lessee to "double ditch" all pipelines and restore the surface.

Address any particular concerns regarding surface use that are unique to your property. Be sure those provisions are in writing and agreed to before the lease is signed.

18. *Well Plugging Insurance*

The Texas Legislature has recently authorized a new form of insurance, whereby an insurance company writes a single-premium policy insuring that a well will be plugged when it is no longer capable of producing. A lease provision requiring the lessee to purchase such a policy for each well it drills is included in the TLMA form.

19. *Access to Information*

Require the lessee to furnish copies of title opinions, drilling permits, drilling and completion reports, and well logs.

20. *A note on the use of bank drafts*

Companies like to use bank drafts to pay lease bonuses. This is convenient for the company, but poses risks to the lessor. First, a draft gives the company a period of time – usually 30 days – after the draft is presented to its bank to decide if it wants to honor the draft and make payment. During that time, it can check the lessor's mineral title to be sure that the lessor has not leased to someone else. But the usual practice is for the lessor to send the lease back to the company at the same time the draft is deposited for collection. The lessor therefore runs the risk that the lessee will record the lease and then not honor the draft. The only way to straighten this out is with a lawsuit. I therefore discourage the use of drafts, and try to insist that the company pay the bonus by check. Usually, the landman will bring the check and exchange it for the executed lease. In that way, the lessor is assured that the signed lease is not delivered until the bonus is paid. If the lessor has any question about whether there will be sufficient funds to pay the check, consider whether you really want to lease to that lessee; if necessary, you can insist on a cashier's or certified check.