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Oil and Gas Leases: Joy or Heartache for Surface and Mineral Owners

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This is the first in a series of two articles related to mineral and surface ownership and use as related to oil, gas or other mineral development. This article addresses issues and ideas for those landowners who own both the surface and mineral estates and have been approached by a company wanting to lease their oil, gas or other minerals. The second article will address the rights of the surface owner when another private party or the federal government owns and leases some or all of the mineral estate.

Leasing your mineral estate, whether it is oil, gas or other underground minerals can result in either joy or heartache, depending on the lease terms. Ownership rights for the surface of the land and the subsurface oil, gas or minerals can vary depending upon how the land was first patented into private ownership. Under some federal homestead or patent acts, the landowner received the entire surface ownership and use and ownership of all oil, gas or minerals beneath his private ground; under other homestead or patent acts, the surface owner only received certain minerals or oil and gas; and under still other homestead or patent acts, the surface owner received the surface only and no subsurface oil and gas or minerals at all. There are also those cases where the surface and minerals were originally patented into private hands, but later the minerals or oil and gas are split from the surface and are under different ownership than the surface. For those who own both the surface and the oil, gas or other minerals, the opportunity to lease oil, gas or minerals and control the surface use can be a complicated, although profitable venture. However, the profitability of the oil, gas or mineral lease is only part of what the landowner should consider. Once the property owner decides to split ownership or control of the surface and oil, gas or mineral estates– a process called "severance" – the landowner needs to understand his assets and liabilities before he signs a lease.

Before you sign. Oil, gas and other mineral developers are increasingly contacting landowners to lease their subsurface rights, many times making unsolicited offers that seem like amazing deals to the landowner. Yet, oftentimes, numerous developers are all vying for the same oil, gas or mineral market. By simply asking around, the landowner can find out if there are other developers or companies that may be interested in leasing the minerals. Like any commodities market, soliciting bids or

proposals from various developers is likely to net the landowner top dollar for the right to produce oil and gas or other minerals from his estate.

Duration of the lease agreement. With regard to an oil and/or gas lease, the agreement should specifically define the amount of time allocated for the developer to inspect and study the land for its feasibility for production. This is normally between three and five years. If the developer fails to begin development and/or production of oil or gas within this amount of time, then the lease agreement should either terminate automatically, or the landowner should receive additional compensation for the time certain that the land is burdened by the lease without any viable production of the oil or gas. Otherwise, the developer may tie up the land indefinitely with little prospect of ever producing oil or gas. While this point is normally negotiable, from the landowners' perspective, normally a shorter lease term with no option is better because it forces the developer to develop the lease faster. If an option is given, payment for that option should be up front.

Once development occurs or starts to occur, the company will want the term of the lease to be held open by either "production" or "operations." Extending the lease by production means the lease continues as long as oil or gas is produced. Importantly the landowner should consider the amount of land covered by the lease once production occurs. This is called the Pew Clause. For example a landowner should not want to have his entire leased acreage held by one well. Therefore the landowner should carefully define the amount of land one well can hold.

A lease extended by operations is one that although the company is not producing, the company is "seriously" trying to get production from the lease. Care should be taken to define "operations." For example a landowner should not agree that the lease remain open simply by the construction of a small section of road.

Finally most oil and gas companies will want the lease held open by paying a shut-in royalty. Shut-in royalties are paid when oil or gas is discovered but either the price is too low or there is not enough quantities to be profitable and the well is shut-in. The company will then want to pay a small "royalty" to the landowner to argue that the lease is being held open by production. Landowners should try to either limit the circumstances a lease can be held open under a shut- in royalty or negotiate a large enough royalty that it is worth the landowners' while.

Financial compensation. Compensation comes in many forms and in exchange for many different uses. Frequently a bonus payment is used by an oil or gas developer to entice the landowner to sign a lease. While this is fairly standard, a landowner should ensure that no strings are attached to the bonus payment. There are a number of methods to calculate the royalty to the landowner. Each type of royalty has its benefits, as well as its problems, and the landowner must understand what he is agreeing to receive in exchange for leasing the right to produce oil or gas. The formula used to calculate the royalty should be defined in the lease. The cost of production should not be subtracted before the royalty is calculated and paid.

"Pooling" and unitization. Most Western states allow or require unitization or pooling of all the lands that cover the underlying geologic formation into a drilling unit. The purpose of unitization is usually to prevent waste and to protect other landowner's rights. Unitization can also be accomplished voluntarily by landowners. As well, the oil or gas resources can be "pooled." While this is very economical for the developer and generally results in more efficient operations and production of the resources, the landowner should be wary of such practice and impose limitations where necessary to prevent his land from being tied up without any actual production on his individually owned tract. As well, both unitization and pooling are likely to have legal consequences on the landowner's rights and royalty interests.

Liability. The landowner should request that the lease include a provision requiring both parties to defend and hold each other harmless from claims for any future loss or damage arising from the various uses of the property. Any loss to the landowner arising from an oil or gas developer's use and occupation of the land will be small compared to the potential loss to the developer from the landowner's use of the land. Typical landowners cannot, and should not, assume such a risk. Thus, landowners should limit their potential liability as much as possible – say, to the receipt of insurance proceeds or some other specified amount. Additionally the landowner needs to make sure the developer indemnifies him if he is brought into any litigation related to the lease.

Assignment of rights by oil and gas corporations. The lease agreement will specify whether the landowner and the oil or gas developer may assign their contractual rights and obligations to third parties. Oil and gas producers always seek broad rights to sublease, assign, and mortgage their rights, without the consent of the landowner. Such broad rights may be necessary for the developer to obtain financing. Landowners, however, should demand to be notified of every such transfer in order to keep track of who is ultimately responsible for any default of the lease agreement.

Liens. The lease agreement should require the oil or gas developer keep the land free and clear of all liens related to the production of oil or gas. It is the responsibility of the developer, not the landowner, to contract for, and make payments for, all labor and materials related to the construction and operation of the oil or gas well and any reclamation. The landowner must take care to ensure that no liens are filed against the land.

Water rights and water protections. Water rights and water quality are essential elements of ownership of property in the West. Therefore, it is extremely important for a landowner to be aware of his existing water rights, if any, and any effect oil or gas productions may have on his water rights or water use. Any agreement to sell or lease water to an oil and gas developer should be part of a separate written contract and must separately comply with state law.

Underground storage rights. Since carbon capture and storage may become a more viable process, landowners should ensure that the lease specifically reserve all underground or subsurface storage rights in the landowner.

Surface use agreements and damages. Many states have enacted "split estate" statutes to attempt to resolve issues that result when a surface owner leases his oil, gas and minerals and a developer seeks to trespass or enter the private land to access the leased minerals. Once the minerals are leased or split, the law has determined that the minerals are the "dominant estate" and the oil or gas developer has the inherent right to enter onto the surface of the property for all purposes reasonably related to oil or gas production. However, the developer must negotiate with the surface estate owner in good faith to reach what is known as a "surface use agreement." This agreement provides for protection of the surface resources, surface reclamation requirements, and payment of damages caused by the oil and gas operations. If surface damages is not provided for in the surface use agreement, and damage occurs to the surface or creates a loss of land value, the surface owner has a limited period of time to bring an action to recover for those damages. Even if the oil and gas or other minerals are owned by the same landowner as the surface, a separate "surface use agreement" should be prepared from the mineral lease and, if possible, the surface use agreement should be negotiated at the same time as the mineral lease, before the mineral estate becomes the dominant estate.

Termination of the agreement. One of the most important provisions of any contract is the default and termination clause. While an oil or gas developer will, in all likelihood, have the ability to terminate the project at any time and for any reason, the landowner, on the other hand, will only be permitted to terminate the lease agreement under very limited circumstances. The landowner should reserve the right to terminate the agreement if the oil or gas developer fails to pay, fails to maintain adequate insurance, commits abandonment, fails to pay taxes, goes bankrupt, or fails or neglects to perform any obligation set forth under the lease.

In the event of a default of the lease, the developer will demand the right to first be notified of the default and then be given the opportunity to cure the default prior to termination of the lease agreement. The landowner must take care to identify which party or parties are to be notified in the event of a default and to prohibit any "partial" default of the lease.

Reclamation and decommissioning. Although surface reclamation is generally addressed through the surface use agreement, it is important to also include provisions and requirements for reclamation and decommissioning in the lease as well. In order to prevent the oil or gas developer from simply "walking away" from the project, the landowner should demand what is known as a "decommissioning security," to be established as soon as oil or gas is produced on the site. This security is generally a specified amount of money which is put aside by the oil or gas developer to ensure there is sufficient funding available for removal and reclamation at the end of the project.

Reclamation is necessary not only after termination of the oil or gas production, but also during construction, operations, and repairs. The landowner cannot rely on governmental authorities to ensure the reclamation of his land, but should ensure that the land will be reclaimed as he sees fit.

Reclamation measures should identify the means to keep track of the original condition of the property, either through photographs or an assessment prepared by a range professional. Other reclamation measures should include: which improvements must be removed and to what extent they should be removed; reclamation of roads; erosion issues; dust control; and trash removal.

As well, in the event of default or termination of the lease, the landowner should specify how much time the oil or gas developer is permitted to remove all drilling and operating structures from the land. Payment must also be established during this time period, including increased payment or obligations should the developer fail to remove the structures within the specified period of time.

Condemnation. Although an oil or gas developer does not have authority to condemn a lease, if there is significant development in an area, the company may want to develop a pipeline to get the oil or gas to a processing plant or market. When negotiating the lease, the landowner should request the company will agree not to condemn his land for pipeline or other purpose.

Miscellaneous. Finally, the lease agreement should address other issues such as which laws apply, in which state may either party go to court to enforce the terms of the agreement, attorneys' fees and what happens to land included in the conservation reserve program or similar governmental program.

Conclusion. Oil, gas and other mineral production can be a highly valuable natural resource. Yet landowners must be aware of all the possible risks, as well as the benefits, associated with entering into these lease agreements. The topics discussed above are just an illustrative sample of some of the most important issues facing landowners when considering leasing the right to produce oil or gas or lease other minerals. While complex, these lease agreements represent a potential for landowners to supplement their income and to provide for their families.

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