Denver Law Review

Volume 29 | Issue 5 Article 5

June 2021

# The Oil and Gas Lease

Roscoe Walker Jr.

# THE OIL AND GAS LEASE

ROSCOE WALKER, JR.
*of the Denver Bar*

At the outset, it best be said that the writer is not in the business of selling lease forms and it should not be inferred by what is hereinafter set forth that he is recommending or inducing anyone to use any particular lease form. However, for purposes of discussion the writer has chosen a lease form No. 950 C, The Bradford-Robinson Printing Company of Denver, Colorado, identified as "Form 88 Unit-Wyo.-Colo."

The oil and gas lease referred to contains the words "Form 88" to make it of that class known as the "Producers 88". Contrary to popular concept, there is really no such thing as *the* "Producers 88" and it is estimated that there are one hundred different lease forms, each with variations, bearing the title "Producers 88". All of these leases however contain the basic concept of the old original "Producers 88" lease, but care should be taken, to avoid indefiniteness, not to bind a party or parties by a contract requiring merely the future execution of a "good and sufficient Producers 88 oil and gas lease".

Consider first the granting clause of the oil and gas lease which reads:

> . . . . hereby grants, leases and lets exclusively unto lessee for the purpose of investigating, exploring, prospecting, drilling and mining for and producing oil, gas, casinghead gas and all other materials, laying pipe lines, building tanks, power stations, telephone lines and other structures thereon to produce, save, take care of, treat, transport and own said products, and housing its employees, the following described land . . . .

There has been some conflict in the cases faced with a determination of the nature of the interest given the lessee by the granting clause of an oil and gas lease. Some writers have catagorized the lessee's interest as three types—type one being to "grant lease and let" like the granting clause above set out, this having been determined as a lease; type two in which the lessor grants unto the lessee the "exclusive right to mine and produce" establishing only a license; and, type three in which the lessor "grants, bargains, and sells" which really amounts to a mineral deed. In determining the nature of the lessee's interest by technical interpretations of the granting clause there have been established what appear to be conflicting decisions. As one court put it after reviewing numerous decisions, the oil and gas lease has been called a chattel real, option, license, interest in land, and is a "hybrid estate deriving its legal characteristics from both real and personal property, yet it is actually neither." It is interesting to note also that some jurisdictions, particularly Texas, have refused to be bound by technical rules of interpretation of the granting

clause and rely on the true import of the instrument as a whole and the intention of the parties. Under this theory, Texas, which to the knowledge of the writer is the only state so holding, has determined that under an oil and gas lease the lessor grants to the lessee a determinable fee.[1] Of course the nature of the interest given the lessee under an oil and gas lease has so many ramifications it would be impossible even to touch upon them in this article. It seems well established, however, that the lessee's interest is an interest in land, is subject to the recording acts and as a general principal should be executed with the same formalities required for the execution of a deed.

The habendum clause of the oil and gas lease can be stated as follows:

> TO HAVE AND TO HOLD the same (subject to the other provisions herein contained) for a term of ten years from this date (called "primary term") and as long thereafter as oil or gas or casinghead gas or either or any of them, is produced thereform; or as much longer thereafter as the lessee in good faith shall conduct drilling operations thereon and, should production result from such operations, this lease shall remain in full force and effect as long as oil or gas or casinghead gas, shall be produced therefrom.

The particular lease form here under discussion also contains in the body of the lease an additional clause as follows:

> If the lessee shall commence to drill a well within the term of this lease or any extension thereof, the lessee shall have the right to drill such well to completion with reasonable diligence and dispatch, and if oil or gas, or either of them, be found in paying quantities, this lease shall continue and be in force and the like effect as if such well had been completed within the term of years herein first mentioned.

I should like to discuss the habendum clause as first quoted above as though that clause had completed the sentence after the words "is produced therefrom". The primary term is the stated time of ten years. The additional words "and as long thereafter as oil or gas or casinghead gas or either or any of them is produced therefrom" are known as the "thereafter clause". The "thereafter clause" has been held not to be bad under the rule against perpetuities.[2] Concerning the effect of this sentence to the point indicated, it is perfectly obvious that the lease will exist for ten years at the outset (subject to the further limitation discussed hereinafter) and will terminate unless at the end of that time any of the products specified are being produced. It

[1] Stephens County v. Mid-Kansas Oil and Gas Company, 254 S.W. 290, 29 A.L.R. 566.

[2] Rosson x. Bennett, 294 S.W. 660 and cases of many jurisdictions cited therein.

is to be noted that this lease form contains the words "is produced therefrom". Some lease forms, however, contain the words "produced in paying quantities". Where the latter wording is present the courts have said that "paying quantities" exist: (1) when the amount of oil is sufficient, if marketed, to insure a reasonable return above expenses, that is, operating expenses and not development costs;[3] or (2) to "pay a profit, though small, over operating expenses, although it may never repay the cost of the well and its operation, and the whole may result in a loss to the lessee."[4] Where the words "produced therefrom" alone are used, as in the lease form here under discussion, a conflict exists. In *Gas Ridge, Inc., v. Suburban Agricultural Properties, Inc.*[5] the court held that the production must still be in paying quantities. But in *South Penn Oil Co. v. Snodgrass*,[6] and in *Ohio Fuel Oil Company v. Greenleaf*,[7] the court held that where the word "produced" without the phrase "in paying quantities" was used, producing a mere trace during the fixed term was sufficient to keep the lease in effect. Also in *Sawyer v. Potter*,[8] the thereafter clause omitted the words "in paying quantities" and read "found" and there the court held that producing during the exploratory period a quantity of oil sufficient to be capable of division, and giving the lessor a royalty, although small, was sufficient.

EQUITIES ARE CONSIDERED

In summation then, it can be stated that if the lessee does not have production or production in paying quantities (according to the different views above set out) as of the end of the primary term the lease must terminate, if there are no provisions expressly providing for continued existence under other contingencies. The courts however, have in some instances given a protection to the lessee under its equity powers where the acts of the lessor prevented the lessee from complying with the habendum clause to obtain his production prior to the end of the primary term. There are also those instances where compliance was prevented by government regulations, floods, fires, and so on, where relief has been granted but generally this is so only where the lease contains the force majeure clause.

The lease form under consideration, however, by the additional provision above quoted, permits the extension of the lease beyond the fixed primary term if the lessee is at the end of that time conducting drilling operations in good faith. He shall also have the right to drill such well to completion with reasonable diligence and dispatch and if the oil, gas, or the other products

[3] Barbour, Stedman & Co. v. Tompkins, 81 W. Va. 116, 93 S.E. 1038.
[4] Masterson v. Amarillo Oil Co., 253 S.W. 908 (Tex. Civ. App. 1923).
[5] 150 F. (2d) 363 (CCA 5th, 1945).
[6] 76 S.E. 961.
[7] 99 S.E. 274.
[8] 3 S.W. (2d) 758 (Kentucky).

are obtained as a result of such drilling then the lease shall extend further under the thereafter clause.[9]

Other problems have arisen in connection with the duration of the lease where production or production in paying quantities has been obtained by the lessee but, because of his inability to obtain a market for the product, some time elapses before both the lessee and lessor realize any proceeds from the production obtained. Based upon the literal wording of the lease, the mere obtaining of production in paying quantities is sufficient to extend the term of the lease, as there is no specific requirement therein that the lessee market the product in order to extend the lease. This situation is adequately covered by the well-established implied covenant requiring that the lessee develop and market the product that is obtained. Since this article deals only with the express provisions in the oil and gas lease we shall not dwell further upon that point. There is an express provision in the oil and gas lease, however, pertaining to the marketing of gas, as it is more difficult to market than oil since it cannot be stored upon the land or shipped other than by means of a pipe connection. That provision is the "shut-in gas well" provision which states:

> . . . for gas from wells where gas only is found, and where not used or sold, (lessee) shall pay fifty ($50.00) dollars per annum as royalty from each such well, and while such royalty is so paid such well shall be held to be a producing well.

It is established that the lessee has a reasonable time in which to market gas obtained, but what amounts to the exercise of reasonable diligence in wild-cat territory under all the circumstances involves questions of fact. The effect of the "shut-in gas well" provision is to give the lessor a fixed sum, in the nature of a rental, for a gas well where the gas is not being marketed. Upon payment of this sum the lessee is not held to the same degree of diligence in producing and marketing the gas which has been found in paying quanitities as he would be in those instances where the lease does not contain a specific provision.[10]

The next clause to be considered is the operating or development clause. It is stated as follows:

> If operations for the drilling of a well for oil or gas are not commenced on said land on or before one year from this date, this lease shall terminate as to both parties, unless the lessee shall, on or before one year from this date, pay or tender to the lessor or for the lessor's credit in.....Bank at.....or its successor or successors, which bank and its successors are

[9] Prowant v. Sealy, 187 P. 235 and Simons v. McDaniel, 7 P. (2d) 419, both Oklahoma cases.

[10] Brewster v. Lanyon Zinc Co., 140 F. 801 and Union Gas & Oil Co. v. Adkins, 278 F. 854.

> lessor's agent and shall continue as depository regardless of changes in ownership of the land, the sum of .....dollars which shall operate as a rental and cover the privilege of deferring the commencement of operations for the drilling of a well one year from said date. In like manner and upon like payments or tenders the commencement of operations for the drilling of a well may be further deferred for like periods successively during the primary term of this lease. And it is understood and agreed that the consideration first recited herein, the down payment, covers not only the privileges granted to the date when said rental is payable as aforesaid, but also the lessee's option of extending that period as aforesaid, and any and all other rights conferred. All payments or tenders may be made by check or draft of lessee or any assignee thereof, mailed or delivered on or before the rental paying date.

The most important thing to realize about this clause is that it is a further limitation upon the primary term of the lease as expressed in the habendum clause. The habendum clause provides that the lease shall exist for ten years and so long thereafter, but the operating and development clause provides for an earlier automatic termination of the lease if no well is commenced within one year from the date or if the lessee fails to make prescribed rental payments to defer drilling operations. This clause is also an express covenant which prevails over the old implied covenant to drill an exploratory well. It is to be noted that the provision of the lease above quoted determines what is known as an "unless" form of oil and gas lease. Its wording is such that if the well is not commenced and if the rental is not paid as provided, the lease *ipso facto* terminates. There are other types of leases which are very seldom seen today requiring the lessee to drill the well, to pay the rental, or to surrender the lease. These leases were called the "drill or pay" type of lease. The difference of that type of lease with the "unless" form of lease is that in the former there was required of the lessee an affirmative act on his part either to commence the well prior to the due date, to pay the rental prior to the date, or to surrender the lease under the surrender clause prior to the due date. If he failed to do any of these things the lessor, at his option, could cancel the lease or sue for and collect from the lessee the amount of delay rental payable under the lease inasmuch as the obligation became fixed by prior failure to surrender. While this form is seldom seen today, it is mentioned principally for the reason that the federal oil and gas lease forms operate substantially on the same principal. Hence, if the lessee does not make the affirmative act of surrender of the lease prior to the rental due date the United States can sue and collect the amount of the rental payment.

The words "if operations for the drilling of a well for oil or gas are not commenced on said land" do not, by the general view, require actual drilling. It is usually enough if the lessee in good faith stakes a location, moves in machinery, drills a water well or digs a slush pit, grades the location, and continues the drilling operations thereafter in good faith. Generally, any acts showing intention and the actual beginning of performance carried on with due diligence thereafter are adequate.[11] There is one decision that the writer is aware of which requires actual drilling. That case holds that the first movement of the drill penetrating the ground is necessary to constitute "commencing operations to drill".[12]

TERMINATION IS AUTOMATIC

On the payment of the annual delay rental provided for in the lease form, basically, because of the *ipso facto* termination of the "unless" form of lease, the courts require strict compliance by the lessee in connection with the payment of this rental. Leases have been held to terminate by reason of the payment of an insufficient amount of rental, payment to the wrong depository, payment to the wrong person, sending an unsigned check, mailing to the wrong address and various other situations. Many lease forms require the receipt of the rental by the depository prior to the due date, but it is to be noted that the particular lease form here under discussion specifically provides that payment or tender may be made by check or draft of the lessee (thus not requiring the actual cash to be in the hands of the depository prior to the due date), and that it is sufficient if the rental is mailed prior to the due date. Consequently, in that situation, the receipt after the due date would still constitute proper payment. There are many cases which have rendered relief to the lessee, notwithstanding the automatic termination of the oil and gas lease, by waiver or estoppel on the part of the lessor; this, despite that there is generally no duty on the part of the lessor to notify the lessee if he has made an error in the rental payment. Such cases are those where the acts of the lessor have misled the lessee and estoppel has been imposed; and where laches, adoption and such other equitable remedies have been enforced by the court. It is also possible for the lessor to waive the automatic termination of the lease by an acceptance of a late payment of rental. I submit, however, that this should be done with knowledge on the part of the lessor.

In view of space limitation, there is only one other provision in the lease which merits discussion at this time. That provision

[11] For cases holding that "operations for drilling" and "commencement" do not mean to begin actual drilling, see Aldridge v. Gypsy Oil Co., 268 P. 1109; Fast v. Whitney, 187 P. 192 (Wyo.); Wooten v. McAdoo, 293 P. 694 (Calif.); 67 A.L.R. 531.

[12] Solberg v. Sunburst Oil and Gas Co., 73 Mont. 94, 235 P. 761.

is the so-called "lesser interest clause". It is stated as follows:

> If said lessor owns a less interest in the above described land then the entire and undivided fee simple estate therein, then the royalties and rentals herein provided for shall be paid the lessor only in the proportion which his interest bears to the whole and undivided fee.

This provision has been held to be for the benefit of the lessee as it affords the lessee the remedy of reducing rental or royalty payments to a lessor where subsequent title determination discloses the lessor's interest to be less than that originally thought to exist at the time the lease was executed. Such reduction is on a proportionate basis. Because of the operation of this clause, it is proper to state in the space provided in the operating or development clause the amount of the rental payable as to the full ownership (unless the lease otherwise specifically indicates a lesser interest) so that there will be no reduction not in the contemplation of the parties under this clause. Suppose at the time a lease is executed it is known by the lessee and lessor that the lessor only owns an undivided one-half interest and the parties have agreed upon a rental of one ($1.00) dollar per acre for 160 acres covered by the lease. It would be proper to state the rental payment as $160.00 unless in the body of the lease it is clearly indicated that it is only a one-half interest lease. The lesser interest clause reduces the rental to $80.00, which is the correct amount agreed upon between the lessor and lessee; but if the sum of $80.00 is stated in the development clause an innocent purchaser of the lease might well, under the lesser interest clause, reduce the $80.00 rental to $40.00, which of course was not the intention of the parties.

I do not believe that the lesser interest clause is repugnant to the warranty clause also contained in the lease for the lesser interest clause would probably not operate to give the lessee any right of action for damages as against the lessor in the event of a complete title failure although it would establish the fact that no rentals or royalties are to be paid to the lessor in such event. It is aimed primarily at a situation where a partial title failure exists and it permits the lessee to reduce the rentals and royalties proportionately therefore. The warranty clause should probably be considered applicable principally to give the lessee a remedy against complete title failure and to enable him to seek return of the bonus erroneously paid at the time the lease was executed. More important, as a practical matter, the warranty clause will also permit the applicability of the doctrine of after-acquired property to the oil and gas lease.

The writer is well aware that there are many other provisions of this lease, controversial and otherwise, that could not be discussed at this time.