Chapter 16
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Hidden Provisions of Oil and Gas Leases or
“You Can’t Fool Me — There Ain’t No Sanity Clause”

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§ 16.01  Introduction.

Over the last 16 years, attendees at the Annual Institutes of the Eastern Mineral Law Foundation and aficionados of the published Proceedings of those Annual Institutes have savored the fruits of a multi-faceted and continuing examination of the oil and gas lease. Among the oil and gas lease provisions that have been dissected and scrutinized are the habendum (term) clause and certain related savings provisions,\(^1\) the granting clause,\(^2\) the royalty clause,\(^3\) the shut-in royalty clause,\(^4\) the pooling provision,\(^5\) and the free gas clause.\(^6\) The attention given these provisions is well


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deserved, for they can justly be characterized as “essential” terms of the agreement between the lessor and the lessee, primarily because their subject matter — what the lessor and the lessee each expect to receive as a result of the bargain they have made — is so obviously of critical importance to both parties.

The same can be said of the so-called “implied covenants,” which several other authors have essayed to illuminate. These covenants, which impose duties deemed so important that they are implied by law in all oil and gas leases, even though they may not even be suggested in the written agreement that constitutes the lease, are truly “hidden” provisions that become, as characterized by more than one shocked and befuddled lessee, “the binding contract I never agreed to be bound by.”

There are a number of lease provisions that, like the implied covenants, may be characterized as “hidden.” The simple fact, however, is that the provisions that will be addressed in this chapter are “hidden” only because they satisfy one of the author’s two definitional criteria:

1. They are clauses of the type that virtually no one bothers to read at all; or
2. They are clauses of the type that, even if read, are not fully understood.


Cautious and knowledgeable lessors may attempt to avoid this situation by including in their leases a provision that expressly negates the implied covenants, such as the following:

This Lease contains all of the agreements and understandings of Lessor and Lessee respecting the Leased Premises, and no verbal representations or promises have been made or relied on by Lessor or Lessee supplementing or modifying this Lease or as an inducement thereto. No implied covenants or obligations shall be read into this Lease or imposed on either Lessor or Lessee.

The enforceability of such clauses — which are hidden provisions designed to counteract other hidden provisions — remains open to question. See generally, John K. Keller, “Drafting the Modern Oil and Gas Lease,” 2 E. Min. L. Inst. ch. 15, § 15.03[4] (1981).
Since these provisions, unlike the implied covenants, are there in the oil and gas lease for all to see, it might be more appropriate to say that they are ignored or misunderstood. These are the provisions typically dismissed by landmen with a wave of the hand and the oft repeated phrase, “Oh, that’s just boilerplate. It’s in every contract.”

The fact that a provision is “in every contract” does not, of course, mean that it is unimportant. Indeed, it is most likely to be there because it is extremely important. That provisions of this type have escaped critical examination is perhaps understandable, since legal scholars may rightly regard them as unworthy of the level of scrutiny reserved for those clauses traditionally regarded as constituting the “essence” of the oil and gas lease. Moreover, most seasoned lawyers believe (not always with justification) that they are fully cognizant of the profound impact that these clauses can have on the relationship between the lessor and the lessee. However, the blithe dismissal of such so-called “boilerplate” provisions by unwary landmen, operators, and landowners — as well as by untutored counsel — cannot be justified; for within these hidden provisions often lurk

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9 The author acknowledges that his profession may bear some responsibility for this problem. As noted by the immortal Will Rogers: “The minute you read something you can’t understand, you can almost be sure it was drawn up by a lawyer.” Quoted in Laurence J. Peter, Peter’s Quotations: Ideas for Our Time 293 (Bantam Books 1977)[hereinafter cited as “Peter”].

10 This flip dismissal provided the genesis for this chapter’s subtitle, an illusion to Hollywood’s superlative paean to contract negotiation, a scene in the classic Marx Brothers film, “A Night at the Opera.” Groucho (as Otis B. Driftwood) and Chico (as Fiorello), each intent on arriving at an acceptable contract for the services of “the greatest tenor in the world,” systematically rip out every provision of Groucho’s form contract, until only one is left. The following exchange ensues:

Fiorello: Hey wait — wait! What does this say here? This thing here?
Driftwood: Oh, that? Oh, that’s the usual clause. That’s in every contract. That just says — uh — it says — uh — if any of the parties participating in this contract is shown not to be in their right mind, the entire agreement is automatically nullified.
Fiorello: Well, I don’t know.
Driftwood: It’s all right. That’s — that’s in every contract. That’s — that’s what they call a sanity clause.
Fiorello: Oh, no. You can’t fool me. There ain’t no Sanity Clause!

agreements of considerable significance. The following discussion will focus on a few — but by no means all — of the relatively standard oil and gas lease clauses whose meaning and impact all too often escapes the parties to the lease.

§ 16.02. The Granting Clause: What May the Lessee Do?


The granting clause of an oil and gas lease sets forth the rights granted by the lessor to the lessee. While one would not tend to think of so basic a provision as being a “hidden” one, the sad truth is that the granting clause is typically examined — at least at the time the oil and gas lease is executed — primarily to assure that it adequately identifies the land and the substances covered. Only later, when the operator discovers that he wants to do something he fears is not addressed and clearly provided for in the lease, does he finally approach his oil and gas lawyer and ask: “Can I . . . ?”¹¹ Such queries are usually precipitated by a granting clause that reads something like this:

Lessor hereby grants, leases, and lets exclusively to Lessee,
for the purpose of exploring for, developing, producing, and marketing oil and gas, . . . .

The lack of specificity in such provisions raises the question of whether the activity in which the lessee desires to engage will be implied by the general grant.

Courts have generally held that an oil and gas lease (or, for that matter, any grant or reservation of minerals) gives the lessee an implied right to use the surface to locate, to develop, and to produce the oil and gas

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¹¹ The question, as was once emphasized by J. Pierpont Morgan, is really “How can I?”: “I don’t hire a lawyer to tell me what I cannot do; I hire him to tell me how to do what I want to do.” *Quoted in* Peter, at 293.

¹² See, e.g., Telford v. Jenning Producing Co., 203 F. 456 (7th Cir. 1913); Jilek v. Chicago, Wilmington & Franklin Coal Co., 47 N.E.2d 96 (Ill. 1943); Pyramid Coal Corp. v. Pratt, 99 N.E.2d 427 (Ind. 1961); Buchanan v. Watson, 290 S.W.2d 40 (Ky. 1956); Blue v. Charles F. Hayes & Assoc., Inc., 215 So. 2d 426 (Miss. 1968), *appeal after remand*, 233 So. 2d 127 (Miss. 1970); Marvin v. Brewster Iron Mining Co., 55 N.Y. 538 (1874); Harper v. Jones, 74 N.E.2d 397 (Ohio C.P. 1946); Tennessee Gas Transmission Co. v.
underlying the leased premises.\textsuperscript{12} Basically, it may be said that the mineral interest or leasehold interest is superior to the surface interest, subject to the following limitations:

1. The intended use of the surface must be \textit{reasonable} or reasonably necessary to obtain the minerals.\textsuperscript{13}

2. The lessee’s use may need to comply with the so-called “accommodation doctrine,” which requires the lessee to accommodate existing surface uses. Under the accommodation doctrine, which has been

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clearly adopted in only a few jurisdictions, the lessee will not be permitted
to interfere substantially with an existing surface use if any reasonable
alternative is available.\(^{14}\)

3. The lessee’s use of the surface must be for the express benefit of
the subsurface oil and gas.\(^{15}\)

4. The lessee’s use may be restricted (or expanded) by the express
terms of the lease or of some other agreement between the lessor and the
lessee.\(^{16}\)

5. The scope of the implied easement for surface use may be restricted
by statutes, ordinances, rules, or regulations.\(^{17}\)

\(^{14}\) See generally, Smith, § 16.06[3][b]; Lowe, § 4.03[2]; 1 Williams & Meyers, § 218.8,
at 243-245; and Stuart C. Hollimon, “The Accommodation Doctrine: Its Current Status
and Future Application,” 45th \textit{Oil & Gas Inst.} ch. 3 (1994) [hereinafter cited as
“Hollimon”].

\(^{15}\) See generally, Lowe, § 4.03[3].

\(^{16}\) See generally, id., § 4.04[1]. Unless insisted upon by the landowner, an oil and gas
lease will rarely say very much that could be deemed to restrict the lessee’s right to use
the surface, although provisions such as the following are fairly commonplace:

The location of all wells drilled on the Leased Premises shall be determined
solely by Lessee; \textit{provided, however,} that no well shall be drilled nearer
than two hundred (200) feet to any dwelling house or barn located on the
Leased Premises at the date of execution of this Lease without the written
consent of Lessor. When requested by Lessor, Lessee shall bury Lessee’s
pipeline(s) below plow depth. Lessee shall pay for all damage to growing
crops and fences caused by Lessee’s operations on the Leased Premises.
Said damages, if not mutually agreed upon, shall be ascertained and
determined by three (3) disinterested persons, one thereof to be appointed
by Lessor, one by Lessee, and the third by the two (2) so appointed as
aforesaid; and the award of such three (3) persons shall be final and
conclusive. Lessee shall restore any land surface upon the Leased Premises
disturbed in siting, drilling, completing, and producing any well drilled
on the Leased Premises in accordance with applicable laws and regulations.

Such provisions, though arguably prized by lessors, may actually give them very little
beyond what they would be entitled to under applicable law.

\(^{17}\) See generally, Lowe, § 4.04[2]; Hollimon, § 3.05[2]; Smith, § 16.06[3]; Ronald W.
Polston, “Oil and Gas Law Developments,” \textit{10 E. Min. L. Inst.} ch. 21, § 21.3 (1989); and
Ronald W. Polston, “Redefining the Relationship Between the Surface Owner and the
If a lessee’s use of the surface is excessive, its position differs little from that of any other trespasser.\(^\text{18}\)

Needless to say, the granting clause should be carefully drafted to assure that there is no question whatsoever as to the right of the lessee to engage in the broadest possible range of activities. The following provision is recommended:

Lessor, in consideration of the sum of One Dollar ($1.00) and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, and also in consideration of the covenants and agreements contained herein, hereby grants, demises, leases, and lets exclusively to Lessee, for the purposes of exploring (by geophysical and other methods), drilling, mining, and operating for, producing, and marketing oil, gas, casinghead gas, distillate, and other liquid and gaseous hydrocarbons; injecting or moving gas into, storing or holding gas in storage in, or withdrawing from storage or removing gas from, any sands, strata, or formations lying thereunder; injecting water, brine, or other fluids into sands, strata, or formations lying thereunder; engaging in any secondary or tertiary recovery methods now known or hereafter developed, irrespective of the possible migration of oil or gas resulting from such waterflooding or secondary recovery methods; and constructing, utilizing, and maintaining pipelines, electric lines, power stations, ponds, roadways, fixtures, and any other things needed or desirable to produce, to save, to treat, to process, to store, to transport, and/or to market the substances described above and the products therefrom, whether derived from the same or other lands, the following described tract of land . . . .

Unfortunately, the granting provisions of most oil and gas leases are not nearly as broad and all-encompassing as this clause.\(^\text{19}\)

\(^{18}\) See generally, 4 Summers, § 652; and 1 Williams & Meyers, §§ 218.8 and 218.10.

\(^{19}\) So pervasive are the traditional generalized granting provisions that even Thomas W. Lynch, in his excellent article entitled “The ‘Perfect’ Oil and Gas Lease (An Oxymoron),” 40 Rocky Mt. Min. L. Inst. ch. 3, § 3.03[2] (1994)[hereinafter cited as “Lynch”], offers up a granting clause whose description of authorized activities is limited to the following: “Lessor hereby grants, leases and lets exclusively to Lessee . . . for the purpose of exploring for, developing, producing and marketing oil and gas, along with all hydrocarbon and nonhydrocarbon substances produced in association therewith.”
Note that this provision specifically states that these rights are granted *exclusively* to the lessee. This inclusion of this single word is critical! Its absence creates a compelling argument that the lessor has retained rights that it may then grant to others.20


[a] — Seismic Exploration.

The advent of significantly greater utilization of geophysical exploration in the Appalachian Basin has brought with it a recurring question as to the scope of the granting clauses of oil and gas leases: Does a very general grant of the right to produce oil and gas carry with it the right to utilize geophysical or seismographic exploration methods in the development of the lease, despite the fact that the granting clause of the lease does not specifically address such methods of exploration? Fortunately for operators, the courts that have addressed this question — and there are surprisingly few, since the matter has seldom been squarely at issue — have expressed the view that such a right is implicit, even though the lease antedates the use of such methods of exploration.21

The issue has been most clearly addressed by the Fifth Circuit Court of Appeals, applying Texas law, in *Yates v. Gulf Oil Corp.*22 The occupants of the surface claimed that the lessee did not have the right to conduct geophysical operations, including seismographic work, because the granting clause in the 1924 lease only provided for “mining and operating” for oil and gas. They further asserted that the original parties to the lease could not have contemplated conducting geophysical operations because

20 See, e.g., *Shell Petroleum Co. v. Puckett*, 29 S.W.2d 809 (Tex. App. 1930), in which it was held that a lessor who had granted rights that were not specifically “exclusive” retained the right to grant geophysical permits to third parties.

21 See generally, Annot., “Construction of Oil and Gas Lease as to the Lessee’s Right and Duty of Geophysical or Seismograph Exploration or Survey,” 28 A.L.R.3d 1426 (1969); Annot., “What Constitutes Reasonably Necessary Use of the Surface of the Leasehold by a Mineral Owner, Lessee, or Driller under an Oil and Gas Lease or Drilling Contract,” 53 A.L.R.3d 16, § 10 (1973); 1 Williams & Meyers, § 218.5; and John K. Keller, “Legal Aspects of Geophysical Exploration,” 13 E. Min. L. Inst. § 17.03[2][b](1992)[hereinafter cited as “Keller”].

22 *Yates v. Gulf Oil Corp.*, 182 F.2d 286 (5th Cir. 1950).
seismic tests were unknown to the parties at the time of the contract, and, as a result, the right to conduct seismic testing could not have been contemplated. In addressing the surface holders’ argument, the court of appeals stated:

In view of the fact that the lessors retained a royalty under the lease, and in view of the fact that there is an implied obligation on the part of the lessee to make reasonable and appropriate efforts to develop the oil possibilities of the leased lands, we, in the absence of impelling precedent from the Courts of Texas, are unwilling to hold that in the discharge of such obligation to develop the lessee is prohibited from taking advantage of the recent, modern, and effective developments of science in exploring for, or producing, the minerals covered by the lease.23

The court went on to conclude that a right to prospect for oil and gas was incidental to the right conveyed to the lessee to mine and to operate for oil and gas on the land and that, in prospecting for oil and gas, the lessee had a right to conduct seismic testing.24

Under most circumstances a right to conduct seismic exploration on the leased premises — whether expressly granted or implied — does not extend to the lessee of adjoining lands. Consequently, if a lessee wants to run seismic over a neighboring leasehold, it must obtain the consent of the surface owner of that property and also, if the lessee of the neighboring property was granted rights to conduct seismic that were exclusive, the consent of that lessee as well; and either may rightfully demand to be compensated for this privilege.25 Unless the lessee has the exclusive right, under its own lease, to conduct seismic exploration, the lessor has concurrent rights to do so, and it may assign these rights to the lessee’s competitors.26

23 Id. at 289.
24 Id.
25 See generally, 1 Summers, § 25.1; and Keller, § 17.04.

As a general concept, the right to conduct secondary recovery operations is likely to be implied, since secondary recovery may be regarded as an obvious concomitant of the basic right to produce. However, particularly if the right to engage in secondary recovery operations is not specifically provided for, the lessee’s activities may be subject to challenge as constituting an unreasonable use of the surface. To minimize any dispute, the granting clause should be broadly framed to include the following purposes:

- engaging in any secondary or tertiary recovery methods now known or hereafter developed, irrespective of the possible migration of oil or gas resulting from such waterflooding or secondary recovery methods.

A far more complicated issue involves the extent of the lessee’s right to use surface or underground water in its drilling operations, particularly in a context in which large quantities of water are likely to be used, such as a waterflooding operation. A thorough treatment of this difficult question would involve water law issues that are beyond the scope of this chapter. The dispute is best avoided — or at least minimized — by addressing the matter head on, preferably by including in the lease a provision such as the following:

Lessee shall have the right to use, free of cost, oil, gas, and water (except water from the wells of Lessor) produced on


28 The “irrespective” clause in this provision is a classic example of language whose purpose is unknown or misunderstood. It is designed to protect the lessee in the event of a suit by the lessor alleging that injection under pressure as part of the secondary or tertiary recovery operation has forced oil from under the lessor’s land to under someone else’s property, thereby damaging the lessor.

the Leased Premises for Lessee’s operations thereon, including repressuring, pressure maintenance, cycling, and secondary recovery operations; and the royalties on production herein provided shall be computed after deducting any oil or gas so used.30

Such a provision is not a panacea; but a lease containing similar language was construed, in Sun Oil Co. v. Whitaker,31 to grant the lessee the right to drill its own water well and to use not more than 100,000 gallons of fresh water per day, from that well, for secondary recovery operations: “Sun has an implied right to waterflood because the waterflood operation is reasonably necessary to carry out the purposes of the lease. The reasonableness of Sun’s waterflood operation stands uncontradicted in this record.”32

Note that this provision does not grant the lessee the right to draw water from the lessor’s wells. This is a business issue, of course; but most operators would likely agree that landowners will be extremely sensitive — if not outright hostile — to the idea of sharing their own water supply.

[c] — Pipelines.

One of the most vexing problems relating to the scope of the granting clause relates to the right to lay and to maintain pipelines. While such a right will almost certainly be implied, at least where the pipelines clearly benefit the leased property,33 it is advisable that the granting provision contain language specifically authorizing the lessee to construct pipelines

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30 A knowledgeable lessor will want to limit water usage to drilling operations and specifically to exclude repressuring, pressure maintenance, compression of produced gas, cycling, plant use, and secondary recovery operations.
31 Sun Oil Co. v. Whitaker, 483 S.W.2d 808 (Tex. 1972).
32 Id. at 811.
33 See, e.g., Mountain Fuel Supply Co. v. Smith, 471 F.2d 594 (10th Cir. 1973); Lewis v. Ada Oil Co., 279 So. 2d 622 (Miss. 1973); and Delhi Gas Pipeline Corp. v. Dixon, 737 S.W.2d 96 (Tex. App. 1987). But see Roye Realty & Developing, Inc. v. Watson, 791 P.2d 821 (Okla. App. 1990), in which it was held that the fact that a pipeline might benefit other leases does not preclude the lessee from using so much of the surface as is reasonably necessary.
across the leased premises to transport hydrocarbons produced elsewhere, such as the following:

. . . constructing, utilizing, and maintaining pipelines, electric lines, power stations, ponds, roadways, fixtures, and any other things needed or desirable to produce, to save, to treat, to process, to store, to transport, and/or to market the substances described above and the products therefrom, whether derived from the same or other lands.

Such language expressly gives the lessee the right to place pipelines on the leased premises for the purpose of transporting hydrocarbons produced elsewhere without acquiring a separate easement or surface lease from the lessor. Unfortunately, this may be insufficient to resolve a key problem: What happens when the lease terminates? Absent some clear agreement to the contrary, it is arguable — if not axiomatic — that the easement will terminate when the lease terminates. A provision such as the following is therefore advisable:

Lessee shall, as provided in Section 1, above, have the right to lay, to maintain, to repair, to replace, and to remove pipelines. When requested by Lessor, Lessee shall bury Lessee’s pipeline(s) below plow depth. Lessor covenants and agrees to execute, at any time prior to the termination of this Lease and without additional consideration, a right of way, in recordable form, evidencing Lessee’s exclusive pipeline easement. Lessor further covenants and agrees that, for so long as such right of way or this Lease shall remain in full force and effect (whether during the primary term or any extended term hereof), such easement is exclusive unto Lessee; and Lessor shall not agree to or allow the construction, by any third party(ies), of any pipeline, transmission, or distribution facilities on or under the surface of the Leased Premises, for whatever purpose, without the prior written consent of Lessee.

This additional clause provides a mechanism — the filing of a separate pipeline easement — to assure that the lessee will not be denied access to the leased premises for pipeline purposes after the lease has expired for
It also reemphasizes the exclusive nature of the lessee’s pipeline easement.

[d] — Gas Storage Wells and Disposal Wells.

It is doubtful that a granting provision that does not specifically address gas storage will be construed to give the lessee an implied right to use subsurface formations from which the native gas or oil has been removed for the purpose of injecting and storing natural gas or for disposing of brine or other oilfield wastes. This is aptly illustrated in Pomposini v. T.W. Phillips Gas & Oil Co., 35 a case involving a lease whose granting clause provided that it was “for the sole and only purpose of drilling and operating for oil and gas, with the exclusive right to operate the same . . . .”36 The lessor accepted quarterly rental payments, believing them to be production royalties. When he learned that they were for gas storage, he sued the lessee for unauthorized use of the well. The trial court held for the lessor and the appellate court agreed, concluding that neither the express language of the lease nor the intent of the parties suggested any authority to use the lease for gas storage:

The written lease agreement does not expressly authorize the use of the land or the well thereon for the storage of gas. The lease was solely for “the purpose of drilling and operating for oil and gas. . . .” Storage can be permitted under such a lease only if it was the intent of the parties to include storage within the grant of authority to operate for oil and gas. The trial court determined that storage was not a use contemplated by the parties.

The parties’ intention must be gathered from a reading of the entire agreement. . . .

34 It would, of course, be possible to draft the provision in the lease to provide that the termination of the lease will not result in the termination of the easement. While this may be far simpler from a purely administrative standpoint, a separate recorded easement clearly provides the greatest protection to the lessee vis-à-vis third parties.
36 Id. at 777.
The written agreement between Pomposini and his lessee does not disclose an implied intent to allow gas storage in the well or in the subsurface caverns underlying the same. It is revealing of their intent that the scheme for payment of royalties is based on gas pressure at any well “from which gas is marketed.” The lease does not establish any means for determining the amount of rent to be paid for use of the premises for gas storage. It seems reasonably certain, therefore, that the parties did not contemplate that the premises would be used for the storage of gas. 37

Whether or not gas storage is contemplated at the time the oil and gas lease is executed, injecting or moving gas into, storing or holding gas in storage in, or withdrawing from storage or removing gas from, any sands, strata, or formations lying thereunder should always be one of the expressly stated purposes for which the lease is granted. Moreover, if the lessee has any reasonable expectation that it will use the leased premises for gas storage, the lease should include an additional provision such as the following:

At any time during the effective term of this Lease or any extension thereof, Lessee may notify Lessor of Lessee’s intention to use the Leased Premises and/or any well located or to be drilled and located thereon for any and all of the purposes hereinbefore provided of injecting or moving gas into, storing or holding gas in storage in, or withdrawing from storage or removing gas from, any sands, strata, or formations underlying the Leased Premises; and, upon the giving of such notice, Lessee may use the Leased Premises and/or any such well for any and all of said purposes. If there is no well used for gas storage purposes on the Leased Premises, but if a well used by Lessee for any of the gas storage purposes hereinbefore specified is located on other lands and within _________________ (___) miles of any point along the perimeter of the Leased Premises, Lessee may give like written notice to Lessor of Lessee’s intention to use the Leased

37 Id. at 778.
Premises for any and all of said gas storage purposes and thereupon may use the Leased Premises for said purposes and shall be the sole judge as to whether gas is being stored or held in storage within or under the Leased Premises. Lessee shall pay to Lessor, in the manner and at the place provided for in the Lease with respect to the payment of delay rentals, an annual rental equivalent to the greater of (a) _______________ Dollars ($______) for each such well so used by Lessee on the Leased Premises or (b) _______________ Dollars ($______) per acre then covered by this Lease; and the payment of such rentals shall have the same effect of continuing this Lease in full force and effect as though a producing well were being operated by Lessee upon the Leased Premises. Said gas storage rentals shall be payable in quarterly installments, the first such installment to be payable within ten (10) days of the notice provided for herein and subsequent installments to be payable at three (3)-month intervals thereafter.

Similarly, if the lessee intends to use the leased premises for the disposal of liquid wastes, the granting clause should specifically authorize “injecting water, brine, or other fluids into sands, strata, or formations lying thereunder.” In addition, the lease should include a provision such as the following:

Whenever any well or wells on the Leased Premises shall be used by Lessee for the injection of water, brine, or other fluids produced from lands other than the Leased Premises for disposal as a conservation measure, Lessee shall pay to Lessor the sum of _______________ Dollars ($_____) per year for each well so used in addition to any other royalty or rental payments specified in this Lease. Such injection or disposal as a conservation measure shall be effected in accordance with the applicable regulations of the governing bodies having jurisdiction over such activities.

While there appears to be no authority expressly on point, it is submitted that the inclusion of provisions such as those suggested above
is wise — if not necessarily essential — not merely to establish unequivocally the right to the subsurface use but also to deflect a challenge in the event the lease is never used, or ceases to be used, for the production of oil or gas. While it may be sufficient simply to provide that the lease will continue, beyond its primary term, so long as the leased premises are used for gas storage operations or waste disposal, the want of any provision for the continuing payment of rentals could, in such cases, support a landowner challenge to the continuing validity of the lease. The agreement of the parties notwithstanding, there is an obvious attraction to the argument that it is fundamentally unfair that a lease should be held, potentially in perpetuity, without any continuing rentals, royalties, or other additional consideration being paid to the lessor. This is not the type of situation that a prudent operator should want to litigate.

§ 16.03. The Delay Rental and Royalty Clauses: To Whom Must Delay Rentals and Landowners’ Royalties be Paid?

Delay rentals and production royalties are, to landowners, the essential reason for entering into an oil and gas lease. Consequently, it is critical that they be paid — in the correct amount, at the right time, and to the appropriate party. Most lessees are concerned primarily with paying the correct amount, and it is perhaps for this reason that so many disputes relate to the more commonly neglected areas of timeliness and appropriate recipient.

[1] — Payment to an Agent.

One of the best examples of a hidden provision is found in the clauses directing how payments due under the lease should be made. Many leases contain provisions such as the following:

Each such payment . . . may be deposited in the ______________ Bank at ________________________, or its successors, which shall continue as the depositories . . . Any payment hereunder may be made by check or draft of Lessee deposited in the mail or delivered to the party entitled to receive payment or to the depository bank provided for above on or before the last date for payment.
It is fairly obvious to all but the most obtuse reader that an agency relationship is created by such a clause: if a depository bank is designated, it becomes an agent of the lessor for purposes of receiving delay rental and royalty payments.

Few readers, however, immediately grasp the fact that this clause may also create a more significant agency — on behalf of the lessor — in the United States Postal Service. This provision clearly authorizes a check for the requisite payment to be “deposited in the mail” and, in fact arguably resolves — by its express terms — the more difficult question of when payment is timely made. It would appear, under this language, that payment is effective when the check is sent, not when it is received.

Many leases, however, are somewhat more vague, providing simply:

All payments required or permitted hereunder shall be sent by Lessee to Lessor at Lessor’s address as set forth at the beginning of this Lease or at the last address of Lessor of which Lessor shall have notified Lessee.

There is nevertheless authority for the proposition that the same result should obtain even under such a provision. The authorization to “send” or to “mail” payments rather than to deliver them personally may be construed as an authorization for the lessee to select the Postal Service or some other courier as the lessor’s agent; and timely delivery of a check to such agent will therefore constitute timely payment, even though the check was not actually received until later than the default date. In Hitz v. Ohio Fuel Gas Co., an Ohio appellate court, in construing a lease that accorded the lessee the privilege of paying delay rentals “by Bank check to the order of W.J. Hitz at his P.O. address,” concluded:

It is not provided that the lessee should see to it that the checks were to be delivered to the lessors by the mails within the specified time, but only that the bank check be mailed to Hitz, properly addressed. We are now asked to declare in fact that the mails be adjudged to be the agent of the lessee company. We think it is plain that the reverse is true. The lessee is not required by the covenant to mail and deliver, but only to mail. The instrument makes the postal service the lessors’ agent to

deliver the check which the lessee must see “mailed.” It is common knowledge that a letter is mailed when it is posted, that is, placed in the mails, and it is a well-recognized rule of law that payment may be made to the creditor’s authorized agent. It follows that if the check was properly prepared, addressed, stamped, and mailed, the lessee was not bound to see to its delivery.\(^{39}\)

 Presumably, delivery to a reputable courier will also suffice, at least where the authorization is to “send,” rather than to “mail,” the payment.\(^{40}\) In any event, a lessor that expects to receive a delay rental or royalty payment within a specified time period would be well advised to state

\(^{39}\) Id. at 769. See also, Norskog v. Atha, 102 N.E.2d 907 (Ohio Mun. 1951).

\(^{40}\) In this regard, note should be taken of the definition of the word “send” under Uniform Commercial Code (UCC) § 1-201(38)(emphasis added):

> “Send” in connection with any writing or notice means to deposit in the mail or deliver for transmission by any other usual means of communication with postage or cost of transmission provided for and properly addressed and in the case of an instrument to an address specified thereon or otherwise agreed, or if there be none to any address reasonable under the circumstances. The receipt of any writing or notice within the time at which it would have arrived if properly sent has the effect of a proper sending.

 Although the UCC does not apply to oil and gas leases, the argument by analogy is rather compelling. The final sentence of this provision should not be construed to require that a writing or notice have been sent sufficiently in advance of its due date that it would have arrived timely if properly sent, but rather to mean that actual receipt within any specified time period will cure a sending that is otherwise defective. The concept of “receipt” is separately defined, as part of the definitions involving notice and notification, in UCC § 1-201(26):

> A person “notifies” or “gives” a notice or notification to another by taking such steps as may be reasonably required to inform the other person in ordinary course whether or not such other actually comes to know of it. A person “receives” a notice or notification when

(a) it comes to his attention; or

(b) it is duly delivered at the place of business through which the contract was made or at any other place held out by him as the place for receipt of such communications.
this explicitly or, at the very least, never to enter into a lease that permits a payment to be “mailed” or “sent.”

[2] — Transfers by Lessors:


Virtually every oil and gas lease contains some manner of provision dealing with assignments. Most lessees focus on the assignment provision solely from the standpoint of the legitimacy and effect of an assignment by the lessee of all or a portion of its working interest.41 In fact, assignment clauses also address the effect of transfers by the lessor. A typical assignment provision might read, in part, as follows:

The rights, interests, and estates of either party hereto may be assigned, but no change or division in ownership, however accomplished, shall operate to enlarge the obligations or to diminish the rights of Lessor or Lessee. No change in the ownership of the Leased Premises, and no assignment of rentals or royalties, shall be binding upon Lessee until Lessee has first been furnished with a written transfer or assignment or a true copy thereof.

This portion of the assignment provision is designed to protect the lessee from certain possible consequences of an assignment by the lessor. Absent such language, the lessee could be obligated to make a periodic review of the public records to determine the appropriate party to which delay rentals, production royalties, or other payments due from the lessee under the lease are to be made. A clause of this type operates to shift the administrative burden to the lessor.42

The drafters of the UCC clearly intended that the obligations to send and to receive be carefully distinguished:

“Notifies.” New. This is the word used when the essential fact is the proper dispatch of the notice, not its receipt. Compare “Send.” When the essential fact is the other party’s receipt of the notice, that is stated.

Official Comment No. 26 to UCC § 1-201.

41 On this issue see the discussion at Section 16.03[3][a], infra.

42 Similar language worked in favor of the lessees in Humble Oil & Refining Co. v. Harrison, 205 S.W.2d 355, 361 (Tex. 1947), and Gulf Refining Co. v. Shatford, 159 F.2d
[b] — The Apportionment of Delay Rentals and Royalties.

When a property is subdivided by the landowner, applicable state law will normally require that any rentals due and owing — including delay rentals accruing under oil and gas leases — be apportioned pro rata among the new owners of the subdivided property, unless the transferor has expressly retained the right to receive such rentals.43 A different rule is usually applied to royalties on oil and gas production.

[i] — The Apportionment Rule Versus the Nonapportionment Rule.

Under the majority rule, oil and gas royalties are not apportioned when the fee estate is subdivided. Instead, the owner of the tract on which the producing well is located is entitled to all royalties due under the lease with respect to that well.44 A distinct minority of the oil and gas producing jurisdictions follow the apportionment rule, which treats royalties in the same manner as delay rentals.45

231, 233 (5th Cir. 1947). See generally, 4 Williams & Meyers, § 677.4. Occasionally, however, it may operate to their detriment. The lessee in Atlantic Refining Co. v. Shell Oil Co., 46 So. 2d 907 (La. 1950), received no notice of a transfer of a portion of its lessor’s interest; but it paid delay rentals based upon information it had received in a title opinion that contained an erroneous interpretation of an ambiguity in the conveyance. The Supreme Court of Louisiana held that the lease had terminated because the lessee had no occasion to rely on the public records!

43 See generally, John S. Lowe, Oil and Gas Law in a Nutshell, 140 (1983).
44 The nonapportionment rule appears to be followed in Arkansas, Colorado, Illinois, Indiana, Kansas, Kentucky, Louisiana, Nebraska, New Mexico, Ohio, Oklahoma, Texas, and West Virginia. See, 2 Williams & Meyers, § 520, at 678-678.2, nn. 3.1-3.13 and cases cited therein; and Schetroma, § 13.02[2][a], [b], [c], [d], [e], [f], [g], [i], [j], [k], [l], and [m].
45 The apportionment rule is apparently embraced only in the States of California, Mississippi, and Pennsylvania and in the Canadian Province of Ontario. See, 2 Williams & Meyers § 520, at 678.2-678.3, nn. 3.14-3.17 and cases cited therein; and Schetroma, §§ 13.01 and 13.02[1] and [2][h] and [n].

An entirety provision is the contractual agreement of the parties to apportion the landowner’s royalty, thereby supplanting the nonapportionment rule in those states that would otherwise preclude apportionment. The following is a fairly typical entirety (or apportionment) clause:

If the Leased Premises are now or shall hereafter be owned in severalty or in separate tracts, the premises shall nevertheless be developed and operated as one lease, and all production royalties, shut-in royalties, and delay rentals accruing hereunder shall be treated as an entirety and shall be divided among and paid to such separate owners in the proportion that the acreage owned by each separate owner bears to the entire leased acreage. There shall be no obligation on the part of Lessee to drill offset wells on separate tracts into which the Leased Premises may hereafter be divided by sale, devise, or otherwise, or to furnish separate measuring or receiving tanks.

The above-quoted provision contains additional language designed to make it clear that the subdivision of the leased premises will not result in the imposition of additional duties on the lessee.

While it would seem to be axiomatic that an entirety provision will be enforced, the courts of many states that adhere to the nonapportionment rule have often found some basis to ignore the contractual agreement and instead to apply the property law rule with which they are familiar. Consequently, the enforceability of an entirety provision may be open to question, depending on the circumstances. What is most likely to raise the issue is the inclusion of nonapportionment language in the deed subdividing the premises, i.e., a specific retention by the lessor/transferor of the right to receive production royalties. One authoritative treatise concludes:

(1) An appropriate entirety clause in a lease will cause royalties to be apportioned despite subsequent subdivisions of the leased premises in the absence of contrary provision in a conveyance subdividing the leased premises.

(2) The presence of such an entirety clause in the lease should not be viewed as inhibiting the lessor from conveying a portion of the leased premises with an express provision for nonapportionment of royalties.

(3) However, as far as the lessee is concerned, his duties may not be increased by such express provision for nonapportionment made in such subsequent conveyance by the lessor.

(4) And such express provision made in such subsequent conveyance does not affect the right of the owner of an interest in another portion of the leased premises to continue to claim the benefit of the entirety clause in the lease so as to be entitled to an apportioned share of the royalty from production anywhere on the leased premises.\(^47\)

Another commentator states:

The foregoing analysis reveals the entirety clause to represent a viable and welcome tool in non-apportionment states by which the parties can elect and contract to obtain apportionment benefits on a case-by-case basis. The courts are slowly developing the parameters of the law applicable to these clauses. Restrictive cases only appear to arise in the absence of clear language. It would appear that the courts would uniformly give effect to any rational clearly drawn clause. Only the absence of clear contract guidance gives rise to such questions as whether the parties intended to bind successors, whether the clause was intended to apply to mineral and royalty transfers or only to one or the other and whether the clause was intended to reach specific interests existing at the time of the grant of the lease. In the absence of

\(^{47}\) 2 Williams & Meyers § 521.3, at 689-690 (footnote omitted).
clear contract language governing any specific point, litigants can anticipate that the non-apportionment state courts will resolve the point as the “equities” are perceived to exist and as the intent of the original parties is divined. Again, the difficulties and case-specific equities which arise in the apportionment/non-apportionment cases produce result oriented opinions and a difficult law for the analyst.48

The wisdom of providing contractually for the apportionment of royalties is open to debate. Given the trend toward urbanization and the resultant subdivision of many large, previously rural tracts subject to oil and gas leases, a lessee that is committed — whether as a matter of contract or of state law — to the apportionment of royalties may be confronted with a crushing administrative burden of cutting scores of small checks, as to all of the owners of lots in a new residential subdivision.49


Virtually every form oil and gas lease contains a lesser interest (or proportionate reduction) clause. A typical provision of this type reads as follows:

If Lessor owns a lesser interest in the Leased Premises than the entire, undivided fee simple estate therein, then the production royalties, shut-in royalties, and delay rentals herein provided for shall be paid to Lessor only in the proportion that Lessor’s interest bears to the whole and undivided fee.

The purpose of the lesser interest provision is to reduce the rentals, royalties, or other payments that the lessor owes the lessee in the event that the lessee owns less than the full mineral estate, i.e., less than what is necessary to give the lessee a full 100 percent working interest.50 For instance, if John Smith has executed an oil and gas lease covering a 50-

49 For some sample nonapportionment provisions see 4 Williams & Meyers, § 678.1, at 260-261. For an interesting — but ultimately unsatisfying — decision addressing one such provision see Burtner-Morgan-Stephens Co. v. Wilson, 586 N.E.2d 1062 (Ohio 1992).
50 See generally, 4 Williams & Meyers, §§ 686, 686.6, and 686.8; and Lynch, § 3.09.
acre tract of land in favor of Oilco, Inc., and Oilco subsequently discovers that Smith was a cotenant with Jim Jones, who owned an undivided 40 percent of the fee and mineral estates, and that Smith owned only an undivided 60 percent, the working interest acquired by Oilco will be 60 percent, not 100 percent, and its payment obligation to Smith will be reduced by 40 percent, to 60 percent.

The proportionate reduction clause, which is designed to address a failure in the lessor’s title as of the time the lease was granted, is not intended to address the situation in which the fee or mineral estate out of which the oil and gas leasehold estate has been carved is subsequently subdivided. Consequently, it should not be given the same effect as an entirety provision as concerns the apportionment of royalties. 51


Needless to say, the lessee is no less likely than the lessor to transfer or to dispose of all or a portion of its interest under an oil and gas lease. Consequently, most oil and gas leases contain provisions designed to address what happens in such situations.


As previously discussed, most oil and gas leases contain provisions that address what happens when the lessor transfers its interest in the lease or the leased premises. 52 What is typically of greater concern to the lessee, however, is its ability to assign all or a portion of its leasehold interest. Many lessees, however, are so focused on assuring that they have the right to assign 53 that they neglect to focus on the effect of an assignment. Oil and gas leases often contain assignment provisions such as the following:

The rights, interests, and estates of either party hereto may be assigned, but no change or division in ownership, however accomplished, shall operate to enlarge the obligations or to diminish the rights of Lessor or Lessee.

51 See generally, 2 Williams & Meyers § 521.5, nn. 1-2 and cases cited therein.
52 See Section 16.03[2], supra.
53 On the right of the lessee to assign see Section 16.04[1], infra.
The apparent evenhandedness of such a provision makes it fairly easy for a prospective lessor to accept it, but it may not accomplish what the lessee seeks to achieve.

From the lessee’s standpoint, of course, the ultimate goal of an assignment provision is not merely to assure that it has an unrestricted right to assign its leasehold interest, in whole or in part, but also to assure that a complete or partial assignment by the lessee relieves it of any further obligation with respect to the interest assigned. In the absence of an express provision to the contrary, the assignee will, upon acceptance of the assignment, assume the rights and obligations that its assignor possessed at the moment of assignment; but, unless there is a clause expressly relieving the lessee/assignor of liability, it will probably remain liable to the lessor for breach of an express covenant.\(^{54}\) The lessee may avoid this problem by including in its assignment provision language such as the following:

If Lessee transfers its interest hereunder in whole or in part, Lessee shall be relieved of all obligations thereafter arising with respect to the transferred interest, and failure of the transferee to satisfy such obligations with respect to the transferred interest shall not affect the rights of Lessee with respect to any interest not so transferred.\(^{55}\)

Such a provisions provides exculpation to the lessee only with respect to breaches occurring after the transfer. A similar provision focuses more clearly on partial assignments and provides for the apportionment of the lessee/assignor’s obligations to pay delay rentals and royalties:

It is hereby agreed that, in the event that this Lease be assigned as to a part or parts of the Leased Premises, (a) Lessee shall be liable only for (1) such proportion of the delay rental due hereunder as the acreage retained by Lessee bears to the entire

\(^{54}\) See generally, 2 Williams & Meyers § 403.1. In short, both the assignor and the assignee are liable to the lessor for breaches. As between the assignor and the assignee, the assignee bears the ultimate responsibility; and the assignor may therefore seek reimbursement from the assignee for damages for breach that it pays. See generally, id., § 403.4, at 271.

\(^{55}\) Lynch, § 3.10[2].
acreage covered by the Lease and (2) royalties accruing on
the acreage retained by Lessee, and (b) the assignee or
assignees of Lessee shall have corresponding rights,
privileges, and obligations with respect to delay rentals and
royalties as to the acreage assigned to such assignee or
assignees. In any such event, if any such assignee shall fail or
make default in the proportionate part of delay rentals or
royalties due from it, or shall default in any of the obligations
imposed upon Lessee by this Lease, such default shall not
subject this Lease to forfeiture or other liability, or affect this
Lease, insofar as this Lease covers any part or parts of the
Leased Premises as to which Lessee or any assignee of Lessee
shall not be in default.


Because lessees may wish to surrender an oil and gas lease to the
extent that it covers land thought to be unproductive, they often include
in their lease forms a surrender provision, such as the following:

Lessee may at any time surrender this Lease as to all or any
part of the Leased Premises covered hereby by delivering or
mailing a release thereof to Lessor, if the Lease is not recorded,
or by placing a release thereof of record in the county in which
the Leased Premises are situated, if the Lease is recorded;
and, if surrendered only as to a part of the Leased Premises,
any rentals or other payments that may thereafter be payable
hereunder shall be reduced proportionately. Upon any such
surrender of all or any part of the Leased Premises, Lessee
shall be relieved of any and all obligations and liabilities
whatsoever incident thereto.

Such clauses were initially challenged by lessors, who claimed that
they rendered the leases in which they were included void for want of
mutuality of obligation. This argument was rejected by the United States
Supreme Court in *Guffey v. Smith*, and surrender provisions are now

fairly commonplace. Their principal effect is — upon the lessee’s surrender of the lease as to a portion of the leased premises — to proportionately reduce the lessee’s liability for delay rentals and other acreage-based payment obligations. Under normal circumstances, a surrender provision has no effect on the lessee’s obligation to pay royalties on production.


The lessee’s ultimate fear, of course, is that it will make some mistake that will result in its forfeiture of a potentially valuable oil and gas lease. There are many different provisions designed to provide the lessee with notice of, and an opportunity to cure, any alleged default before any forfeiture may be declared or pursued. The following is a typical example of the simpler type of notice-and-demand provision:

In the event Lessor considers that Lessee has not complied with all of its obligations under this Lease, both express and implied, Lessor shall notify Lessee in writing setting out specifically in what respects Lessee has breached this Lease. Lessee shall then have thirty (30) days after receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by Lessor. The service of said notice shall be a condition precedent to the bringing of any action by Lessor on this Lease for any cause, and no such action shall be brought until the lapse of thirty (30) days after service of such notice on Lessee. Neither the service of said notice nor the doing of any acts by Lessee aimed to meet all or any of the alleged breaches shall be deemed an admission or presumption that Lessee has failed to perform all its obligations under this Lease.

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57 See generally, 4 Williams & Meyers, § 680.
58 Of course, if the leased premises have been subdivided, and the lessee surrenders all of its interest in one separately owned tract, the owner of that tract would, under normal circumstances, be deprived by such surrender of any rights it may have had as a result of apportionment — whether by contract or by applicable state law — to a portion of the production royalties derived from a well on the separately owned tract not surrendered.
Judicial ascertainment clauses are closely related to notice-and-demand clauses but go even further to protect the lessee by requiring that the lessor first prove in court that a breach has occurred and then still give the lessee an opportunity to cure that breach. A typical judicial ascertainment clause reads:

12. Breach or Default. No litigation shall be initiated by Lessor for damages, forfeiture or cancellation with respect to any breach or default by Lessee hereunder, for a period of 90 days after Lessor has given Lessee written notice fully describing the breach or default, and then only if Lessee fails to remedy the breach or default within such period. In the event the matter is litigated and there is a final judicial determination that a breach or default has occurred, this lease shall not be forfeited or canceled in whole or in part unless Lessee is given a reasonable time after said judicial determination to remedy the breach or default and Lessee fails to do so. This Paragraph 12 shall not apply to erroneous payment of rental.59

Any lessor who has the advice of even marginally competent counsel will likely reject a judicial ascertainment provision.

[a] — Nonpayment of Delay Rentals: the “Unless” Lease Versus the “Or” Lease.

Whether a notice-before-forfeiture provision will be applied to protect a lessee that has defaulted in its obligation to pay delay rentals depends in large part on the nature of the drilling and delay rental provision in the lease. The drilling and delay rental clause is concerned with the requirement for maintaining the lease in effect during the primary term. Generally speaking there are two varieties of drilling and delay rental clauses, and they cause contemporary leases to be denominated as “or” leases or “unless” leases. Both forms are designed to ensure the lessor a periodic return during the primary term in the absence of production and to permit the lessee to postpone drilling operations by the payment of the

59 Lynch § 3.14[2].
stipulated delay rental without fear of breaching the implied covenant to develop the premises.60

A fairly comprehensive delay rental provision of the “unless” variety reads as follows:

If no drilling operations are commenced on the Leased Premises (or any acreage pooled therewith, as provided in Section 11, below) on or before twelve (12) months from the execution date hereof, this Lease shall terminate as to both parties, unless, on or before such anniversary date, Lessee shall have paid or tendered to Lessor the sum of ____________________ Dollars ($____) per acre, which shall operate as a delay rental and which shall cover the privilege of deferring commencement of drilling operations for a period of twelve (12) months from said date. In like manner and upon like payments and tenders annually, the commencement of drilling operations may further be deferred for successive periods of twelve (12) months each during the primary term. No such delay rental payment shall be due while oil, gas, casinghead gas, distillate or other liquid or gaseous hydrocarbons are being produced in paying quantities, in the judgment of Lessee, from the Leased Premises (or any acreage pooled therewith, as provided in Section 11, below), or while gas storage rentals are being paid by Lessor to Lessee pursuant to Section 9, below.

A comparable delay rental provision of the “or” variety might read as follows:

Lessee agrees to commence drilling operations on the Leased Premises (or any acreage pooled therewith, as provided in Section 11, below) on or before twelve (12) months from the execution date hereof, or to pay or to tender to Lessor, on or before such anniversary date, Lessee shall have paid or tendered to Lessor the sum of ____________________

60 See generally, 3 Williams & Meyers, §§ 605-607.
Dollars ($_____) per acre, which shall operate as a delay rental and which shall cover the privilege of deferring commencement of drilling operations for a period of twelve (12) months from said date. In like manner and upon like payments and tenders annually, the commencement of drilling operations may further be deferred for successive periods of twelve (12) months each during the primary term. No such delay rental payment shall be due while oil, gas, casinghead gas, distillate or other liquid or gaseous hydrocarbons are being produced in paying quantities, in the judgment of Lessee, from the Leased Premises (or any acreage pooled therewith, as provided in Section 11, below), or while gas storage rentals are being paid by Lessor to Lessee pursuant to Section 9, below.

The “unless” clause differs from the “or” clause in one important respect. In an “or” lease, the lessee covenants to do a specific act, e.g., it covenants “to drill a well or to pay delay rentals.” The “unless” clause, on the other hand, does not contain any covenant by the lessee. It is not obligated to do anything, but the lease will terminate “unless” it does some act, e.g., commence a well or pay rentals. The result is that the “unless” clause (like the habendum clause) is construed as a clause of special limitation, whereas the “or” clause is construed as a clause of condition. This means that an “unless” lease will terminate automatically if the lessee fails either to drill a well or to pay delay rentals in a timely fashion, while an “or” lease requires some action by the lessor to effect a termination, i.e., reentry or its equivalent, institution of an action to recover possession of the premises.61

The question that this author has most often encountered is whether the existence in an oil and gas lease of a notice-and-demand provision has any effect on the special limitation provision embodied in the “unless”-type delay rental clause. A review of the cases that have addressed this issue discloses the following generally accepted legal conclusions:

61 See generally, id., § 607.
1. A provision requiring the lessor to give the lessee notice of, and an opportunity to cure, a default in the payment of delay rentals is compatible with an “or” type lease and will probably be enforced.

2. A generally worded notice-and-demand provision is repugnant to an “unless” type delay rental provision and will not be enforced.

3. A notice-and-demand provision that is specifically applicable to the nonpayment of delay rentals will probably be enforced.62

The judicial ascertainment provision cited above is specifically inapplicable to erroneous delay rental payments; and the simpler notice-and-demand provision cited above is not specifically applicable to the nonpayment of delay rentals. In fact, the delay rental provision of the lease in which the latter clause appeared specifically provided that “[t]his lease shall become null and void for failure to pay rental for any period when same becomes due and payable.” The lesson should be clear: plan to pay delay rentals in a timely fashion or risk having the lease terminate automatically (in the case of an “unless” lease) or be terminated by reentry by the lessor or institution of proceedings to recover possession (in the case of an “or” lease. An operator that has any concern about its ability to pay delay rentals in a timely manner should utilize a lease that provides specifically that notice of nonpayment and demand for such payment is a prerequisite to the termination of such lease for nonpayment of delay rentals and should be absolutely certain that its lease contains no provisions that might be construed otherwise. Alternatively, such an operator should seriously consider utilizing a paid-up lease. The prepayment of delay rentals is a simple — and comparatively inexpensive — method of avoiding major problems.

[b] — Nonpayment of Royalties.

It is well established that, in the absence of express provisions providing for forfeiture or automatic termination, damages, rather than cancellation, is the more appropriate remedy for nonpayment of royalty.63

62 See generally, id., § 682.2 and cases cited therein. The author wishes to thank John K. Keller and John N. Teeple for their invaluable assistance in providing cases pertaining to this issue.

63 See, e.g., Schaffer v. Tenneco Oil Co., 647 S.W.2d 446 (Ark. 1983); Evans Clay Co. v. Simms, 296 S.E.2d 587 (Ga. 1982); Davis v. Chautauqua Oil & Gas Co., 96 P. 47
Only in Louisiana is there authority to the contrary, and the subsequent federal district court cases construing Louisiana law declined to take an expansive reading of this precedent. Consequently, a properly drafted notice-before-forfeiture provision will almost certainly be enforced where the nonpayment of production royalties is the issue.


As previously discussed, most oil and gas leases contain provisions that addresses what happens when the lessor transfers its interest in the lease or the leased premises or when the lessee transfers all or a portion of its leasehold interest. Most oil and gas lease forms provide that either

(Kan. 1908); Kelley v. Ivyton Oil & Gas Co., 265 S.W. 309 (Ky. 1924); Tri M Petroleum Co. v. Getty Oil Co., 792 F.2d 558 (5th Cir. 1986)(applying Mississippi law); Wagoner Oil & Gas Co. v. Marlow, 278 P. 294 (Okla. 1929); Morriss v. First Nat’l Bank of Mission, 249 S.W.2d 269 (Tex. App. 1952, error ref’d n.r.e.); and Castle Brook Carbon Black Co. v. Ferrell, 85 S.E. 544 (W. Va. 1915). So loathe are courts to declare a forfeiture that they will often deny it even where the lease so provides. See, e.g., Headley v. Hoopengarner, 55 S.E. 744 (W. Va. 1906).

64 See, e.g., Melancon v. Texas Co., 89 So. 2d 135 (La. 1956); and Bollinger v. Texas Co., 95 So. 2d 132 (La. 1957).


66 See Section 16.03[1][b], supra.

67 See Section 16.03[3][a], supra.
the lessor or the lessee may freely assign its interest without first obtaining the other’s consent. Language such as the following is fairly typical:

The rights, interests, and estates of either party hereto may be assigned, but no change or division in ownership, however accomplished, shall operate to enlarge the obligations or to diminish the rights of Lessor or Lessee.

While the apparent evenhandedness of such a provision should make it acceptable to most prospective lessors, many lessors find such provisions to be inherently unpalatable.

Sophisticated lessors who desire, for whatever reasons, that the original lessee be responsible for all work on the leased premises will often seek to insert provisions that restrict the lessee’s freedom to assign. This may be done by simply forbidding any assignment of the lessee’s interest without the prior consent of the lessor or by more complex provisions relating to the criteria that must be met before any particular assignee will be consented to, such as the satisfaction of net worth and similar requirements designed to assure creditworthiness and the express agreement of the assignee to assume the assignor’s liabilities under the lease (often without releasing the original lessee/assignor from such liability). On rare occasions a landowner who has had a bad experience with a specific operator (or who has been warned by others that a specific operator is “bad” or disreputable) may specifically designate a person or entity to which a lease may not be assigned. Express restraints on the alienation of the lessee’s interest have generally been sustained.

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68 Paradoxically, this would most likely be the case — as a matter of applicable state law — even absent an assignment provision. See generally, 2 Williams & Meyers § 402, at 261. Moreover, the right to assign will typically be implied if the lease contains a provision stating that its terms and provisions are binding on the successors and assigns of the lessor and the lessee. See generally, id. § 677.2, at 232.3-232.4.
69 See generally, 4 Williams & Meyers, § 677.1. Occasionally a lease will provide that the assignment is ineffective until the assignment is filed for record and/or the lessor is provided with notice of the assignment. See generally, id., § 677.3, at 233.
70 See generally, 2 Williams & Meyers, § 402, at 262, and § 412.2.
The extent of a restriction on assignment is not always obvious. There is a split of authority, for instance, as to whether such transactions as mergers and stock transfers constitute assignments to which a lessor must consent.71

Lessees that have acceded to lessor demands for provisions requiring lessor consent to any assignment often attempt to dilute the lessor’s power by negotiating additional language that places certain acts outside the scope of the lessor-consent clause. A common provision of this sort states:

Such consent shall not, however, be required in those cases in which a lessee desires (a) to mortgage or to pledge its interest as security for its indebtedness, (b) to dispose of its interest by merger, reorganization, consolidation, or sale of all or substantially all of its assets to a subsidiary or parent company, or to a subsidiary of a parent company, or to any company controlled by Lessee (i.e., a corporation in which Lessee owns at least sixty-seven percent (67 percent) of the voting stock), or (c) to make an *inter vivos* assignment of its interest, for consideration or as a gift, to its spouse, or to its children, or to a trustee to be held in trust for the benefit of its spouse or children.

Clause (b) of this provision can, of course, be manipulated so as to circumvent the lessor consent requirement. A clever lessee that believes that lessor consent may be difficult or impossible to obtain will simply form a wholly owned subsidiary, transfer its leases to that subsidiary, and then sell the stock of the subsidiary to the otherwise prohibited assignee.

Where consent to assignment will be required, it is highly advisable that the words “which consent shall not unreasonably be withheld” be added. The question of whether, absent such a provision, consent may be withheld for any reason — or for no reason whatsoever — is an interesting one, but one that will not be addressed further in this chapter. The lessee should never allow this to become an issue.

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Few lessees will attempt to impose any outright restrictions on the ability of the lessor to transfer its interest in the leased premises. Occasionally, however, a lessee will seek to have a preferential right to purchase, such as the following, included in the lease:

If, during the term of this Lease, Lessor desires to sell or to transfer all or any part of its interest in the Leased Premises, it shall promptly give written notice to Lessee with full information concerning its proposed sale, which shall include the name and address of the prospective purchaser (who must be ready, willing, and able to purchase), the purchase price, and all other terms of the offer. Lessee shall then have an optional prior right, for a period of ______ (__) days after receipt of the notice, to purchase on the same terms and conditions the interest that Lessor proposes to sell. There shall, however, be no preferential right to purchase in those cases in which Lessor desires (a) to mortgage or to pledge its interest as security for its indebtedness, (b) to dispose of its interest by merger, reorganization, consolidation, or sale of all or substantially all of its assets to a subsidiary or parent company, or to a subsidiary of a parent company, or to any company controlled by Lessor (i.e., a corporation in which Lessor owns at least sixty-seven percent (67 percent) of the voting stock), or (c) to make an inter vivos assignment of its interest, for consideration or as a gift, to its spouse, or to its children, or to a trustee to be held in trust for the benefit of its spouse or children.

Similarly, a lessee may likewise seek to have included in the lease an option to purchase the leased premises, either at some agreed price per acre or at its fair market value (usually as determined by appraisal).


Oil and gas leases usually contain one or more provisions relating to the lessor’s title. One such provision is the standard warranty-of-title provision, often containing subrogation language:

Lessor hereby warrants and agrees to defend the title to the Leased Premises and agrees that Lessee may, at its option, pay and discharge any taxes, mortgages, or other liens existing, levied, or assessed on or against the Leased Premises. If Lessee
exercises such option, Lessee shall be subrogated to the rights of the party to whom payment is made and, in addition to its other rights, may reimburse itself by applying to the discharge of any such mortgage, tax, or other lien any royalties or rentals accruing hereunder. If Lessee is made aware of any claim inconsistent with Lessor’s title, Lessee may suspend the payment of delay rentals, royalties, and shut-in royalties hereunder, without interest, until Lessee has been furnished with satisfactory evidence that such claim has been resolved.

The typical warranty language serves the same purpose as a general warranty in any other conveyance and permits the lessee to recover damages if there is a title failure. In most states, the limit of the lessor’s liability will be the lessee’s actual damages, up to the consideration the lessor has received under the lease, plus interest.72

The provision cited above specifically authorizes the lessee to suspend payments to the lessor — without interest — in the event of a title failure. The rational behind this is that holding the money without interest compensates the lessee for the additional administrative expenses incurred in suspending payments. Even if the lease contains such a provision, a lessee would be well advised never to suspend rental payments, since, if the suspension turns out to have been unjustified, the lease could be deemed to have been forfeited. Because delay rentals are usually nominal, the risk of double payment does not impose a financial burden sufficient to justify the far greater risk of losing the lease.73

Many lessors refuse to give such a warranty, believing that it is incumbent on the lessee to determine that the state of title is satisfactory if it wants the lease.74 Lessors are often willing to strike the warranty provision, but this should be done with caution. There are at least two good reasons why the warranty provision should not be sacrificed:

72 See generally, 4 Williams & Meyers, § 685.1, at 417-420.2.
73 Lynch, at § 3.15.
74 A lessor that is willing to give a warranty should insist on the addition of the following sentence: “This warranty is expressly limited to Lessor’s undivided interest in the Leased Premises.” Such a limitation is a good idea in any event but is absolutely necessary when the lessor knows that it owns only an undivided fractional interest in the mineral estate.
1. The existence of a warranty provision makes the doctrine of after-acquired title available to protect the lessee. A full discussion of this doctrine, which is also known as estoppel by deed, is beyond the scope of this chapter. Suffice it to say that, if the lessor conveys an interest he does not own in a conveyance in which he warrants title to that interest, the instrument will be effective to transfer title to the lessee as of the moment the lessor acquires such title.75

2. While the lessee may be reasonably satisfied with the current state of title, as disclosed by its own title examination, it should be wary of giving up the subrogation clause. This provision allows the lessee to protect its interest by paying taxes or mortgages encumbering the leased property and then stepping into the shoes of the former creditor. This could prove to be a valuable right if the lessor encounters financial difficulties.

   It the lessee is willing to abandon the warranty provision, it should be certain that the lease includes the other key title provision: the lesser interest or proportionate reduction clause. As previously discussed,76 the lesser interest clause authorizes the lessee to proportionately reduce future lease benefits to the extent that there has been a title failure.


   The surrender clause, a typical example of which has been cited above,77 is closely related to both the entirety and lesser interest provisions78 and to the assignment provision.79 If properly drafted, it will relieve the lessee of any further obligation with respect to the acreage surrendered, including the obligation to pay any delay rentals or royalties whose calculation is dependent on the released acreage.

   A typical surrender provision operates in favor of the lessee, providing the right, but not the obligation, to file a release or partial release. If the surrender provision, or some comparable clause in the lease, requires the

75 See generally 4 Williams & Meyers, § 685.1, at 420.2; and 1 Williams & Meyers, §§ 309 and 311.
76 See Section 16.03[2][b][iii], supra.
77 See Section 16.03[3][b], supra.
78 See Section 16.03[2][b][ii] and [iii], respectively, supra.
79 See Sections 16.03[3][b], supra.
lessee to file a release or partial release upon the surrender or termination, or partial surrender, of the lease, the lessee should strictly adhere to this provision. Failure to file the requisite release could expose the noncomplying lessee to damages for slander of title or tortious interference with contractual relations.

Most oil and gas leases contain an express provision authorizing the lessee to remove casing, fixtures, and other leasehold equipment from the leased premises. The following clause is fairly typical:

Lessee shall have the right at any time during or after the expiration of this Lease to remove all machinery, fixtures, houses, buildings, and other structures placed or utilized by Lessee on the Leased Premises, including the right to draw and to remove all casing.

Such provisions will usually authorize the lessee to remove his equipment “at any time,” but, in some cases, the clause will specify a time period within which the lessee must act. Sometimes this is framed simply as a “reasonable” time, and the phrase “at any time” will typically be construed as having this meaning, even absent an express statement to that effect. What a “reasonable time” is, of course, is a difficult question that is likely to result in litigation.

Under most circumstances, an equipment-removal provision will not authorize the lessee to plug a well that is producing. However, the Pennsylvania Supreme Court, in Willison v. Consolidation Coal Co., validated a lessee’s abandonment of a 1901 oil and gas lease that provided for annual payments of $300.00 per year for each gas well (subsequently amended to $50.00), free gas for the lessors’ domestic use, and the right of the lessee at any time to remove all machinery and fixtures placed on

80 See, e.g., 4 Williams & Meyers, § 679. Many states have adopted statutes requiring the release of expired oil and gas leases. See generally, id., § 679.1.
82 See generally, 4 Williams & Meyers, § 674.1.
83 See generally, id., § 674.2, at 215-219 and cases cited therein.
said premises, and further, upon the payment of $50.00 at any time . . . “to surrender this lease for cancellation, after which all payments and liabilities thereafter to accrue under and by virtue of its terms shall cease and determine, and this lease become absolutely null and void.”

The owner of the coal rights with respect to the lessors’ property acquired the oil and gas lease for the purpose of plugging the well, without which it could not have mined the more valuable coal. After being notified of the new lessee’s intent to plug the well and to remove the equipment, the lessors, anxious to preserve their free gas supply, sought to enjoin the lessee’s actions. The trial court would not permit the abandonment of the producing well, holding that the lessee had breached an implied covenant to continue to operate the well as long as it was profitable to do so and ordering that the equipment be sold to the lessees at market value. The Pennsylvania Supreme Court reversed, concluding that the plain meaning of the terms of the lease must be given effect:

The decisions below may indeed reflect the commonly followed approach in other jurisdictions, as well as the approach outlined in various treatises on oil and gas law. It is clear, however, that construing the present lease in terms of presumed purpose and other external factors yields a result that is contrary to the terms of the lease. The lease expressly gave Consol a right to remove its equipment “at any time.” That right has been extinguished by the courts below. . . .

The express language of the present agreement provided that Consol could remove its equipment “at any time.” Consol was not required, therefore, to continue operating its well until gas production was exhausted or until parties other than Consol came to view the well as lacking in profitability. The decisions of the courts below holding to the contrary must be reversed.

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85 Id. at 980 (emphasis added).
86 Id. at 981-982. Two concurring justices would have reversed and remanded for a determination of profitability to the lessee.
One wonders whether this result could have been reached in a state, such as Ohio, that implicitly prohibits the plugging and abandonment of a well that is being used to produce oil and gas for domestic purposes.87

§ 16.05. Protections for the Unwary: Is There a Sanity Clause?

There are few statutory or juridical protections designed specifically to insulate unwary parties to oil and gas leases from their own folly. Although there are clearly statutes that impose obligations on the lessee, such as surface damage acts,88 the most meaningful barrier to the abuse of lessors is the implied covenant.89 Lessors may take some further comfort in the fact that, because oil and gas leases are almost always drafted by lessees, standard rules of construction will dictate that they be construed in favor of the lessor and against the lessee.90 Strictly speaking, however, this should be helpful only where there is some ambiguity in the lease.

As a general rule, oil and gas leases will continue to be treated just as most other contracts are treated under American law, i.e., with great deference being given to the time-honored principle of freedom of contract. Oliver Wendell Holmes, Jr., once noted that “Freedom of contract begins where equality of bargaining power begins.”91 It is perhaps for this reason that special consumer-protection type statutes for oil and gas lessors have not proliferated. Lessors are not perceived as having so weak a bargaining position as to merit legislative or judicial paternalism, since they are under no compulsion, other than their own avarice, to execute oil and gas leases.

87 The Ohio statute relating to plugging provides in pertinent part:
Unless written permission is granted by the chief, any well which is or becomes incapable of producing oil or gas in commercial quantities shall be plugged, but no well shall be required to be plugged under this section which is being used to produce oil or gas for domestic purposes, or which is being lawfully used for a purpose other than production of oil or gas.
Ohio Revised Code § 1509.12 (emphasis added).
88 See, e.g., Section 16.02[1], supra. There are some still more basic protections, of course. For instance, Michigan requires that, for recording purposes, an instrument be in no smaller than 8-point type. Mich. Stat. Ann. § 565.201(g).
89 See Section 16.01, supra.
90 See generally, 2 Williams & Meyers, § 372.
91 Quoted in George Seldes, The Great Quotations 229 (Pocket Books 1960).
This is not to suggest, however, that operators will be given free rein. Particularly onerous provisions may not be enforced for a variety of reasons, which are not necessarily mutually exclusive. A court may express its displeasure by manipulating the rules of construction in construing the offending provision or by characterizing it as a violation of public policy, as antithetical to the requirements of a statute or regulation, or as the result of mistake, misrepresentation, fraud, duress, or similar evil. Occasionally, a just and equitable result will be achieved by declaring the entire contract void, as for indefiniteness or lack of consideration.

The need for a single mechanism by which courts of law could address such evils within the context of our open and competitive society prompted the drafters of the Uniform Commercial Code to develop the concept of unconscionability:

(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

(2) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.92

The doctrine of unconscionability is intended “to permit courts to do overtly what they had formerly been forced to do by specious arguments and reasoning to achieve desired results.”93 As noted by the drafters of the UCC:

1. This section is intended to make it possible for the courts to police explicitly against the contracts or clauses which they

92 UCC § 2-302 (emphasis added). UCC § 2A-108, the corresponding provision of UCC Article 2A, differs somewhat because of its special treatment of “consumer leases.”
find to be unconscionable. In the past such policing has been accomplished by adverse construction of language, by manipulation of the rules of offer and acceptance or by determinations that the clause is contrary to public policy or to the dominant purpose of the contract. This section is intended to allow the court to pass directly on the unconscionability of the contract or particular clause therein and to make a conclusion of law as to its unconscionability. The basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract. Subsection (2) makes it clear that it is proper for the court to hear evidence upon these questions. The principle is one of the prevention of oppression and unfair surprise (Cf. Campbell Soup Co. v. Wentz, 172 F2d 80, 3d Cir 1948) and not of the disturbance of allocation of risks because of superior bargaining power. . . .

2. Under this section the court, in its discretion, may refuse to enforce the contract as a whole if it is permeated by the unconscionability, or it may strike any single clause or group of clauses which are so tainted or which are contrary to the essential purpose of the agreement, or it may simply limit unconscionable clauses so as to avoid unconscionable results. (3) The present section is addressed to the court, and the decision is to be made by it. The commercial evidence referred to in subsection (2) is for the court’s consideration, not the jury’s. Only the agreement which results from the court’s action on these matters is to be submitted to the general triers of the facts.94

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94 Official Comments to UCC § 2-302 (emphasis added), reprinted in 2 Hawkland, § 2-302.
Oil and gas leases are not governed by the Uniform Commercial Code. The author submits that it would be appropriate to apply either the UCC — or its concepts — to oil and gas leases. This would make applicable not only the doctrine of unconscionability but also the concept of “good faith,” thereby providing the “sanity clause” that is now — because it exists primarily in the context of semi-covert judicial manipulation of recognized legal doctrines — the ultimate “hidden” provision of oil and gas leases.

**§ 16.06. Conclusion.**

The critical lesson that must be learned — by lessees and lessors alike — is that every provision in the lease is there for a reason. If a party does not understand what that reason is, a visit to a competent oil and gas lawyer is a necessity. To remove a provision simply because one does not grasp its significance may seem to be a good negotiating tactic, but, in the final analysis, it is not very smart. While it may normally be safe to assume that most provisions in oil and gas lease forms tend to favor lessees, this rule is not always applicable; so both parties should fully understand the

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95 UCC Article 2, which relates to sales of goods, covers contracts for the sale of “minerals or the like (including oil and gas) . . . if they are to be severed by the seller.” UCC § 2-107. UCC Article 2A, relating to the leasing of goods, specifically excludes “minerals of the like, including oil and gas, before extraction” from the definition of the word “goods.” UCC § 2A-103(1)(h).

96 UCC § 1-203 provides that “[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.” “Good faith” means — in all transactions governed by the UCC — “honesty in fact in the conduct or transaction concerned.” UCC § 1-201(19). Under UCC Article 2, good faith, in the case of a merchant, means “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” UCC § 2-103(1)(b). The term “merchant” is defined in UCC § 2-104(1) to mean a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill. UCC Article 2A incorporates by reference the UCC Article 2 definitions of “good faith” and “merchant.” UCC § 2A-103(3). Most oil and gas operators should qualify as merchants under such definitions.
document from which they are starting before they begin to tinker with it, adhering always to the “First Law of Wing-Walking”: “Never leave hold of what you’ve got until you’ve got hold of something else.”97