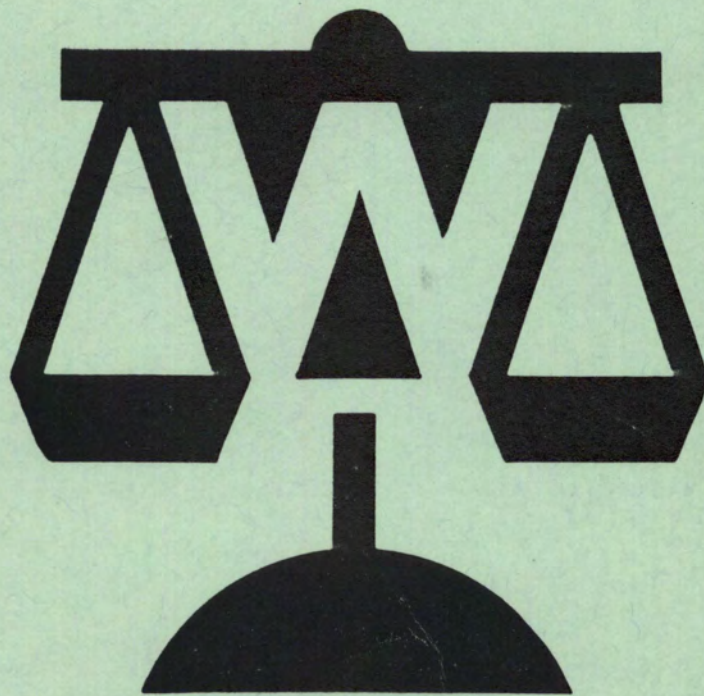


DRAFTING A BETTER OIL AND GAS LEASE



FEBRUARY 27, 1987

Wichita, Kansas

DRAFTING A BETTER OIL AND GAS LEASE

FRIDAY, FEBRUARY 27, 1987

1:00 p.m. BASIC STRUCTURE OF THE OIL AND GAS LEASE
Granting Clause
Habendum (Term) Clause
Drilling/Delay Rental Clause
Royalty Clause
Other Express and Implied Obligations

PERENNIAL PROBLEMS WITH THE OIL AND GAS LEASE
Scope of the Grant
 The Affected Land
 "Other Minerals"
 Surface Use
Duration of the Grant - Habendum Clause
 "Production"
 "Paying Quantities"
 Cessation of Production
Duration of the Grant - Drilling/Delay Rental Clause
 "Commencement" of a Well
 Payment of Delay Rental
Duration of the Grant - Production Substitutes
 Completion Clause
 Dry Hole Clause
 Cessation Clause
 Shut-In Royalty Clause
 Pooling Clause
Royalty
 "Market Value"
 "Proceeds"
 Marketing Changes

2:15 p.m. BREAK

2:30 p.m. A DRAFTING "PROCESS"

RESPONSES TO LEASE PROBLEMS
Judicial Responses
Legislative Responses
Traditional Drafting Responses
Alternative Drafting Responses

A PROPOSED OIL AND GAS LEASE FOR THE 80'S AND BEYOND

3:45 p.m. BREAK

4:00 p.m. LIMITATIONS ON DRAFTING SOLUTIONS
Judicial Limitations
Statutory Limitations

ALTERNATIVES TO THE OIL AND GAS LEASE
The Standard Relationship
Judicial Hostility Toward the Relationship
Inherent Conflicts
Eliminating the Conflicts
 Purchase the Mineral Estate
 Nonoperating Interests Tied to Operator's Costs
 Joint Operation

PARTING COMMENTS

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DRAFTING A BETTER OIL AND GAS LEASE

by

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February 27, 1987
Wichita, Kansas

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DRAFTING A BETTER OIL AND GAS LEASE

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SECTION 1 - INTRODUCTION

I. PRELIMINARY CONSIDERATIONS

- A. Basic transaction for developing oil and gas in America is for the landowner to "lease" the minerals, and associated surface easements, to a developer.
- B. Generally, the relationship created by the oil and gas lease is not governed by landlord/tenant law.
 1. Special rules have been developed by the courts to govern the oil and gas lessor/lessee relationship.
 2. There has also been some statutory intervention governing the relationship. For example: Kan. Stat. Ann. §§55-223 through 55-229 (1983) address the lessee's implied obligation to explore and develop the lease.
- C. No standard "form" of oil and gas lease. Veverka v. Davies & Co., 10 Kan.App.2d 578, 584, 705 P.2d 558, 563 (1985) (concurring opinion; no such thing as a "standard" oil and gas lease form, reference to "Producer's 88" is meaningless). Fagg v. Texas Co., 57 S.W.2d 87 (Tex.Com.App. 1933) ("the character of printed matter contained in any designated class of oil and gas lease form depends on what matter various designers of such forms may deem appropriate - and may vary accordingly.").
- D. Although there is no standard form of oil and gas lease, oil and gas leases create a standard relationship. See Pierce, "Rethinking the Oil and Gas Lease," Tulsa Law Journal (1987) (to be published in May 1987); See generally M. Merrill, Covenants Implied in Oil and Gas Leases §§220-223 (2d ed. 1940); Polston, "Recent Developments in Oil and Gas Law," 6 Eastern Min. L. Inst. 19-1, 19-2 (1985).

1. The relationships created by varying oil and gas lease forms are typically identical in structure.
 2. Courts and legislatures have fashioned rules to respond to the relationship, not necessarily the terms of a particular lease form.
- E. The basic structure of the standard relationship consists of the following:
1. Lessee given option to conduct operations on the leased land for a specified term.
 2. Lessee must pay a "rental" if development is not immediately pursued. This is an interim fee to maintain the option in effect.
 3. If lessee discovers oil or gas during the option period, the grant is extended until it is no longer profitable for the lessee to produce existing wells.
 4. Lessee pays all the costs and keeps all the revenue, subject to an obligation to pay or deliver a cost-free share of production to lessor.

II. BASIC STRUCTURE OF THE OIL AND GAS LEASE

- A. The basic structure of the oil and gas lease, like the relationship it creates, has become standardized, consisting of the following clauses:
1. Granting Clause.
 2. Habendum (Term) Clause.
 3. Drilling/Delay Rental Clause.
 4. Royalty Clause.
- B. Granting Clause - defines the scope of the rights conferred upon lessee.
1. Land encompassed by the grant. Surface and subsurface extent.
 2. Purpose of the grant.
 3. Substances encompassed by the grant.

4. Easement burdening the surface estate necessary to exercise the grant.
- C. Habendum (Term) Clause - defines the duration of the grant.
1. Primary term - the period of time, specified in the lease, during which it will remain in effect. (Subject to the operation of other clauses which may extend or reduce the specified term.)
 - a. Example: "This lease is for a term of three years from the effective date"
 - b. Also known as the "term" clause.
 2. Secondary term - a contingency which extends the lease beyond the primary term.
 - a. Example: "This lease is for a term of three years from the effective date and so long thereafter as oil or gas, or either of them, is produced from the leased land."
 - b. Also known as the "thereafter" clause.
- D. Drilling/Delay Rental Clause - limits the duration of the lease unless the lessee develops the leased land or pays a "rental" to delay development.
1. Limitation on the primary term of the lease.
 2. Lessee has the option to either drill or pay delay rental. Unless the lessee drills or pays rental, the lease terminates.
- E. Royalty Clause - specifies the lessor's share of production, substances subject to the royalty obligation, costs chargeable to lessor's share, how it will be valued and paid, and when it is payable.
- F. Miscellaneous Express Clauses - most of the remaining clauses found in the typical lease are designed to expand or qualify the operation of the four basic clauses. For example:
1. Pooling Clause provides a mechanism to expand the scope of the habendum clause and modify the drilling/delay rental and royalty

clauses.

2. Completion, dry hole, cessation, shut-in royalty, and force majeure clauses are designed to expand the duration of the lease under the habendum clause.

G. Judicially-Defined Implied Obligations - express lease clauses are affected by judicial attempts to balance the relative positions of the lessor and lessee under the standard relationship created by the oil and gas lease.

SECTION 2 - THE DRAFTING PROCESS

I. GENERAL CONSIDERATIONS

- A. Not concerned with whether the lessor or lessee will be the "winner" in the ambiguity contest.
- B. Goal is to draft a lease which minimizes problems and clearly declares the winner or loser at the negotiation stage of the transaction - not the post-contract litigation stage.
- C. All experienced oil and gas attorneys should be "on notice" of the perennial problems and be prepared to take measures to avoid the potential for future disputes.
- D. Major reason for so many problems in this area - lack of meaningful negotiation of lease terms.

II. BASIC GOALS AND TOOLS

- A. Attorney's Goal Should Be To Prepare Documents Which:
 - 1. Meet the requirements of local law necessary to accomplish the transaction. For example:
 - a. Must the document be signed by the parties?
 - b. Must it be recorded? If so, need an acknowledgment.
 - c. Must the lessor's spouse join in the grant?
 - d. NOTE: The requirements for an effective lease are not discussed in this seminar. However, a detailed discussion can be found in D. Pierce, Kansas Oil and Gas Handbook §§9.08 - 9.14 (Kansas Bar Association 1986).
 - 2. Address any special requirements of the transaction (client's special needs).
 - 3. Employ only those terms and provisions determined to be necessary to accomplish the transaction.
 - 4. Express the transaction as briefly and simply

as the subject matter and circumstances will permit.

B. Tools The Attorney Must Use To Create Workable Documents.

1. Questions.

- a. Discover the facts which affect the transaction. Ascertain the surrounding circumstances.
- b. Client will be one of your major resources. Other parties to the transaction may also be available. Get your client's permission to collect facts from other sources.
- c. Ask your client what they want to accomplish.
 - (1) Looking for specific intent on matters affecting the transaction.
 - (2) Need to ascertain each party's specific intent on major issues arising out of the transaction.

2. Define legal issues implicated by the facts.

- a. For example, all attorneys drafting (or reviewing) an oil and gas lease should be aware of the "other minerals" problem, and the major cases interpreting lease clauses.
- b. It would be difficult to approve a traditional form of oil and gas lease without providing your client with numerous disclaimers.
- c. Research issues as required.

3. Plan the document.

- a. Prepare an outline of the document.
- b. Break the transaction into its component parts.
 - (1) Easier when you can visualize the essence of the transaction.

(2) Take a general view of the transaction and then add detail as you address special problems and issues.

4. Prepare the first draft.

a. Focus on structure, then detail.

b. Edit and revise.

5. Cross check the document to ensure internal consistency.

a. Does it work? Have I accounted for each individual section so they function as a unit without any conflicting obligations or statements?

b. Is the format consistent?

c. Are definitions and other repeated materials consistent?

6. Final draft. Get it to where you think it is the best it can be.

7. Get a second opinion. NOTE: Participants in this seminar are my second opinion. I welcome your input on how my draft lease can be improved.

8. Final product.

a. Be prepared to reevaluate.

b. New law and new clients have a tendency to make standardization difficult.

c. Don't need to reinvent the wheel every time, just need to remember what went into inventing it.

C. Editorial Guides.

1. Try to use normal language.

a. Tradition infects.

b. Use forms as a post first draft check. Avoid them at the "thinking" stages of the project.

2. Omit unnecessary clauses, paragraphs, sentences, phrases, and words.
 - a. Be concise.
 - b. Avoid redundant legalisms. E.g. "If lessee fails to pay delay rental when due this lease shall be totally null and void and of no further force and effect whatsoever."

How about: If lessee fails to pay delay rental when due the lease terminates.
 - c. Consider:

KNOW ALL MEN BY THESE PRESENTS;
WITNESSETH -

How about:

LOOKY HERE FOLKS! (Although I wouldn't advise using this phrase, it has the same legal significance as Know All Men By These Presents - Witnesseth).
3. Use short sentences.
 - a. Definitions can help.
 - b. Dividing the drafting project into logical sections can help.
4. Consider your reader.
 - a. Make the document useable.
 - b. Title sections.
 - c. Avoid long blocks of type.
5. Communicate.
 - a. Use simple sentence structure. Keep the subject, verb, and object close together.
 - b. Focus on modifiers to ensure they are modifying the right word.
 - (1) Use list or charts.
 - (2) Simplify sentence structure to

avoid misplaced modifiers.

c. Use common language.

d. Use precise language.

6. Buy and read: Plain English for Lawyers by Richard Wydick (2d ed. 1985). Carolina Academic Press, P.O. Box 8795, Forest Hills Station, Durham, North Carolina 27707. Read it as part of the editorial process.

SECTION 3 - PROBLEMS AND SOLUTIONS
THE GRANTING CLAUSE

I. GRANTING CLAUSE - SCOPE OF THE GRANT

A. Describing The Affected Land.

1. Surface boundary limitations.

- a. Not much of a problem in Kansas and Oklahoma when lands are described by government survey. Greater problem in Texas where many descriptions reflect Spanish units of land measurement.
- b. Mother Hubbard or Cover-All Clause - introduces uncertainty into the description which can generate disputes over the areal extent of the grant. See Jones v. Colle, 709 S.W.2d 8 (Tex. Ct. App. 1986).

2. Depth limitations.

- a. Select workable divisions. Avoid splitting potentially productive reservoirs. See Carter Oil Co. v. McCasland, 190 F.2d 887 (10th Cir. [Okla.] 1951); Carter Oil Co. v. State, 205 Okla. 541, 240 P.2d 787 (1951).
- b. Avoid selecting formations to define depths when the limits of the formation (geological distinguishing characteristics) are not easily identifiable. May want to use other wells in the area as marker wells to identify specific formations by log references. See discussion in Handbook §7.06.
- c. Obtain the necessary technical advice to prepare workable depth and formation limitations.

B. Substances Encompassed By The Grant.

1. What is a "mineral?"

- a. A mystery in most states. Courts addressing the issue have not successfully defined the term "minerals"

or the phrase "other minerals."

b. A conveys to B "all the minerals in Section 30." What substances does B receive by this grant? What does A own? Who owns the oil and gas? Helium, hydrogen, and carbon dioxide? Is coal, recoverable only through surface mining, included in the grant? Do we classify everything as animal, vegetable, and mineral so that B owns the soil on the surface of Section 30?

c. Interpretive guides:

(1) Construe against grantor - If the minerals are severed as part of a conveyance of real property, construe the deed against the grantor so as to pass the largest estate possible to the grantee. Kan. Stat. Ann. §58-2202 (1983).

(2) Community knowledge test - Include the substance in the definition of minerals only if it was generally known to exist at the time of the conveyance. See Roth v. Huser, 147 Kan. 433, 76 P.2d 871 (1938).

(3) Surface destruction test - Include the substance in the definition of minerals only if it can be extracted without significant destruction of the surface. See Payne v. Hoover, Inc., 486 So.2d 426 (Ala. 1986).

(4) Miscellaneous factors -

Some courts focus on the unique character of the mineral and refuse to include common varieties of minerals such as sand, gravel, and stone, which require destruction of the surface to mine.

Some courts look to extrinsic evidence of what the parties were attempting to do when the conveyance was made. For example, a conveyance of all minerals to an oil and gas operator may be more

limited than a similar conveyance from a father to his son. Some courts declare the conveyance ambiguous and consider extrinsic evidence of each party's intent.

- d. Most cases addressing this issue (like the "other minerals" issue addressed in B.2. below) concern mineral conveyances as opposed to mineral leases. When the scope of a mineral deed is at issue, courts are more inclined to construe ambiguous language in favor of the grantee. However, courts will favor the grantor (lessor) when the language appears in an oil and gas lease.

For a statutory statement of this interpretive rule see N.D. Cent. Code §47-10-24 (1983).

- e. Observation - courts often inclined to adopt a rule for determining "title" to a substance which will not surprise the owner of the surface estate. Scope of the grant often restricted to protect surface estate from a claim to mine unspecified minerals which would cause significant surface damage.

2. What minerals are included in a grant of oil, gas, and "other minerals?"

3. Texas' attempt to define "other minerals."

- a. Refuse to apply ejusdem generis. Southland Royalty Co. v. Pan American Petroleum Co., 378 S.W.2d 348 (Tex. 1964).

- b. If the severance is made after June 8, 1983 (or if the surface and mineral estates were divided prior to June 8, 1983 but merge and are separated again after June 8, 1983) - the phrase "other minerals" includes "all substances within the ordinary and natural meaning of that word, whether their presence or value is known at the time of the severance." Moser v. United States Steel Corp., 676 S.W.2d 99 (Tex. 1984).

(1) However, previous Texas decisions

holding a substance belongs to the surface owner, as a matter of law, are still effective. Court in Moser lists cases on building stone, limestone, caliche, surface shale, water, sand, gravel, "near surface" lignite, iron, and coal.

Must still use Acker v. Guinn test to determine what is "near surface" lignite, iron, and coal.

- (2) No free "reasonable use" surface easement for substances included under the "other minerals" definition. Must pay for all surface destruction caused when extracting unspecified substances included in the grant.
- c. If the severance is made on or before June 8, 1983, the tests created by Acker v. Guinn, 464 S.W.2d 348 (Tex. 1971); Reed v. Wylie, 554 S.W.2d 169 (Tex. 1977) (Reed I); and Reed v. Wylie, 597 S.W.2d 743 (Tex. 1980) (Reed II) must be used. Friedman v. Texaco, Inc., 691 S.W.2d 586 (Tex. 1985); Atlantic Richfield Co. v. Lindholm, 714 S.W.2d 390 (Tex. App. 1986).
- (1) Acker v. Guinn - Surface Destruction Test: if you have to destroy the surface to remove an unspecified "mineral," it is not a mineral included in a grant of "other minerals." It belongs to the surface owner.
 - (2) Reed I - if substantial quantities of the mineral lie so near the surface that extraction, at the time of the conveyance, would consume, deplete, or destroy the surface, the mineral belongs to the surface owner. (holding revised by Reed II)
 - (3) Reed II - substances "near the surface" are part of the surface estate if any reasonable method of production, at the time of conveyance or thereafter, would

consume, deplete, or destroy the surface.

(i) Any deposit within 200 feet of the surface is "near the surface" as a matter of law.

(ii) If surface owner establishes ownership of substance at or near the surface, the surface owner owns the substance at all depths.

4. Oklahoma has applied the ejusdem generis maxim. Vogel v. Cobb, 193 Okla. 64, 141 P.2d 276 (1943); West v. Aetna Life Ins. Co., 536 P.2d 393 (Okla.App. 1974).roblem.

5. The Kansas approach to the "other minerals" problem.

a. Kansas courts have applied the community knowledge and surface destruction tests to the "other minerals" situation, but have relied more strongly on the ejusdem generis maxim.

b. Ejusdem generis - where a general description follows a more specific description, the general is limited to items encompassed by the specific. Keller v. Ely, 192 Kan. 698, 702, 391 P.2d 132, 135 (1964).

c. Example: in Keller v. Ely a reservation of "all of the oil, gas, casing-head gas and other liquid semi-solid and solid minerals . . ." was held not to include gypsum because " . . . the general terms contained in the reservation must be deemed to embrace and include only those things similar in nature to those previously specifically enumerated - that is, oil, gas and kindred minerals." Keller, 192 Kan. at 703, 391 P.2d at 136.

d. Court in Keller also purports to apply the community knowledge test, surface destruction test, and Kan. Stat. Ann. §58-2202. Similar analytical sequence used in Wulf v. Shultz to hold a lease,

granting the right "to dig, drill, operate and procure natural gas, petroleum and other mineral substances," does not include the right to mine limestone. [Note: Kan. Stat. Ann. §58-2202 not applicable to a mining lease; construe against drafting party - usually grantee instead of the grantor].

- e. Problem with the current state of the law in Kansas - what sequence should be followed in deciding which test or maxim to apply before resorting to other tests or maxims?

C. Substances Encompassed By Terms "Oil and Gas."

1. A conveys to B "all the oil and gas in Section 30." What substances are included in the grant of "oil and gas?" Does it include helium or carbon dioxide - which are non-hydrocarbon gases? Does it include substances which are produced as a component of the oil and gas stream?
2. Northern Natural Gas Company v. Grounds, 441 F.2d 704 (10th Cir. 1971), cert. denied, 404 U.S. 951, 1063 (1971), rehearing denied, 404 U.S. 1065 (1971). Court had to determine whether a lease covering "oil and gas" included helium extracted from the gas stream by the lessee's gas purchaser.
 - a. Court refuses to apply ejusdem generis maxim to limit the term "gas" to oil-like hydrocarbon substances. Court holds: "absent specific reservations, the grant of gas by the leases covered all components of the gas, including helium." Northern Natural Gas Company, 441 F.2d at 715.
 - b. Here the helium was initially being produced as an impurity incidental to production of natural gas. It would have been impossible, or uneconomic, for the lessee to separate the helium and produce only natural gas at the well. The court apparently thought the fair and workable result would be to find helium, produced as a component of the gas stream, would be included in the

grant of the major gas stream substance - natural gas. The lessor would be obligated to specifically exclude component substances from the grant.

3. Northern Natural Gas Company v. Grounds analysis would not apply when the substance in issue is not a "component" of the specifically conveyed substances ("oil and gas").

- a. Example: A conveys to B the "oil and gas" in Section 30. B, drilling for oil, strikes an almost pure deposit of carbon dioxide gas. Who owns the carbon dioxide under Section 30, A or B? Here the substance is not a component of the oil or gas stream. Instead the issue is the scope of the term "gas." Does it include a non-hydrocarbon gas like carbon dioxide?

- (1) Kansas courts may be more inclined to apply ejusdem generis maxim in this situation.

- (2) Community knowledge test may also be determinative - if the court chooses to apply it in this situation.

- b. Where the substance is not a component of a listed substance, essentially have an "other minerals" interpretive problem.

4. For a recent analysis interpreting the term "gas" for purposes of the royalty clause, see First National Bank of Jackson v. Pursue Energy Corp., 784 F.2d 659 (5th Cir. 1986).

D. Purpose Of The Grant.

1. Typically stated in conjunction with the substances included in the grant and the lessee's surface rights under the grant.

2. For example: Form 88 - (Producers)
Kan., Okla. & Colo. 1962 Rev. Bw
Paragraph #1

[Lessor] . . . "grants, leases, and lets exclusively unto lessee for the purpose of

investigating, exploring, prospecting, drilling, mining and operating for and producing oil, liquid hydrocarbons, all gases, and their respective constituent products, injecting gas, water, other fluids, and air into subsurface strata, laying pipe lines, storing oil, building tanks, power stations, telephone lines, and other structures and things thereon to produce, save, take care of, treat, manufacture, process, store and transport said oil . . . and housing and otherwise caring for its employees"

3. Exclusive Rights?

- a. The right to drill for, produce, and market oil and gas are impliedly exclusive to the lessee. However, some rights, unless exclusively granted to the lessee by the express terms of the lease, may be exercised concurrently by the lessor or a third party designated by the lessor.
- b. Absent express limiting language in the lease, the lessor may grant a license to third parties allowing them to conduct geophysical operations on the leased land. Mustang Production Co. v. Texaco, Inc., 549 F.Supp. 424 (D. Kan. 1982), affirmed, 754 F.2d 892 (10th Cir. 1985); Roye Realty and Developing, Inc. v. Southern Seismic, 711 P.2d 946 (Okla. Ct. App. 1985); Shell Pet. Co. v. Puckett, 29 S.W.2d 809 (Tex. Civ. App. 1930).
- c. The Mustang analysis could be applied to other rights granted under the lease. If the right is not exclusively granted, and the lessee and lessor could concurrently exercise the rights without interfering with one another, the lessor may be able to license others to exercise the right.

For example: The lessor might authorize another operator to build tanks, roads, or pipelines on the leased land.

E. Rights Incident To The Grant.

1. Lease typically lists a number of things the lessee can do on the leased land. Paragraph #1 - Form 88; Paragraph #1 - Form 690.

- a. Other portions of the lease may expand or define the items listed in the granting clause.

- b. For example: Form 88 - (Producers)
Kan., Okla. & Colo. 1962 Rev.Bw
Paragraph #7

"Lessee shall have free use of oil, gas, and water from said land, except water from lessor's wells and tanks, for all operations hereunder, including repressuring, pressure maintenance, cycling, and secondary recovery operations, and the royalty shall be calculated after deducting any so used.

"Lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by Lessee on said land, including the right to draw and remove casing.

"When required by lessor, lessee will bury all pipe lines below ordinary plow depth.

"Lessee shall pay all damages caused by its operations to growing crops on said land.

"No well shall be drilled within two hundred feet (200 ft.) of any residence or barn now on said land without lessor's consent.

"Lessor shall have the privilege, at his risk and expense, of using gas from any gas well on said land for stoves and inside lights in the principal dwelling thereon, out of any surplus gas not needed for operations hereunder."

2. If the lease merely grants the right to develop oil and gas, without addressing surface access rights to conduct operations, lessee has an implied right to make

reasonable use of the surface to facilitate operations.

3. In Kansas the scope of the surface easement remains undefined. See Handbook §12.06.

- a. Thurner v. Kaufman, 237 Kan. 184, 188, 699 P.2d 435, 439 (1984) ("Under an oil and gas lease, the lessee has the implied right to make reasonable use of the surface in order to develop the land for the oil and gas." - dicta).

- b. Brooks v. Mull, 147 Kan. 740, 746-47, 78 P.2d 879, 883 (1938) (implied easement when surface estate is severed from the mineral estate).

4. Texas - defines the implied easement to include the right to take materials from the leased land necessary to support reasonable operations under the grant.

For example, in Sun Oil Co. v. Whitaker, 483 S.W.2d 808 (Tex. 1972), the lessee had the right to use fresh groundwater to conduct secondary recovery operations.

NOTE: In Sun the lease provided: "Lessee shall have free use of oil, gas, coal, wood and water from said land except water from Lessor's wells for all operations hereunder" The Court of Civil Appeals held this language was ambiguous and the parties did not intend to allow the use of large quantities of water necessary for secondary recovery operations. However, the Supreme Court held the right to use the water was encompassed by the implied easement without reference to the express lease provisions.

5. Dominant/Servient estates.

- a. Most states view the mineral estate as the "dominant" estate with the surface estate being "servient" to the mineral estate. This has affected, to some extent, the scope of the developer's implied easement.

- b. Texas recognizes a limited obligation to accommodate the surface owner's interests when it can be done without

unduly burdening the owner of the mineral interest. Getty Oil Co. v. Jones, 470 S.W.2d 618 (Tex. 1971). However, the Texas accommodation doctrine only applies when the lessee's proposed use unduly impairs lessor's preexisting use of the land and reasonable alternatives exist for the lessee.

- c. Kansas does not treat the mineral estate as dominant to the surface estate. The Kansas position is stated in Rostocil v. Phillips Petroleum Company, 210 Kan. 400, 502 P.2d 825 (1972):

"The obvious intent of the parties under . . . [an oil and gas] lease is that the licensed privileges of the lessee are to run hand in hand with those reserved to the lessor with neither interfering more than need be with the continuing uses of the other - the one for the exploration, production and transportation of minerals and the other for the pursuit of agriculture."

Although the Kansas approach remains undefined, it would appear an expanded accommodation obligation could be fashioned by the courts. Consider Hunt Oil Co. v. Kerbaugh, 283 N.W.2d 131 (N.D. 1979).

6. Must the lessee pay for surface damage caused by its exercise of the implied easement?
- a. This is an area undergoing major change. See generally Polston, "Surface Rights of Mineral Owners - What Happens When Judges Make Law and Nobody Listens?" 63 North Dakota L. Rev. 1 (1987).
- b. Oklahoma - Surface Damages Act Okla. Stat. Ann. tit. 52 §§ 318.2 - 318.9 (West 1987).
- c. See Davis Oil Co. v. Cloud, 57 O.B.J. 2885 (Nov. 22, 1986) (Oklahoma Court of Appeals applies the Act retroactively and refuses to apply a reasonable use standard for determining when surface

damages are due.

- d. Texas - adheres to the traditional common law rule that so long as the surface use is reasonably necessary for the exploration, production, and marketing of the granted substances, no payment for surface damage is required. (Unless the lease expressly requires payment of damages). Moser v. United States Steel Corp., 676 S.W.2d 99 (Tex. 1984).

NOTE: Moser limits the free easement rule to substances expressly identified in the grant. Substances included in a grant of "other minerals" requires that the lessee pay for any surface damage relating to their extraction. See discussion at B.3.

- e. Kansas - no definitive statement by the appellate courts.

(1) Fast v. Kahan, 206 Kan. 682, 481 P.2d 958 (1971) suggests no payment is required absent an express lease provision.

(2) Jensen v. Southwestern States Management Co., 6 Kan.App.2d 437, 441, 629 P.2d 752, 756 (1981) contains language (dicta) which broadly asserts an obligation to pay for any damage - probably limited to facts. Case concerned surface mining for coal where the deed expressly provided for a per/acre surface damage payment which was interpreted to require payment of the current market value of the surface when used.

(3) Prediction - when the issue is presented, courts may be inclined to require payment for all damage to the surface. This appears to be the trend of courts and legislatures addressing the issue in recent years. Lessees have contributed to the trend by voluntarily paying damages for surface use within the scope of the

implied easement.

7. Even though the oil and gas lease lists a number of permissible uses, many problems are not addressed. Must resort to the implied easement/reasonable use analysis to determine the rights between surface owner and lessee.
8. Many important issues undecided under the implied right - for example: What can lessor do on the property after a lease is granted? What is an unreasonable use? Must damages be paid for the use?
9. CAUTION: If the lessor is a severed mineral interest owner, must examine the deed severing the minerals from the surface estate to determine if there is any limitation on the lessor's exercise of the implied right.
 - a. Lessor of the severed mineral interest cannot expand the implied development easement created by the deed severing the surface and mineral estates.
 - b. For example: a lease granting the right to use the surface of the leased land to support operations on neighboring lands would be beyond the implied right held by the owner of the severed mineral interest (the lessor).

F. TITLE TO THE GRANT.

1. In most leases the lessor purports to lease the entire mineral interest in the described land. If the lessor owns less than all the mineral interest, their delay rental and royalty is reduced to correspond to their proportionate mineral interest ownership. Lessor also warrants and agrees to defend title to the minerals covered by the lease. Lessee is given the right to discharge liens against the leased land and become subrogated to the lienholders' claims.

May also be implied warranty arising out of the words of grant or the transfer of a personal property interest for a fair price.

Granting clause may also include any after-acquired title obtained by lessor.

2. For example: Form 88 - (Producers)
Kan., Okla. & Colo. 1962 Rev.Bw
Paragraph #10

"Lessor hereby warrants and agrees to defend the title to said land,

"and agrees that lessee, at its option, may discharge any tax, mortgage, or other lien upon said land, and in the event lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rentals and royalties accruing hereunder toward satisfying same.

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

3. Granting clause of the same form includes "any reversionary rights and after-acquired interest."
4. Most disputes concern the warranty and proportionate reduction clauses.
- a. Warranty - to what extent is lessor liable to lessee in the event of a title failure?
- b. Proportionate reduction - does it apply to bonus? Is it coordinated with the pooling clause?

II. GRANTING CLAUSE - TRADITIONAL DRAFTING RESPONSES

A. The Affected Land - Surface And Subsurface Descriptions.

1. Not much of a problem. Traditional approach has worked well. Paragraph #1 - Form 88; Paragraph #1 - Form 690.
2. Attempts to further define or limit the scope of Mother Hubbard or cover-all clause have not been successful.
3. Depth limitation descriptions have not been a

problem because most leases cover all depths.

a. As horizontal Pugh clauses become more popular, problems will increase.

b. As lessors become more sophisticated with oil and gas matters depth limitations and multiple zone leasing will become more common.

B. Substances Included In The Grant.

1. Traditional approach has been to describe the target minerals and then include a general all-encompassing phrase such as "other minerals." Consider the following granting clauses:

Form 88 - (Producers)
(KsOkCoNe) (1981) Rev. Bw

"[O]il, liquid hydrocarbons, all gases, and their respective constituent products . . ."

Form 88 - (Producers)
Kan., Okla, & Texas 1942 Rev. 2-70 Bw

"[O]il, gas, casinghead gas, casinghead gasoline and all other gases and their respective constituent vapors, and all other minerals"

Standard Producers 88 Rev.
3-66

B

"[M]inerals, oil, liquid hydrocarbons, all gases, their constituent elements, and all other substances, whether similar or dissimilar"

Form 88 - (Producers)
Kan., Okla. & Colo. (12-63) Rev. Bw

"[O]il (including but not limited to distillate and condensate) and gas (including but not limited to casinghead gas and helium and all other gases and all constituents of all gases)"

Form 88 - (Producers)
Kan.Okla. & Colo. 1963 Rev. (JW) Bw

"[O]il, gas, gas condensate, gas distillate,

casinghead gas, casinghead gasoline, and all other gases and their constituent parts, and other minerals produced in connection with oil and gas operations hereunder, or as a by-product of oil and gas"

Form 88 UNIT - WYO.-COLO.
5-54

"[O]il, gas, casinghead gas, and all other minerals"

Form 88 - (Producers)
454

"[O]il and gas"

Form 88 - (Producers) 1-48 B+

"[O]il and gas"

Form 88 - (Producers)
(KANSAS) (Rev. 1981) B w

"[O]il and gas"

Form 88-42 B w
(KsOkCoNe)

"[O]il and gas, casinghead gas and casinghead gasoline"

2. Promotes uncertainty and will precipitate litigation if a commercial deposit of a "mineral," not expressly identified in the grant, is subsequently discovered.

C. Substances Produced As Components Of Granted Substances.

1. Traditional response has been to amend the grant to include "all gases, and their respective constituent products." Paragraph #1 - Form 88.
2. Problems - What is a "constituent product?" When does it cease being a constituent product and become a separate substance? Is a royalty due on the constituent product?

D. Purpose Of The Grant.

1. Traditional approach has been to list a number of purposes for which the land can be used. This protects the lessee when asserting broad implied rights to use the surface to support listed activities. Paragraph #1 - Form 88.
2. Many leases, however, fail to mention land uses necessary to conduct enhanced recovery operations.
3. Many leases fail to effectively indicate which of the rights granted lessee are to be exclusive rights.
4. Broad purpose statements have been used to avoid consideration of the relative surface rights and burdens of the lessor and lessee.

E. Surface Rights And Burdens.

1. Traditional approach does not attempt to deal with the current and future uses of the lessor and potential areas of dispute between the lessor and lessee.
2. List a number of permitted uses and then rely upon the implied right of reasonable use to determine disputes as they arise. Paragraph #1 - Form 88.
 - a. Problem - reasonable use doctrine is not finely tuned; usually requires a law suit to determine the scope of the easement and whether the lessee has gone beyond its scope.
 - b. Problem - eliminates opportunity to discuss, and plan, surface use with the landowner. Landowners are usually surprised when they discover the potential scope of the easement.
3. Surface Damages.
 - a. Traditional approach - provide for payment of crop damages. This has generally been used by the lessee as a limitation of liability for other damages - such as permanent damage to land.
 - b. Lessees often pay even though not required to pay.

c. Surface damage disputes are common - especially when the surface and mineral estates have been severed. Typical lease provisions, and the common law, do not provide efficient mechanisms for resolving these disputes.

d. Traditional approach has invited legislative intervention.

F. Use Of Oil, Gas, And Water For Lease Operations.

1. Traditional Approach - specific clause addressing these matters. For example:

"Lessee shall have the right to use free of cost, gas, oil and water found on said land for its operation thereon, except water from the wells of the Lessor." Paragraph #8 - Form 690. Compare Paragraph #7 - Form 88.

2. Not many problems. Most common issues are:

a. Can fresh water be used? Can surface water be used?

b. What can the substances be used for? Can water and gas be injected to conduct enhanced recovery operations?

G. Removal Of Fixtures.

1. Traditional Approach - broad right to remove at any time before or after termination of the lease. Paragraph #7 - Form 88.

2. Problem - Courts, regardless of the express language, will limit removal rights to a reasonable time after termination. Pratt v. Gerstner, 188 Kan. 148, 151, 360 P.2d 1101, 1103-04 (1961) (29 months after production ceased not within a reasonable time).

H. Title To The Grant.

1. Traditional approach - lessor warrants the grant to all the minerals. Lessees have not pressed their rights under the warranty clause but have relied upon it mainly to facilitate proportionate reduction and estoppel by deed. Paragraph #10 - Form 88.

2. Most problems relate to ambiguity over the

scope of the proportionate reduction clause.

III. GRANTING CLAUSE - ALTERNATIVE DRAFTING RESPONSES.

A. The Affected Land - Surface and Subsurface Descriptions. LEASE - SECTIONS 1.A. and 1.B.

1. Surface description problems can often be detected before drilling through surface inspections and, if necessary, surveying the lease lines. Any problems can usually be taken care of if discovered before development begins.
2. Discussion with the landowner and neighboring landowners can often disclose potential problems which can be specifically addressed.
3. If you use a landowner's questionnaire in the leasing process, in addition to the traditional questions regarding marital status, homestead claims, and mortgages, consider adding questions concerning the property boundaries. For example: Is all of the described land fenced? Has there ever been any dispute over where the boundaries of your property are located? Do you think you actually own more land than is described in your deed? Why?
4. Use Mother Hubbard or cover-all clause only when you suspect there may be strips of land owned by the lessor not covered by the legal description and you don't anticipate being able to resolve the problem before development takes place.
5. Avoid drafting a "blank check" for a future greedy lessee. If possible, draft the clause to account for the specific problem you have identified. Avoid broad language which may encompass adjacent blocks of land - which would ordinarily have been described in the lease had there been an intent to include them.
6. Depth Limitations - Seek technical advice. Select a division which can be readily identified by a petroleum geologist. Avoid selecting depth measurements which might divide a potentially productive reservoir. To the extent possible, use log readings in area wells to define formations and

divisions.

7. Specific Depth Limitations - consult geologist to determine where a safe formation or depth break is located. If possible, use reference wells on adjacent lands to identify an acceptable place to divide the leasehold rights. May want to specify the depth as being the stratigraphic equivalent of a depth measured in a nearby marker well. This will account for the nonuniformity of subsurface structures. For example:

b. DEPTH LIMITATIONS. The rights granted under this Lease are limited to depths from the surface down to the stratigraphic equivalent of 4,000 feet beneath the surface, as measured in the Farmer 1-30 Well completed in the Northwest Quarter of the Northwest Quarter of Section 30, Township 36 South, Range 10 East, from the Sixth Principal Meridian, Eureka County, Kansas.

Lessor excepts from this lease and retains all rights below the stratigraphic equivalent of 4,000 feet beneath the surface as measured in the bore of the Farmer 1-30 Well.

8. Specific Formation - the goal here is to limit disputes over where one formation begins and another ends. If it is difficult to distinguish two horizontally contiguous formations, perhaps a simpler dividing guide should be selected. If this is not possible, it is necessary to resolve any dispute over the limits of the leased formation in the lease document. This can be done by using an area marker well to indicate the depths the formation is agreed to occur, as shown by a particular log, in the marker well. For example:

Lessor wants to lease rights to the Dakota Formation in Section 30. There are no wells on Section 30, but there is a well on Section 29 which penetrates the Dakota Formation. Lessor and Lessee each examine the sonic log ran on the Section 29 well and agree that the Dakota Formation begins at 3,010 feet and ends at 3,250 feet below the surface - in the

Section 29 well bore. Using this as a standard for log interpretation for wells in Section 30, the lease can provide:

For reference purposes, Lessor and Lessee agree the Dakota Formation is identified by sonic log as beginning at 3,010 feet and ending at 3,250 feet in the Smith 1-29 Well located in [legal description].

9. Surface and Formation Rights - whenever an interest is limited by depth or formation, the lease should reserve rights to each of the parties to use the surface of the leasehold, and to drill through excepted formations, to access their divided interest.

B. Substances Included In The Grant. LEASE - SECTION 1.C.

1. Courts and commentators agree the basic cause of problems in this area is the lessor and lessee never express their specific intent as to what is included in the phrase "other minerals."
 - a. Solution appears simple - ascertain their specific intent and eliminate general references altogether.
 - b. Traditional leasing process does not permit solicitation of the lessor's intent. There is little discussion and no negotiation.
2. Courts in this area tend to agree on one concept - if you have a specific substance in mind when conveying or leasing the mineral estate be sure and specifically list the substance.
3. Policy courts are probably attempting to promote in this area - protect the unwary lessor from inequities which may arise when a substance, not contemplated or discussed during the bargaining process, and not expressly revealed by the terms of the lease, is subsequently asserted to come within the general terms of the lease grant.
4. Ask your client what substances they intend to lease. If the lessee wants "other

minerals," find out what they are and state them specifically in the lease grant. Raise the issue during negotiations so it can be resolved. Consider asking the following questions:

- a. Do you want to lease all types of minerals, to include those not currently known to exist in the area?
- b. Do you want to lease mineral substances which are not currently of any commercial value, but which may become valuable in the future?
- c. Do you want to lease minerals which may require destruction of the surface for their extraction?
- d. Do you want to convey rights to ground water or geothermal resources?
- e. [Lease of "Oil and Gas"]
 - (1) Do you want to lease non-hydrocarbon substances which may be produced as a gas?
 - (2) Do you want to lease non-hydrocarbon substances which are produced as a component of the natural gas or oil stream?

5. If you anticipate problems with a specific substance in an area, for example helium, specifically address it in the lease grant. Don't rely on general language such as "all gases, and their respective constituent products." You may want to use that phrase, but if you know helium is a substance that might pose problems, give helium specific mention in the granting clause.

- a. Coordinate the habendum and royalty clause with the granting clause.
- b. If you mention a substance in the granting clause consider whether you want production of that substance to continue the lease in effect. How will royalty be calculated for the substance?

C. Substances Produced As Components Of Granted

Substances. LEASE - SECTION 1.D.

1. In many cases, careful consideration of the other minerals problem will eliminate, or minimize, the component substance problem. For example, in Kansas, Oklahoma, and Texas, certain reservoirs are known to produce natural gas with helium as an impurity. Although the helium is considered an impurity, it is valuable when it can be extracted from the gas stream and sold as a separate product.
 - a. In such areas helium should be specifically addressed in the lease.
 - b. If helium is included in the lease, the lessee should ensure helium gets special treatment in any gas sales contract it may make.
2. In most cases the substance will cause problems only when it can be economically marketed separately from the gas stream. Consider the following grant:

"Lessor leases to Lessee all oil, gas, and similar hydrocarbon substances, including, to the extent they cannot be profitably separated at the lease, constituent non-hydrocarbon substances produced with the oil, gas, and similar hydrocarbon substances, in the following land:"

 - a. The effect of this grant would be to give title to constituent substances to the Lessee until it became profitable to separate them at the lease - at which time title to the substance would revert to the Lessor.
 - b. Additional language may be desirable to indicate that Lessee can continue to produce and market the substance until Lessor has made arrangements to separate the substance from the gas stream.
 - c. A further refinement of the clause may allow the Lessor to assert title to the substance only to the extent the Lessor actually separates the substance from the gas stream. This could be accomplished only to the extent it did

not interfere with the Lessee's rights.

- d. Granting title to the substance to the Lessee, and providing for a royalty on it if the Lessee is able to market it as a separate product, is probably the most workable solution.

D. Purpose Of The Grant. LEASE - SECTION 1.E.

1. Recognizing the difficulty in anticipating and enumerating all rights necessary to facilitate development of the leased land, a general statement of why the grant is being made can help determine whether Lessee activity, not expressly addressed in the lease, is authorized. Paragraph #1 - Form 88.
2. Also serves as a convenient place to indicate the exclusive nature of the grant.

E. Surface Rights And Burdens. LEASE - SECTION 1.F.

1. To avoid surface use conflicts, there must be meaningful communication between the Lessor and Lessee when the lease is negotiated.
 - a. Establish each party's expectations through open discussion of surface uses.
 - b. Stating permitted uses in a form document will not alleviate surface disputes.
2. Attorney's obligation (regardless of which side you represent) to instruct your client regarding how they can create a relationship which requires minimal judicial intervention.
3. Consider the following process:
 - a. Educate the landowner about the oil and gas development process and the demands it places on the land resource.
 - b. Inquire about the landowner's existing and planned uses of the property.
 - c. Are there other persons, such as farm lessees or mortgagees, who have an interest in the surface? If so, they

should be included in the process unless the existing contracts between the landowner and such persons already address the matter.

- d. Is there existing damage to the surface from previous oil and gas operations or other activity? If so, this should be noted so it doesn't become an issue under your lease.
- e. Provide a system for coordinating surface use with the landowner. Arguably an obligation created by the accommodation doctrine - although it is seldom done. Imposed by statute in Oklahoma. Okla. Stat. Ann. tit. 52 §318.3 (West 1987).
 - (1) Consider a proposed land use plan showing where roads, drill sites, pipelines, fence gates, tanks, and other facilities will be located. LEASE - SECTION 1.F.3.a.
 - (2) Include the landowner at a meaningful stage so that his input can be considered and areas of accommodation identified. LEASE - SECTION 1.F.2.
 - (3) Landowner should keep Lessee informed of proposed new surface uses.
 - (4) NOTE: the time spent doing these things should save you time in having to deal with hostile landowners. It may also set the stage for a working relationship so if you get in a bind, i.e. need an extension to get a rig to commence operations, you will have some good will, as opposed to bad will, to draw on.
- f. Enumerate surface uses and limitations on use in the lease. LEASE - SECTION 1.F.1 and 1.F.3.b.
 - (1) Should be tailored to the landowner and the land.

- (2) Unique land uses, or planned uses, require special treatment.
 - g. Identify any incidental rights such as the right to use water, gas, and oil for operations. LEASE - SECTION 1.G.
 - h. Allow for future operating techniques which may require land uses not currently anticipated.
4. After addressing land use rights and limitations, consider what, if anything, Lessee must pay for surface use.
- a. In Oklahoma this process is governed by statute. See Okla. Stat. Ann. tit. 52 §§ 318.3, 318.5 (West 1987).
 - b. In Kansas and Texas the payment of surface damages should be addressed.

Damages in Oklahoma should also be addressed in the lease. Okla. Stat. Ann. tit. 52 §318.5 suggests the required "written contract" on surface damages only need be in place prior to entering the site. Apparently the oil and gas lease, if it expressly addresses payment of surface damages, would be sufficient.

§318.7 supports this approach by providing: "Nothing herein contained shall be construed to impair existing contractual rights nor shall it prohibit parties from contracting to establish correlative rights on the subject matter contained in this act."

- c. Approach will vary depending upon whether you are buying the lease for development or for assignment to a developer.
- (1) Buying it for development - probably want to negotiate for a one-time payment which will become due in the event actual drilling on the lease takes place. May want other provisions for seismic damages.

- (2) Buying for assignment - probably want a formula based upon the land or resources actually damaged in the development process.
 - d. Attempt to establish objective guidelines for determining the damages due.
5. Should address the Lessee's obligations in the event the lease is abandoned after operations have been undertaken on the leased land. LEASE - SECTION 1.F.3.d.
- a. Plugging obligations.
 - b. Reclamation obligations.
 - c. Right to remove equipment. LEASE - SECTION 1.H.
 - d. Coordinate with damage payments. May have statutory obligations to reclaim which will mitigate damages.
- (1) Kan. Stat. Ann. §55-132b (1983). Does not offer much protection to the landowner. It merely requires Lessee to remove structures and return the land to its original grade. The productive capacity of the soil, or affected vegetation, does not have to be restored.
 - (2) Provisions of the Kansas statute can be waived by agreement. Lease is the place to address this. For example, has the Lessor agreed to accept \$2500 in lieu of Lessee reclaiming the drill site?
- CAUTION: Lessee may have public obligations which require some form of reclamation. All states require plugging. Hazardous waste laws may require removal of drilling mud.
6. GENERAL ADVICE - boilerplate will not accomplish your goal (to avoid dispute). Must initiate frank discussion of anticipated surface uses and anticipated conflicts with landowner's present and future uses. Must address the damage issue up front -

especially since other lessees may be "gratuitously" paying surface damages in the area. Try to view the landowner as an essential "partner" in your enterprise.

F. Use Of Oil, Gas, And Water For Lease Operations.
LEASE - SECTION 1.G.

1. Scope of use defined by water quality.
2. Address use of oil, gas, and water to support enhanced recovery operations.

G. Removal Of Fixtures. LEASE - SECTION 1.H.

1. Don't write a provision you know the court will not enforce.
2. Danger - if it is in writing, your client, and perhaps an attorney unfamiliar with oil and gas law, may rely on the clause.

F. Title To The Grant. LEASE - SECTION 1.I.

1. Lessees should rely upon title reports, instead of warranty clauses, to ensure they are leasing from the appropriate persons.
2. Lessee should frankly state in the lease that lessor is purporting to convey 100% of the mineral rights in the described land and if lessor subsequently acquires title to additional mineral interests in the property, such after-acquired interests will be subject to the lease. This seems to be a fairer way to approach the issue and will avoid having a sloppy lessee trying to use a warranty covenant to avoid pre-leasing title reviews.
LEASE - SECTION 1.I.2.
3. After-acquired title rights should be joined with proportionate reduction and subrogation clauses. LEASE - SECTION 1.I.3., 4. and 5.
4. Lessor may want to include a "no warranty" statement to avoid possible implied warranties. This should not affect the Lessee's rights under a properly drafted after-acquired title clause. LEASE - SECTION 1.I.1.

SECTION 4 - PROBLEMS AND SOLUTIONS
THE HABENDUM (TERM) CLAUSE

I. HABENDUM CLAUSE - DURATION OF THE GRANT

A. Habendum Clause Establishes Duration Of The Lease.

1. Other clauses, such as the drilling/delay rental clause, may limit the duration of the lease.
2. Other clauses may extend the lease.

B. Consists Of A Primary Term And Secondary Term.

1. Primary term is the definite period of time, stated in the lease, that the lease will be in effect.
 - a. Example: "This lease is for a term of two years from the effective date"
 - b. Also called the "term clause."
2. Secondary term is the indefinite period during which the lease will be extended by its express terms.
 - a. Example: "This lease is for a term of two years from the effective date and as long thereafter as oil or gas, or either of them, is produced from the leased land."
 - b. Also called the "thereafter clause."

C. Coordinating Habendum Clause With Granting Clause.

1. Should ensure production of any of the granted substances will extend the lease into the secondary term.
2. Substances should be stated in the disjunctive. Rostocil v. United Oil and Gas Royalty Ass'n, 177 Kan. 15, 274 P.2d 761 (1954).
 - a. Granting clause: "oil, gas, coal, and other minerals."
 - b. Habendum clause: "as long thereafter as

oil and gas is produced." Reversioner of defeasible term mineral interest unsuccessfully asserted 14 producing oil wells did not extend the interest because no gas was being produced. Ambiguity found because singular verb "is" was used with the plural subject "oil and gas."

D. Production Must Be From The Granted Land.

1. Effect of pooling and unitization on oil and gas lease:

a. If, pursuant to a valid pooling or unitization clause in the lease, or by separate agreement, some or all of the leased land is included in a unit, any production attributed to any portion of the leased land will extend the lease as to all the leased land.

b. A gives B a lease on Section 30. By separate agreement between A and B, or pursuant to a pooling clause in the lease, B commits the South Half to a unit. At the end of the primary term there is no production from any wells located on Section 30. However, the South Half is sharing in production from other lands as a member of a unit. Has the lease, as to the North Half, terminated? Has it terminated as to the South Half?

(1) Somers v. Harris Trust & Savings Bank, 1 Kan.App.2d 397, 566 P.2d 775 (1977). The lease, as to both the North Half and the South Half of Section 30, would be extended by unit production attributed to the South Half.

(2) "The majority rule elsewhere is that where a portion of an oil and gas lease is committed to a unit, production anywhere in the unit extends the term of the entire lease." Somers, 1 Kan.App.2d at 400, 566 P.2d at 777.

(3) Basis for rule "conservation and public policy." Perhaps a more

appropriate basis is contract.

2. Lessor can, by the terms of the lease contract, limit the area from which the required production must be obtained. See Mesa Petroleum Co. v. Scheib, 726 F.2d 614 (10th Cir. 1984).

3. Different rule applied in Kansas when a defeasible term mineral interest, as opposed to an oil and gas lease, is involved.

a. Using the example in paragraph D.1.b., suppose A's mineral interest was a defeasible term mineral interest and X owned the reversionary interest.

In Kansas, any portion of the interest not participating in unit production on the date the primary term expires would terminate and revert to X. Therefore, the mineral interest in the North Half of Section 30 would terminate and revert to X. Unless B has a lease from X covering the North Half, his rights will also terminate.

b. Acreage included in the grant, but not participating in unit production, will not be held beyond the primary term by pooled or unitized operations. Classen v. Federal Land Bank of Wichita, 228 Kan. 426, 437-38, 617 P.2d 1255, 1264 (1980).

(1) Parties could provide for a different rule in the conveyance document.

(2) Agreements between grantor and third parties, and between grantee and third parties, will not affect the rights created by the original grant between grantor and grantee. See Dewell v. Federal Land Bank, 191 Kan. 258, 263, 380 P.2d 379, 383 (1963).

c. Basis for rule - judicially articulated policy favoring conservation.

4. Oklahoma and Texas follow a different rule. Production attributable to any portion of the

leased land would extend the lease as to all the leased land. See Fox v. Feltz, 697 P.2d 543 (Okla. App. 1984) and Spradley v. Furly, 157 Tex. 260, 302 S.W.2d 409 (1957).

E. Habendum Clause Creates A "Special Limitation" On The Grant.

1. This is an area where the lease "contract" is treated more like a conveyance.
2. If the requirements of the habendum clause are not met, the lease terminates. The terms of the habendum clause are a "special limitation" on the leasehold grant. Kansas courts will not extend the grant beyond the period stated in the lease. Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 310, 553 P.2d 885, 894-95 (1976).
 - a. Not a forfeiture; no equity to mitigate.
 - b. Acts of God and the lessee's good faith will not mitigate the termination. Kahm v. Arkansas River Gas Co., 122 Kan. 786, 791-92, 253 P. 563, 566 (1927).
3. Similar approach followed in Oklahoma and Texas.

F. Production Requirement.

1. Typical habendum clause extends the grant "for so long as oil or gas is produced."
2. Kansas - Must be actual production at the end of the primary term.
 - a. Substance must be produced and marketed on the date the primary term ends or the lease terminates. Baldwin v. Oil Company, 106 Kan. 848, 850, 189 P. 920, 921 (1920).
 - b. Similar rule applied to defeasible term mineral interests. Home Royalty Ass'n v. Stone, 199 F.2d 650, 653 (10th Cir. 1952).
3. Oklahoma - Discovery of production satisfies the habendum clause. A reasonable time is allowed to initiate marketing of production.

McVicker v. Horn, Robinson & Nathan, 322 P.2d 410 (Okla. 1958) (contrasts the Kansas position).

4. Texas - Follows the Kansas rule. Production requires marketing.
5. Well not completed by end of primary term - Lessees responded with express lease provisions allowing lessee to "complete" a well which was "commenced."
6. Well completed but unable to market production by end of primary term - Lessees responded with shut-in royalty clause to avoid situations like Elliott v. Oil Co., 106 Kan. 248, 187 P. 692 (1920), where lessee had, during the primary term, completed several productive gas wells on the land but was unable to get it hooked up to a pipeline prior to the end of the primary term. Held: lease terminated.
6. Most leases have a shut-in royalty clause to address the delayed marketing of gas. Consider Collins v. Oil & Gas Co., 85 Kan. 483, 487-89, 118 P. 54, 56 (1911) where the lessee completed five oil wells but failed to produce because of the depressed price of oil. Held: lease terminated.
7. Even though the lease is producing when the primary term ends, lease remains in effect only so long as production continues.
8. Variations in wording of habendum clause:
 - a. So long as oil or gas "is produced from said land . . . , or the premises are being developed or operated." Adolph v. Stearns, 235 Kan. 622, 684 P.2d 372 (1984) (requires lessee to be engaged in the diligent and good faith development or operation of the lease).
 - b. "Found in paying quantities" = "Produced in paying quantities." Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 311, 553 P.2d 885, 895-96 (1976).
 - c. Production from land "or land with which said land is pooled." Martin v. Kostner, 231 Kan. 315, 644 P.2d 430

(1982).

- d. Statute may extend the area from which production can be obtained and the activity required to satisfy the habendum clause. Parkin v. Kansas Corporation Comm'n, 234 Kan. 994, 1007, 677 P.2d 991, 1002 (1984) (commission's unitization order extended lease habendum clause to continue "so long as unitized substances are produced in paying quantities and as long as unit operations are conducted").
9. Lease forms often expand the habendum clause by specifying events which will extend the lease without actual production or discovery of production. For example, gas storage, pooling, unitization, shut-in royalty, commencement of a well, operations, completion of a dry hole.

G. Paying Quantities.

1. Phrase "so long as oil or gas is produced" means produced in paying quantities. Pray v. Premier Petroleum, Inc., 233 Kan. 351, 353, 662 P.2d 255, 257 (1983); Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959).
 - a. Same rule applied to defeasible term mineral interests. Texaco, Inc. v. Fox, 228 Kan. 589, 582, 618 P.2d 844, 847 (1980).
 - b. Commercial quantities = paying quantities. Texaco, Inc. v. Fox.
2. Depending upon the context in which it is used, "paying quantities" may have different meanings.
 - a. When used in habendum clause of lease or defeasible term mineral interest, it requires "production of quantities of oil or gas sufficient to yield a profit to the lessee over operating expenses, even though the drilling costs, or equipping costs, are never recovered, and even though the undertaking as a whole may result in a loss to the lessee." Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 311, 553 P.2d 885,

895-96 (1976).

- b. When used in a drilling or development contract, or continuous development covenant in a lease, the costs of drilling and completing the well would be included to determine whether a party was required to drill or continue development. Wolf Creek Oil Co. v. Turman Oil Co., 148 Kan. 414, 419-20, 83 P.2d 136, 139-40 (1938).
3. To maintain a lease, or defeasible term mineral interest, the lessee must:

"[O]perate the lease to produce those quantities of oil or gas which will produce a profit, however small, over operating expenses, after eliminating the initial cost of drilling and equipping the well or wells on the lease which are required to prepare the lease for production."

Reese, 220 Kan. at 314, 553 P.2d at 897.
4. To determine profit, Kansas courts use an objective test which employs a mathematical computation. If gross income exceeds lease operating costs, there is production in paying quantities.
 - a. Lessee's good faith judgment regarding profitability immaterial.
 - b. Objective approach goal - keep lessee from holding unprofitable leases for speculation. Reese, 220 Kan. at 314, 553 P.2d at 897.
 - c. NOTE: waiting for the price of oil to rise to make the operation profitable would seem to be the sort of speculation the objective approach is designed to prevent.
5. Texas Approach - Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959):

"In the case of a marginal well, . . . the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a

profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated."

Whether there is a reasonable basis for the expectation of profitable returns from the well is the test."

6. Two major problems in determining profitability:

- a. What items to charge as expenses and include as income; and
- b. The period of time over which profitability should be considered.

7. Accounting Period.

- a. Must select appropriate period before considering expenses and income. The accounting period will determine what items of expense and income will be included.
- b. Well may not show a profit during a certain month or quarter, but may show a profit over a longer period of time. The test is not so "objective" when selecting the time frame for determining profitability - court may be inclined to consider whether lessee can reasonably anticipate operations will be profitable. Tertiary recovery - expenses may exceed income for long period of time before it begins paying back.
- c. Courts have not offered much guidance in this area - up to litigants to convince the trial court what is a reasonable accounting period under all the facts. See generally Texaco, Inc. v. Fox and Reese Enterprises, Inc. v. Lawson.

8. Income - Income is calculated by crediting the lessee with all income generated by the lease except for amounts attributable to the landowner's royalty.

Amounts payable out of the working interest as overriding royalties are credited as income to the lessee. Reese, 220 Kan. at

9. Expenses - (Kansas Approach) Expenses include "current costs of operations in producing and marketing the oil and gas." Called "direct costs."
- a. May include more than costs actually paid. Held accountable for amounts a "prudent operator working for the common advantage of both the lessor and the lessee" would have paid. This creates certain "accrued" expenses which may not have been incurred, or paid, but should have been. Reese.
 - b. Cost of plugging abandoned wells included as an accrued cost which a prudent operator would have paid. Wrestler v. Colt, 7 Kan.App.2d 553, 559, 644 P.2d 1342, 1347 (1982).
 - c. Direct costs include: "[L]abor, trucking, transportation expense, replacement and repair of equipment, taxes, license and permit fees, operator's time on the lease, maintenance and repair of roads, entrances, and gates, and expenses encountered in complying with state laws which require the plugging of abandoned wells and prevention of pollution." Reese, 220 Kan. at 314-15, 553 P.2d at 898.
 - d. Depreciation.
 - (1) Do not include, as an expense, depreciation on the original equipment used to complete the well. Kansas courts treat this as part of the initial cost of drilling and equipping the well. Texaco, 228 Kan. at 594, 618 P.2d at 848. Oklahoma rejects this view. Stewart v. Amerada Hess Corp., 604 P.2d 854 (Okla. 1979).
 - (2) Kansas undecided whether depreciation on equipment not associated with the initial cost of drilling and equipping the well will be included as an expense

item.

e. What are the "initial costs of drilling and equipping the well?"

(1) Cost of building gas pipeline required to make initial gas deliveries to a market is part of the initial cost of drilling and completing well. It will not be included as an expense item.

(2) Pray v. Premier Petroleum, Inc., 233 Kan. 351, 662 P.2d 255 (1983). When lease contains a shut-in royalty clause, or a similar provision recognizing a delay between discovery and marketing, pipeline costs will be treated as costs of drilling and equipping the well. Conceptually, the well, under a lease with a shut-in royalty clause, is never completed until production is marketed.

10. Treatment of expenses varies greatly from state-to-state.

H. Cessation Of Production.

1. If lessee quits producing during the primary term, absent other lease clauses or implied covenant problems, the cessation will not affect the lease. Baker v. Huffman, 176 Kan. 554, 557, 271 P.2d 276, 278 (1954).

2. If lessee quits producing during the secondary term, the lease will terminate if the cessation is "permanent" as opposed to "temporary." Wrestler v. Colt, 7 Kan.App.2d 553, 556, 644 P.2d 1342, 1345 (1982).

3. If cessation is temporary, lessee has "only a reasonable time, under all the circumstances, to return the leasehold to production in paying quantities." Wrestler, 7 Kan.App.2d at 558, 644 P.2d at 1347.

4. Same rule applied to defeasible term mineral interests. Wilson v. Holm, 164 Kan. 229, 188 P.2d 899, 905-06 (1948).

a. Special problem with the defeasible term

mineral interest owner because they may not be able to enter the lease to remedy a temporary cessation.

- b. Courts will protect them from fraud where their lessee conspires with the reversionary mineral interest owner to terminate the defeasible mineral interest. Wagner v. Sunray Mid-Continent Oil Company, 182 Kan. 81, 318 P.2d 1039 (1957); Wilson v. Holm.
5. Reason for the temporary cessation exception - parties to the lease, recognizing the realities of oil and gas operations, must have intended "production" to mean production with its normal interruptions for well maintenance, reworking, and similar activities which require a temporary cessation of actual production. Wilson, 164 Kan. at 236, 188 P.2d at 905-06.
6. To determine whether cessation is permanent or temporary, Kansas courts will consider evidence addressing the following three questions:
 - a. How long has the lease failed to produce in paying quantities?
 - b. What caused the cessation of production?
 - c. What was the lessee's intent when operations were discontinued?
7. Duration of the lessee's failure to produce.
 - a. Time alone is not determinative. Kelwood Farms, Inc. v. Ritchie, 1 Kan.App.2d 472, 479, 571 P.2d 338, 344 (1977).
 - b. The time factor will be significantly influenced by the cause of the cessation and lessee's actions during the cessation.
8. Cause of the cessation.
 - a. Often it is the decisive factor.
 - b. For example, all recoverable production has been obtained.

9. Lessee's intent.

- a. Court tends to look at objective acts as opposed to subjective intentions. Lessee's conduct during the cessation is important.
- b. Even though all recoverable production has been obtained through primary and secondary operations, lessee's conduct may indicate the cessation is temporary because of immediate acts to commence tertiary recovery. Contrast Wrestler v. Colt.

10. Cessation problem often addressed by special lease clauses.

II. HABENDUM CLAUSE - TRADITIONAL DRAFTING RESPONSES

A. Primary Term.

1. Specify a term of years. "This Lease shall remain in force for a primary term of years." Paragraph #2 - Form 690.
2. Problem - how do we calculate time? See Winn v. Nilsen, 670 P.2d 588 (Okla. 1983).
3. Time critical since the primary term is a special limitation on the grant.

B. Operations Clause.

1. Must have actual production at the end of the primary term. To provide lessee with additional time to obtain production, a "completion" clause is used similar to the following:

"[I]f the Lessee shall commence operations for drilling at any time while this Lease is in force, this Lease shall remain in force and its terms shall continue so long as such operations are prosecuted and, if production results therefrom, then as long as production continues." Paragraph #12 - 690.
2. Major problem - what action constitutes "commence operations for drilling?" Must take the appropriate action and continue it diligently.

3. Kansas - undecided what will satisfy the commencement requirement. Anything less than actual drilling is risky.

a. Herl v. Legleiter, 9 Kan.App.2d 15, 668 P.2d 200 (1983) (interpreting similar language under drilling/delay rental clause).

b. A & M Oil, Inc. v. Miller, 11 Kan.App.2d 152 (1986) (interpreting clause similar to the Form 690 provision).

c. Phillips v. Berg, 120 Kan. 446, 243 P. 1054 (1926) (hauling sand and cement to land and commencing to drill a water well, which water would presumably be used in drilling the oil well, was not "commencement of operations").

d. It appears where something less than actual drilling is being relied upon, the lessee should be able to demonstrate what amounts to an irrevocable commitment to conduct operations, to completion, on the leased land.

e. Good faith of lessee no defense - "[L]essee . . . may in good faith have attempted to commence a well, but as a matter of fact the steps he took fell short of accomplishing what he was attempting to do." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.

4. Oklahoma - Actual drilling not required. In Wilds v. Universal Resources Corp., 662 P.2d 303 (Okla. 1983), the court states:

"[A] commencement clause of an oil and gas lease has been generally interpreted to mean that operations for the drilling of a well and not the actual drilling must be commenced prior to the end of the primary term with good faith intention of completing the operation."

"The commencement provision in the lease at issue did not expressly require due diligence to avoid termination of the lease, but Oklahoma law has considered the requirement implicit."

C. Production In Paying Quantities.

1. Production must be sufficient to pay lessee a profit.
2. Traditional approach - lease in effect for primary term and "as long thereafter as oil, gas or other hydrocarbons is or can be produced." Paragraph #2 - Form 690.
 - a. Courts uniformly interpret "produced" to mean produced in paying quantities.
 - b. Common alternative approach - continue for so long as there is production, of any kind, whether in paying or nonpaying quantities.
3. No guidance on how to calculate "paying quantities." How much production is credited to lessee? What expenses are charged against such production? What accounting period is used to compare production and expenses?
4. How is enhanced recovery dealt with? May have substantial initial expenditures and a long period of time before success can be determined and investment evaluated.

D. Dry Hole Clause.

1. What happens if a well, drilled under an operations clause, is unable to produce in paying quantities? The lease will terminate unless there is a special clause addressing this problem.
2. Dry hole clause designed to address this problem by permitting lessee to commence operations to drill other wells to try and obtain production in paying quantities.
 - a. Generally give lessee a stated period of time following "completion of a dry hole" to commence drilling operations on a new well.
 - b. Compare Paragraph #6 - Form 88 with Paragraph #6 - Form 690.
3. Common problems - Commencement issue similar to the drilling/delay rental clause and operations clause. What is a dry hole? What

about multiple dry holes? What is the effect of a dry hole during the primary term? (usually this problem is specifically addressed in existing lease forms).

E. Cessation of Production.

1. What happens if there is production in paying quantities when the primary term ends but the well subsequently ceases to produce in paying quantities?
 - a. Cessation permanent, lease terminates - absent a special lease provision covering this problem.
 - b. Cessation temporary - have a reasonable time to regain production in paying quantities.
2. Traditional approach - expand rights when cessation permanent and restrict rights when cessation temporary. For example:

"If, after the expiration of the primary term of this Lease, production on the leased premises shall cease from any cause, this Lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues." Paragraph #13 - Form 690.
3. Major problems: What action is required to resume "operations for drilling a well?" When did the event triggering the clause occur?

F. Shut-In Royalty Clause.

1. What happens if a well is drilled, it is not a dry hole, it is capable of producing, but lessee is unable to produce the well because there is no market for production? Lease terminates unless there is production. Shut-in Royalty Clause designed to substitute a periodic cash payment for actual production.
2. Traditional Approach - Limit scope of clause

to gas. Make payment of shut-in royalty the event which maintains the lease in effect.

a. "[I]f there is a gas well . . . on the . . . land . . . and such well or wells are shut in before or after production therefrom, lessee . . . may pay . . . at the end of each yearly period during which such gas well or gas wells are shut in, as substitute gas royalty, a sum equal to the amount of delay rentals . . . and if such payments or tenders are made it shall be considered under all provisions of this lease that gas is being produced" Paragraph #3 - Form 88.

b. "Where there is a gas well, or wells on the lands covered by this Lease . . . and such well or wells are shut-in, and there is no other production [or other clause] keeping this Lease in force . . . , Lessee shall pay as royalty to Lessor . . . the sum of \$1.00 per year per net royalty acre . . . and upon such payment it shall be considered that this Lease is maintained in full force and effect." Paragraph #4 - Form 690.

3. Major Problems:

a. Often special limitation language is used in shut-in royalty clauses. This seems odd since a lessee will seldom want to surrender a well, or wells, capable of producing in paying quantities. See, e.g., Amber Oil & Gas Co. v. Bratton, 711 S.W.2d 741 (Tex. Ct. App. 1986) (lessee accidentally paid shut-in royalty to wrong party - lease terminated).

b. When can lessee declare a well shut in and for what purposes?

c. Clause limited to gas.

d. Should there be a limit on how long it can be shut in?

G. Force Majeure.

1. What happens if it rains for two weeks prior

to the end of the primary term and lessee is unable to access the land to conduct operations? What happens if the state corporation commission, or the federal government, prohibits drilling on the leased land for two weeks prior to the end of the primary term? What if employees, equipment, or materials are not available? Absent a special lease clause, the lease will terminate.

2. Typical force majeure clauses: See Paragraph #9 - Form 88 and Paragraph #15 - Form 690. Note how much narrower the Form 690 provision is.
3. Typically, development of the lease is within lessee's control.
4. Development situations beyond lessee's control, but typically addressed by a lease clause:
 - a. Results of development - no control so provide for possibility of dry hole or cessation with the appropriate lease clause.
 - b. Market for production - no control so provide for possibility of well being shut-in awaiting a market.
5. Development situations beyond lessee's control, but often not addressed by a lease clause:
 - a. Poor weather, natural disaster, disease. Acts of God.
 - b. War, control of raw materials, markets, and lessee's activities. Acts of Government.
6. Regardless of the equities involved, courts will not expand the lease contract to account for unforeseen and uncontrollable occurrences which prevent the lessee from complying with the express terms of the lease. Baldwin v. Oil Co., 106 Kan. 848, 850, 189 P. 920, 921 (1920) (lessee unable to complete well within primary term because of intervening drought followed by excessive rain and a blizzard; lessee's employees became diseased; federal

government, reacting to wartime needs, prohibited the use of coal or iron in drilling wells on the leased land - HELD: no excuse because the obligation undertaken was absolute).

7. Major Problems: Scope of events subject to force majeure. Effect of force majeure on lease provisions. How to calculate the duration of force majeure.

H. Pooling And Unitization Clauses.

1. Lessee often wants authority to expand the area from which production can be obtained to satisfy the habendum and related clauses.
2. Often necessary because lessee will be unable, because of economic or regulatory limitations, to drill well attributed solely to the leased acreage.
3. In Kansas, pooling must be accomplished through a lease clause or separate agreement.
4. For example: Spacing or proration regulation in effect permits only one gas well per 640 acres. Lessee A has a lease on the North Half of Section 30 containing a pooling clause. B has a lease on the South Half which also contains a pooling clause.

If A and B exercise their pooling authority to declare Section 30 a single pooled unit, a producing well anywhere within the pooled unit will, under a properly drafted pooling clause, satisfy the production requirement of the habendum clause in each lease.

5. Pooling clause should allow lessee to exercise the pooling power as to individual formations, and to exercise the pooling power whenever necessary to pool newly discovered formations in the leased land. This avoids having to calculate participation in subsequently created units based upon prior pooling of all formations. See Rogers v. Westhoma Oil Company, 291 F.2d 726 (10th Cir. 1961).
 - a. CAUTION: The pooling clause should make it clear that although you are only pooling a specified formation,

production from that formation will hold all leases included in the pooling declaration as to all formations. See Morgan v. Mobil Oil Corp., 726 F.2d 1274 (10th Cir. 1984).

b. See Rogers v. Westhoma Oil Company.

6. If you have a properly drafted pooling clause, the lessor's consent should be unnecessary when rights under the pooling clause are exercised. Kennoyer v. Magnolia Petroleum Co., 173 Kan. 183, 187-88, 245 P.2d 176, 180 (1952).
7. Questions the pooling clause should answer:
 - a. Does the pooling right apply to all substances granted under the lease?
 - b. Is there a geographic limit on the pooling right?
 - c. Is there a geologic limit on the pooling right?
 - d. What effect will pooling part of the leased acreage have upon leased acreage outside (not participating in) the pooled unit?
 - e. What effect will operations on the pooled unit have on the habendum clause and clauses which affect the habendum clause?
 - f. How will the royalty of each lessor subject to the unit be calculated?
 - g. How is the pooling power exercised? When does the unit take effect? Can the pooling power be used on a recurring basis?
8. Major Problems: Defining the extent of the pooling power and the scope of its effect.
9. Unitization - in Kansas, leases seldom give lessee authority to unitize on a field-wide basis.
 - a. Have what is called "compulsory" unitization. K.S.A. §§55-1301 et seq.

(1983). Not of much assistance to the operator.

- b. Would be desirable to include unitization clause to permit consolidation of leases to conduct primary or enhanced recovery operations on part or all of a reservoir.
- c. When area unitized pursuant to statute, must look to the statutes, the order approving unitization, and any agreements signed by the unitized parties to determine their rights. See Parkin v. Kansas Corporation Comm'n, 234 Kan. 994, 677 P.2d 991 (1984).

III. HABENDUM CLAUSE - ALTERNATIVE DRAFTING RESPONSES

A. Primary And Secondary Terms.

- 1. Primary Term - specify the date and time the lease terminates. LEASE - SECTION 2.A.
- 2. Secondary Term - indicate how the lease can be extended beyond the primary term. Refer to pertinent extension clauses; don't try to restate them in the habendum. LEASE - SECTION 2.B.

B. Operations Clause.

- 1. A few simple definitions will save a lot of time and money.
- 2. Define exactly what the lessee must do to extend the lease. LEASE - SECTION 5.A.

C. Production In Paying Quantities.

- 1. Could eliminate the paying quantities requirement altogether and merely require production sufficient to generate a stated amount of royalty each year.
- 2. If life of lease tied to production in paying quantities, you must expand the traditional clause considerably. LEASE - SECTION 4.
- 3. Many key matters to resolve and define:
 - a. How do the parties wish to determine paying production? LEASE - SECTION 4.B.

- b. How will income be allocated to lessee?
LEASE - SECTION 4.C., D., & E.
- c. What expenses will be deducted from income? LEASE - SECTION 4.F.
- d. What period of time will be used to compare income and expenses? LEASE - SECTION 4.G.

D. Dry Hole Clause.

- 1. Define dry hole. LEASE - SECTION 5.B.
- 2. When is a dry hole completed? LEASE - SECTION 5.C.
- 3. What is the effect of a dry hole? LEASE - SECTION 5.
- 4. Coordinate with Cessation Clause since many times permanent cessation has the same effect as a dry hole.

E. Cessation of Production.

- 1. Retain temporary cessation flexibility. Kelwood Farms, Inc. v. Ritchie, 1 Kan.App.2d 472, 571 P.2d 338 (1977) (seventeen-month cessation of production held to be temporary). But see Warner v. Oil & Gas Co., 114 Kan. 118, 217 P. 288 (1923) (three month cessation - lease terminated). LEASE - SECTION 6.A.
- 2. Definition of production makes it easier to determine when cessation occurs. LEASE - SECTION 6.B.

F. Shut-In Royalty Clause.

- 1. Avoid special limitation language. LEASE - SECTION 7.
- 2. Identify events authorizing shut in status. LEASE - SECTION 7A. - C.
- 3. Provide a procedure for putting the clause in effect.

G. Force Majeure.

- 1. Identify events giving rise to force majeure.

LEASE - SECTION 8.A.

2. Identify procedure for initiating force majeure and calculating its effect on lease time periods. LEASE - SECTION 8.

H. Pooling And Unitization Clauses.

1. Detail how the unit can be created. LEASE - SECTION 9.A.
2. Detail the effect of the unit on each party's rights under the lease. LEASE - SECTION 9.B.

SECTION 5 - PROBLEMS AND SOLUTIONS
THE DRILLING/DELAY RENTAL CLAUSE

I. DRILLING/DELAY RENTAL CLAUSE - DURATION OF THE GRANT

A. Purpose.

1. State lessee's development obligations during the primary term.
2. Avoid the implied covenant requiring lessee to drill a well to test the leased land within a reasonable time. See Mills v. Hartz, 77 Kan. 218, 94 P. 142 (1908).

B. Effect.

1. Conditions the continued validity of the lease, during the primary term, on lessee either commencing drilling operations on the leased land or paying lessor a sum of money to delay operations.
2. Compliance with the terms of the drilling/delay rental clause, i.e. commencement of a well, will not satisfy habendum clause which requires "production" at the end of the primary term. See Perkins v. Saunders, 109 Kan. 372, 198 P. 954 (1921).

C. Special Limitation On The Grant.

1. If the optional payment is not made when due, or operations commenced in lieu of the payment, the lease terminates. Gasaway v. Teichgraeber, 107 Kan. 340, 341, 191 P. 282, 282 (1920).
2. Automatic termination only applies to the "unless" form of drilling/delay rental clause which makes payment of the delay rental optional with the lessee. For example: "If no well be commenced on or before the 18th day of December, 1934, this lease shall terminate as to both parties unless the lessee on or before that date shall pay or tender . . . the sum of (Fifty Cents) per acre, which sum shall operate as a rental . . . for the privilege of deferring the commencement of a well for 12 months" Stady v. Texas Company, 150 Kan. 420,

424, 94 P.2d 322, 326 (1939).

3. If lessee obligated to pay rental, failure to pay will be a breach of covenant and will not result in automatic termination - forfeiture principles apply. Early Kansas leases made payment of delay rental an obligation; these lease forms are called "or" leases. For example: "[Lessee] . . . agrees to drill a well upon said premises within two years from this date or thereafter pay to . . . [Lessor] eighty (\$80) dollars until said well is drilled" Rhodes v. Mound City Gas, Coal & Oil Company, 80 Kan. 762, 764, 104 P. 851, 852 (1909).

4. Although Kansas courts have generally followed the special limitation analysis in enforcing "unless" leases, it has, under certain factual settings, acted to prevent what it has termed a "forfeiture." See paragraph G. of this Outline.

5. To avoid automatic termination, must either commence the required operations or pay the stipulated delay rental. In keeping with the special limitation approach, courts require strict adherence to the lease terms.

D. "Drilling" To Satisfy The Drilling/Delay Rental Clause.

1. Common variations of lease clauses require the lessee to "commence a well," "commence operations to drill a well," or "commence operations."

2. Problem is determining what actions, short of actual drilling, will satisfy the drilling/delay rental clause.

3. Activity to meet the clause must be taking place on the specified date.

4. Activity that will satisfy the drilling clause:

a. Undecided in Kansas. Specific terms of each lease will control - but usually they are worded in general terms such as "commence operations to drill a well."

b. In Herl v. Legleiter, 9 Kan.App.2d 15,

668 P.2d 200, 201 (1983), the court suggests something less than actual drilling may satisfy a commencement clause.

It appears where something less than actual drilling is being relied upon, the lessee should be able to demonstrate what amounts to an irrevocable commitment to conduct operations, to completion, on the leased land. Such as a drilling contract with a third party to drill a well on the leased land.

- c. In Kansas, anything less than actual drilling is risky. Good faith of lessee no defense - "[Lessee] . . . may in good faith have attempted to commence a well, but as a matter of fact the steps he took fell short of accomplishing what he was attempting to do." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.

- 5. Once the well is properly commenced, the lessee must diligently continue operations. "[T]he duty to commence is accompanied by a duty to continue operations with due diligence." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.

E. "Paying" To Satisfy The Drilling/Delay Rental Clause.

- 1. Kansas courts require strict compliance with the delay rental provisions of the lease. Generally, there is no allowance made for honest mistakes - inadvertent error concerning the time, place, manner, or amount of payment can terminate the lease.
- 2. Date of payment.
 - a. A delay rental payment made after the date specified in the lease is too late. The lease terminates. Doornbos v. Warwick, 104 Kan. 102, 177 P. 527 (1919).
 - b. Watch out for multiple dates in the lease.
- 3. Amount of payment.

- a. If you fail to pay the full amount due, and the error is not corrected prior to the required payment date, the lease terminates. See Endicott v. Phillips Petroleum Co., 172 F.2d 372 (10th Cir. 1949).
 - b. Seems fair since, under the unless form of lease, lessee is not obligated to pay the balance due.
 - c. Rental expressed in dollars per acre may create calculation problems.
 - d. Problems when acreage is assigned or parts of a lease are surrendered. Covenant to pay delay rental not divisible unless lease provision allows it.
4. Form of payment. Is payment by check authorized by the terms of the lease? Chapple v. Kansas Vitrified Brick Co., 70 Kan. 723, 79 P. 666 (1905).
 5. Recipient of payment.
 - a. Payment must be to the appropriate payee. Consider Duer v. Hoover & Bracken Energies, Inc., 57 O.B.J. 1447 (June 14, 1986) (Oklahoma Court of Appeals held payment of delay rental to the wrong bank terminated the lease).
 - b. Change in ownership clause and designated depository bank.

F. Excuses For Improper Payment.

1. Kansas recognizes a limited exception to the strict compliance special limitation operation of the drilling/delay rental clause.
2. Kays v. Little, 103 Kan. 461, 175 P. 149 (1918). Delay rental payment sent registered mail in plenty of time to arrive before payment date. Lost in mail, found, then delivered three days after the payment due date.
 - a. Court talks in terms of preventing a forfeiture.

- b. Court considers the "equities" noting the lessee had done everything possible to make the payment on time. Held: lease did not terminate.
3. Young v. Moncreif, 117 Kan. 698, 232 P. 871 (1925). Lost in mail, check never arrived. Held: lease did not terminate. Court here, as in Kays, notes the lessee had spent "considerable sums in developing tracts in the vicinity." Young, 117 Kan. at 700, 232 P. at 872.
 4. Stady v. Texas Company, 150 Kan. 420, 94 P.2d 322 (1939). Since lessee, under the unless lease, is not obligated to pay delay rental, lessee must act, prior to the payment date, to unequivocally and irrevocably manifest its intent to pay delay rental.
 5. Browning v. Weaver, 158 Kan. 255, 146 P.2d 390 (1944). Applies unequivocal/irrevocable test to payment made to lessor's credit at the wrong bank.
 6. Morton v. Sutcliffe, 175 Kan. 699, 266 P.2d 734 (1954). Due 22 April, paid 28 April. Court refuses to grant relief because there was no evidence of lessee's intention to comply with the terms of the lease.
 7. How would the test be applied to a payment of the incorrect amount?
 8. Modern lease forms often include a clause excusing the lessee from improper payment.

G. Excuse For Nonpayment Of Delay Rental.

1. If lessor is attacking lessee's title, lessee will have a reasonable time, following resolution of the case in his favor, to pay delay rental [or proceed with drilling]. Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (1984) (dicta).
2. No excuse when it is the lessor's title in issue; or when the lessee's title is being attacked by someone other than the lessor. Newell v. McMillan, 139 Kan. 94, 30 P.2d 126 (1934).

II. DRILLING/DELAY RENTAL CLAUSE - TRADITIONAL
DRAFTING RESPONSES

A. Current Practices.

1. Most lease forms use an unless form of drilling/delay rental clause. For example:

"If operations for drilling are not commenced on said land or on land pooled therewith on or before one (1) year from this date, this lease shall terminate as to both parties, unless on or before one (1) year from this date lessee shall pay or tender to the lessor a rental of _____ dollars (\$____) which shall cover the privilege of deferring commencement of such operations for a period of twelve (12) months.

"In like manner and upon like payments or tenders, annually, the commencement of said operations may be further deferred for successive periods of the same number of months, each during the primary term.

"Payment or tender may be made to the lessor or to the _____ Bank of _____, which bank, or any successor thereof, shall continue to be the agent for the lessor and lessor's successors, heirs and assigns.

"If such bank (or any successor bank) shall fail, liquidate, or be succeeded by another bank, or for any reason fail or refuse to accept rental, lessee shall not be held in default until thirty (30) days after lessor shall deliver to lessee a recordable instrument making provision for another method of payment or tender, and any depository charge is a liability of the lessor.

"The payment or tender of rental may be made by check or draft of lessee, mailed or delivered to said bank or lessor, or either lessor if more than one, on or before the rental paying date.

"Notwithstanding the death of the lessor or his successors in interest, the payment or tender of rentals in the manner provided herein shall be binding on the heirs, devisees, executors and administrators of the

lessor [and] his successors in interest."
Paragraph #4 - Form 88.

2. Create a special limitation and then attempt to protect against inadvertent termination.

B. Major Problems.

1. What must lessee do to comply with the "operations for drilling are not commenced," standard?
2. If lessee, in good faith, guesses wrong on what is required to commence operations or pay delay rental, the lease terminates.
3. Clause requires intensive administrative attention.

III. DRILLING/DELAY RENTAL CLAUSE - ALTERNATIVE DRAFTING RESPONSES

A. Matters The Clause Should Address.

1. What must be done?
 - a. What does "commence" or "commencement" mean?
 - b. What are the delay rental requirements?
2. Delay Rental:
 - a. When is it due?
 - (1) No drilling.
 - (2) Drill dry hole, producing well ceases production, producing well shut-in?
 - (3) Any obligation during secondary term? Will it be used, by reference, for events occurring during the secondary term?
 - b. On what specific date is it due?
 - c. How much is due?
 - (1) Effect of a partial assignment.

(2) Effect of a partial surrender.

(3) Effect of lessor's failure of title.

d. Who can it be paid to?

(1) Depository bank.

(2) Change of ownership clause.

e. How can it be paid?

f. What if lessee improperly pays or fails to pay?

(1) Automatic termination.

(2) Obligation to pay.

(3) Mistake, notice before forfeiture, and judicial ascertainment clauses.

B. Current Thoughts On The Drilling/Delay Rental Clause.

1. Use "paid up" lease. Should address effect of lessor's assignment after the delay rental is paid. See generally, Sidwell Oil & Gas Co. v. Loyd, 230 Kan. 77, 630 P.2d 1107 (1981).

2. Use an or form lease to avoid automatic termination.

3. Eliminate the drilling/delay rental clause altogether. Kansas law would permit the parties to expressly provide that lessee is not obligated to drill any well on the lease during the primary term. See Skinner v. Ajax Portland Cement, 109 Kan. 72, 197 P. 875 (1921); Ringle v. Quigg, 74 Kan. 581, 87 P. 724 (1906); Monfort v. Lanyon, 67 Kan. 310, 72 P. 784 (1903).

a. In Kansas, the parties to the lease can contract to avoid the implied covenant to drill an initial test well. See also Eastern Oil Co. v. Beatty, 71 Okla. 275, 177 P. 104 (1918).

b. Deep Horizons Act only prohibits limitation of the implied covenants to

develop and explore. These do not take effect until an initial well has been drilled. Kan. Stat. Ann. §§55-223 through 55-229 (1983).

- c. Problem will be getting lessors to break with tradition of receiving delay rental. The break can be accomplished by payment of a larger bonus.

C. Preferred Approach.

- 1. Eliminate drilling/delay rental clause.
- 2. Substitute clause designed to negate the implied covenant to drill an initial test well. LEASE - SECTION 3.

D. Second Alternative Approach.

- 1. Define operations necessary to avoid payment of delay rental. For example:

"A. 'Operations' means:

Any action taken toward obtaining Production. This includes actual drilling and any act preparatory to drilling, such as obtaining permits, contracting for drilling services, surveying a drill site, staking a drill site, building roads, clearing a drill site, and hauling equipment and supplies." LEASE - SECTION 5.A.

- 2. Lessor-oriented definition could require actual drilling. Either approach is better than leaving it for judicial resolution.
- 3. Define when payments are due, how much, and how they can be made. LEASE - SECTION 3.A.2.a.
- 4. Describe lessee's delay rental obligation after a well has been drilled. LEASE - SECTION 3.A.2.b.
- 5. Describe the effect of dividing the leasehold on payment and development obligations. LEASE - SECTION 3.A.2.a. and SECTION 11.A.
- 6. Make any payments mandatory. LEASE - SECTION 3.A.2.a.

SECTION 6 - PROBLEMS AND SOLUTIONS
THE ROYALTY CLAUSE

I. ROYALTY CLAUSE - LESSOR'S SHARE OF PRODUCTION

A. Purpose.

1. The royalty clause determines the lessor's share of production, the substances it is payable on, how it will be valued and paid, the costs which can be deducted from lessor's share, and when it is payable.
2. In most cases the royalty clause will be silent or vague on many of these matters.
3. Standard rule of lease interpretation - lessee always loses. Ambiguities in the lease are interpreted against the lessee and in favor of the lessor.
4. Same type of problems in determining what other nonoperating interest owners are entitled to from the working interest owner.

B. Substances Subject To The Royalty Clause.

1. Coordinate with the granting clause.
2. Royalty clauses generally limit the obligation to pay royalty to substances "produced and saved," "used," "sold," or "marketed." Used to avoid liability for royalty on production which is lost through prudent lease operations.
 - a. Without such a clause, lessor can argue they are entitled to a royalty on all oil and gas brought to the surface.
 - b. Gas flaring and venting may create problems.
3. Lease often contains clause relieving lessee from paying royalty on production used to conduct operations on the lease.
4. It may be difficult to determine whether the oil royalty or gas royalty portion of the royalty clause applies to a particular substance.

- a. "Distillate" and "condensate" are liquid hydrocarbons produced from a gas well.
- b. "Casinghead gas" is gas produced from an oil well.
- c. See generally Skelly Oil Company v. Savage, 202 Kan. 239, 447 P.2d 395 (1968) (whether condensate and distillate produced from gas well were subject to a lease clause pooling "gas rights only.").

C. Royalty On Processed Gas.

- 1. Problem: calculating royalty when production from the lease has been altered by processing and marketed as different products.
 - a. "Wet" or unprocessed gas can be processed to separate hydrocarbon liquids from the remaining "dry" or "residue" gas. Value of the liquids and dry gas generally exceed value of the wet gas.
 - b. Gas royalty clause typically requires payment of royalty on gas sold "at the well" or sold or used "off the lease."
 - c. Problem is determining at what point in time will the royalty be calculated - before or after processing? The answer will vary depending on the lease terms, but leases seldom expressly address the issue. In most cases, the matter will be determined by the way the sale of the gas is structured.
- 2. Consider the following situations: (Assume X, Y, and Z, are purchasers unaffiliated with Lessee)
 - a. Lessee takes natural gas at the well and transports it to a processing plant where lessee, or an affiliate of lessee, separates liquid hydrocarbons from the gas stream and sells them to X. The "dry" or "residue" gas is sold to Y.
 - b. Lessee sells natural gas at the well to X but retains, in his gas sales contract, the right to process the gas

to recover liquid hydrocarbons. Following delivery of the gas to X at the well, X, under the gas sales contract, redelivers it to lessee at lessee's processing plant. The gas is processed, the liquids are sold to Y, and the residue gas delivered to X.

- c. Lessee sells natural gas at the well to X. Lessee then repurchases the gas from X, processes it, and then sells the liquid hydrocarbons to Y and the residue gas to X.
- d. Lessee sells natural gas at the well to X. X processes the gas, separates the liquids, and sells them to Y. Residue gas is sold to Z.

3. Possible solutions:

- a. Situation 2.a. - Pay royalty based on the market value of the gas at the wellhead or pay royalty on the market value of the liquids and residue gas. Proceeds lease - pay royalty based upon a share of the proceeds from sale of the liquids and residue gas. See Matzen v. Hugoton Production Company, 182 Kan. 456, 321 P.2d 576 (1958).
- b. Situation 2.b. - Are the reserved processing rights in the gas purchase contract a "proceed" of the lessee's sale of the gas? See Waechter v. Amoco Production Co., 217 Kan. 489, 537 P.2d 228 (1975). Also consider Matzen.
- c. Situation 2.c. - Is the repurchase a separate transaction? See Cline v. Angle, 216 Kan. 328, 532 P.2d 1093 (1975).
- d. Situation 2.d. - Generally, no problem. But see Northern Natural Gas Company v. Grounds, 441 F.2d 704, 723 (1971) (the unique statutory status of helium at this time probably explains the court's holding). See also McCue v. Deerfield Gas Production Co., 173 Kan. 302, 245 P.2d 1191 (1952).

4. Processing charges.

- a. If the lessee pays royalty on processed gas, the lessee will typically charge the royalty owner with a share of the processing costs.
- b. Usually this processing charge is determined unilaterally by the lessee and, as might be expected, the lessee treats itself very favorably.
- c. Common industry practice - lessee pays royalty based upon $\frac{1}{3}$ of the total value of the processed liquid hydrocarbons and retains $\frac{2}{3}$ as a processing charge. This practice is not binding on the lessor without his prior consent. Lessor could argue, if he has to pay a share of costs, it should be calculated using the actual cost of processing.

D. Identifying Lessor's Share Of Production.

1. Lease may provide for delivery of a fractional share of the production (right to take in kind), the market value of a fractional share of production, or a fractional share of the proceeds from the sale of production. Still may find flat rate gas royalty leases.
2. Must define the fraction of production the lessor is entitled to.
3. Measurement of production is critical to ensure the correct quantity of production is used in calculating royalty.
4. Other lease clauses may affect the lessor's fractional share. For example: proportionate reduction clause, entirety clause, pooling clause, and unitization clause.

E. Calculating "Gross Value" Of Lessor's Royalty.

1. Oil royalty.
 - a. Clause often gives lessor the option to take oil in kind.
 - b. Crude oil purchasers generally buy oil by "posting" a price, called the "posted price," which establishes the price they

will pay for oil in the field or area. Generally regarded as the market price for oil in the area.

- c. Not many problems with valuation of oil because the competitive crude oil sales market reflects the current value of the oil when it is sold.

- (1) Oil exchanges.

- (2) Payment of "premiums" by crude oil purchasers.

- d. Don't have transportation problems you encounter with the marketing of gas.

2. Gas royalty.

- a. Lots of litigation in Kansas, and elsewhere, over how the gross value of gas should be determined for royalty purposes. Three major issues:

- (1) Does the lease clause require the calculation of royalties based upon "proceeds" for the sale of gas or the "market value" of the gas?

- (2) If calculated on "market value," how will market value be determined when gas has been committed to a long-term gas sales contract?

- (3) If calculated on "market value," will the value of lessor's share of production be limited by federal regulation of natural gas prices?

3. Kansas courts classify gas royalty clauses into three categories:

- a. "Proceeds" leases.

- b. "Market Value" ("Market Price") leases.

- c. "Waechter" leases.

4. Proceeds lease - gross royalty value calculated by multiplying the amount received by the lessee, in an actual sale of production, by the lessor's fractional royalty. For example:

"The lessee shall pay lessor, as royalty, one-eighth of the proceeds from the sale of gas, as such, for gas from wells where gas only is found"

Lightcap v. Mobil Oil Corp., 221 Kan. 448, 460-61, 562 P.2d 1, 10-11 (1977), cert denied, 434 U.S. 876 (1977), rehearing denied, 440 U.S. 931 (1979).

5. Market value lease - values production by ascertaining the "price which would be paid by a willing buyer to a willing seller in a free market." Holmes v. Kewanee Oil Co., 233 Kan. 544, 551, 664 P.2d 1335, 1341 (1983). For example:

"To pay the lessor one-eighth, at the market price at the well for the gas so used"

"Lessee shall pay Lessor for gas from each well where gas only is found one-eighth. . . of the gross proceeds at the prevailing market rate, for all gas used off said tract."

6. Waechter lease - valuation is by proceeds or market value depending upon the point of sale. For example:

"Lessee shall pay lessor monthly as royalty on gas marketed from each well one-eighth (1/8) of the proceeds if sold at the well, or if marketed by lessee off the leased premises, then one-eighth (1/8) of the market value thereof at the well."

Waechter v. Amoco Production Co., 217 Kan. 489, 490, 537 P.2d 228, 231 (1975).

- a. Sale of gas "at the well" or "on the lease" use proceeds calculation.
- b. Sale "off the lease" use market value.
- c. Point of sale and transfer of title to gas will determine how gas is valued. Lessee, in cooperation with the gas purchaser, can control the Waechter lease through structuring the point of sale in the gas sales contract.

7. Determining "market value."

- a. Requires payment of gas royalty calculated by using the "value or price at the current rate prevailing when the gas is delivered rather than the proceeds of amount realized under a gas purchase contract." Holmes, 233 Kan. at 548, 664 P.2d at 1339.
- b. Market value can therefore be in excess of the amount paid to lessee by his gas purchaser. Gas value determined at the time it is produced - not when the gas contract was entered into.
- c. Market value to be determined by what a willing seller will pay a willing buyer in a "free market." Lightcap. How does federal price regulation of gas affect this free market test?
 - (1) Not a limitation on what the lessor can receive as royalty.
 - (2) However, courts can consider the affect of federal price controls on the gas market when looking at "comparable sales" of gas from other area fields. A factor to consider in determining market value. Matzen v. Cities Service Oil Co., 233 Kan. 846, 667 P.2d 337 (1983).

8. Kansas takes a pro-lessor position on the market value issue.

Oklahoma takes a pro-lessee position. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981) (market value equals sales contract price).

Texas requires payment of current market value but considers the legal status of the gas (federal price limitations). First National Bank of Weatherford v. Exxon Corp., 622 S.W.2d 80 (Tex. 1981).

9. Could the market value analysis be used to pay lessor the market value of their share of production when that amount is less than the fractional share of proceeds received by

lessee?

- a. Kansas cases do not limit determination of market value to situations where market value exceeds value of the proceeds.
- b. The Kansas approach would seem to allow lessee to use the lower, market value price, to calculate royalty.
- c. In effect, the lessee is being forced to assume the risk if his gas sales contract does not keep pace with market prices. Shouldn't the lessee enjoy the benefits of his willingness to assume the risk? Especially when it is at no risk to the lessor?
- d. In Piney Woods Country Life School v. Shell Oil Co., 765 F.2d 225 (5th Cir. 1984), cert. denied, 105 S.Ct. 1868 (1985), the court observes in a footnote:

"If the price of gas declines, a market value royalty clause would benefit a lessee who has contracted to sell gas at a favorable price."

- e. Lessor should consider lease clause which provides for an amount equal to the greater of: (1) the gross proceeds from the sale of gas; or (2) an amount equal to the market value of the substance at the well.

E. Calculating The "Net Value" Of Lessor's Royalty.

1. Royalty generally defined as a cost-free share of production paid or delivered to the lessor.
2. "Cost-free" refers to costs associated with drilling, completing, and producing the well. However, the lessor may be assessed a share of costs incurred after production. Problem in Kansas is determining where the production function ends and the post-production function begins.
3. Does the production function include marketing?

- a. Implied covenant to market production.
 - b. In Kansas, "production" for habendum clause purposes requires marketing.
 - c. However, these rules do not necessarily mean lessee must absorb all the costs.
4. Transportation Charges - Early Kansas cases permit lessee to deduct the cost of transporting production to a market.
- a. Scott v. Steinberger, 113 Kan. 67, 213 P. 646 (1923) (can deduct cost of transporting gas to market and then calculate royalty using the net figure).
 - b. Voshell v. Indian Territory Illuminating Oil Co., 137 Kan. 160, 19 P.2d 456 (1933) (can deduct cost of arranging for contract carriage of oil, by pipeline, to a market).
 - c. Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943) (can deduct cost of trucking oil to market).
5. More recent cases, although not directly addressing the issue, cast doubt on whether transportation and other marketing costs are deductible, absent express lease provisions.
- a. Matzen v. Hugoton Production Company, 182 Kan. 456, 467, 321 P.2d 576, 585 (1958) (concurring opinion of Justice Fatzer).
 - b. Gilmore v. Superior Oil Company, 192 Kan. 388, 388 P.2d 602 (1964) and Schupbach v. Continental Oil Company, 193 Kan. 401, 394 P.2d 1 (1964). Lessee not allowed to deduct "compression costs" in calculating royalty.

Court in Gilmore, without discussion, quotes the following from M. Merrill, Covenants Implied in Oil and Gas Leases:

"If it is the lessee's obligation to market the product, it seems necessary to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No

part of the costs of marketing or of preparation for sale is chargeable to the lessor.'" Gilmore, 192 Kan. at 393, 388 P.2d at 607.

- c. Cline v. Angle, 216 Kan. 328, 333, 532 P.2d 1093, 1097 (1975) (court, by dicta, suggests helium extraction and purification costs may not be deducted from overriding royalty owner's share of production unless there are express provisions in the assignment allowing for the deduction).

F. Payment Of Royalty.

- 1. Frequency of payment generally governed by the lease. If not specified in the lease, the division order will specify when royalty will be paid.
- 2. Division Orders.
 - a. "[A]n instrument required by the purchaser of oil and gas in order that it may have a record showing to whom and in what proportions the purchase price will be paid. Its execution is procured primarily to protect the purchaser in the matter of payment for the oil or gas, and may be considered a contract between the sellers on the one hand and the purchaser on the other." Wagner v. Sunray Mid-Continent Oil Company, 182 Kan. 81, 92, 318 P.2d 1039, 1047 (1957).
 - b. Have been used by lessees to try and amend the oil and gas lease. These attempts have been unsuccessful in Kansas. See, e.g., Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983) and Maddox v. Gulf Oil Corporation, 222 Kan. 733, 567 P.2d 1326 (1977), cert. denied, 434 U.S. 1065 (1978).
- 3. Remedies for nonpayment of royalty.
 - a. No legislation in Kansas.
 - b. Oklahoma has statute to obtain interest on late payments and attorney fees required to enforce the obligation.

Okla. Stat. Ann. tit. 52 §540 (West 1987).

c. Texas - see Tex. Nat. Res. Code. Ann. §52.131(e) (Vernon 1978).

d. Action to enforce the royalty covenant.

(1) Generally, cancellation of lease not a remedy - damages adequate. Edwards v. Iola Gas Co., 65 Kan. 362, 69 P. 350 (1902).

(2) However, for a "continuous unreasonable" failure to comply with essential lease covenants, cancellation of the lease may be an appropriate remedy. Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (1984) (surface use covenant).

c. Interest.

(1) Kansas - no statutory provisions but uses a common law unjust enrichment theory to require payment of interest on suspended royalties. See, e.g., Shutts v. Phillips Petroleum Co., 235 Kan. 195, 679 P.2d 1159 (1984), aff'd in part, rev'd in part, Phillips Petroleum Co. v. Shutts, 105 S.Ct. 2965 (1985) (reversed as to conflicts of law issue).

(2) For a statutory approach see Okla. Stat. Ann. tit. 52 §540A. (West 1987).

d. Payment Information..

(1) Lessor requires information to audit lessee's payment of royalty.

(2) No statutes in Kansas. See the Oklahoma check stub law - Okla. Stat. Ann. tit. 52 §§ 567 and 568 (West 1987).

II. ROYALTY CLAUSE - TRADITIONAL DRAFTING RESPONSES

A. Current Practices.

1. Most lease forms utilize the traditional cryptic code to determine the gross and net value of lessor's royalty. For example:

"The royalties to be paid lessee are:

"(a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected;

"(b) on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale;"

Paragraph #3 - Form 88.

B. Major Problems.

1. What costs can be deducted from lessor's royalty?
 - a. Most clauses presume the lessor will take oil royalty in kind. In practice oil royalty is sold by lessee with lessee's share of production.
 - b. Variation of oil royalty clause:

"Lessee shall deliver to Lessor as royalty, free of cost, on the Lease, or into the pipeline to which the Lessee may connect its well, the equal one-eighth part of all oil produced and saved from the leased premises, or at the Lessee's option, may pay to the Lessor for such one-eighth royalty the market price for oil of like grade and gravity prevailing on the day such oil is run into the pipeline or into storage tanks." Paragraph #3 - Form 690.

- c. If lessee is required to treat the oil to remove water, and then transport it by truck to a refinery, can any of these costs be charged against lessor's share of production? If so, how will such expenses be calculated?
 - d. Marketing gas may require treatment, gathering, and compression. Can lessee charge any part of these costs against lessor's share of production? If so, how will such expenses be calculated?
- 2. How will the "value" of production be determined? What is market value?
 - 3. What are "proceeds?" Is it anything a lessee receives in consideration for the transfer of title to the gas?
 - 4. To what extent can lessor participate in any of lessee's other business activities? Separate liquid hydrocarbons from a gas stream and sell liquids and residue gas for an amount ten times greater than the value assigned to the unprocessed gas for royalty purposes.
 - 5. What are the mechanics of payment?

III. ROYALTY CLAUSE - ALTERNATIVE DRAFTING RESPONSES

A. Matters The Clause Should Address.

- 1. How the gross value of royalty will be determined.
- 2. Costs lessee can deduct from the gross value to arrive at lessor's royalty.

B. Calculating Gross And Net Value:

- 1. At what point in the production process will gross value be determined?
 - a. At the well?
 - b. First sale?
 - c. What's the effect of lessee using the production? What's the effect of a sale to lessee or its affiliate?

- d. What if the gas is processed to separate it into its liquid and gas components for sale?
 - e. What if other components of the production stream are removed in treating or processing the gas?
 - f. What if the production is not sold, but instead "exchanged" for other production?
2. What expenses can lessee deduct (charge against lessor's share of production) to arrive at the net value of production to calculate royalty?
- a. A stated formula or actual costs? Lessee better off using a stated formula.
 - b. If lessor receives royalty on processed gas, must lessor pay a share of processing costs?
 - c. Will lessor be responsible for its share of treating, compression, transportation, and other marketing costs?
 - d. What is the effect of lessee reserving certain rights under a gas purchase agreement?
3. Proceeds Lease.
- a. Define proceeds to include or exclude other gas contract benefits.
- Consider Amoco Production Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex. Civ. App. 1979), writ refused n.r.e. (lessee traded for benefits under gas contract which affected lessor's royalty).
- b. Address lessee's rights to amend or otherwise manage the gas contract.
 - c. Address how proceeds will be calculated in situations noted in Subsection B.1 and B.2.

4. Market Value Lease.

- a. Define market value and how it will be determined.
- b. If a Waechter lease, remember the structure of the gas sales agreement will affect how royalty is determined.

C. General Advice To Lessees - Be sensitive to situations where it is necessary, or advisable, to include lessor in the lease operation decision-making process.

1. A concept foreign to lessees.
2. Kansas Supreme Court has often noted the lessee's failure to consult the lessor on matters directly affecting lessor's economic interest. See, e.g., Schupbach v. Continental Oil Co., 193 Kan. 401, 406, 394 P.2d 1, 5 (1964).
3. What do you think a lessor would have done in 1965 if the lessee had gone to them and said: "We have a gas purchaser willing to enter into a gas purchase agreement to buy all the gas from our well for the next 20 years - under these terms"

If the price and other contract terms were reasonable, at that time, do you think the lessor would have been willing to amend the lease to accept the gas contract proceeds for calculating royalty?

D. Share Of Production.

1. State the proportionate share of production excepted from the grant and retained by the lessor.
2. Use fraction or percentage. Make it clear you are excepting a share of all production.
 - a. 1/8 of 8/8 of production.
 - b. 12.5% of 100% of production.
 - c. 12.5% of all production. LEASE - SECTION 10.A.1.
3. Nothing sacred about a 1/8th royalty.

Bargaining position and prowess will determine the lessor's share of production.

E. Processed Production.

1. Indicate whether lessor will have any claim to a royalty based upon the value of products separated from production. LEASE - SECTION 10.A.2. and 10.G.3.
2. If lessor's royalty includes processed production, are any costs chargeable against lessor as a result of such processing? How will they be calculated? LEASE - SECTION 10.B.1.

F. Gross Value Of Production.

1. Indicate how production will be valued. LEASE - SECTION 10.D.
2. What if lessee sells a leased substance under a long-term sales contract? LEASE - SECTION 10.D.3.

G. Net Value Of Production.

1. What costs are deductible from lessor's share of production? LEASE - SECTION 10.B.1. and 10.B.2.
2. How will such costs be determined? Formula or actual costs? Formula is more manageable.

H. Payment Details.

1. When is initial payment due after a well begins to produce? When are payments due on subsequent production? LEASE - SECTION 10.E.
2. Must lessor sign a division order? LEASE - SECTION 10.F.
3. What periodic documents must lessee provide to lessor? LEASE - SECTION 10.E.

SECTION 7 - MISCELLANEOUS CLAUSES

I. TRADITIONAL CLAUSES

A. Change Of Ownership.

1. Lessee and lessor each given the authority to assign or convey their interests. Paragraph #8 - Form 88; Paragraph #9 - Form 690; LEASE - SECTION 11.A. and B.
2. Provide for the effect of an assignment of the lease by lessee.
 - a. Assignment of all rights - concerned with the continuing liability of lessee and the liability of assignees.
 - b. Partial Assignment - concerned with the divisibility of lease obligations.
3. Usually provide for termination of liability under the lease after assignment. Presume that lessee (assignor) remains liable for acts prior to assignment. Paragraph #10 - Form 690; LEASE - SECTION 11.A.
4. Address rights of parties when the lease is divided between lessee and one or more assignees.
 - a. Will an assignee's failure to pay delay rental affect the remainder of the lease held by lessee?
 - b. Lease is held to be indivisible unless the express terms make it divisible for a particular purpose.
 - c. Major concern is apportioning the delay rental obligation when the lease is assigned. Paragraph #8 - Form 88; Paragraph #10 - Form 690; LEASE - SECTION 11.A. and SECTION 3.A.2.a.
5. Address effect of a conveyance by lessor. Major concern is ensuring lessee's obligations are not expanded and that lessee will not be required to account to a new owner until they have provided proof of ownership. Paragraph #8 - Form 88; Paragraphs #9 and #8 - Form 690; LEASE -

SECTION 11.B.

B. Lessee's Termination Rights.

1. Designed to permit Lessee to divide the lease and retain portions without continuing liability for the portions surrendered. Paragraph #12 - Form 88; Paragraph #14 - Form 690; LEASE - SECTION 12.
2. Clause should clearly indicate what rights can be surrendered, how they are surrendered, and the effect of surrender.

C. Covenants Running With The Land.

1. Parties, contemplating changes in ownership, intend to make the lease rights and obligations binding upon the successors and assigns of the parties.
2. Most lease forms repeat this in many clauses and then restate it when closing. See, e.g., Paragraphs #5, #9, and closing sentence before signature lines - Form 690.
3. A simple statement, one time, that the terms of the lease are binding upon the successors and assigns of lessor and lessee, is adequate. LEASE - SECTION 17.

II. NON-TRADITIONAL CLAUSES TO CONSIDER

A. Diligence And Good Faith.

1. Attempt to establish the nature of the lessor lessee relationship. Is it a fiduciary relationship?
2. State a generic requirement of diligence and good faith. LEASE - SECTION 13.

B. Merger Clause.

1. Oil and gas transactions are often replete with assertions of oral or written promises not embodied in the final lease document. For example: "The landman said you would have a rig on site in a week."
2. Although lessees need to protect against such language, oil and gas lease forms do not

contain any sort of a merger clause.
Consider LEASE - SECTIONS 14. and 15.

C. Remedy Clause.

1. If representing a lessor, perhaps the best provision you can negotiate on their behalf is the right to reasonable attorney fees and litigation costs in the event they must enforce lessee's lease obligations.
2. May also want to negotiate for a performance bond to insure lessor against lessee's nonperformance. Especially important to secure reclamation and plugging obligations when the lease reaches its economic limit.
 - a. Especially important in Kansas where lessor does not have the protection of any sort of statutory bonding requirement.
 - b. Consider Okla. Stat. Ann. tit. 52 §318.4 (West 1987).

D. Effective Date.

1. Ensure the lease contains only one effective date. Avoid dating instruments at the top and bottom.
2. Designate the date signed as the effective date. Useful as a reference for calculating time under the lease.

E. Warning Clause.

1. Lessors, particularly lessors in Kansas, have assumed a "consumer" status. Courts police oil and gas leases to ensure the lessor has not been overreached.
2. My alternative approach is premised upon meaningful and informed communication between all parties. Issues should be resolved through negotiation, not adhesion contract type tactics. The landowner's attorney should play a major role in the process. The lessee should at least inform lessor of the potential significance of the transaction and let lessor decide if they require legal counsel.

Suggested cautionary statement:

THIS LEASE GRANTS SIGNIFICANT PROPERTY RIGHTS WHICH MAY LAST FOR AN EXTENDED PERIOD OF TIME. EACH PARTY SHOULD CONSULT AN ATTORNEY VERSED IN OIL AND GAS LAW BEFORE SIGNING.

SECTION 8 - ALTERNATIVES TO THE OIL AND GAS LEASE

I. THE STANDARD RELATIONSHIP

A. Creation.

1. The standard relationship is created by all oil and gas leases. Basic design:
 - a. Lessee given option to develop lease.
 - b. Lessee under no obligation to develop.
 - c. Any development is at lessee's sole risk and expense.
 - d. Lessor's primary compensation is the prospect of royalty.
2. Relationship has been around since turn of the century.

B. Why Has The Relationship Endured?

1. Because the oil and gas lease has endured.
2. Lack of meaningful negotiation of lease terms.
3. Benefits of standardization.
4. Major participants in the industry will readily purchase leases on forms that look familiar.
5. Printing companies have reproduced popular forms.
6. Oil and gas leases have a potentially long-term existence.
7. Courts have been willing to use creative interpretation to avoid evaluating the conscionability of the lease form and the leasing process.
8. Major participants in the industry have been willing to accept the courts' guidance.
9. Lack of creativity; form mentality.
10. Frequent reason that is noted: The oil and

gas lease has proven to be very versatile and its terms have been extensively litigated.

- a. The lease is versatile because courts have been willing to rewrite its terms to arrive at a contract more in line with their concepts of fairness.
- b. The lease has been the subject of extensive litigation. However, there appears to be no sign that a hundred years of litigation and thousands of appellate opinions have debugged the lease.

The oil and gas lease is an "adjudicated form." Beardsley, "Beware of Eschew and Avoid Pompous Prolivity and Platitudinous Epistles!" 16 Cal. S. B. J. 65 (1941).

Beardsley defines the adjudicated form as one "that has attached to it a certificate that there is something terribly wrong with it. If there were not something terribly wrong with it, it would not have been adjudicated." Id. at 66.

C. Problems.

1. Oil and gas lease form leaves too much for factual resolution; matters which often could be easily addressed in the lease.
2. When a problem is noted, the response has been too narrow. Focus only on the latest instance of judicial hostility toward the document.

Drafting becomes a process of collecting prior failures and restating them for another round of litigation.

3. Since substantial rights turn on the interpretation of the lease, parties will be prone to exploit every weakness in the document.
4. The interests of lessor and lessee conflict.

D. Solutions.

1. Some of the problems can be addressed through creative drafting.
2. Some of the problems will require a change in attitude.
 - a. Lessee must view lessor as a sort of partner in the development process.
 - b. Lessee must realize a lease obtained without meaningful negotiation may not be the best lease.
3. Some of the problems can be addressed only by abandoning the standard relationship.
 - a. Inherent conflict between lessee's right to retain the lease without development and lessor's expectation of royalty.
 - b. Inherent conflict between lessee's obligation to pay development costs and lessor's right to a cost-free share of production.
4. This seminar focuses on creative drafting as a solution.
5. Courts are attempting to focus on the attitudinal solution.

For example, if lessee doesn't care to consult lessor on something affecting lessor's interests, lessee may become an insurer of lessor's interests. The Kansas approach to the market value royalty issue is an example.

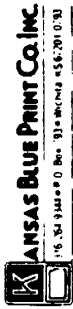
6. Perhaps it is time to address defects in the basic relationship created by oil and gas leases.
 - a. Attempt to bring the economic interests of landowner and developer into harmony.
 - (1) Net profits interest.
 - (2) Any sort of relationship where the lessor's potential income is tied to lessee's business success.

- b. Eliminate the conflict by eliminating the lessor - purchase the mineral estate.
- 7. For a detailed discussion of these issues see: Pierce, "Rethinking the Oil and Gas Lease," to be published in the May issue of the Tulsa Law Journal.
- 8. It's a good time to experiment.

Form 88 - (Producers) **B W**
Kan., Okla. & Colo. 1962 Rev.

OIL AND GAS LEASE

Reorder No. **(b)**
09-119



THIS AGREEMENT made this _____ day of _____, 19____, between _____

_____ of _____
(Post Office Address)

herein called lessor (whether one or more), and _____, lessee:

1. Lessor, in consideration of _____ Dollars (\$ _____) in hand paid, receipt of which is here acknowledged and of the royalties herein provided and of the agreements of the lessee herein contained, hereby grants, leases and lets exclusively unto lessee for the purpose of investigating, exploring, prospecting, drilling, mining and operating for and producing oil, liquid hydrocarbons, all gases, and their respective constituent products, injecting gas, water, other fluids, and air into subsurface strata, laying pipe lines, storing oil, building tanks, power stations, telephone lines, and other structures and things thereon to produce, save, take care of, treat, manufacture, process, store and transport said oil, liquid hydrocarbons, gases and their respective constituent products and other products manufactured therefrom, and housing and otherwise caring for its employees, the following described land, together with any reversionary rights and after-acquired interest, therein situated in _____ County, Kansas, to-wit:

In Section _____, Township _____, Range _____, and containing _____ acres, more or less, and all accretions thereto.

2. Subject to the provisions herein contained, this lease shall remain in force for a term of ten (10) years from this date (called "primary term"), and as long thereafter as oil, liquid hydrocarbons, gas or other respective constituent products, or any of them, is produced from said land or land with which said land is pooled.

3. The royalties to be paid by lessee are: (a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected; (b) on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale; and (c) at any time, either before or after the expiration of the primary term of this lease, if there is a gas well or wells on the above land (and for the purposes of this clause (c) the term "gas well" shall include wells capable of producing natural gas, condensate, distillate or any gaseous substance and wells classified as gas wells by any governmental authority) and such well or wells are shut in before or after production therefrom, lessee or any assignee hereunder may pay or tender annually at the end of each yearly period during which such gas well or gas wells are shut in, as substitute gas royalty, a sum equal to the amount of delay rentals provided for in this lease for the acreage then held under this lease by the party making such payments or tenders, and if such payments or tenders are made it shall be considered under all provisions of this lease that gas is being produced from the leased premises in paying quantities. Such substitute gas royalty may be paid or tendered in the same manner as provided herein for the payment or tender of delay rentals.

4. If operations for drilling are not commenced on said land or on land pooled therewith on or before one (1) year from this date, this lease shall terminate as to both parties, unless on or before one (1) year from this date lessee shall pay or tender to the lessor a rental of _____ Dollars (\$ _____) which shall cover the privilege of deferring commencement of such operations for a period of twelve (12) months. In like manner and upon like payments or tenders, annually, the commencement of said operations may be further deferred for successive periods of the same number of months, each during the primary term. Payment or tender may be made to the lessor or to the _____ which bank, or

any successor thereof, shall continue to be the agent for the lessor and lessor's successors, heirs and assigns, if such bank (or any successor bank) shall fail, liquidate, or be succeeded by another bank, or for any reason fail or refuse to accept rental, lessee shall not be held in default until thirty (30) days after lessor shall deliver to lessee a recordable instrument making provision for another method of payment or tender, and any depository charge is a liability of the lessor. The payment or tender of rental may be made by check or draft of lessee, mailed or delivered to said bank or lessor, or either lessor if more than one, on or before the rental paying date. Notwithstanding the death of the lessor or his successors in interest, the payment or tender of rentals in the manner provided herein shall be binding on the heirs, devisees, executors and administrators of the lessor his successors in interest.

5. Lessee is hereby granted the right to pool or consolidate the leased premises, or any portion or portions thereof, as to all strata, or any stratum or strata, with other lands as to all strata, or any stratum or strata, but only as to the gas right hereunder (excluding casinghead gas produced from oil wells) to form one or more gas operating units of not more than 640 acres, plus a tolerance of ten per cent (10%) to conform to Governmental Survey quarter sections. Lessee shall file written unit designations in the county in which the premises are located. Such unit may be designated either before or after the completion of wells. Drilling operations and production on any part of the pooled acreage shall be treated as if such drilling operations were upon or such production was from the land described in this lease whether the well or wells be located on the land covered by this lease or not. The entire acreage pooled into a gas unit shall be treated for all purposes, except the payment of royalties on production from the pooled unit, as if it were included in this lease. In lieu of the royalties herein provided, lessor shall receive on production from the unit so pooled only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit or his royalty interest therein on an acreage basis bears to the total acreage so pooled in the particular unit involved.

6. If, prior to the discovery of oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, on said land or land pooled therewith lessee should drill and abandon a dry hole or holes thereon, or if, after discovery of oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, the production thereof should cease from any cause, this lease shall not terminate if lessee commences reworking or additional drilling operations within sixty (60) days thereafter, or if it be within the primary term. (1) In the case of a dry hole, commences or resumes the payment or tender of rentals or commences operations for drilling or reworking on or before the rental paying date occurring twelve (12) months after the expiration of the rental period during which such dry hole was drilled, or (2) in the case of cessation of production, commences or resumes the payment or tender of rentals or commences operation for drilling or reworking on or before the rental paying date next ensuing after the expiration of three (3) months from the cessation of production. If, at the expiration of the primary term, oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, is not being produced on said land or land pooled therewith but lessee is then engaged in operations for drilling or reworking of any well thereon, this lease shall remain in force so long as drilling or reworking operations are prosecuted (whether on the same or different wells) with no cessation of more than sixty (60) consecutive days, and if they result in production, so long thereafter as oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, is produced from said land or land pooled therewith.

7. Lessee shall have free use of oil, gas, and water from said land, except water from lessor's wells and tanks, for all operations hereunder, including repurposing, pressure maintenance, cycling, and secondary recovery operations, and the royalty shall be computed after deducting any so used. Lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by lessee on said land, including the right to draw and remove all casing. When required by lessor, lessee will bury all pipe lines below ordinary plow depth. Lessee shall pay for damages caused by its operations to growing crops on said land. No well shall be drilled within two hundred feet (200 ft.) of any residence or barn now on said land without lessor's consent. Lessor shall have the privilege, at his risk and expense, of using gas from any gas well on said land for stoves and inside lights in the principal dwelling thereon, out of any surplus gas not needed for operations hereunder.

8. The rights of either party hereunder may be assigned in whole or in part and the provisions hereof shall extend to the heirs, executors, administrators, successors, and assigns, but no change or division in ownership of the land, rentals or royalties, however accomplished, shall operate to enlarge the obligations or diminish the rights of lease. No such change or division in the ownership of the land, rentals or royalties shall be binding upon lessee for any purpose until such person acquiring any interest has furnished lessee with the instrument or instruments, or certified copies thereof, constituting his claim of title from the original lessor. In the event of an assignment of this lease as to a segregated portion of said land, the rentals payable hereunder shall be apportioned as between the several leasehold owners ratably according to the surface area of each, and default in rental payment by one shall not affect the rights of other leasehold owners hereunder. An assignment of this lease, in whole or in part, shall, to the extent of such assignment, relieve and discharge lessee of any obligations hereunder, and, if lessee or assignee of part or parts hereof shall fail or make default in the payment of the proportionate part of the rentals due from such lessee or assignee or fail to comply with any other provision of the lease, such default shall not affect this lease in so far as it covers a part of said lands upon which lessee or any assignee thereof shall make payment of said rentals.

9. Lessee shall not be liable for delays or defaults in its performance of any agreement or covenant hereunder due to force majeure. The term "force majeure" as employed herein shall mean: any act of God including but not limited to storms, floods, washouts, landslides, and lightning; acts of the public enemy; wars, blockades, insurrections, or riots; strikes or lockouts; epidemics or quarantines; regulations; laws, acts, order or requests of federal, state, municipal or other governments or governmental officers or agents under color of authority; freight embargoes or failures; exhaustion or unavailability or delays in delivery of any product, labor, service, or material. If lessee is required, or ordered or directed by any federal, state or municipal law, executive order, rule, regulation or request enacted or promulgated under color of authority to cease drilling operations, reworking operations or producing operations on the land covered by this lease or if lessee by force majeure is prevented from conducting drilling operations, reworking operations or producing operations, then until such time as law, order, rule, regulation, request or force majeure is terminated and for a period of ninety (90) days after such termination each and every provision of this lease that might operate to terminate it or the estate conveyed by it shall be suspended and inoperative and this lease shall continue in full force. If any period of suspension occurs during the primary term, the time thereof shall be added to such term.

10. Lessor hereby warrants and agrees to defend the title to said land, and agrees that lessee, at its option, may discharge any tax, mortgage, or other lien upon said land, and in the event lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rentals and royalties accruing hereunder toward satisfying same. In case said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties, including substitute gas royalty, and rentals herein provided for shall be paid the said lessor only in the proportion that his interest bears to the whole and undivided fee; however, such rental shall be increased at the next succeeding rental anniversary after the acquisition of any reversionary interest or after-acquired title to cover the interest so acquired, and lessor agrees to notify lessee in writing upon acquisition of any additional interest in the above described property, whether it be by reversion or after-acquired title, or if such additional acquisition occurs after production be obtained, then the royalty shall be increased to cover the interest so acquired. Should any one or more of the parties named above as lessors fail to execute this lease, it shall nevertheless be binding upon the party or parties executing the same.

11. If the leased premises shall hereafter be owned in severalty or in separate tracts, the premises, nevertheless, shall be developed and operated as one lease, and all royalties 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 such separate owner bears to the entire leased acreage. There shall be no obligation on the part of the leasee to offset wells on separate tracts into which the land covered by this lease may be hereafter divided by sale, devise, or otherwise, or to furnish separate measuring or receiving tanks.

12. Lessee and lessee's successors and assigns shall have the right at any time to surrender this lease, in whole or in part, to lessor or his heirs and assigns by delivering or mailing a release thereof to the lessor, or by placing a release thereof of record in the county in which said land is situated; thereupon lessee shall be relieved from all obligations, expressed or implied, of this agreement as to the acreage so surrendered, and thereafter the rentals payable hereunder shall be reduced in the proportion that the acreage covered hereby is reduced by said release or releases.

IN WITNESS WHEREOF, we sign the day and year first above written.

WITNESSES:

STATE OF _____

COUNTY OF _____

ACKNOWLEDGMENT FOR INDIVIDUAL (KsOkCoNe)

The foregoing instrument was acknowledged before me this _____ day of _____, 19____,
by _____ and _____

My commission expires _____

Notary Public

STATE OF _____

COUNTY OF _____

ACKNOWLEDGMENT FOR INDIVIDUAL (KsOkCoNe)

The foregoing instrument was acknowledged before me this _____ day of _____, 19____,
by _____ and _____

My commission expires _____

Notary Public

AAPL FORM 690

THIS AGREEMENT, made and entered into this _____ day of _____, 19____, by and between _____, hereinafter called Lessor, and _____, hereinafter called Lessee;

_____ , hereinafter called Lessee;

WITNESSETH:

1. That Lessor for and in consideration of the sum of _____ Dollars in hand paid, receipt of which is hereby acknowledged, and the covenants and agreements hereinafter contained to be performed by the Lessee, has granted, leased and let, and does by these presents hereby grant, lease and let exclusively unto said Lessee, the lands hereinafter described, with the right to unitize this Lease or any part thereof with other Oil and Gas Leases as to all or any part of the lands covered hereby as hereinafter provided, for the purpose of carrying on geological, geophysical, or other exploration work, including core drilling and the drilling, mining, and operating for, producing, and saving all of the oil, gas and other hydrocarbons, and for constructing roads, laying pipelines, building tanks, storing oil, building power stations, telephone lines, and other structures thereon necessary or convenient for the economical operation of said land alone, or conjointly with neighboring lands, to produce, save, take care of, and manufacture all of such substances, and for the housing and boarding of employees, said tract of land with any reversionary rights therein, being situated in the County of _____, State of Kansas, and more particularly described as follows:

in Section _____, Township _____, Range _____, containing _____ acres, more or less.

2. This Lease shall remain in force for a primary term of _____ years and as long thereafter as oil, gas or other hydrocarbons is or can be produced.

3. Lessee shall deliver to Lessor as royalty, free of cost, on the Lease, or into the pipeline to which the Lessee may connect its well, the equal one-eighth part of all oil produced and saved from the leased premises, or at the Lessee's option, may pay to the Lessor for such one-eighth royalty the market price for oil of like grade and gravity prevailing on the day such oil is run into the pipeline or into storage tanks.

4. Lessee shall pay to Lessor for gas produced from any oil well and used by the Lessee for the manufacture of gasoline or any other product, as royalty, one-eighth of the market value of such gas at the mouth of the well; if said gas is sold by the Lessee, then as royalty, one-eighth of the proceeds of the sale thereof at the mouth of the well. The Lessee shall pay Lessor as royalty one-eighth of the proceeds from the sale of gas as such at the mouth of the well where gas only is found. Where there is a gas well, or wells on the lands covered by this Lease or acreage pooled therewith, whether it be before or after the primary term hereof, and such well or wells are shut-in, and there is no other production, drilling operations or other operations being conducted capable of keeping this Lease in force under any of its provisions, Lessee shall pay as royalty to Lessor (and if it be within the primary term hereof such payment shall be in lieu of delay rentals) the sum of \$1.00 per year per net royalty acre, such payment to be made to the depository bank hereinafter named on or before the anniversary date of this Lease next ensuing after the expiration of 90 days from the date such well or wells are shut-in, and thereafter on the anniversary date of this Lease during the period such wells are shut-in, and upon such payment it shall be considered that this Lease is maintained in full force and effect.

5. If operations for the drilling of a well for oil or gas are not commenced on said lands on or before the _____ day of _____, 19____, this Lease shall terminate as to both parties unless the Lessee shall on or before said date pay or tender to the Lessor or to Lessor's credit in the _____ Bank, at _____

_____ , or its successors, which bank and its successors are the Lessor's agent, and shall continue as a depository of any and all sums payable under this Lease regardless of changes in ownership in said lands or in the oil and gas or in the rentals to accrue hereunder, the sum of _____ Dollars which shall operate as a rental and cover the privilege of deferring the commencement of operations for drilling for a period of one year. In like manner and upon like payments or tenders the commencement of operations for drilling may be further deferred for like periods successively. All payments or tenders may be made by check or draft of Lessee or any assigns thereof mailed or delivered on or before the rental paying date, either direct to Lessor or his assigns, or to said depository bank, and it is understood and agreed that the consideration first recited herein, the down payment, covers not only the privilege granted to the date when said first rental is payable as aforesaid, but also the Lessee's option of extending that period as aforesaid, and any and all other rights conferred herein. Notwithstanding the death of the Lessor or his successors in interest, the payment or tender of rentals in the manner above set out shall be binding on the heirs, devisees, executors and administrators of such persons.

6. If at any time prior to the discovery of oil or gas or other hydrocarbons on this land and during the term of this Lease the Lessee shall drill a dry hole or holes on said lands, this Lease shall not terminate, provided operations for the drilling of a well shall be commenced by the next ensuing rental paying date, or provided that the Lessee begins or resumes the payment of rentals in the manner and amount hereinabove provided for, and in this event the preceding paragraphs hereof governing the payment of rentals and the manner and effect thereof shall continue in force.

7. In case said Lessor owns a lesser interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided for shall be paid the said Lessor only in the proportion which his interest bears to the whole and undivided fee. Failure to proportionately reduce the rental hereinabove provided for shall have no effect on the right to reduce royalties to correspond with Lessor's actual interest in the above described lands. The rental above provided for shall be increased at the next succeeding rental paying date after any reversion occurs to cover the interest so acquired by the Lessor.

8. Lessee shall have the right to use, free of cost, gas, oil and water found on said land for its operation thereon, except water from the wells of the Lessor. When required by Lessor, the Lessee shall bury its pipelines below plow depth and shall pay for damages caused by its operations to growing crops on said land. No well shall be drilled nearer than 200 feet to any house or barn now on said premises without the written consent of the Lessor. 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 on said premises, including the right to draw and remove all casing, but Lessee shall be under no obligation to do so, nor shall Lessee be under any obligation to restore the surface to its original condition where any alterations or changes were due to operations reasonably necessary under this Lease.

9. If the estate of either party hereto is assigned, and the privilege of assigning in whole or in part is expressly allowed, the covenants hereof shall extend to the heirs, devisees, executors, administrators, successors and assigns, but no change of ownership in the lands or in the rentals or royalties, or any sum due under this Lease shall be binding on the Lessee until it has been furnished with either the original recorded instrument of the conveyance or a duly certified copy thereof, or a certified copy of the Will of any deceased owner and the probate thereof, or a certified copy of the proceedings showing the appointment of an administrator of the estate of any deceased owner, whichever is appropriate, together with all original recorded instruments of conveyance or duly certified copies thereof necessary to show a complete chain of title back to Lessor to the full interest claimed, and all advanced payment of rentals made hereunder before receipt of such documents shall be binding on any direct or indirect assignee, grantee, devisee, administrator, executor or heir of the Lessor.

10. No change or division in the ownership of the land, rentals or royalties, however accomplished, shall operate to enlarge the obligation, nor diminish the rights of the Lessee. In the event of assignment hereof in whole or in part, liability for breach of any obligation hereunder shall rest exclusively upon the owner of this Lease, or portion thereof who commits such breach. There shall be no obligation on the part of the Lessee to offset wells on separate tracts into which the lands covered by this Lease may be divided by sale, devise, descent or otherwise, or to furnish separate measuring or receiving tanks. It is further agreed that in the event this Lease shall be assigned as to a part or as to parts of the above described land and the holder or owner of any such part or parts shall make default in the payment of the proportionate part of the rental due from him, such default shall not operate to defeat or affect this Lease insofar as it covers a part of said land upon which the Lessee or any assignee hereof shall make due payment of said rentals. If six or more parties become entitled to royalty payments hereunder Lessee may withhold payment thereof unless and until furnished with a recordable instrument executed by all such parties designating an agent to receive payment for all.

11. Lessor hereby warrants and agrees to defend title to the lands herein described and agrees that the Lessee at its option may pay and discharge in whole or in part any taxes, mortgages or other liens existing, levied or assessed on or against the above described land and in the event it exercises such option it shall be subrogated to the rights of any holder or holders thereof and may reimburse itself by applying to the discharge of any such mortgage, tax or other lien, any royalty, shut-in royalty, or rentals accruing hereunder.

12. Notwithstanding anything in this Lease contained to the contrary, it is expressly agreed that if the Lessee shall commence operations for drilling at any time while this Lease is in force, this Lease shall remain in force and its terms shall continue so long as such operations are prosecuted and, if production results therefrom, then as long as production continues.

13. If within the primary term of this Lease, production on the leased premises shall cease from any cause, this Lease shall not terminate provided operations for the drilling of a well shall be commenced before or on the next ensuing rental paying date; or, provided lessee begins or resumes the payment of rentals in the manner and amount hereinbefore provided. If, after the expiration of the primary term of this Lease, production on the leased premises shall cease from any cause, this Lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues.

14. Lessee may at any time surrender or cancel this Lease in whole or in part by delivering or mailing a release to the Lessor, or by placing same of record in the proper county. In case said Lease is surrendered and cancelled as to only a portion of the acreage covered thereby, then all payments and liabilities thereafter accruing under the terms of said Lease as to the portion cancelled shall cease and terminate and any rentals thereafter paid may be apportioned on an acreage basis, but as to the portion of the acreage not released the terms and provisions of this Lease shall continue and remain in full force and effect for all purposes.

15. All provisions hereof, express or implied, shall be subject to all federal and state laws and the orders, rules, or regulations (and interpretations thereof) of all governmental agencies administering the same, and this Lease shall not be in any way terminated wholly or partially nor shall the Lessee be liable in damages for failure to comply with any of the express or implied provisions hereof if such failure accords with any such laws, orders, rules or regulations (or interpretations thereof). If Lessee should be prevented during the last six months of the primary term hereof from drilling a well hereunder by the order of any constituted authority having jurisdiction thereover, or if Lessee should be unable during said period to drill a well hereunder due to equipment necessary in the drilling thereof not being available on account of any cause, the primary term of this Lease shall continue until six months after said order is suspended and/or said equipment is available, but the Lessee shall pay delay rentals herein provided during such extended time.

16. Lessee at its option, is hereby given the right and power to voluntarily pool or combine the lands covered by this Lease, or any portion thereof, as to oil and gas or either of them, with any other land, lease or leases adjacent thereto, when in Lessee's judgment it is necessary or advisable to do so in order to properly develop and operate said premises, such pooling to be into units not exceeding eighty (80) acres for an oil well plus a tolerance of 10%, and not exceeding six hundred forty (640) acres, for a gas well plus a tolerance of 10%, except that larger units may be created to conform to any spacing or well unit pattern that may be prescribed by governmental authorities having jurisdiction. Lessee shall execute in writing and record in the County Records an instrument identifying and describing the pooled acreage. The entire acreage so pooled into units shall be treated for all purposes, except the payment of royalties, as if it were included in this Lease, and drilling or reworking operations thereon, or production of oil or gas or other hydrocarbons therefrom, or the completion thereon of a well as a shut-in gas well, shall be considered for all purposes, except the payment of royalties, as if such operations were on or such production were from, or such completion were on the lands covered by this Lease, whether or not the well or wells be located on the premises actually covered by this Lease. In lieu of royalties elsewhere herein specified, including shut-in gas royalties, Lessor shall receive from a unit so formed only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit, or his royalty interest therein, bears to the total acreage so pooled.

This Lease and all its terms, covenants and conditions shall extend to and be binding on all successors of said Lessor and Lessee.

IN WITNESS WHEREOF this instrument is executed on the day and year first above written.

STATE OF

COUNTY OF

} ss.

ACKNOWLEDGMENT FOR INDIVIDUAL

Before me, the undersigned, a Notary Public, within and for said County and state, on this _____ day of _____, 19____, personally appeared _____ and _____

to me personally known to be the identical person _____ who executed the within and foregoing instrument and acknowledged to me that _____ executed the same as _____ free and voluntary act and deed for the uses and purposes therein set forth.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal the day and year last above written

My commission expires _____

Notary Public

27 February 1987

Harry Engineer
Vice President - Land
Big Oil Company
P.O. Box 1000
Oiltown, Kansas 66762

Re: Big Oil's Standard Oil and Gas Lease Form

Dear Harry:

I recently attended a seminar titled "Drafting A Better Oil and Gas Lease." During the seminar we examined a number of problems associated with oil and gas lease forms used in Kansas. We also studied how to draft leases to avoid problems and provide the developer with maximum flexibility.

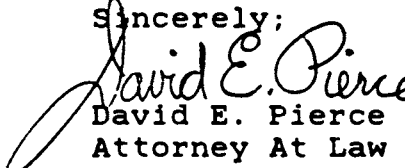
I have conducted a brief review of the oil and gas lease forms regularly used by my clients. I note that you have been using the Form 88 - (Producers) Kan., Okla. & Colo. 1962 Rev. Bw. It appears this form, as well as all the other "standard" forms used in Kansas, and other states, suffer from most of the problems discussed at the seminar.

Although I do not recommend altering existing leases, I strongly suggest, for future transactions, that you consider alternatives to the lease form you are currently using. As an example of problems surrounding your existing lease form, suppose the primary term expires on March 1. From February 23 through February 28 you do the following: stake a location, build roads, clear a drill site, move equipment and material onto the lease, and contract with a driller who enters the property, erects a rig, but does not begin to cut dirt with its drill until March 2.

Under your lease, it would take a lawsuit to determine whether you had "commenced operations for drilling" a well. It is not clear, under Kansas law and the terms of your lease, whether anything less than actual drilling will comply with the lease terms. This is just one example of the type of problems forms in current use create. However, I can draft a lease which addresses most of these problems while providing you with greater certainty and flexibility in your operations.

Let me know if you want to discuss your lease form in more detail. I believe this is an area where an investment in some preventative law will payoff many times in the future.

Sincerely;


David E. Pierce
Attorney At Law

NOTE

The lease document which follows is not a model lease form. It represents my current thoughts on how to address many of the problems associated with existing lease forms. It is not designed to benefit any particular faction. Most of the operating provisions are pro-lessee. The royalty provision is pro-lessor.

This is my preliminary draft which I am giving to you for refinement. It should prompt you to evaluate the oil and gas lease and the relationship it creates.

I am very interested in your thoughts about this document. Any comments or suggestions regarding the document are encouraged. Also, I would like to know if you use any part of the document when drafting future leases. I welcome the opportunity to discuss this document and other lease problems with you in the future.

You can reach me at: (913) 295-6691 EXT 675 or write to David E. Pierce, Washburn University School of Law, Topeka, Kansas 66621.

OIL AND GAS LEASE
("Lease")

Fred A. Farmer and Frita B. Farmer (husband and wife) of
[Name of Lessor]

Rural Route #2, Box 142, Oiltown, Kansas 66762 ("LESSOR")
[Address]

and David E. Pierce of
[Name of Lessee]

2007 S.W. Gas Street, Oiltown, Kansas 66762 ("LESSEE"),
[Address]

for valuable consideration, agree to the following:

LESSOR leases [, conveys, and grants] to LESSEE the land, substances, and rights described in SECTION 1, pursuant to the terms of this Lease.

SECTION 1. SCOPE OF GRANT.

A. SURFACE BOUNDARIES OF LEASED LAND.

The Northwest Quarter of the Northwest Quarter of Section 30,
Township 36 South, Range 10 East, from the Sixth Principal
Meridian in Eureka County, Kansas.

B. DEPTH LIMITATIONS ON LEASED LAND.

There are no depth limitations. This Lease covers all depths
within the surface boundaries of the Leased Land.

This land is called the "Leased Land."

C. SUBSTANCES GRANTED IN THE LEASED LAND.

Substances in or on the Leased Land which are subject to the terms of this Lease include:

Oil, gas, and similar hydrocarbon substances; helium, hydrogen,
nitrogen, carbon dioxide.

The listed substances are called the "Leased Substances." The term "Leased Substance" is used to identify any one of the listed substances.

D. COMPONENT SUBSTANCES.

Substances, other than Leased Substances, produced in the same production stream as Leased Substances, are called "Component Substances." LESSEE is given title to produced Component Substances.

However, if LESSOR provides for the separation of Component Substances, without unreasonably interfering with LESSEE's rights under this Lease, title to Component Substances, to the extent they are actually separated from the production stream, is given to LESSOR. LESSOR may arrange for separation of Component Substances either before or after the Component Substances leave the Leased Land.

E. PURPOSE OF THE GRANT.

LESSEE is given the exclusive right to explore for, extract, and market Leased Substances from the Leased Land, and all rights necessary or convenient for LESSEE to exercise the exclusive rights created by this Subsection.

LESSEE is given the right to engage in Enhanced Recovery operations and any other technique, presently developed or developed in the future, intended to obtain the maximum efficient recovery of Leased Substances. "Enhanced Recovery" includes any activity designed to obtain increased production of Leased Substances above the amount recoverable through primary production operations.

However, the rights created by this Subsection are subject to limitations enumerated in SECTION 1, Subsection F.

F. SURFACE RIGHTS AND LIMITATIONS.

1. LESSEE'S SURFACE RIGHTS.

Subject to the other terms of this SECTION, LESSEE is given the right to use so much of the surface of the Leased Land as is consistent with the purposes stated in Subsection E. [This includes, without limiting the general scope of LESSEE's surface rights, the following activities: Build roads, etc.]

[If the Leased Land is Pooled or Unitized pursuant to SECTION 9, LESSEE is given the right to use so much of the surface of the Leased Land as is necessary or convenient to support operations on Pooled or Unitized lands.]

2. LESSOR'S SURFACE RIGHTS.

LESSOR excepts from this Lease the following rights:

[a. To construct any structure, at any location selected by

LESSOR, on the Northeast Quarter of the Northwest Quarter of the Northwest Quarter of Section 30 ("Homestead Tract"). However, if prior to LESSOR commencing actual construction of any structure LESSEE commences actual drilling on the Homestead Tract, LESSOR will not interfere with LESSEE's operations.

[b. To initiate irrigation on the Leased Land. If LESSOR decides to irrigate the Leased Land LESSEE will make whatever adjustments in its operations necessary to reasonably accommodate the use of irrigation equipment on the Lease Land.

[c. To raise livestock on the Leased Land. If LESSOR decides to use all or part of the Leased Land to raise livestock, LESSEE will construct the necessary fence gates and cattle guards, and fence all drill sites, pits, tanks, and other drilling or production facilities on the Leased Land.

[d. List any other rights LESSOR wants to except. For example, bury pipelines and Free Gas Clause (in Kansas the Free Gas Clause benefits and runs with the surface estate).]

3. LESSEE'S SURFACE USE OBLIGATIONS.

a. LAND USE PLAN.

Before entering the Leased Land to exercise any rights granted by this Lease, LESSEE will contact LESSOR so they can meet to prepare a land use plan ("Plan"). The Plan will describe the location of proposed drill sites and where LESSEE plans to conduct geophysical operations, build roads, run wire, lay pipelines, and locate supporting facilities, such as mud pits, and storage tanks.

After the Plan has been reviewed by LESSOR, the parties will attempt to coordinate their surface activities. LESSOR will give LESSEE written notice of any objections to the Plan within 7 days following LESSOR's review.

If a proposed well, road, facility location, or activity is objected to by LESSOR, LESSEE will accommodate LESSOR's objections and revise the Plan accordingly unless accommodation would require LESSEE to drill at a location which, based upon the geological information then available to LESSEE, would not be the optimum location. LESSEE will accommodate road or facility location objections unless to do so would significantly burden LESSEE's operations. [or require an additional expenditure in excess of \$_____.]

b. RESTRICTIONS ON LESSEE'S SURFACE RIGHTS.

Unless written authorization is obtained from LESSOR, LESSEE will not do any of the following on the Leased Land: [Drill within 300 feet of any structure, whether an existing structure

or one under construction at the time drilling is proposed.]

c. SURFACE DAMAGE PAYMENTS.

LESSOR and LESSEE recognize it is difficult or impossible to determine actual surface damage from LESSEE's exercise of rights granted by this Lease. Therefore, LESSEE agrees to pay LESSOR, as liquidated damages for all operations authorized by this Lease, \$2500.00 for each Drill Site located on the Leased Land. "Drill Site" means an area which has been prepared to conduct drilling operations even though such operations are never pursued.

This amount represents all damages associated with the drilling, operation, and abandonment of wells on the Leased Land [and reclamation of drill sites and supporting roads and facilities]. However, this amount does not cover any use of the Leased Land which violates the terms of this Lease or goes beyond the rights granted by this Lease. Surface damages will be paid when Operations begin on the Leased Land.

d. RESTORE AFFECTED SURFACE AREA.

[Specify or disclaim any reclamation obligations.]

G. USE OF WATER AND LEASED SUBSTANCES.

1. WATER.

LESSEE will not use any water from the Leased Land except for Produced Salt Water. "Produced Salt Water" means any water produced in conjunction with the Production of a Leased Substance which has a chloride concentration in excess of 5000 milligrams per liter. LESSEE can use Produced Salt Water for Enhanced Recovery operations.

2. LEASED SUBSTANCES.

LESSEE is given the right to use any Leased Substance to support Lease Operations, including Enhanced Recovery operations. If a Leased Substance is consumed, or removed from the Leased Land for use, LESSEE will pay a Royalty on such Leased Substance pursuant to SECTION 10. This includes any Leased Substance used to support Enhanced Recovery operations when LESSEE is unable to demonstrate the Leased Substance will be recovered through Production from the Leased Land.

H. REMOVAL OF EQUIPMENT AND FIXTURES.

For a period of 180 days following Termination of this Lease, LESSEE is given the right to enter the Leased Land to remove any Material on the Leased Land owned by LESSEE.

1. "Termination" means the lease is no longer in effect. The cause of termination is immaterial. However, where LESSEE disputes Termination, and the issue is litigated, the removal period will not commence until the day following issuance of a final judgment in the dispute.

2. "Material" means anything owned by LESSEE and placed on the Leased Land pursuant to this Lease. Material includes such things as equipment, supplies, fixtures, and casing in wells.

I. TITLE.

1. NO WARRANTY.

LESSOR makes this Lease without any warranty, express, implied, or statutory.

2. AFTER-ACQUIRED TITLE.

If at the time of making this Lease LESSOR owns less than the entire surface and mineral estates in the Leased Land, but subsequently acquires, through gift, purchase, reversion, or other means, any interest in the Leased Land, such after-acquired interest is subject to the terms of this Lease. If a watercourse serves as a boundary for the Leased Land, any increase in LESSOR's title by accretion or reliction is included in the grant in SECTION 1.A. and covered by the terms of this Lease.

3. FAILURE OF TITLE.

LESSEE, at its option, may elect to rescind this LEASE if a court determines, as to the oil, gas, and similar hydrocarbon substances, any of the following situations exist:

a. LESSOR does not own such substances in the Leased Land.

b. LESSOR does not have the authority to grant a Lease of such substances.

c. LESSEE will be entitled to less than a 7/8ths share of such substances after accounting for LESSOR's Royalty and any other valid charge against production created by LESSOR or LESSOR's predecessors in title.

If LESSEE rescinds this Lease under this Subsection, LESSOR will pay LESSEE an amount equal to all Bonus, Royalty, [Delay Rental,] and Advance Royalty paid by LESSEE to LESSOR pursuant to this Lease. [Interest]

4. PROPORTIONATE REDUCTION.

If at the time of making this Lease LESSOR does not own 100%

of the mineral interest in a Leased Substance in the Leased Land, LESSOR's rights under this Lease are affected as follows:

a. LESSOR's Royalty on such Leased Substance will be reduced in the proportion that LESSOR's mineral interest bears to 100% of the mineral interest.

b. LESSOR's Bonus will not be affected by this Subsection. "Bonus" means the amount paid by LESSEE to LESSOR at the time this Lease was signed.

c. [LESSOR's Delay Rental under Section 3 will be reduced in the proportion that LESSOR's mineral interest bears to 100% of the mineral interest.

5. LIENS AND ENCUMBRANCES.

LESSEE is given the continuing option to discharge any delinquent tax, mortgage, lien, or other delinquent encumbrance upon the LESSOR's interest in the Leased Land or Leased Substances. To the extent LESSEE obtains a discharge, LESSEE will be subrogated to the rights of the creditor holding the discharged debt. LESSEE may apply any Delay Rental, Royalty, or Advanced Royalty toward satisfaction of any debt discharged by LESSEE under this Subsection.

SECTION 2. DURATION OF GRANT

A. TERMINATION DATE.

Unless extended by Subsection B., this Lease terminates at 5:00 PM 1 March 1990 (called the "Termination Date").

B. EXTENSION OF LEASE.

This Lease can be extended beyond the Termination Date pursuant to the terms of Sections 4, 5, 6, 7, 8, and 9.

SECTION 3. DEVELOPMENT OBLIGATIONS

A. PRIOR TO TERMINATION DATE.

Prior to the Termination Date, LESSEE is under no obligation, express or implied, to explore, develop, or otherwise conduct operations on the Leased Land.

B. AFTER TERMINATION DATE.

If this Lease is extended beyond the Termination Date, LESSEE's development obligations will be governed by the implied covenant law of the state where the Leased Land is located.

SECTION 4. PRODUCTION

The duration of this Lease will extend beyond the Termination Date for so long as there is Production of one or more of the Leased Substances, in Commercial Quantities, from the Leased Land.

A. "Production" means:

The actual extraction of one or more of the Leased Substances from the Leased Land.

B. "Commercial Quantities" means:

The Value of Leased Substances extracted from the Leased Land exceeds Current Operating Costs during an appropriate Accounting Period.

C. "Value" means:

An amount determined by multiplying the Production Attributed To LESSEE times the Price of such Production.

D. Production Attributed To LESSEE.

LESSEE will be deemed to receive 7/8ths of all Production, regardless of what LESSEE's actual share of Production may be after deducting royalty, nonoperating interests, and any other interests payable out of the leasehold interest.

E. Price of Production.

Production sold during the Accounting Period will be deemed to have been sold for an amount calculated by taking the average price paid for extracted Leased Substances during the Accounting Period, adding to such average price the highest price ever paid for extracted Leased Substances during the existence of the Lease, and then dividing the total by two.

F. "Current Operating Costs" include only amounts actually paid by LESSEE which relate directly to the operation of a well or wells on the Leased Land.

1. The following costs are representative of items which will be included as Current Operating Costs:

a. Energy purchased to operate equipment used to produce or market Leased Substances.

b. Taxes relating to the Lease or LESSEE's share of production from the Leased Land.

c. Material and labor necessary for the routine

maintenance of wells.

d. Material and labor necessary for the routine maintenance of roads and other structures used to support production or marketing operations and located on the Leased Land.

e. Transportation of production.

2. The following costs are representative of items which will not be included as Current Operating Costs:

a. Drilling, completing, and equipping wells.

b. Acquiring or replacing major items associated with the continued operation of the Lease. This includes such things as pumping units, tubing, casing, wellhead apparatus, separators, heater-treaters, injection wells, and storage tanks.

c. Stimulating wells, to include fracturing, acidizing, and similar techniques.

d. Reworking operations designed to regain or improve production from a well.

e. Planning for Enhanced Recovery operations and the cost of any pilot project to determine whether Enhanced Recovery techniques are feasible.

f. Overhead, depreciation, and income taxes.

g. Plugging wells and reclaiming affected surface areas.

h. Construction of pipelines necessary to deliver Production to a purchaser.

G. "Accounting Period" means:

A period of time which adequately reflects the productive potential of the Leased Land. The Accounting Period should be long enough to provide LESSEE with sufficient information to determine whether to continue operating the Leased Land. If LESSEE is conducting Enhanced Recovery operations on the Leased Land, the Accounting Period should be long enough to evaluate the success of such operations.

[Alternatives - select a period of time such as 12 months or 18 months to determine production issue.]

SECTION 5. OPERATIONS

If, on the Termination Date, Operations are being conducted

on the Leased Land, this Lease will extend beyond the Termination Date for so long as Operations are being pursued. If Production results from the Operations, this Lease will remain in effect for so long as there is Production in Commercial Quantities as defined by Section 4.

If Operations result in a Dry Hole, LESSEE, at its option, has 90 days following the date the Dry Hole is Completed to begin Operations on a new well. There is no limit on the number of Dry Holes LESSEE can drill under this Section.

A. "Operations" means:

Any action taken toward obtaining or regaining Production. This includes actual drilling and any act preparatory to drilling, such as obtaining permits, contracting for drilling services, surveying a drill site, staking a drill site, building roads, clearing a drill site, and hauling equipment and supplies.

If a well has ceased producing, "Operations" includes any action taken to regain Production. This includes reworking the well and any act preparatory to reworking.

B. "Dry Hole" means:

A well not capable of Production in Commercial Quantities.

C. "Completed" means:

The date the drilling rig is removed from the well site.

SECTION 6. PRODUCTION CEASES

A. TEMPORARY CESSATION.

LESSOR and LESSEE recognize that Production will be interrupted periodically for well maintenance, reworking, and other activities. Such temporary cessations of Production will not terminate this Lease so long as LESSEE takes action within a reasonable time to regain Production.

B. PERMANENT CESSATION.

If Production in Commercial Quantities ceases, due to an exhaustion of recoverable Leased Substances from existing wells, or due to any other cause not covered by SECTION 6.A., LESSEE has 90 days following the date of such cessation to begin Operations in an effort to regain Production in Commercial Quantities from the Leased Land.

SECTION 7. UNABLE TO MARKET PRODUCTION

If the Leased Land is capable of Production in Commercial Quantities, but LESSEE is unable to market Production because of the inability to Access A Market, Unacceptable Terms, or Market Conditions, LESSEE may Declare wells on the Leased Land to be Shut-in.

The duration of this Lease will extend beyond the Termination Date for so long as a Shut-in well exists on the Leased Land.

If LESSEE is relying upon this SECTION to extend the Lease beyond the Termination Date, and Production is Shut-in for 90 consecutive days following the date the well was Declared Shut-in, LESSEE will pay to LESSOR \$500.00 as an Advanced Royalty, regardless of the number of wells Shut-in on the Leased Land.

If Production remains Shut-in, LESSEE will pay LESSOR \$500.00 for each period of 365 consecutive days following the initial 90 day period. LESSEE will pay any Advanced Royalty due under this Section within a reasonable time following the close of the Shut-in period entitling LESSOR to Advanced Royalty.

A. "Access A Market" means:

The availability of a mode of transportation, under reasonable terms, to deliver Leased Substances to a buyer.

B. "Unacceptable Terms" means:

Offered contract terms which are not reasonable when compared with terms of existing contracts with other producers similarly situated to LESSEE. If comparison is not possible, then any term which a reasonable person in LESSEE's position would find unconscionable. The terms may relate to an offer to buy, transport, treat, or market Leased Substances.

C. "Market Conditions" means:

The market price being paid for a Leased Substance is such that a reasonable person in LESSEE's position, having the power to do so, would refrain from marketing the Leased Substance.

D. "Declare" and "Declared" means:

LESSEE provides LESSOR with written notice stating Production from the Leased Land is Shut-in. LESSEE will also indicate, in the notice, why a well is being Shut-in.

E. "Shut-in" means:

A well capable of Production which is not being produced.

F. "Advanced Royalty" means:

A payment made under this SECTION which LESSEE can recoup, on a dollar-for-dollar basis, from future royalty payable to LESSOR. LESSEE can recoup Advanced Royalty only to the extent there is future royalty payable to LESSOR.

SECTION 8. UNAVOIDABLE CIRCUMSTANCES

Calculation of time under this Lease, including the Termination Date and any extensions of the Termination Date, can be affected by any period of time when LESSEE is unable to exercise his Lease rights due to Unavoidable Circumstances. When any event occurs, constituting Unavoidable Circumstances, LESSEE can provide LESSOR with a Suspension Notice. Lease Suspension begins on the date LESSOR receives the Suspension Notice and terminates on the date LESSEE is able to resume exercise of its Lease rights. When a Lease Suspension terminates LESSEE will provide LESSOR with a Resumption Notice.

Any Suspension Period will be added to the Lease and will extend the Lease terms, to include the Termination Date and any extensions of the Termination Date. To claim any Suspension Period, LESSEE must comply with the terms of this SECTION.

The total amount of time that a Lease can be extended by this Section, including all Suspension Periods, cannot exceed 730 days.

If the event giving rise to Unavoidable Circumstances is caused by a wrongful or negligent act of LESSEE, this SECTION will not apply.

A. "Unavoidable Circumstances" means:

Acts of God, including weather and conditions caused by weather, adverse conditions at or near the Leased Land caused by LESSOR or third parties, LESSOR's unauthorized obstruction of LESSEE's activities, laws, orders, or requests by federal, state, and local governments or their employees, unavailability of equipment, material, labor, or support services, or any other act, beyond LESSEE's control, which prevents LESSEE from exercising his Lease rights. If title to the Leased Land or one or more Leased Substances is being disputed, and it would be imprudent for LESSEE to exercise Lease rights until the dispute is determined, court proceedings to determine title constitute Unavoidable Circumstances.

However, it is not Unavoidable Circumstances when LESSEE is unable to exercise Lease rights because of LESSEE's financial condition.

B. "Suspension Notice" means:

LESSEE's written notice to LESSOR describing the Unavoidable Circumstances preventing LESSEE from exercising his Lease rights.

C. "Lease Suspension" means:

The Lease, for all purposes, is suspended. The time for computing any rights or obligations under the Lease are suspended.

D. "Resumption Notice" means:

LESSEE's written notice to LESSOR indicating the specific date Unavoidable Circumstances terminated and LESSEE was able to resume exercising Lease rights.

E. "Suspension Period" means:

The period of time from the date the Suspension Notice was received by LESSOR to the date, indicated in the Resumption Notice, when the events constituting Unavoidable Circumstances terminated. The day the Suspension Notice was received, and the day stated in the Resumption Notice, will each be counted as a day when calculating the total duration of the Suspension Period.

SECTION 9. OPERATIONS WITH OTHER LANDS

A. CREATION OF THE UNIT.

LESSEE is given the right to Pool or Unitize the Leased Land, at any time, with other lands for Consolidated Development. A Unit Declaration will be used to establish the Unit. A Unit can include all or any part of the Leased Land and pertain to any one or more Leased Substances. LESSEE can exercise the right to Pool or Unitize as often as LESSEE deems appropriate. However, once a Unit is created, it cannot be altered by LESSEE without LESSOR's consent.

B. EFFECT ON LEASE RIGHTS.

Production of any Leased Substance from any land which is included in a Unit formed pursuant to this SECTION is deemed, for purposes of this Lease, to be production from the Leased Land. Although a Unit Declaration may be limited to a specific Leased Substance, or limited to a specified depth, formation, or

only include a portion of the Leased Land, Production from the Unit extends this Lease as to all Leased Substances, depths, formations, and all the land described in SECTION 1.A. of the Lease.

For purposes of this Lease, any action taken or occurring on a Unit is deemed to be action taken or occurring on the Leased Land. This includes, without limiting the scope of this Subsection, any action or event required to extend this Lease under SECTIONS 4, 5, 6, 7, and 8.

C. EFFECT ON LESSOR'S ROYALTY.

If a Unit is created under this Section, LESSOR's Royalty will be reduced as follows:

1. LAND POOLED TO CREATE UNIT.

If land is Pooled to create a Unit, LESSOR's Royalty is reduced in the proportion Leased Land surface acreage included in the Unit bears to the total surface acreage comprising the Unit.

2. LAND UNITIZED TO CREATE UNIT.

If land is Unitized to create a Unit, LESSOR's Royalty is reduced in the proportion LESSOR's interests included in the Unit bear to similar interests comprising the Unit as determined by whatever formula LESSEE and other members of the Unit agree to in their Unit Agreement.

D. DEFINITIONS:

1. "Pool" and "Pooled" mean:

Combining lands to comply with dilling, spacing, or proration laws or oil and gas conservation guidelines.

2. "Unitize" and "Unitized" mean:

Combining lands to efficiently develop all or part of a reservoir with the goal of maximizing ultimate recovery of Leased Substances. The unitized area will usually include more than a single drilling, spacing, or proration unit.

3. "Consolidated Development" means:

Any combination of all or part of the Leased Land with other land to form a Pooled or Unitized Unit. Consolidated Development can be used to support primary or Enhanced Recovery operations.

4. "Unit Declaration" means:

A written document which describes the area covered by the Unit, Leased Substances covered by the Unit, LESSOR's proportionate share of Unit production, and the date the Unit becomes effective. The Unit Declaration will be filed for record with the appropriate Register of Deeds and a copy provided to the LESSOR.

5. "Unit" means:

The geographic and geologic area created by a Unit Declaration.

6. "Unit Agreement" means:

A contract between interest owners in the Unit which specifies, among other things, how Production from the Unit will be allocated.

SECTION 10. ROYALTY

LESSEE will pay to LESSOR a Royalty as follows:

A. LESSOR'S SHARE OF PRODUCTION.

1. LEASED SUBSTANCES.

There is excepted from this Lease and retained by LESSOR, out of Production from or attributable to the Leased Land, 12.5% of all Leased Substances Produced And Saved. [NOTE: may want separate royalty provisions for helium, hydrogen, nitrogen, and carbon dioxide.]

2. PRODUCTS FROM LEASED SUBSTANCES.

If LESSEE, or any affiliate of LESSEE, Processes a Leased Substance, LESSOR is entitled to 12.5% of the Leased Substance after Processing. LESSOR has the continuing option to either receive a Royalty on a Leased Substance before or after Processing. LESSOR elects, at this time, to receive Royalty on Leased Substances after Processing.

B. COSTS.

1. DEVELOPMENT, PRODUCTION, PROCESSING, AND MARKETING COSTS.

LESSOR's Royalty is not burdened by any expenses or charges relating to developing, producing, operating, treating, gathering, compressing, transporting, processing, manufacturing, or marketing Leased Substances or Processed Leased Substances.

Such expenses are payable solely from LESSEE's share of Production.

2. TAXES.

Properly assessed taxes, levied against LESSOR's Royalty, can be deducted from LESSOR's Royalty to reimburse LESSEE or any third party properly paying such taxes.

C. OPTION TO TAKE IN KIND.

LESSOR has the continuing option to take all or any part of Royalty in kind by giving LESSEE notice at least 30 days prior to the effective date of LESSOR's election. LESSOR will give LESSEE similar notice in advance of ceasing to take in kind. In the event LESSOR elects to take in kind, LESSOR can require LESSEE to deliver Royalty, without cost to LESSOR, to the pipelines, tanks, separators, or manufacturing plant tailgates which wells on the Leased Land may be connected.

D. VALUE OF PRODUCTION NOT TAKEN IN KIND.

To the extent LESSOR has not elected to take Royalty in kind, LESSEE will pay LESSOR an amount equal to the greater of:

1. GROSS PROCEEDS.

The gross proceeds from the sale of Leased Substances; or

2. MARKET VALUE.

The market value of Leased Substances. It is presumed that a current sale of Leased Substances, to a third party in an arms-length transaction, represents market value.

3. SALES CONTRACTS.

If LESSEE plans to commit its share of Production from the Leased Land to a sales contract, LESSEE will provide LESSOR with a copy of the proposed sales contract. LESSOR has the option, within 30 days following receipt of the sales contract, to elect to have Royalty calculated according to the terms of the sales contract. If LESSOR elects, in writing, to commit to the sales contract, LESSEE will calculate LESSOR's Royalty based upon the proceeds paid to LESSEE under the approved contract.

However, LESSOR's Royalty will be calculated as though any automatic price escalation clause, or other provisions having the potential to increase proceeds payable on production, (such as take-or-pay rights and severance tax reimbursements), became effective on the earliest date permitted under the contract. Royalty will be paid as though such amounts were paid to LESSEE, even though LESSEE fails to initiate the process to become

entitled to the increased proceeds or fails to actually collect such increased proceeds.

E. PAYMENT.

LESSEE will pay LESSOR's Royalty no later than 90 days after Production is obtained from the Leased Land. After the first Royalty payment, subsequent payments will be made no later than 15 days following the month in which the Leased Substances were produced. Any amount not paid when due under this Subsection will bear interest at an annual percentage rate of 18%.

[Payment documentation - monthly accounting information.]

F. DIVISION ORDER

LESSOR agrees to sign division orders certifying LESSOR's ownership interest in Leased Substances and the Leased Land to prevent LESSOR, while the division order remains unrevoked, from claiming any greater ownership interest for purposes of the payment of Royalty. Any division order signed by LESSOR must be revokable at LESSOR's election.

G. DEFINITIONS.

1. "Royalty" means:

LESSOR's share of Production provided for by this SECTION.

2. "Produced And Saved" means:

The Leased Substance has been extracted from the Leased Land and is available for sale or use. Any intentionally flared or vented gas, or gas from a Unit delivered under a free gas clause, is deemed to be Produced And Saved. Leased Substances unavoidably lost during prudent operations are not considered Produced And Saved. Subject to SECTION 1.G.2., Leased Substances used to support Lease or Unit operations are deemed to be Produced And Saved.

3. "Process," "Processed," and "Processing" mean:

A Leased Substance is separated into various products or otherwise treated or altered to enhance its value.

SECTION 11. CHANGE IN OWNERSHIP

A. ASSIGNMENT BY LESSEE.

LESSEE is given the right to Assign all or any part of the Lease.

As to portions of the Lease covered by the Assignment:

To the extent LESSEE's assignee becomes contractually bound to comply with Lease obligations, LESSEE will be relieved of any liability for such obligations arising after the date the Assignment is recorded with the appropriate register of deeds. However, LESSEE remains responsible for all express and implied Lease obligations arising on or before the date the Assignment is recorded. LESSEE will give LESSOR a copy of the Assignment showing the recording date.

Once Lease rights have been divided by Assignment, if the owner of an interest in the Lease fails to comply with express and implied Lease obligations, such failure will not affect the rights of others owning Divided Interests in the Lease.

1. "Assign" and "Assigns" mean:

A written transfer of rights in the Lease, whether technically classified as an assignment or sublease.

2. "Assignment" means:

The written document used to Assign rights in the Lease.

3. "Divided Interests" means:

Rights in the Lease which are segregated from other Lease rights and owned by different owners. Divided Interests include divisions of Lease rights by surface boundaries, depths, and Leased Substance. However, a nonoperating interest carved from an interest in the Lease is not a Divided Interest and will be subject to any rights LESSOR may have against the owner of the interest from which it was carved.

B. CONVEYANCE BY LESSOR.

LESSOR is given the right to convey all or any part of the Leased Land, or Assign its rights under the Lease. However, LESSEE is not required to recognize any conveyance or Assignment until LESSOR provides LESSEE with a copy of the conveyance or Assignment showing the date it was recorded with the appropriate register of deeds. LESSEE is not required to recognize any change in ownership caused by operation of law until LESSEE is provided with a certified copy of the documents evidencing the change in ownership.

However, no change in ownership will in any way affect LESSEE's rights, or enlarge LESSEE's obligations, under this Lease. In no event will LESSEE be required to offset wells on the Leased Land or provide for separate metering and storage of a Leased Substance.

SECTION 12. TERMINATION BY LESSEE

LESSEE may, at any time, voluntarily terminate all or part of the rights and obligations created by this Lease. LESSEE will terminate Lease rights and obligations by filing a Release with the appropriate register of deeds identifying the Lease rights being terminated.

As to portions of the Lease covered by the Release, LESSEE will be relieved of any liability, under express or implied Lease obligations, arising after the date the Release is recorded. However, LESSEE remains responsible for all express and implied Lease obligations arising on or before the date the Release is recorded. LESSEE will give LESSOR a copy of the Release which shows the recording date.

For purposes of this Lease, "Release" means a written document which effectively surrenders to LESSOR Lease rights specified in the document.

SECTION 13. DILIGENCE AND GOOD FAITH

All rights and obligations under this Lease will be exercised with appropriate diligence and in good faith.

The relationship between LESSOR and LESSEE created by this Lease is not a fiduciary relationship.

SECTION 14. PRIOR DISCUSSIONS AND WRITINGS

Signing this Lease voids all prior or contemporaneous oral or written communications regarding matters addressed by this Lease. There are no oral or written conditions to this Lease taking effect that are not expressly stated in this Lease.

SECTION 15. SUBSEQUENT MODIFICATIONS

This Lease can be modified only by a writing which references this Lease, states the SECTION modified, the modification, and is signed by LESSOR and LESSEE.

SECTION 16. INDEX OF LEASE TERMS

If a term is defined in this Lease, and the term is being used in its defined context, the first letter of each word in the term will be capitalized. An index of where terms are defined in this Lease follows:

[List term and the SECTION and page where it is defined.]

SECTION 15. BINDING EFFECT

The terms of this Lease are binding upon the successors and assigns of LESSOR and LESSEE.

THIS LEASE GRANTS SIGNIFICANT PROPERTY RIGHTS WHICH MAY LAST FOR AN EXTENDED PERIOD OF TIME. EACH PARTY SHOULD CONSULT AN ATTORNEY VERSED IN OIL AND GAS LAW BEFORE SIGNING.

SIGNED TO TAKE EFFECT THIS _____ DAY OF _____,
19____ ("Effective Date").

FRED A. FARMER

FRITA B. FARMER

DAVID E. PIERCE

ACKNOWLEDGMENT

This OIL AND GAS LEASE was acknowledged before me on the _____ day of _____, 19__ by Fred A. Farmer, Frita B. Farmer, and David E. Pierce.

(Seal, if any)

BETTY ROE, Notary Public
My appointment expires:_____

[Alternative Drilling/Delay Rental Provision]

SECTION 3. DEVELOPMENT OBLIGATIONS

A. PRIOR TO TERMINATION DATE.

1. NO DEVELOPMENT OBLIGATION.

Prior to the Termination Date, LESSEE is under no obligation, express or implied, to explore, develop, or otherwise conduct Operations on the Leased Land.

2. DELAY RENTAL.

a. NO OPERATIONS.

If LESSEE fails to conduct Operations (as defined in SECTION 5.A.) on the Leased Land on or before the 365th day following the Effective Date of this Lease, LESSEE will pay to LESSOR \$100.00 as a "Delay Rental." For each successive period of 365 days during which LESSEE fails to conduct Operations, LESSEE will pay a like amount to LESSOR as Delay Rental.

Payment under this Subsection is deemed made when LESSEE mails a check, in the stated amount and payable to LESSOR, to LESSOR's address stated in the first paragraph of this Lease. If LESSOR's address changes, LESSOR will provide LESSEE with written notice of LESSOR's new address.


If LESSEE divides the Leased Land by surface boundary and Assigns an interest in the Lease, Delay Rental obligations will be apportioned among LESSEE and any assignees based upon the proportion Leased Land surface acreage covered by the Assignment bears to the total surface acreage comprising the Leased Land.

b. OPERATIONS.

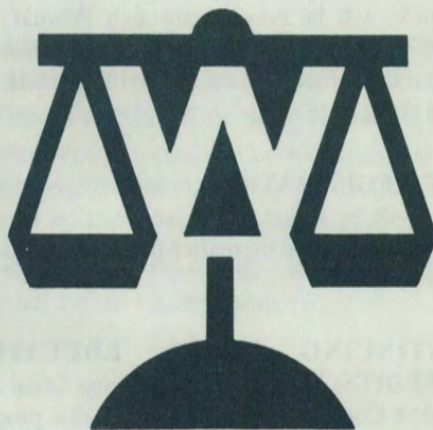
If LESSEE actually drills a Well on the Leased Land no further Delay Rental will be required under this SECTION. "Well" includes a well producing in Commercial Quantities, a Shut-in well, or a Dry Hole.

B. AFTER TERMINATION DATE.

If this Lease is extended beyond the Termination Date, LESSEE's development obligations will be governed by the implied covenant law of the state where the Leased Land is located.



DRAFTING A BETTER OIL AND GAS LEASE



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