THE FINE PRINT MATTERS: NEGOTIATING AN OIL AND GAS LEASE IN NORTH DAKOTA

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I. THE NORTH DAKOTA POWERBALL

North Dakota has become the talk of the nation when it comes to domestic energy production. The talk has people in high places paying attention. On January 24, 2012, President Barack Obama spent several paragraphs of his State of the Union address highlighting the increases in domestic energy production.[1] "[R]ight now—American oil production is the highest that it's been in eight years," noted President Obama.[2] For emphasis, the President then added, "[n]ot only that—last year, we relied

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1. *Remarks by the President in State of the Union Address*, THE WHITE HOUSE (Jan. 24, 2012), http://www.whitehouse.gov/the-press-office/2012/01/24/remarks-president-state-union-address.

2. *Id.*

less on foreign oil than in any of the past [sixteen] years."[3] Less reliance is, thanks in large part, to the oil production from North Dakota. In mid-January of 2012, Lynn Helms, State Mineral Resources Director, announced North Dakota's oil developers had surpassed the half-million-barrels-per-day milestone.[4] The Associated Press reported "North Dakota went from the ninth-biggest producer in 2006 to fourth in 2009. Helms said North Dakota is on track to become the nation's [number two] oil producer early next year [2013], surpassing California and Alaska, and trailing only Texas."[5]

Headlines such as Bloomberg Businessweek's "North Dakota Surpasses OPEC Member Ecuador in Oil Production" is one of hundreds regularly appearing daily in newspapers and media reports across the country.[6] Last fall, the inaugural episode of NBC's weekly television news show, *Rock Center with Brian Williams*, featured "Now Hiring: North Dakota Oil Boom Creates Thousands of Jobs," proclaiming that some are predicting the Bakken formation "will produce the biggest boom in North America since the 1960s."[7] Everyone from the New York Times to the Wall Street Journal and CNN to NBC is covering this modern-day energy oasis.

Today, for North Dakotans, these headlines take on a whole new meaning as a letter may arrive on your own front porch from BigTime Energy Co., one of the many mineral developers in North Dakota.[8] It is the North Dakota Powerball without even buying a ticket. The letter may explain your grandfather owned mineral rights in Mountrail County.[9] He

3. *Id.*

4. Press Release, N.D. Dep't of Mineral Res., Oil & Gas Division, North Dakota Surpasses Half a Million Barrels of Oil Per Day (Jan. 10, 2012), *available at* https://www.dmr nd.gov/oilgas/pressreleases/PressRelease01102012.pdf.

5. James MacPherson, *ND Oil Production Exceeds 500,000 Barrels Daily*, BLOOMBERG BUSINESSWEEK, Jan. 10, 2012, *available at* http://www.businessweek.com/ap/financialnews/D9S69H980 htm.

6. *See* Joe Carroll, *North Dakota Surpasses OPEC Member Ecuador in Oil Production*, BLOOMBERG BUSINESSWEEK, Jan. 12, 2012, *available at* http://www.businessweek.com/news/2012-01-12/north-dakota-surpasses-opec-member-ecuador-in-oil-production html. The story reports that "North Dakota oil production surged [forty-two] percent to 510,000 barrels a day in November [2011], exceeding the output of OPEC member Ecuador, as energy explorers accelerated drilling in the Bakken Shale formation." *Id.* The story also notes, like many, that the Bakken Shale is "estimated to hold as much as 4.3 billion barrels of technically [sic] recoverable oil in North Dakota and Montana, according to a 2008 report by the U.S. Geological Survey." *Id.*

7. *Now Hiring: North Dakota Oil Boom Creates Thousands of Jobs*, ROCK CENTER WITH BRIAN WILLIAMS (Oct. 27, 2011), http://rockcenter msnbc msn.com/_news/2011/10/27/8495501-now-hiring-north-dakota-oil-boom-creates-thousands-of-jobs.

8. To the author's knowledge, BigTime Energy Co. is a fictitious company. There is no such company registered with the North Dakota Secretary of State.

9. The mineral estate is a separate interest from the surface estate. *See* Burlington N., Inc. v. Hall, 322 N.W.2d 233, 240 (N.D. 1982). A disappointing surprise to many North Dakota surface

died in 1955. The minerals were never probated because they were not worth a Buffalo nickel then. They are worth something now, potentially millions of Buffalo nickels. BigTime Energy Co. wants to pay your family a $1000 per net acre mineral bonus and is offering a fifteen percent royalty. If the letter further says your grandfather owned 640 net mineral acres, there is a bonus payment of $640,000 (the $1000 per acre bonus times 640 mineral acres). All you and your two siblings, your grandfather's only surviving heirs, have to do is sign the lease enclosed with the letter and you can pay off your mortgage, get rid of your farm loans, and put your kids through college. Basically, you are one signature away from never having to worry about money again. Why in the name of Jed Clampett would you not sign this lease?

II. THE FINE PRINT MATTERS: WHAT IS IN YOUR BEST INTEREST

The scene just described is playing out in living rooms all across North Dakota. Letters containing such leases arrive daily in mailboxes from Crosby to Casselton. So, what do you do once you receive this letter with an oil and gas lease? The promise of quick money is tempting, but the lease is filled with terms and language you do not understand. Common sense dictates you should not sign a contract without some sort of understanding of what you are committing to in the contract. You decide to call the regional land manager for BigTime Energy Co. who sent you the letter. The land manager, Mr. Lacero, tells you the lease is fair, the terms are better than what anybody else is offering, and you have nothing to worry about.[10]

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owners is the "well-settled rule that where the mineral estate is severed from the surface estate, the mineral estate is dominant." Hunt Oil Co. v. Kerbaugh, 283 N.W.2d 131, 135 (N.D. 1979). To the consternation of many surface owners, the rule means the:

> mineral ownership of necessity carries with it inherent surface rights to find and develop the minerals, which rights must and do involve the surface estate. Without such rights the mineral estate would be meaningless and worthless. Thus, the surface estate is servient in the sense it is charged with the servitude for those essential rights of the mineral estate.

Id. Notwithstanding, the surface owner does have some rights under the Surface Owner Protection Act. *See* N.D. CENT. CODE ch. 38-18 (2004).

10. Mineral owners are not required to sign the lease. When presented with a lease, mineral owners have several options: (1) sign the lease; (2) elect to participate in the well and pay their percentage share of the costs upfront and, in turn, receive a full share of anything produced; or (3) refuse to sign the lease, in which case they are deemed a nonparticipating owner. If they elect to go nonparticipating, they will not pay any upfront costs for their share of the well and have no risk of loss if nothing is produced. However, if minerals are produced, before they receive their share of the production, the operator will deduct the nonparticipator's share of the drilling costs plus an additional "risk penalty" authorized by North Dakota law. *See* N.D. CENT. CODE § 38-08-09.4. This article proceeds under the assumption the mineral owner decides negotiating and/or signing a

Do you take his advice and sign? I would not, at least not without a grain, or two, of salt. Mr. Lacero works for BigTime Energy Co., and contrary to anything he tells you, he does not work for you. His best interest, and the best interest of his company, is to get you to sign the lease for as cheap as possible and on terms most favorable to BigTime Energy Co. It is self-evident, but you should proceed under what is in your best interest. Several important questions then arise, like what is in your best interest? How do you even know what to look for in the lease? Is the $1000 per net acre bonus and fifteen percent royalty offered by BigTime Energy Co. reasonable? Does the lease have a Pugh clause;[11] what qualifies as drilling operations; is the force majeure[12] provision too broad; does a shut-in well[13] hold the lease; what exactly does held by production mean; and who is responsible for damages if something goes wrong? These questions pertain to just a few of the many important clauses contained in an oil and gas lease.

An oil and gas lease is a complex legal document with many moving and interacting parts. Make no mistake, the fine print matters. A seemingly innocuous clause buried within many lines of that fine print can lead to substantial headaches down the road in the form of lost income, costly court battles, or—perhaps most importantly—your land being tied up for decades with little or no benefits realized. Without being melodramatic, an oil and gas lease is unlike any other contract you have ever dealt with in your life.[14] A leading authority on contract law has described these leases as belonging to a category by themselves. "Gas and oil leases and contracts are a part by themselves. There is scarcely any comparison between them and the ordinary farm or house lease . . . ."[15] This uniqueness was summarized fifty years ago by the Alabama Supreme Court: "The situations in which courts

lease is the most favorable option. In some cases, it may make more sense for the mineral owner to either elect to become a participating owner or nonparticipating owner, but that decision is the subject for another article.

11. *Infra* Part II.D.

12. *Infra* Part II.E.

13. *Infra* Part II.E.

14. While oil and gas leases are unique, they are interpreted under the general rules of contract law. "The same general rules that govern interpretation of contractual agreements apply to oil and gas leases." Egeland v. Cont'l Res., Inc., 2000 ND 169, ¶ 10, 616 N.W.2d 861, 864 (citing Johnson v. Mineral Estate, Inc., 343 N.W.2d 778, 780 (N.D. 1984)).

15. 17 RICHARD A LORD, WILLISTON ON CONTRACTS § 50:57 (4th ed. 2000) (quoting Moorer v. Bethlehem Baptist Church, 130 So. 2d 367, 371 (Ala. 1961)). When it comes to an oil and gas lease, even the most experienced and knowledgeable judicial body on the subject, the Texas Supreme Court, has recognized their uniqueness. "The Texas Supreme Court has explained that oil and gas leases are unique: In Texas it has long been recognized that an oil and gas lease is not a 'lease' in the traditional sense of a lease of the surface of real property." Ramsey v. Grizzle, 313 S.W.3d 498, 502 (Tex. Ct. App. 2010).

have been called upon to determine the nature of the legal interest created by oil and gas leases are many and diverse, involving practically all of the classifications of legal interests and of legal operative acts."[16]

With this principle in mind, case law on the topic interpreting oil and gas leases is chalk full of legalese, such as "[t]he vast majority of oil and gas leases use judicially defined terms such as 'market value at the well' or 'amount realized' to measure the lessor's royalty,"[17]

> [t]he 'unless' clause states a limitation upon which the lease terminates if no drilling or payment of delay rentals occurs. Because no covenant or duty is imposed by the clause, the lessor cannot recover in an action for damages for failure to drill or for the failure to pay rentals,[18]

and

> defendant's operations automatically extended the lease term. Drilling operations commence when (1) work is done preparatory to drilling, (2) the driller has the capability to do the actual drilling, and (3) there is a good faith intent to complete the well. It is not necessary that the drill bit actually penetrate the ground.[19]

These three examples are just a few of the seemingly innocuous clauses to the untrained eye that can eventually have a significant impact on the mineral owner. To put it mildly, for those who decide to proceed without the assistance of legal counsel in interpreting or negotiating an oil and gas lease, *caveat emptor*, or buyer beware.[20]

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16. *Moorer*, 130 So. 2d at 371-72 (quoting a leading oil and gas treatise). Similarly, fifty years after *Moorer*, with the latest oil boom in North Dakota, North Dakota courts are frequently being called on to adjudicate disputes involving the nature of those legal interests, rights, and obligations created by oil and gas leases.

17. Yturria v. Kerr-McGee Oil & Gas Onshore, LLC, 291 F. App'x 626, 630 (5th Cir. 2008).

18. Norman Jessen & Assocs., Inc. v. Amoco Prod. Co., 305 N.W.2d 648, 651 (N.D. 1981).

19. Murphy v. Amoco Prod. Co., 590 F. Supp. 455, 458 (D.N.D. 1984) (citations omitted). In finding Amoco's activities constituted "drilling operations" under the lease, which operated to extend the lease beyond its primary term, the court explained:

> [p]rior to the expiration date of the primary term, defendant had undertaken substantial activities in preparation for spudding the well. The work had progressed so far that the preliminary drilling for the piping was done. A workover rig capable of spudding was in place and operating. And defendant had a good faith intent to complete the well, as evidenced by the advanced stage of drilling operations reached on the eve of expiration and by defendant's actually and timely completing the well.

Id. The lease did not specifically define what activities constituted drilling operations. As discussed herein, what activities constitute "drilling operations" sufficient to hold a lease beyond its primary term is emerging as a subject of dispute between mineral developers and mineral owners starting to play out in North Dakota courts. *See infra* Part II.C.

20. This article examines several provisions of the oil and gas lease. There are numerous other provisions of the lease not addressed herein and the reader should not rely on this article as a

A. NEGOTIATING AN OIL AND GAS LEASE

In its most basic and common form, an oil and gas lease is a contract whereby the mineral owner agrees to allow the mineral developer the right to explore and drill on his or her land in exchange for an up-front lease bonus payment and a royalty percentage of whatever is actually produced.[21] As such, an oil and gas lease is by necessity "a cooperative venture in which the lessor contributes the land and the lessee the capital and experience necessary to develop the minerals for the mutual benefit of both parties."[22] Most mineral developers have a particular form lease they use, oftentimes written or reviewed by lawyers with significant experience in the area. The starting point in any lease negotiation—like any contract negotiation—is that everything is negotiable. Many internet sites purporting to offer helpful tips to mineral owners, including those from "oil and gas" law firms, emphasize this point ad nauseam. A "Checklist for Negotiating an Oil and Gas Lease" from the Texas Land & Mineral Owners Association advises that "all lease terms are negotiable. The landman acquiring the lease may not have the authority to negotiate those terms, but someone does. Don't be timid."[23]

In theory, this advice is true. And certainly, in any negotiation, it is important to project confidence and show backbone. In practice, the "everything is negotiable" theory is perhaps a stretch, particularly for most North Dakotans with mineral interests. Rare is the case where the mineral developer will agree to every term proposed or every modification requested by the mineral owner. Like any negotiation, the ability to bargain depends on your leverage. In negotiating an oil and gas lease, leverage depends primarily on three key factors: (1) how many mineral acres you own; (2) how close those acres are to known production; and (3) how many suitors are competing to lease that acreage.[24] The more acres you own and

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security blanket when negotiating a lease. Reading a single law review article or internet research is not a substitute for obtaining qualified legal counsel.

21. "A lease is nothing more than a contract between the parties which contract contains certain bargained-for promises." Olson v. Schwartz, 345 N.W.2d 33, 41 (N.D. 1984) (Schneider, J., concurring); *see also* 17 LORD, *supra* note 15, § 50:57 ("A gas, oil, or other mineral lease is a contract by which a lessee is granted the right to explore for and produce mineral resources on the lands of another. Although the right to explore and develop one's property for production of minerals and to reduce minerals to possession and ownership belongs exclusively to the landowner, the landowner may convey, reserve, or lease that privilege.").

22. Klein v. Jones, 980 F.2d 521, 531 (8th Cir. 1992) (referring to the idea that the lease is a cooperative venture as the "Harrell Rule"). *See generally* Thomas A. Harrell, *Developments in Nonregulatory Oil and Gas Law*, 30 INST. ON OIL & GAS L. & TAX'N 311 (1979).

23. JOHN B. MCFARLAND, CHECKLIST FOR NEGOTIATING AN OIL AND GAS LEASE 2 (2006), *available at* http://www.tlma.org/oilgasleasechecklist.pdf.

24. This triad of factors is a familiar mantra from those advising mineral owners in negotiating leases. *See, e.g.*, JUDON FAMBROUGH, HINTS ON NEGOTIATING AN OIL AND GAS

the closer those acres are to production, the more valuable your mineral interest. These factors generally determine the bonus payment and royalty percentage offered by the mineral developer.[25]

B. MONEY IS NOT EVERYTHING (ALTHOUGH IT IS IMPORTANT)

Value should not be measured by money alone; i.e., the bonus payment and royalty percentage. While the bonus payment and royalty percentage are certainly two of the most significant terms of any oil and gas lease,[26] and the most economically appealing, they are not the panacea. This is especially true if you also own the surface rights and are farming, ranching, or living on or near the acreage subject to the lease. In that case, there are numerous terms that should be considered, including water use and rights, the construction of roads and pipelines, and prohibiting drilling within a defined distance of farm buildings. Failure to specifically delineate the parties' rights and responsibilities as related to activities occurring on the surface estate can lead to costly litigation that was completely preventable.

As previously noted, the surface estate is servient to the mineral estate and the mineral developer can use as much of the surface as is reasonably necessary to explore, develop, and transport the minerals.[27] What happens when damage resulted to the surface estate even though the use of the surface was reasonably necessary? Is the mineral developer or mineral owner liable, or are both liable?[28] This question can be addressed with one

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LEASE 1 (1997), *available at* http://recenter.tamu.edu/pdf/229.pdf ("Three factors influence the negotiating power of the mineral owner. The first is the amount of acreage the lessor controls. The second is the proximity of the acreage to known production. And the third is the number of oil companies vying for the lease. The ideal situation for the mineral owner is to have a larger tract next to a newly discovered field with numerous oil companies seeking a lease.").

25. *See* N.D. INDUS. COMM'N, DEP'T OF MINERAL RES., OIL & GAS DIV., https://www.dmr nd.gov/oilgas/ (last visited Feb. 26, 2012) (providing tools for determining how close your acreage is to known production). The GIS Map Server tool allows users to enter their township, range, and section and see the drilling activity or actual production in the area. The map also shows the well number, which can be used to locate the well's operator, view the well file and the production history from that well. For example, if you enter Township: 151, Range: 95, and Section: 8, you will see Hess Corporation has several active wells in 151-95-8 (file nos. 10149, 18218, and 9951). *Id.* (follow "GIS Map Server," click on "Find Section," and enter information).

26. As a side note, the mineral owner should request the term of royalty payment be a "condition" instead of a "covenant," and breach of this condition—missing a royalty payment—results in the termination of the lease at the lessor's option if the payment is not made within a predetermined number of days, such as thirty days.

27. *See* Hunt Oil Co. v. Kerbaugh, 283 N.W.2d 131, 135 (N.D. 1979).

28. In *Hunt Oil Co.*, the North Dakota Supreme Court noted, "[t]his case does not present, nor does this opinion decide, the issue of whether or not the owner or lessee of the mineral estate is liable for damages arising from the reasonably necessary use of the surface incident to exploration, development, and transportation of the minerals." *Id.* at 135 n.4. This reminder is helpful to practitioners and mineral owners alike to specifically address such liability in the lease.

simple sentence in the lease: "The lessee [BigTime Energy Co.] shall be liable and indemnify the lessor [mineral owner] for any and all damages caused by its operations." The clause protects the mineral owner and defines the parties' liabilities in the event the mineral developer's operations cause damages. The North Dakota Supreme Court has explained, "[e]ven though the surface rights of the lessee may arise by implication, it is important to note that lessee's rights are primarily governed by the specific grant of such rights in the lease."[29] Being able to point to a specific controlling clause also acts as a buffer to costly court battles as the parties rights' are defined clearly by the lease.

C. THE HABENDUM CLAUSE AND HELD BY PRODUCTION: ANOTHER CASE FOR CLEARLY DEFINING TERMS

The duration of any oil and gas lease is controlled by the habendum clause. The habendum clause sets forth the duration of the mineral developer's interest in the lessor's property.[30] The duration of any oil and gas lease consists of two terms: the primary term and the secondary term. The primary term is the initial term of the lease and typically consists of a three- or five-year term.[31] If production occurs within the initial term, the lease then extends into a secondary term.[32] The secondary term continues

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29. Feland v. Placid Oil Co., 171 N.W.2d 829, 834 (N.D. 1969). In reaching its conclusion, the court further stated,

> in the lease before us, express uses of the surface were set forth and the extent of such uses was specified . . . . The case before us is controlled by the express provision as to extent or scope of the use to be made of the surface, rather than any implied right to use.

Id. (quoting Texaco, Inc. v. Faris, 413 S.W.2d 147, 149 (Tex. Civ. App. 1967)).

30. *See* Egeland v. Cont'l Res., Inc., 2000 ND 169, ¶ 3 n.1, 616 N.W.2d 861, 862 n.1 ("A habendum clause sets forth 'the duration of the grantee's or lessee's interest in the premises.'") (citations omitted).

31. During previous oil booms in North Dakota, it was not unusual for mineral owners to agree to seven- or ten-year primary terms. *See, e.g.*, Sorum v. Schwartz, 411 N.W.2d 652, 652 (N.D. 1987) (noting a ten-year primary term); Olson v. Schwartz, 345 N.W.2d 33, 34-35 (N.D. 1984) (noting ten-year primary terms); *Feland*, 171 N.W.2d at 830 (noting a ten-year primary term). Today, a mineral owner should immediately see a red flag if a developer proposes a seven- or ten-year primary term.

32. An example of a common habendum clause was included in *Egeland*.

> It is agreed that this lease shall remain in force for a term of FIVE (5) years from this date, and as long thereafter as oil, gas, casinghead gas, casinghead gasoline and other hydrocarbon substance or any of them is produced from said leased premises, or drilling operations are continued as hereinafter provided. If, at the expiration of the primary term of this lease, oil or gas is not being produced on the leased premises but lessee is then engaged in drilling operations, then this lease shall continue in force so long as drilling operations are being continuously prosecuted on the leased premises; and drilling operations shall be considered to be continuously prosecuted if not more than sixty days shall elapse between the completion or abandonment of one well and the beginning of operations for the drilling of a subsequent well. If oil or gas shall be

indefinitely so long as production continues. The idea that the lease continues indefinitely so long as oil or gas is produced is referred to as "held by production."[33] Intertwined with the primary term and continuation of the lease into its secondary term is the "continuous drilling operations" clause.[34] This clause provides that a lease may continue after its primary term without actual production so long as drilling operations are continued as set forth in the lease.[35]

The interplay between actual production, continuous drilling operations, and what qualifies as drilling operations sufficient to hold a lease beyond its primary term is an emerging topic of litigation in North Dakota. Whether it is mineral developers arguing that mere staking and surveying for a well qualifies as drilling operations that hold the lease, or mineral owners arguing a four-month period of cessation in production several years ago does not constitute drilling operations and the lease was terminated as a result, the dispute underlines the importance of specifically defining terms—in this case, "drilling operations" in the lease.[36] The mineral owner's failure to define drilling operations as limited to those operations whereby the appropriate equipment is onsite with the capability for physically drilling or reworking the well, not merely minimal preparatory steps taken to demarcate the boundaries of the well or preliminary administrative steps like securing permits from the necessary agencies, can bolster the mineral owner's argument that a lease has terminated.[37] Defining the terms, like drilling operations, in advance leaves

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> discovered and produced from any such well or wells drilled or being drilled at or after the expiration of the primary term of this lease, this lease shall continue in force so long as oil or gas shall be produced from the leased premises.

Egeland, ¶ 3, 616 N.W.2d at 863.

33. *See, e.g.*, Greenfield v. Thill, 521 N.W.2d 87, 89 (N.D. 1994) (explaining the concept of "held by production" extending an oil and gas lease).

34. *See Egeland*, ¶ 3 n.2, 616 N.W.2d at 862-63 n.2.

35. *See id.* ("A continuous drilling operations clause provides that a lease may be kept alive after the expiration of the primary term and without production by drilling operations of the type specified in the clause continuously pursued.") (citations and internal quotations omitted).

36. As a result, North Dakota oil and gas practitioners have become intimately acquainted with North Dakota Century Code section 47-16-36, which outlines the process for declaring an oil and gas lease terminated or forfeited. The importance of following the statutory requirements of section 47-16-36 has been recognized by the North Dakota Supreme Court. *See* Ridl v. EP Operating Ltd. P'ship, 553 N.W.2d 784, 787 (N.D. 1996) (stating the consequence of the lessee's failure to notify the register of deeds within twenty days of being served notice of termination was loss of record notice "to the public of the existence of said lease or of any interest therein, or rights thereunder, and said record shall not be received in any court of the state on behalf of the lessee . . . ").

37. *See* MCFARLAND, *supra* note 23, at 3 (advising mineral owners to "[c]learly define what is necessary to constitute drilling operations, and when drilling operations are completed [as well as d]efine what 'operations' will maintain the lease in effect beyond the primary term absent actual production").

the mineral owner free to negotiate subsequent leases for more favorable terms rather than engaging in a protracted court battle should the mineral developer fail to continue drilling operations pursuant to the lease.[38]

D. THE PUGH CLAUSE

One of the other more important clauses in the oil and gas lease that relates to the habendum clause is the Pugh clause. The failure to include a Pugh clause in your lease can result in your acreage being tied up indefinitely with little benefit from production if those acres are pooled into a single unit. Acres belonging to different owners are often pooled into a single unit for drilling and production purposes.[39] Most leases contain a clause allowing the mineral developer to combine your acres with adjoining leased acres.[40] The Pugh clause provides that drilling operations or production from a pooled unit or units maintains the lease only for the acres included within the unit or units.[41]

The practical application of the Pugh clause demonstrates its importance. The general rule is an oil and gas lease is indivisible and

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38. It should be noted that nonstop continuous production is not required to extend the lease beyond its primary term.

> [The North Dakota Supreme Court has] addressed the effect of a cessation of production during the secondary term of an oil and gas lease containing a similar habendum clause. [It] held that, where the lease has been extended beyond its primary term by production, a temporary cessation of production will not automatically terminate the lease. This is the universally accepted rule for leases.

Greenfield, 521 N.W.2d at 89 (internal citations omitted).

39. In *Egeland*, the North Dakota Supreme Court described the relationship between spacing and pooling:

> Spacing and pooling are separate concepts. A pool is a reservoir, or a common source of supply, and constitutes a common accumulation of oil or gas, or both. A spacing unit is the area in each pool which is assigned to a well for drilling, producing, and proration purposes in accordance with the commission's rules or orders. A spacing order standing alone without a pooling order does not operate as a de facto pooling of all fractional interests under the drillsite . . . .

Egeland, ¶ 11 n.5, 616 N.W.2d at 865 n.5.

40. The mineral owner can negotiate for a clause providing any pooling and unitization has to be with his or her consent. Pooling is authorized by North Dakota Century Code section 38-08-08. However, as noted in *Egeland*, the mineral developer can overcome the required consent of the mineral owner.

> Under [section 38-08-08], pooling of a spacing unit can occur either (1) by the parties voluntarily pooling their separately owned tracts or interests, or (2) by the Commission's order entered upon the application of any interested person. Consent of an individual interest owner is relevant only under the first option. Consent is irrelevant if an interested person applies to the [North Dakota Industrial] Commission for a pooling order.

Id. ¶ 12, 616 N.W.2d at 865.

41. *Id.* ¶ 4 n.4, 616 N.W.2d at 863 n.4 ("A Pugh clause is 'a type of pooling clause which provides that drilling operations on or production from a pooled unit or units shall maintain the lease in force only as to lands included within such unit or units.'").

production or operations on any part of the land included in the lease perpetuates the lease beyond its primary term.[42] Let's assume that of the 640 acres subject to your lease with BigTime Energy Co., forty acres later become part of a drilling unit. Without a Pugh clause, production anywhere within that pooled acreage holds your entire lease. "In other words, a principal effect of the pooling or the unitization of a lease in most states is to preserve the entire lease even if only a portion, however small, of the lease is included in the unit."[43] The result is that your royalty interest can be diluted and, perhaps worse, the bulk of your acres can sit idle without any drilling or production necessary to extend the lease beyond its primary term.

The Pugh clause solves that problem. In the previous example, if your lease included a Pugh clause, only the forty acres within the drilling unit is held by the drilling or production that occurs within that unit. The remainder of your 600 acres is not affected and the mineral developer will have to engage in activities pursuant to the lease to extend the primary term. As noted by the North Dakota Supreme Court, "[t]he main purpose of a Pugh clause is to protect the lessor from the anomaly of having the entire property held under a lease by production from a very small portion, and the clause is designed to foster reasonable development of leased property."[44] If mineral owners have any substantial amount of acreage, they should insist on having a Pugh clause in their lease. Like other clauses providing protection to the mineral owner, unless you specifically request a Pugh clause, you cannot be guaranteed the mineral developer will include it in its proposed lease.

E. OTHER CONSIDERATIONS: FORCE MAJEURE, WARRANTY OF TITLE, IMPLIED COVENANTS, SHUT-IN ROYALTY, ETC.

There are numerous other provisions that should be considered when negotiating an oil and gas lease with the mineral developer. Several, warrant specific mention, although this list is by no means exhaustive.

42. *Id.* ¶ 16, 616 N.W.2d at 866.

43. *Id.* (internal quotations and citation omitted); *see also id.* ("The majority rule is governmental pooling and unitization orders do not divide a lease, and production anywhere on the pooled acreage holds all leases that may be wholly or partly in the unit.").

44. *Id.* ¶ 17. For example, the Pugh clause in *Egeland* stated "[a] producing well, or well capable of production, will perpetuate this lease beyond its Primary Term ONLY as to those lands as are located within, or committed to, a producing or spacing unit established by a Government authority having jurisdiction." *Id.* ¶ 18, 616 N.W.2d at 867; *see also* 38 AM. JUR. 2D *Gas and Oil* § 178 (2d ed. 2010) (discussing the Pugh clause).

These include removing any language warranting title,[45] limiting the scope of the force majeure clause,[46] stipulating any shut-in gas provisions cannot extend the lease for more than two years beyond the primary term,[47] specifically defining production as paying production,[48] eliminating any provisions where the mineral owner has to notify the mineral developer of offers to top lease the acreage,[49] and including language clarifying that

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45. Most leases contain a clause providing the mineral owner warrants they have title to the property subject to the lease and will defend and indemnify the lessee from any claims against the mineral owners' title. In the vast majority of cases, it is the mineral developer that commissioned the search, or title opinion, to determine who owns the mineral interests. The mineral owner should not hold themselves responsible and agree to defend and indemnify the mineral developer for their mistake. The failure to remove this provision from the lease can have serious consequences. *See, e.g.*, 25 LORD, *supra* note 15, § 66:95.

46. *See, e.g.*, 38 AM. JUR. 2D, *supra* note 44, § 83 (explaining the force majeure clause extends leases when circumstances are unforeseeable and beyond the parties' control and noting, among other things, "[t]he parties to an oil, gas, or mineral lease are assumed to know what laws and regulations will affect the lessee's ability to win permits, and for that reason a lessee's failure to secure a permit is not deemed an event of force majeure"). *See generally* Joan Teshima, Annotation, *Gas and Oil Lease Force Majeure Provisions: Construction and Effect*, 46 A.L.R. 4TH 976 (1986). Notwithstanding, the force majeure clause in too many oil and gas leases is now written to give the mineral developer broad protections against foreseeable events or the effects of uncertain government rules and regulations. Narrowing force majeure to true "Act of God" events, like floods, fires, wars, etc., limits the mineral developers ability to hold the lease indefinitely without production in the event of governmental rules and regulations they deem unfavorable or in the event the developer cannot procure the necessary permits, equipment, and the like.

47. *See, e.g.*, 38 AM. JUR. 2D, *supra* note 44, § 84 ("A 'shut-in royalty clause' in an oil and gas lease allows the lessee to keep a nonproducing lease in force by paying a predetermined amount as a substitute for royalty payments from production; the clause allows the lessee to hold the lease while waiting for the market to improve but ensures that the lessor continues to receive some benefit from the lease."). This "benefit from the lease" is a misnomer as the typical payment under a shut-in royalty clause is one dollar per acre, per year. Even if a mineral owner has substantial acres under lease, this payment results in a small benefit compared to royalty payments from production. By capping the shut-in royalty clause at two years, the mineral developer cannot rely on a shut-in royalty to extend the lease indefinitely.

48. *See id.* § 214 (explaining the concept of production in paying quantities); *see also* Reese Enterprises, Inc. v. Lawson, 553 P.2d 885, 895-96 (Kan. 1976) ("It is generally accepted that the phrase 'in paying quantities' in the 'thereafter' provision (extension clause) of an oil and gas lease's habendum clause means 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 thus result in a loss to the lessee. In this connection the term 'found in paying quantities,' as used in the habendum clause of the lease here in question, is uniformly interpreted as requiring 'production in paying quantities.'"); Sorum v. Schwartz, 411 N.W.2d 652, 655 n.2 (N.D. 1987) ("It is to be noted that, under the lease agreement, [the lessee] must produce oil or gas 'in paying quantities' within a reasonable time in order for the lease to continue.").

49. A top lease takes effect when the existing lease expires without production. "The term 'top lease' is defined . . . as: A lease granted by a landowner during the existence of a recorded mineral lease which is to become effective if and when the existing lease expires or is terminated." Nantt v. Puckett Energy Co., 382 N.W.2d 655, 657 n.1 (N.D. 1986). The practical reason for eliminating the requirement of providing notice of any offer to top lease the acres is to prevent the current lessee from taking steps to continue the lease before its expiration. If a top lease is offered by another mineral developer, the mineral owner, in many cases, is able to negotiate more favorable lease terms as compared to the original lease.

royalty payments shall not be reduced by the mineral developer's processing, transporting, preparing, marketing, or delivering costs.[50]

Similarly, the mineral owner should carefully review the lease to make sure the mineral developer has not disclaimed any of the implied covenants. The mineral developer has an obligation "to act as a reasonable and prudent operator in developing, operating, and protecting the [mineral owner's] property" with regard for both parties' interests.[51] This obligation is referred to as the "prudent operator rule." These implied covenants exist in favor of the mineral owner unless they are expressly disclaimed by the mineral developer.[52] The most frequently cited implied covenant is the implied covenant of reasonable development.[53] The covenant is emerging as a popular tool for mineral owners in challenging mineral developers whom they feel have not done enough to develop their acreage.[54] Again, these clauses are just a few that warrant the mineral owner's consideration when reviewing and negotiating an oil and gas lease. Finally, although it

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50. *See, e.g.*, West v. Alpar Res., Inc., 298 N.W.2d 484, 491 (N.D. 1980) ("If [the lessee's] predecessor in interest had desired to limit the royalty payments under the lease to a fraction of the net proceeds received from the sale of gas after allowance for a deduction of certain costs such as the cost of extracting hydrogen sulfide, it could have easily included express language to that effect in the lease."). Lack of such language is another emerging area of dispute between mineral developers and owners in North Dakota as mineral owners are often surprised to see deductions from their royalty checks for these costs.

51. Irgens v. Mobil Oil Corp., 442 N.W.2d 223, 225 (N.D. 1989).

52. *See* Slaaten v. Amerada Hess Corp., 459 N.W.2d 765, 769 (N.D. 1990). "It is well settled that the lessee of an oil and gas lease has an implied obligation to the lessor to do everything that a reasonably prudent operator would do in operating, developing, and protecting the property, with due consideration being given to the interests of both the lessor and the lessee, if there is no express clause in the lease relieving the lessee of this implied duty." *Id.* (citations omitted).

53. Generally, there are six general categories of implied covenants, including:

> 1. The implied covenant to drill an initial exploratory well; 2. The implied covenant to protect against drainage; 3. The implied covenant to use reasonable care in producing the minerals; 4. The implied covenant of reasonable development; 5. The implied covenant of further exploration; 6. The implied covenant to market the product.

Olson v. Schwartz, 345 N.W.2d 33, 41-42 n.5 (N.D. 1984) (Schneider, J., concurring) (citation omitted).

54. Claims for breach of the implied covenant of reasonable development have not been met with favor by the North Dakota Supreme Court. *See, e.g.*, Johnson v. Hamill, 392 N.W.2d 55, 57-60 (N.D. 1986) (discussing North Dakota case law on the implied covenant of reasonable development). However, the North Dakota Supreme Court recognized in *Olson* that a mineral developer cannot indefinitely hold undeveloped portions of an oil and gas lease:

> If . . . [lessee's] theory is correct, it may hold without further development as long as production from the present wells continues in paying quantities, regardless of how long that may be. The courts and text writers condemn such attempts of lessees to so indefinitely freeze the undeveloped portions of oil and gas leases, hold them for speculative purposes, and thus prevent the owners from getting full development of their land . . . .

345 N.W.2d at 39 (quoting Doss Oil Royalty Co. v. Texas Co., 137 P.2d 934, 936 (Okla. 1943)).

goes without saying, when negotiating a lease, be sure to get any modifications you request—and the mineral developer agrees to—in writing.

III. CONCLUSION

Receiving an oil and gas lease is generally welcomed news and provides its recipient with an opportunity to supplement their income—sometimes enough to be financially secure for life, sometimes just enough to make ends meet. It is also a serious commitment with lasting implications on behalf of both parties involved. This sort of commitment warrants the mineral owner to take pause, exercise patience, and evaluate the lease before signing the document they may not fully understand or appreciate. As the cases and authorities cited herein demonstrate, a lease is a complex contract with many moving parts. If done right, the lease can be mutually beneficial for all parties involved. Sometimes, the process calls for the mineral owner to obtain legal counsel to assist them in dealing with the oil company, particularly if there is a substantial amount of acreage involved.[55] Now, the only question remaining is what will you do if and when you receive that letter in the mail asking you to sign the lease.

55. The mineral owner should also consider discussing with a legal counsel the financial and estate planning issues that arise with having mineral rights, again, particularly if there is a substantial amount of acreage involved.