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Goliath

Representing oil and gas lessors

by Alan D. Wenger

As Ohio becomes a new site for horizontal shale drilling purveyors, many landowners are finding themselves up against a giant. Understanding and navigating the challenges associated with this business are keys to avoiding financial disaster for the lessor.

Suddenly, downtrodden eastern Ohio is starting to look pretty good. The bleak post-industrial Appalachian ghost town image is being replaced by a mixture of Beverly Hillbillies, big oil companies, and a few J.R. Ewings thrown in with all stripes of company and independent "landmen," brokers, and self-ordained experts and consultants. They promise all sorts of riches, threats to the hesitant, and curious explanations of oil and gas laws. The region has taken on the feel of the Wild West, including a few earthquakes.

Central to those fortunate enough to own acreage (though we have seen leases taken on as little as one-tenth of an acre) is the oil and gas lease. By and large, the "standard company lease" foisted on landowners is the same form that has been used for many decades for smaller, less-intrusive and conventional vertical-type wells. The new Utica leasing craze involves a completely different proposition: Huge, industrial-scale drilling operations on seven to 10-acre drilling pads accommodating six or more wells with thousands of truckloads of water, sand, and other fluids and materials, magnified environmental and infrastructural concerns, and significant impacts on communities and local government. The standard leases are dramatically slanted in favor of the lessee. The documents appear as several pages of tiny type containing arcane industry phraseology that few folks (including lawyers) understand and that most landowners do not even try to read. For many landowners, it comes down to a simple proposition: "Show me the money."

To those landowners who at least ask some questions (or if they are represented and their lawyer basically just makes an appearance) the lessee will quickly offer addenda terms to address some of the more egregious standard language. These addenda provisions, which can quickly become longer than the basic lease itself and extend up to 40-50 clauses, are usually really just part of the standard company language repertoire. It is a landman's game: Start with the standard form lease, and then look like a "good guy" by throwing in a few gratuitous addenda clauses, like "we will replace any fence that we destroy," and if pushed, a few more, but never anything other than "company-approved language."

Unfortunately, it seems that some attorneys dabbling in this field are fine with playing this game, perhaps out of fear of appearing to the client being an obstruction to the deal and the client's receiving that pot of gold.

In what other multimillion-dollar, extremely complex real estate and industrial transaction that will go on for decades, would any self-respecting attorney approve of a document that consists of a short, obliquely worded form agreement, along with an addendum filled with dozens of confusing, contradictory, poorly worded clauses that appear to have meaning directly opposite to the language of the form agreement? We should do better than this for lessor clients.

There have been a few notable exceptions, normally with collective lessor group negotiations where the lessee agrees to a fairer, comprehensive and cohesively drafted lease in consideration for the advantage of obtaining many acres in a single negotiation.

Here are some terms that appear in most all company leases, along with some suggested approaches more reasonable for the lessor.

Overbroad leasing clause

Standard clauses allow the lessee to exploit and use the surface and subsurface for any imaginable use remotely related to oil and gas, whether those uses are known or even presently not imaginable. These include pipelines, roads, storage yards, permanent compressor stations, underground gas storage rights, hazardous waste injection wells, use of and access to any water on the property, and more.

Response: Limit rights granted as to elevation (lease only regions below the base shale layer to horizontal drilling lessees). Lease only those rights necessary for oil and gas drilling; limit surface use; expressly prohibit storage and injection wells.

The land grab

The description of the leased land includes the property intended by the lessor (often only by parcel number and names of owners of neighbor parcels), and also includes by reference all other land owned by the lessor, contiguous or not, that may be located in the same county or township, to also be automatically included under the lease. These clauses go beyond the "Mother Hubbard" clauses formerly included in leases to address technical description errors. Rarely is it the lessor's intention to include any property other than that described.

Response: Include a provision clarifying that the lease only applies to the expressly described land and make sure the land is described by meets and bounds.

Secondary lease term

Leases have a primary term (original or as extended) and a secondary term continuing so long as "operations are conducted on the leased land or any lands pooled or unitized therewith." Often "operations" are not at all defined in the lease, and are poorly defined (from the lessor's view) in case law. Sometimes lessee-skewed definitions are included, which may include mere "testing" or "planning" or "mapping," leading to the fabled "stake in the ground" or "backhoe parked on the property" scenario that allows the lease to continue beyond the primary term, with little assurance of actual production and resulting royalties.

Response: Provide language that requires an actual well to be underway, such as "bit in the ground" for actual drilling of a well designed for horizontal shale layer production prior to the expiration of the primary term.

Covenants, not special limitations or conditions

Lessees want to avoid the possibility of being "evicted" from the leased premises. They construct protections that will not allow the leasehold interest to be terminated so long as the lessee has any use or need for the property—even if lessee is in abject breach of the lease.

Response: Include reasonable default language, with prior notice and opportunity to cure, and then termination.

Unlimited delay rentals; shut-in

For a nominal periodic rental, the lease can be kept in force at the lessee's discretion while the lessor receives no production royalties.

Response: Limit the cumulative period of time for which delay rentals and shut-in payments are permitted. The lease should terminate when that period is exceeded.

Water

Standard leases may not mention water contamination. The impact of fracturing

activities with their chemical additives, huge volumes of truck traffic, surface tanks and lagoons and the like (all basically exempted from environmental regulations) is rightfully a major concern for lessors and the public at large. With the rise of public scrutiny on this issue, most companies now include rudimentary water test baseline language in their addenda, and perhaps a provision for providing a supply of potable water if the lessor's supply becomes contaminated. But the burden remains with the lessor to prove that the quality or quantity of water supply has been affected by the lessee's activities, and not from some other cause. Sustaining that burden can be beyond the means of most lessors, i.e., David versus Goliath.

Response: Bind the company to furnish baseline water tests, and to provide a replacement supply without prior need to prove causation if water deteriorates after commencement of drilling activities. Place the burden on the lessee to prove that a change in water after drilling begins was not caused by the drilling activity. Provide for corroboration of the existence of a water problem by a neutral party, such as a local board of health. Lessors and their counsel must anticipate that problems will occur. Occasional accidents and spills will be an inherent part of drilling activity. The lease needs to address these risks.

Royalty determination

Leases often provide for payment to the lessor of a stated percentage of the "net revenue" realized by the lessee, and also provide that the royalty will be "less the costs" involved in gathering, transporting, treating, processing and marketing.

Response: Clarify and define any costs that are to be deducted, and be certain that the costs are quantifiable under industry indexes. Distinguish post-production from pre-production costs, in which the lessor should not have to share. Provide that any costs deducted must be based on costs actually paid by the lessee to an unrelated party.

No implied duties or warranties

Standard leases recite that the lessor waives any implied obligations of the lessee. Under common law, a lessee has an implied duty to develop the leased oil and gas rights for the benefit of the lessor.

Response: The lessee should be obligated to comply with all express and implied representations, warranties and obligations to the lessor, including the obligation to diligently extract and market the oil and gas.

Lessor title representations

Under standard lease language, the lessor warrants title to mineral rights. Normally a lessor (even one who is real-estate savvy) has little idea of the status of their mineral rights. These representations can leave the lessor exposed to claims for refund of bonus payments and potentially for lessee damages.

Response: Place the burden on the lessee to determine the quality of title to minerals, and provide that any bonus payments are nonrefundable.

Held by production

Standard lease language provides that if any portion of the leased acreage is included in a drilling unit, then all of the leased acreage is bound under the terms of the lease, even if no royalties are being paid on any of the acreage other than the portion in the drilling unit. For example, a 100-acre leased parcel can be "held by production" (HBP) if only five of its acres are in a royalty-producing drilling unit. The other 95 acres are still subject to the lease, including the potential of construction of pipelines, roads, storage and other uses allowed under the lease. The remaining acreage cannot be leased to another lessor so long as there is any production on the active five acres. This arcane HBP concept is a creation of the oil and gas industry and its customs formalized in standard leases. It has no basis otherwise in law, and it defies common logic.

Response: Include a "Pugh clause" or other "use it or lose it" provision. If the

lessor has not included any portion of the leased acreage (or identifiable depths) in a drilling unit during the primary term of the lease, then those portions should be released.

Unlimited unit size

Ohio has no maximum drilling unit size. Theoretically a lessee could "hold by production" thousands of acres and tie up many separate property owners' parcels with a single well, yielding miniscule royalties to those property owners. Because of the acreage required, horizontal shale wells do require larger units than vertical wells, probably in the range of 150 acres minimum per well. Standard company leases have unlimited unit size.

Response: Limit the unit size. A common negotiated limit is 640 acres, which can be expanded if and when the lessee actually drills multiple wells, so there is good rationale for the larger unit.

Disputes

Some company leases literally state that if the lessor has a complaint, the exclusive remedy is for the lessor to give notice of the complaint to the lessee, and on review, the lessee's determination is final.

Response: Be sure there is a fair and impartial dispute resolution mechanism that is affordable for the lessor.

These are just some of the glaring issues with standard form oil and gas company leases. There are many others.

Lessors' attorneys deal with agreements other than the lease. Routine documents and negotiations encountered include the following:

Lease amendments

The horizontal shale drilling companies active in eastern Ohio have purchased outright or taken partial assignment of deep drilling rights to hundreds of thousands of acres that were subject to existing leases that were originally intended by the parties for conventional vertical drilling. The horizontal drilling company holding lessee rights needs to adapt those leases to the differing demands for large horizontal shale wells. A common factor is unit size, which may be limited in pre-2010 leases to as little as 40 acres, or more commonly 160 to 200 acres. Lessors under those leases are being contacted in mass with requests for lease amendments for a greater unit size—preferably unlimited size from the lessee's perspective. Lessors are bluntly told that they need to agree to the amend-

ment, or their property will be passed by and they will get no royalty benefit from the deep rights.

Strategies: Try to restrict the larger unit amendment to the deep rights only, and not the shallower regions where vertical wells are drilled, and limit the expanded unit size.

Surface use agreements

Older leases did not contemplate 10-acre drilling pads and the huge industrial-scale imposition on the surface owner that horizontal shale drilling entails. Depending on whether the existing lease requires consent of the lessor as to location of surface activities, lessees may seek to negotiate an agreement with the lessor to accommodate this expanded drilling activity, including the pad, access roads and other facilities. Again, the blunt message from the lessee to the lessor tends to be, "If you want the big royalties from this development, you will cooperate." Lessors can usually negotiate some reasonable damages payment for the impacts on their property.

Pipeline and water impoundment agreements

Huge amounts of water are required for horizontal drilling and fracturing activities. Oil and gas needs to be transported to market, requiring networks of pipelines, both "gathering" lines on or near the drilling unit, and "foreign" pipelines outside the unit needed to transport product to main transmission lines. Companies have standard agreements for these functions that leave full discretion to the company as to location, size, construction, maintenance and use. Prices are negotiable and can vary dramatically. Standard agreements allow the company to place pipelines or water impoundments (above-ground ponds of several acres) anywhere the developer desires within the boundaries of the landowner's property. Landowners' rights must be protected with carefully negotiated agreements.

The horizontal shale drilling explosion in Ohio presents complex new challenges to lawyers who represent landowners. Failure to comprehend and address these issues could result in disastrous consequences for lessor clients. ■

Author bio

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* American Bar Association Standing Committee on Lawyers' Professional Liability. (2008). *Profile of Legal Malpractice Claims, 2004-2007.* Chicago, IL: Haskins, Paul and Ewins, Kathleen Marie.

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