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A Primer on the Modern Oil & Gas Lease in Louisiana

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Part One. Basic Presuppositions

I. Characteristics

The modern oil and gas lease is almost unique in that despite the tremendous amount and value of the oil and gas that has been produced in this country, the diversity of its occurrence, the sophistication and development of the methods of exploring for and producing it, and the enormous economic and social changes that have occurred in society, the basic provisions of the lease have remained virtually unchanged since the earliest days of the industry.

One of its most important provisions does not even appear from its written terms. The reasons for this are found in the fact that the nature of oil and gas exploration and the economic and technical assumptions upon which it is based have in fact, not essentially changed over that time. These reasons are as follows: (1) Despite the advances in geological techniques oil and gas deposits can only be located with certainty by the actual drilling of a well; (2) to locate potential deposits and successfully drill such wells requires a high degree of sophistication and substantial expenditure; (3) the ownership and control of the lands in which oil and gas deposits exist generally are in the hands of individuals who are unequipped and unwilling to undertake such exploration; and (4) the value of the deposits, when they are located, is significantly out of proportion to the cost of exploring for and developing them, so that in individual cases the owner of the deposit can be offered a cost - free share of the potential return that exceeds any other value the land may have or that he, has any expectation of otherwise receiving from it.

The contract, which has come to be called an oil and gas lease, represents the device by which the owners of the land (or its mineral values) and those persons having the expertise and capital to find and develop the oil and gas and to divide the costs, risks and returns from their exploitation. At heart it contemplates that the "Lessor" (i.e the person who owns the rights to exploit the land) will receive some immediate compensation for committing his land to the contract and if development is undertaken and is

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successful will receive what is equivalent to a cost free share of the oil and gas that is produced. The Lessee, on the other hand, has a fixed (the primary term) in which to decide whether and where wells should be drilled on the premises. During that time the lessor ordinarily receives an annual payment (delay rental) until developing of wells commence. If the Lessee's is successful in discovering an economically exploitable oil and gas deposit, he is expected to do those things that are reasonably necessary to exploit it, and to continue to explore for and similarly produce any other such deposits as may exist. If oil or gas is discovered the contract continues as long as they can economically be produced from the land. Finally, because of the uncertainty as to whether oil or gas exists under the land; how many wells may have to be drilled to exploit them and what may be required, even after discovery to produce, prepare and dispose of them, the provisions of the lease are quite vague and general as to the details which the exploration will take and how the production, is to be divided (other than to specify the relative proportions which each party is to receive). On the other hand, before wells are drilled or production is obtained, or if once obtained such production ceases, the leases specify with considerable particularlity what, if anything the lessee must do to preserve his rights.

II. The Essential Lease.

As a consequence of these factors, nearly every oil and gas lease can be reduced to one containing the following essential terms. All other provisions either supplement these, or regulate problems that have arisen from their application in particular, but common cases.

The Essential Oil and Gas Lease.

The undersigned lessor, in consideration of a bonus of $_____ cash paid, and the other obligations undertaken by _____ (Lessee), grants Lessee the exclusive right to explore for and produce oil and gas from the following land:

[Here the land is described]

This lease is given upon and is subject to the following terms and conditions:

It is for a term of ten years and as long thereafter as oil or gas is produced in paying quantities.

It will terminate one year from this date unless, on or before that time, lessee begins drilling a well or pays lessor a rental of $_____ to delay such drilling. Drilling may be deferred for consecutive annual periods if such rentals are paid on or before each succeeding anniversary until a well is begun or the lease terminates pursuant to paragraph 1.

Lessee will pay lessor as a royalty, 1/8 of all oil and 1/8 of the value of all gas produced from the premises.

[Subject to the provisions of Paragraph 2 permitting its deferral, Lessee

undertakes to explore the land for oil and gas deposits and to produce and develop them as a reasonably prudent operator for the mutual benefit of Lessee and Lessor.]

Thus done and signed on the ____ day of, 19___.

_____

Lessor

Note:

The italicised paragraph 4 is only implied and almost never expressed. See M.C. Art. 122:

III. Later Developments

The earliest leases were nearly as simple as that just given. The modern lease, as it has evolved, adds to and modifies their simplicity because of perceived deficiencies in and problems caused by the provisions when applied to concrete situations. The rest of this paper is devoted to a consideration of those problems and deficiencies -- some of which still exist.

Aside from State and Federal leases which are to unique because of political and economic considerations, most Louisiana oil and gas leases in the past fifty years have evolved from two basic forms, both published by the M.L. Bath & Company. One is identified simply by number such as "Bath's form 2" and is represented by a series of revisions, of which forms numbered 2, 4, 10 and 14 were (and are) the most popular. It came to be predominately used in north Louisiana -- i.e. the area roughly north of Alexandria. The other known as form "42C.P.M. -- South Louisiana Revised "(No.) pooling" was and is used predominately in south Louisiana. Of the several revisions those bearing numbers 4 and 6 have proven to be the most popular. In recent years the provisions of both forms have tended to become closely merged so that the most recent editions differ only in a few respects. The writer will refer to these forms as examples of varying kinds of provisions by their numbers as Form 14 (for form 14 B.R 1-2A) and form 42 CPM 6 (for form 42 CPM New South Louisiana Revised 6 - Pooling) both being among the most popular and widely used editions of the two series.

IV. The Nature of the Lease in Louisiana.

A mineral lease is a contract by which the lessee is granted the right to explore for and produce minerals (M.C. Art. 114). The Louisiana courts at first characterized a mineral lease as being a form of servitude--or at least having a "mixed nature, partaking of both sale and lease."[1] Starting with

1 *See* : Cooke v. Gulf Refining Co., 1914, 135 La. 609, 65 So. 758; Rives v. Gulf Refining Co. of Louisiana, 1913, 133 La. 178, 62 So. 623; Spence v. Lucas, 1916, 138 La. 763, 70 So. 796; Gulf Refining Co. of Louisiana v. Hayne, 1916, 138 La. 555, 70 So. 509, Ann.Cas.1917D, 130.

Gulf Refining Co. of Louisiana v. Glassell, 186 La. 190, 171 So. 846 (La. 1936) and culminating in *Reagan v. Murphy*, 105 So.2d 210 (La. 1958), and despite attempts of the legislature to classify the mineral lease as a "real right" the courts decided that the lessee is not vested with any type of ownership in the land or of rights in it. The Mineral Code defines the lease as a real right that is alienable and heritable (MC 16); that must be in writing and is subject to the law of registry (MC 18). It is still clear, however, that it vests no rights of ownership in the land or the mineral servitudes that may be leased and that the lessor-lessee relationship is essentially a contractual one.

A mineral lease under which production is established is not thereby converted into a mineral servitude, so as to divest the lessor of title to mineral rights. *Wall v. Leger*, App. 1 Cir.1981, 402 So.2d 704. The essential difference between a mineral lease and a servitude lies in the contractual nature of the lease. The mineral lessee is bound to the lessor by a contract that contemplates he will develop the premises for their mutual benefit. (MC 122). A servitude owner has no continuing contractual ties to the landowner. He is viewed as owning a property right. He is not bound to use his rights and if he does so the landowner derives no benefit from his actions. (MC 21, 22).

A lease is not subject to prescription of nonuse, but must have a term (MC 115). This continues the prior law. *Reagan v. Murphy*, 235 La. 529, 105 So.2d 210 (1950); *Bristo v. Christine Oil and Gas Co.*, 139 La. 312, 71 So. 521 (1916). A single lease may cover separate non-contiguous tracts. Operations on one tract will continue the entire lease as to all such tracts if its terms do not provide to the contrary. A well on a unit that comprises all or a part of the leased premises is considered to be, for purposes of the lease, as though it were drilled on the leased premises and (if productive) were producing its share of the unit production from the leased premises for a cost proportionate to its share of the unit expenses. (MC 114). This is consistent with the prior law. But unlike the rules pertaining to servitude the location of the unit well is irrelevant in its effect. *Hunter v. Shell Oil Co.*, 211 La. 893, 31 So.2d 10 (1947); *LeBlanc v. Dancinger Oil Refining Co.*, 218 La. 462, 49 So.2d 855 (1950). The rule may be varied by the terms of the lease. Unitizing the leased premises with lands on which there is a well, is ordinarily considered to be equivalent to the lessee drilling a well on the leased premises under the rule mentioned in the preceding paragraph.

The lessee's rights are not those of ownership. The practical effect of the classification of a lease as a contract, albeit one protected by the law of registry, extends not only to the rules just mentioned but to a number of less direct ones that have significant consequences to the lessee. Among these are the following: (1) although the Mineral Code provides that a mineral right may be possessed "according to its nature" the courts have implicitly

recognized that such possession as the lessee has, is that of his lessor -- since possession, in the technical sense is but a presumption of ownership. Accordingly the lessee's possession is "precarious" and for his lessor; (2) the lessee cannot acquire his rights by acquisitive prescription and is absolutely dependent upon the validity of his lessor's title; (3) in the case of title failure, the status of the lessee as a good or bad faith possession also should depend upon the status of the lessor; and (4) the rentals and royalties payable to the lessor under the lease are not independent mineral rights in the nature of the mineral royalty regulated by Chapter 3 of the Mineral Code, but rather, fall in the same category as rent from a building or land -- i.e. contractual benefits incidental to the ownership of the land or the status as a lessor.

Part Two: Provisions of the Modern Lease and Problems They Engender

Section One -- Provisions Relating to Execution

[Date, Parties, Bonus, Interests Covered and Warranty]

I. The Date

The date ordinarily causes no problems -- however it must be remembered that the payment of delay rentals and primary term are tied to the date of the lease. Be sure "date of lease" is certain if there are multiple parties.

II. Parties -- The Lessor.

Normal considerations for dealing with acts affecting immovables apply. The normal considerations in Louisiana for identifying the parties to instruments intended to be recorded apply to mineral leases and will not be particularly mentioned here. Care must be made in listing both the name and the address of the lessor, since the former usually serves as the basis for paying delay rentals and the latter for giving of notices.

Leases with multiple lessors may create particular problems. In order of their encounter they arise from (1) lessors who own undivided interests in the property; (2) servitude owners and landowners join in the same lease, and (3) and most infrequently, who lessors who own differing tracts or parts of the land. Not infrequently, some combination of these may also be present.

Good practice would dictate stipulating the interest of each owner but this is rarely done. A common provision, found in Form 42 CPM 6, is that if several lessors are named, the lease is effective as to those who sign, even if all do not. In absence of such a provision or subsequent estoppel or ratification, the lease is effective only when all persons named as a party have signed. MC Art. 166 provides that a coowner may grant "a valid mineral lease as to his undivided interest" but that the lessee may not exercise his rights "without consent of co-owners owning at least an undivided" 80% interest in the land. Thus taking a lease from 75% of the

owners and paying them the bonus (perhaps with prior verbal assurances that all 100% will sign) leaves lessee in a dilemna if the last 25% refuse. The lease is valid -- ergo the bonus is non-refundable, but pragmatically operations can only be conducted if land is unitized with adjacent lands over which valid and operable leases exist.

The Code's provisions relative to acknowledgment of mineral servitudes apparently are designed to overrule prior holdings that the joinder of a mineral servitude owner and landowner in a lease having a primary term expiring after the prescription of the mineral interests is an implied or tacit extension of the prescriptive period by the landowner.[2]

A usufructuary of land is entitled to lease the land for oil and gas purposes only if: (1) the usufruct is a conventional one and the act creating it gives the usufructuary the enjoyment of " all or a specified portion of the landowner's rights in minerals" M.C. Art. 190, or (2) there was at the time of creation of the usufruct production occurring from a well on the premises or from a unit encompassing the premises, or a well "shown by surface production tests to be capable of producing in paying quantities" in which event the usufructuary is entitled *"to the use and enjoyment of the landowners rights in minerals as to all pools penetrated by the well"*. M.C. Art. 191 (Emphasis supplied)

While a usufructuary of land he may lease his rights to such enjoyment, the lease "may not extend beyond the period of the usufruct. M.C. Arts. 192, 118. If the usufruct is of a mineral right the usufructuary is "entitled to "all the benefits of use and enjoyment" of the right and may grant a lease "that extends beyond the term of the usufruct and binds the naked owner of the servitude". M.C. Arts. 193, 118.

III. Parties -- The Lessee

The practices of taking a lease in the name of an undisclosed agent or "nominated" lessee is not without its danger. Art. 129 provides, in essence that a lessee remains liable for the past and future obligations of the lease even after he has completely assigned all of his rights in the contract to another, unless "the lessor has discharged him expressly and in writing." The "discharge" referred to may be incorporated in the lease itself, but few if any of the forms in current usage contain such a provisions.

Since the rules of registry apply, each record owner of a lease (including one who takes the lease as an agent for an undisclosed principal - see C.C. Art. 3017) would be liable to the lessor or his transferees. Consequently every person who appears in the chain of title as a lessee becomes irrevocably bound (in the absence of an express discharge) not

2 See Comments to M.C. Art. 56. For the prior law, see Armour v. Smith, 247 La. 122, 170 So. 2d 347 (1964); Adam v. Johnson, 133 So. 2d 175 (La. 4th 1961); Mulhern v. Hayne, 171 La. 1003, 132 So. 659 (1931); Achee v. Caillouet, 197 La. 313, 1 So. 2d 530 (1941).

only for the then accrued obligations of the lessee, but for all such obligations as may thereafter arise under its terms.

An address for the lessee should be stated in the lease. Under the contract significant notices are to be received by him. Among these are changes in ownership, status, place of deposit of delay and shut-in rentals; demands for correction or payment of royalties or the remedy of default, it is essential that the lessor be provided with an address to which such matters must be directed.

The lease should be signed by a representative of the lessee as soon as it is intended to be binding upon the parties. Although it is necessary that mineral leases be in writing, it is not essential that lessee sign a written instrument; what is required is that lessee indicate consent to lease agreement. *St. Romain v. Midas Exploration, Inc.*, 430 So.2d 1354 La.App. 3 Cir. 1983. Where lessee's signature on carbon copy of unsigned original of purported counter letter agreement relating to oil and gas leases was not located in place prepared for signature by drafter of document but instead appeared in incomplete notarial acknowledgment following body of agreement, instrument was invalid for lack of execution by lessee. *Webb v. Duke*, 211 So.2d 722, (La.App. 2 Cir. 1968). Oil, gas and mineral lease signed by lessor and two witnesses but not signed by lessee was not valid when executed. *Pennington v. Colonial Pipeline Co.*, 260 F.Supp. 643, affirmed 387 F.2d 903. By recording lease in conveyance records of parish, corporation held itself out to world as lessee of oil, gas, and mineral interests, and the Court could infer from corporation's actions that it consented to lease. *Reed v. Flame Petroleum, Inc.*, 469 So.2d 1217 (La.App. 1 Cir. 1985).

IV. Description of Property Covered

The rules generally prevailing for contracts affecting immovables apply to leases. These can generally be described as requiring the land affected by it to be identifiable from the document with resort to other instruments in the public records referred to in the description and identifiable monuments or physical features on the ground.

The jurisprudence distinguishes certain categories of defective descriptions. Those that are held to be invalid as to third persons, are misleading descriptions, vague descriptions, and general descriptions. Misleading descriptions accurately describe a tract but one other than that intended by the parties, as where an erroneous section, township or range is used or the NE1/4 rather than SE 1/4 is stated. Vague descriptions simply give no guidance to determine what is intended, such as "ten acres in section 2" or even "ten acres in the south east corner of section 2". These are equivalent to no description at all. General descriptions are so indefinite as to make it virtually impossible to determine what they include without a complete examination of the records. For example "all of lessor's property in Caddo Parish." These have also been held to be invalid as to third

persons -- perhaps more as a matter of policy than upon technical grounds.

On the other hand "ambiguous" descriptions may be valid. These contain internally inconsistent statements but put third persons on notice that an error has occurred and are sufficiently definite to indicate certain property may be intended. These are sufficient on notice that persons should proceed only after clarification. An example is describing a tract as being

> "a tract of land 400 feet square, located in the North East Quarter of Section 2 more particularly described as follows: beginning at the northeast corner of the Northwest Quarter of Section 2; then go west along the section line 400 feet, then south 400 feet the parallel to the north line of the section 400 feet to the section line then north along such line to the point of beginning.

Such a description might well be held to be perfectly valid, particularly if the grantor owned no lands at all in the Northwest Quarter of the section, and would in any event be held to cause the lessee to proceed with caution.

Descriptions containing references to other documents, or references to monuments (that can be located) are sustained as being perfectly valid, although one must be careful when dealing with monuments or boundaries such as roads, fences, non-navigable streams and similar items. They are deemed to represent ideal locations, not movable elements, so that the monument is moved if between the time of acquisition and a subsequent transaction occurs the later reference to it is deemed to refer to where the monument then is, not where it was. Thus a purchase of a tract "bounded on the north by state highway 16", and a subsequent lease of the tract "bounded on the north by state highway 16" will not include the area owned by the lessor north of the road, if in the interim between the purchase and the lease, the road was relocated to the south. It is not advisable to use "mineral" and "royalty" acres as a part of a description or in referring to the interest of mineral or royalty owners.

Another popular clause found in some leases (the Form 42 CPM-6 for example, but not in the Form 14) is a "Mother Hubbard" clause, or a statement that the lease is intended to cover all other lands owned by the lessor in the same sections. The clause in the Form 42 CPM-6 reads as follows.

> "All land owned by the Lessor in the above mentioned Section or Sections or Surveys, all property acquired by prescription and all accretion or alluvion attaching to and forming a part of said land are included herein, whether properly or specifically described or not."

The general view in the industry of such clauses, is that they are inserted to protect the lessee from errors of description, encroaching fences, and similar discrepancies between that to which the lessor technically has title and what he may actually own and which he considers to be a part of the land he

claims. However, in at least one federal case, the court gave a literal interpretation to a similar clause, and subjected a 40 acre tract to the lease that was not described in any manner in the lease. See *Bergeron v. Amoco Production Co.*, 789 F.2d 344 (C.A.5, 1986).

Most lease forms contain a statement as to the acreage in the leased premises.

> "For the purpose of calculating the rental payments hereinafter provided for, the above described land is estimated to comprise _____ acres, whether it actually comprises more or less." (Form 42 CPM-6)
>
> "For all purposes of this lease the described premises shall be treated as comprising ____ acres, whether there be more or less." (Form 14)

These clauses are intended to serve the purpose of fixing the amount of the delay rentals where they are based on an amount per acre (as in the Form 42 CPM-6) and to serve as a basis for allocating a division or reduction of such rentals in the event of an assignment or release of a segregated portion, or the unitization of the premises if the lease contains a Pugh clause. Insofar as the initial calculation of the rentals is concerned no problem is presented. However a considerable difficulty can arise if there is a substantial error in the estimate of area. For example, suppose the lease covers "All of the west half of section 10 south of Highway 60" and it is "estimated" to comprise 160 acres (on the assumption that the road cuts the section in half). Suppose the lessee assigns the lease "insofar as it covers the South half of the Southwest Quarter of Section 10." An accurate survey would disclose the lands leased actually covered only 300 acres. Instead of receiving 1/2 of the acreage actually leased the assignee he has received 53.3%. Upon what basis are the rentals to be paid? Simply stated, in cases where payments are to be divided or allocated on the basis of the proportionate area of part of the premises, the "estimates" may give a denominator, but they say nothing as to how the numerator is to be calculated.

V. Warranties Of The Lessor

Under the Civil Code a lessor does not warrant title (and in fact did not have to have title). He does warrant peaceful possession and is obligated to deliver and maintain the lessee in possession of the leased premises. Because the lessee could not sue to defend his rights, but had to call upon his lessor to do so, and could not enforce his warranty until he was actually disturbed, it became customary to add a warranty of title to oil and gas leases.

The Mineral Code carries forth both the warranty of possession and implies a warranty of title as well. Thus the traditional lessor's warranty being expressed in Art. 119 as follows:

> A mineral lessee is bound to deliver the premises that he has leased for use by the lessee to refrain from disturbing the lessee's possession and

to perform the contract in good faith.

The Official Comments explain the article as follows:

> This Article states established law. Both a vendor and a lessor are bound to make delivery and to refrain from interference with possession. La. Civil code arts. 2475, 2692 (1870) The requirement of good faith performance is inherent in all contracts. La. Civil Code art. 1901 (1870).

Art. 120 provides for the warranty of title. A mineral lessor impliedly warrants title to the interest leased unless such warranty is expressly excluded or limited. The liability of the lessor for breach of warranty is limited to recovery of money paid or other property or its value given to the lessor for execution or maintenance of the lease and any royalties delivered on production from the leased.

Finally, a corollary of Art. 119 is that the lessor is obligated to maintain the lessee in possession the parties even if he does not own the premises. Some early cases held that if the lessor warranted title to the land and did not disclose it was subject to outstanding mineral interests the lessor, after their prescription, he was estopped to deny the lease covered the entire interest in the land, at least as to those interests not expressly excluded or disclosed. *See*: *Butler v. Bazemore*, 303 F.2d 188 (5th Cir. 1962) and *St. Landry Oil & Gas Co. v. Neal*, 166 La. 799, 118 So. 24 (1928). Somewhat inconsistently it also was held that a lease, executed by the landowner at a time when there were outstanding mineral servitudes did not cover any greater right to exploit the land for minerals after prescription or extinction of such servitude than before. *See Calhoun v. Gulf Refining Co.*, 235 La. 494, 104 So.2d 547 (1958). It also was held that a lessor of land as to which there were outstanding mineral servitudes, could expressly stipulate the lease would cover "outstanding mineral interests" after they "reverted" to the lands. *Williams v. Arkansas La. Gas Company*, 193 So.2d 78 (2d Cir. 1966). Whether such an agreement would bind particular successors to the land was a matter of doubt. It was generally thought that to do so would be contrary to the prohibition against dealing with the "reversionary" interest. See: M.C. 76 and *Calhoun v. Gulf Refining Co.*, 235 La. 494 104 So.2d 547 (1958).

The Mineral Code explicitly regulates the matters discussed above. When a lessor has purportedly leased rights that are outstanding in another and those interests are extinguished by prescription the interest he so acquires accrues to the benefit of the lessee. (M.C. 145). A former interpretation of the Civil Code that a lessee cannot be compelled to accept the lease under this doctrine if he has filed an action for breach of warranty or put the lessor in default before the "reversion" would appear to be perpetuated. *Brewer v. New Orleans Land Co.*, 154 La. 466, 97 So. 605 (1923). The requirement that the lessor must "purport" to lease the outstanding interest appears to confirm that the rule is impliedly based upon

existence of a warranty. Its effect is thus not clearly applicable if the lease states by its terms that it covers the land, without exception, but the lessee is in fact aware it does not. That is, if no action for breach of warranty exists arguable for the lease to cover such interest would require an express provision to that effect. Particular successors in title of the original lessor are not bound by the effect of the rule unless they expressly agree in writing to become so bound. (M.C. 145). This would seem to mean that a mere acknowledgement of the lease or a ratification of it by a subsequent purchaser of the land would not bind him to the effect of the rule. A mineral lease may also expressly provide that "a mineral right that terminates during the lease and becomes owned by the lessor or his successor in title shall be subject to the lease." (M.C. 144). If the lease is recorded the provision is binding on particular successors to the land. (M.C. 144). The owner of an executive right to lease land belonging to another probably may include such a clause in a lease, absent the express power to do so. (M.C. 105).

M.C. Art. 121 seems to recognize the practice of purchasing so called "protection leases" from others who may have claims adverse to that of his lessor by declaring that a lessee may take leases "from persons claiming the leased land or mineral rights or interests therein adversely to his lessor." This must be read in light of Art. 122 which declares the lessee is obligated to perform the contract in good faith. If, through lack of reasonable investigation of the facts, the lessee acquires a lease from someone who has never made any claim to the leased premises, and if that claim proves to be unfounded, the lessee may face a serious claim from his lessor on the grounds that the person from whom the lease was taken was not a "person claiming the leased premises."

If the lease accurately describes the interest lease, as is also frequently the practice, difficulties can then arise from the relationship of the royalty and delay rental provisions to such interest. The Form 42 CPM-6 provides that if the rentals and royalties shall be reduced proportionately "to the interest of the lessor" if he owns less than the entire undivided interest in all or any portion of the lands or minerals rights relating thereto (*whether such interest is herein specified or not*). Under such a clause, if the lease affirmatively states it covers an undivided 1/2 interest in the land or mineral, it still is necessary to state the royalties and more importantly, the rentals as if the lease covered the entire interest in the land. Other forms, such as the Form 14 provide in that "Lessor warrants .. title to said land..." and that without "impairment of lessor's warranty in the event of failure of title ... if lessor owns an interest in said land less than the entire fee simple estate, then royalties and rentals to be paid lessor shall be reduced proportionately." The difficulty is that the section relating to the description of the lands leased in such leases provides, in substance that

"Lessor ..... leases and lets exclusively unto lessee for the purpose of ...

mining for and producing oil, gas and all other minerals.... the following described land... to wit:"

If the description then says, for example, "an undivided one-half interest in Section 2..." It is arguable that the grammatical meaning of the lease of the term "said lands" or "land leased" refers only to an undivided one-half interest. If then the rentals stated or royalties payable, are not reduced to take that into account, there can easily result in a claim for twice what the lessee expects to pay. For example, the Form 14 does not state the delay rental as an amount "per acre" as does the Form 42 CPM-6, but rather it is stated as a fixed dollar amount and clearly provides that unless a well is commenced on "the land" the lease will terminate unless the fixed amount of rentals are paid. There seems to be no basis for reducing the rentals under the provisions of the lease. Production royalties are, under such a lease, "self reducing" in that the royalty on oil stated as a fraction of the oil produced "from said land." Similarly the so-called "shut in royalties" sometimes are stipulated as a fixed amount "per well per year." Under such a provision, there would be is no reason to reduce the amount, even if the lease only covers an undivided 1/20 interest in the land, of that interest stated is in the lease.

VI. Bonus

Until a well is commenced, oil and gas leases in current usage do not require the lessee to take any action, and the failure to explore or produce merely results in the termination of the lease. After production has commenced, the lessee ordinarily may at any time abandon the premises without further obligations -- other than those of restoration and compliance with accrued liabilities. Before the revision of the Civil Code articles on obligations a lease that did not provide for a bonus or other consideration to the lessor, was considered to contain a potestative condition unless and until the lessee either paid the first delay rentals or commenced the drilling of the first well. (See Oil, gas, and mineral leases executed without consideration except lessee's agreement to commence drilling operations by stated date, and providing no penalty for failure to do so except loss of leasehold rights, were void and lessors could withdraw therefrom at will. *Noxon v. Union Oil Co. of Cal.*, 29 So.2d 67 (La. 1946)). Although the potestative condition has been eliminated as a distinct kind of condition, the fact remains that the performance of the lessee's obligations to explore and develop the premises, or pay rentals in lieu thereof still remain exclusively at the unfettered discretion of the lessee and the lease thus initially does not constitute an onerous contract. Nor is it any recognized form of gratuitous undertaking (if it could ever be characterized as such).

Under certain circumstances the lessee may propose an absolute obligation to commence the drilling of a well on the premises in lieu of a cash bonus. If this is to be done, from the lessor's point of view two considerations need to be taken into account. First, it has been held in such

a case, that the lessee had complied with his obligation to "drill a well" on the premises by obtaining an extension of an existing unit of the commissioner to include a part of the leased premises. Second, the position of the lessor if the well is not drilled is by no means clear. The measure of damages technically would appear to be the loss of the royalties that would have been obtained had the well been drilled. More importantly, even this contention will be met with the argument that is oil and gas is under the ground, absent some showing of drainage, no loss has been incurred and to award damages and leaving the lessor the with the potential royalties (or other revenues) and damages for their non-production. One old case awarded the lessor the cost of the drilling of the well, apparently on the grounds that that was the value the parties had themselves placed upon the rights of the lessee. *See*: *Fite v. Miller*, 187 So. 650, (La. 1939). On the whole, a provision for liquidated damages in the event the lessee does not drill appears to be particularly attractive to both parties.

Some mention should be made of the practice of paying bonuses by delivering the lessor a draft signed by the landman or broker taking the lease, and drawn on a bank for the account of the lessee or upon the lessee himself through the bank. These frequently are payable some time "after sight" and "upon approval of title." It is well known that such drafts do not have to be honored by the bank or lessee who is the drawee and that they may be returned for any cause without liability. What is sometimes overlooked is that the drawor (the one who signs the draft) warrants that the draft will be paid when it is presented according to its terms, and that if it is dishonored [except for grounds specified in it] he becomes liable to the payee for its amount. (La. R.S. 10:3-414). It has also been held lessor can give lessee directly pay bonus, heating the draft as evidence of payment. *See Reed v. Flame Petroleum, Inc.*, 469 So.2d 1217 (La.App. 1 Cir. 1985). Furthermore, in the event of a dispute as to whether its rejection was because of the condition of the draft or some other unrelated, and unjustified cause, the action must be filed against the drawer. Landmen and brokers, therefore, who issue such drafts should use care -- the practice is equivalent to using your own check to pay for the bonus.

Section Two. Term and Matters Pertaining to It

[Primary Term, The Habendum Clause Delay Rentals And Operations To Maintain The Lease]

I. The Ordinary Term

The ordinary lease provides it is for a fixed term of and "as long thereafter as oil and gas is produced." The fixed period is referred to as the primary term, and the extended portion is called the "habendum" clause. In the early days leases having fixed terms of 25 to 30 years and (rarely) 99 years were common, but all were also dependent upon the continued production from the property. The present model developed shortly after oil began to be produced extensively.

An unsuccessful suit by a lessor to evict a lessee or dissolve the lease has been held to give the lessee an extension of the term of the lease equivalent to the time his rights are wrongfully challenged by the lessor. *Baker v. Potter*, 223 La. 274, 65 So.2d 598 (1953).

II. The Primary Term

Before the mineral code doubt existed as to whether a lease was subject to the same limitations as a mineral servitude, which as a matter of public policy established a period of prescription of ten years against servitudes. Although by the 1950s there was strong authority to the effect that the rule did not apply, the fear that if it did, it might invalidate the entire contract, prevented operators from using long-term leases. The mineral code resolves the matter both by prohibiting leases from continuing for more than ten years without drilling, mining operations or production. At the same time the article provides that if the lease permits a continuation for a longer period the period is reduced to ten years. (MC 115). The limitation is not restricted to the primary term, so that any provision (such as continuation because of a lack of a market) which permits such a continuation is limited to ten years

III. Paying Quantities.

Art. 124 also provides that if the term of a lease continues "as long as there is production from the premises", such production must be in "paying quantities". Under the ordinary lease, the term of which is tied to production, failure to produce in paying quantities, is a resolutory condition, or serves as the "triggering event" for a resolutory condition, in that most leases now provide that when production ceases, either during or after the primary term the lessee will have a relatively brief period (60 days in the case of Form 14 and 90 days under Form 42 CPM-6) in which to restore it or commence drilling or reworking.

M.C. Art. 124 provides that production in paying quantities exists when production allocable to the total original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss. The test is neither mechanical nor strictly an accounting one. Arguments about whether depreciation, "overhead" and similar amounts should be considered miss the point -- which is if one were in the operator's place would you realize enough from operating the well to induce you to continue in hopes of making a reasonable gain from your efforts.

Monies spent yesterday are irrelevant, as are non-cash items such as depreciation or depletion which represent an accounting charge for past expenses. So are expenditures which will continue if the well is shut down. That is, if a well is drilled that will never "pay out" or reworking operations are done which are totally unsuccessful, but the well will still currently

produce enough to make a reasonable profit, it is producing in paying quantities.[3]

Somewhat illogically, perhaps, M.C. Art. 124 provides that amounts payable for overriding royalties and similar burdens placed upon the lease after its creation are treated as if they were revenues to the lessee. For a pre-Code case involving a production payment *see*: *Vance v. Hurley*, 41 So.2d 724 (La. 1949). The test is however one of judgment and when wells decline slowly it may be difficult to determine at what point they became uneconomic. But when that point is reached "production has ceased" within the meaning of the lease (*Edmundson Bros. Partnership v. Montex Drilling Co.*, 672 So.2d 1061, (La.App. 3 Cir. 1996) declaring that the "minimum time period" to be considered in determining whether a mineral lease has produced in paying quantities is between 8 and 18 months. The case, decided on motion for summary judgment was reversed by the Supreme Court, on the grounds that the motion was improvidently granted since factual questions existed.[4]

IV. Termination During The Primary Term

Under most leases payment of a "delay rental" or the commencement of a well, usually during the first year of the term is necessary to continue the lease. These provisions in Louisiana and most of the United States generally (except for California) have the same characteristics. The clause is a resolutory condition working an immediate extinction of the lease upon its failure. The basic provision seldom deals with what happens after a well is drilled, and one must resort to other conditions to determine its effect. Courts traditionally have been quite rigid and highly technical in construing such provisions, although later decisions indicate a somewhat more realistic approach, where the lessee makes a bona fide effort to pay and the lessee receives notice that the lessee has attempted to do so.[5]

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3 See: Reworking expenses not considered: Leger v. Lea Exploration Co., Inc., App. 3 Cir.1994, 93-605 (La.App. 3 Cir. 2/2/94), 631 So.2d 716, writ denied 94-0450 (La. 4/4/94), 635 So.2d 1112. Overhead not chargeable, unless being paid to another party. Menoah Petroleum, Inc. v. McKinney, App. 2 Cir.1989, 545 So.2d 1216. [Case raises question as to whether unit well may be producing in paying quantities to one lessee but not others --- in theory differing royalties and costs incurred under operating agreements could lead to that result.].

4 See 679 So.2d 1364 (La. 1996), rehearing denied 683 So.2d 258; For cases involving paying quantities since the adoption of the Mineral Code, see: Kleas v. Mayfield, 404 So.2d 500 (La.App. 3 Cir. 1981) rejecting a plea of estoppel against the lessors who did not object to continued production after it ceased to be in paying quantities; Menoah Petroleum, Inc. v. McKinney, 545 So.2d 1216 (:La App. 2 Cir.1989) ; Webb v. Hardage Corp., App. 2 Cir.1985, 471 So.2d 889 and CCH, Inc. v. Heard, 410 So.2d 1283. (La. App 3 Cir.1982).

5 See: Le Rosen v. North Central Texas Oil Company, Inc., 169 La. 973, 974, 126 So. 442 and Clingman v. Devonian Oil Company, 188 La. 310, 177 So. 59 (payment jointly to husband and wife held invalid, when husband was only lessor -- even though property presumably was community); Rushing v. Griffin, 240 La. 31, 121 So.2d 229 (1960)

They have however, permitted a claim of "estoppel" or "ratification" where the lessor has knowingly accepted the wrong amount, and permitted the lessee to conduct operations on the property. This is perhaps more properly to be classified as a waiver or tacit amendment to the provisions -- which is not inconsistent with the view that the payment or drilling is the exercise of an option by the lessee to continue the lease.[6]

There also is some indication that if the payment is actually received by the lessor, adequately notifies him of the lessee's attempt to comply with the condition, but contains some error or deficiency as to identity of the party or location of the property, the lessor must notify the lessee and give him time to correct it before the termination is effective.[7] It is probably safe to say no court has excused payment unless an erroneous payment was knowingly accepted by the lessor or there has been some objective manifestation of an attempt to pay and the lessee was permitted to conduct operations on the property, inconsistent with anything other than the continued term of the lease.

If there are multiple parties and the lease does not itself define the interests being lease, caution should be used in allocating the rentals and in case of any doubt, joint deposits should be made or an agreement or rental division order obtained. Because of the possibility of changes in ownership, marital status, attainment of majority, death, dissolution of corporations, and the other myriad of events that might cause the persons who sign the lease to no longer be the person who is entitled to receive them, nearly all modern leases provide that no change in the identity of the person will be binding upon the lessee until some time has elapsed after he has received adequate evidence of it. Form 42 CPM-6 contains one of the most extensive:

> ....regardless of any actual or constructive notice thereof, no change in the ownership of the land or any interest therein or change in the capacity or status of Lessor or any other owner of rights hereunder,

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(payment to bank for account of one lessor "and others" invalid as to lease executed by all three) Johnson v. Smallenberger, 237 La. 11, 110 So.2d 119 (1959); through oversight lessee failed to make payment, lessor continued affirmatively to act as if lease were in effect while lessor drilled a unit well on tract off the leased premises -- no estoppel since lessee had right to drill even if lease had expired. Calhoun v. Gulf Refining Co., 235 La. 494, 104 So.2d 547 (1958) court implies that overpayment of amount fails to comply with terms of lease because in case before it rental it was "accepted by lessor without objection." (overpayment made well in advance of rental date coupled with silence of lessor).

6 Jones v. Southern Natural Gas Co., 213 La. 1051, 36 So.2d 34 (1948) (mutual error of parties as to acreage on which rentals based); Baker v. Potter, 223 La. 274, 65 So.2d 598 (1953) (timely dispatch of payment by Western Union with failure of delivery beyond control and without fault on part of lessee.)

7 See: Richard v. Tarpon Oil Company, et al, 269 So.2d 261(La. App. 3d Cir. 1972), writs refused. (Payment with check in proper amount to proper party, erroneously directed to be deposited by depositary bank into a fiduciary account of the payee, held valid.)

> whether resulting from sale or other transfer, inheritance, interdiction, emancipation, attainment or majority or otherwise, shall . . . on Lessee for making any payments hereunder unless, at least forty-five (45) days before any such payment is due, the record owner of this lease shall have been furnished with certified copy of recorded instrument or judgment evidencing such sale, transfer or inheritance, or with evidence of such change in status or capacity of Lessor or other party owning rights hereunder.

The clause encompasses elements which are essential to its use, in that it: (1)covers not only changes in ownership of the land or minerals, but of the status of the payee -- e.g. Emancipation, inheritance, etc.; (2)requires written evidence of the change (and negates the validity of notice in any other manner.); (3)allows the lessee a reasonable time to identify the persons involved, examine the documents, administratively change the records and make the payment; and (4)it provides that payment made in anticipation of the date and before the notice is received is valid. The provisions in Form 14 are more succinct, but also encompass at least by implication, the same elements. Both leases lack a specific direction as to where notices and communications to be addressed.

Having set up such a procedure, it is essential, from the lessees point of view that he rely upon them. The courts, not only have affirmed the validity of such clauses, but have held that where the lessee departs from the plain terms of the contract, he does so at his own risk.[8]

The other branch of the condition necessary to prevent resolution of the lease is the starting of a well. A few early lease forms required the "drilling" of a well -- the unworkableness of this requirement soon caused the provisions to require "operations for drilling" to be "commenced" or to "commence operations for drilling. "Operations for drilling" have been held to commence when there are substantial surface preparations "such as making and clearing a locations, delivering equipment to the well site, and the like, provided that such preliminary operations are continued in good faith and with due diligence until the well is actually spudded in." *Breaux et al. v. Apache Oil Corp.* 240 So. 2d 589 (La. App 1970).[9]

Some lease forms contain a definition of when operations are

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8 See: Hibbert v. Mudd, 294 So.2d 518 (La. 1974) Pearce v. Southern Natural Gas Company, 58 So.2d 396, Atlantic Refining Company v. Shell Oil Company, 46 So.2d 907. Hanks v. Wilson et al, 633 So.2d 1345; (La. App 1st Cir. 1994).

9 See also In Hilliard v. Franzheim, 180 So.2d; 746 (La.App. 3rd Cir. 1965 Allen et al v. Continental Oil Co. et al, 255 So.2d 842 (La. App. 2d Cir. 1972 Johnson v. Houston Oil Co., 229 La. 446, 86 So.2d 97 Texas Co. v. Leach, 219 La. 613, 53 So.2d; Crye v. Giles, La.App. 2 Cir., 200 So. 155; Hudspeth v. Producers Oil Co., 134 La. 1013, 64 So. 891 Wehran v. Helis, La.App. 4 Cir., 152 So.2d 220; Sterling v. McKendrick, La.App. 4 Cir., 134 So.2d 655; and Iberian Oil Corporation v. Texas Crude Oil Co., W.D., La., 212 F.Supp. 941 (1963), affirmed, 5 Cir., 328 F.2d 832 (1964).

commenced, Form 42 CPM-6 provides operations have commenced " when work is commenced or materials placed on the ground at or near the well site preparatory to the drilling of a well." Many recent forms, emulating the mineral code articles relative to the interruption of prescription of servitudes require "actual drilling" to be commenced. This term is generally understood to mean that the drilling bit must penetrate the earth.

Not infrequently with small tracts, cost of administering and paying delay rentals is less than simply adding an additional amount to the bonus. This is accomplished by what is referred to as a "Paid Up" Lease. There are forms in common usage which accomplish that purpose. Occasionally parties will attempt to modify an existing lease by simply striking through the delay rental provision; putting a "zero" in the blank or an asterisk and noting "paid up lease none required" or words to that effect. This practice gives rise to a number of problems unless it is done with care. Since the law declares that every lease implies an obligation by the lessee to develop and operate the properties for the mutual benefit of both parties, the mere omission of delay rentals, arguably, may mean that the lessee is obligated immediately to commence exploration and drilling. This probably is somewhat far-fetched in today's atmosphere. However, delay rentals under most forms also are referred to as the basis for payments under Pugh clauses, shut in royalty clauses, and to defer additional drilling after the first well is commenced. Since, for example, both forms under consideration provide that if the first well drilled is not productive, the lease will terminate unless the lessee commences drilling another within a brief period or resumes payment of delay rentals, the contract is susceptible of the construction that it will terminate unless the well is commenced.

V. Customary Clauses Concerning Maintenance of the Lease in the Absence of Production

The early forms of the habendum clause and delay rental provisions created a number of problems that the Mineral Code addresses only indirectly, but that most modern leases attempt to specifically resolve by their terms. These were (1) the payment of delay rentals was ordinarily expressed only in terms of deferring commencement of the first well. Most leases were silent as to what happened if the first well was dry or, if successful, production later ceased during the primary term; (2) the habendum clause appeared to require production to be occurring at the end of the primary term or the lease terminated even if the lessee was then engaged in drilling or had completed a productive well, but had not been able to get it "on production." The early clauses also implied that the lease would automatically terminate if production ceased, even if a well might be capable of being made to again produce or other valuable deposits were known to exist that could be developed by recompleting the existing well or promptly drilling another.

To resolve these deficiencies most leases currently in use in Louisiana

provide that (1) if a non productive well is drilled or if production ceases during the primary term, the lessee is given a limited period (usually 60 to 90 days) to either commence payment of delay rentals or to commence a new well (or reworking operations) to restore production; (2) if a lessee is drilling at the end of the primary term the lease continues until the well is completed (and thereafter, if production is obtained). (3) after the primary term, if production ceases (or a well being drilled is non-productive) the lessee has a short period, (again, usually 60 to 90 days) to re-establish production or start a new well or commence other operations to restore production; (4) if a well is completed that is capable of producing gas and the lessee is unable to obtain a market for it or to otherwise promptly produce the gas (pending construction of a pipeline, for example) he may make periodic payments (usually quarterly or annually) and the term of the lease will be continued or extended for some limited time as if the well were producing. This type clause is referred to as a "shut in" royalty provision. The Mineral Code also implies that the way in which the parties characterize such "shut in" payments may affect their juridical nature in as far as the rights of other owners of interests in the minerals are concerned. If they are characterized by the lease as "constructive production" or as in being in lieu of production they may be classified as "royalty." If they are characterized as "rentals" paid to continue the term they may be classified as rentals for the use of the land. The significance of such classifications may be found in Mineral Code Articles 105 [the owner of executive right is ordinarily entitled to "rentals" from leases but not "royalty"]; and 80 [A royalty owner ordinarily does not share in "rentals" but only "production" i.e. royalty].

Section Three. Provisions Relating to Operations

I. Rights Granted To The Lessee.

Many forms in current usage grant the lessee the right to produce not only oil and gas, but other undefined minerals. For example the 42 lease grants rights to "oil, gas, sulphur and all other minerals." The 14 lease grants rights only to "oil, gas and all other minerals". Older cases using the "ejudem generis" rule restricted the latter clause to oil and gas and other minerals found or produced in association with them. The addition of sulphur in the south Louisiana form, makes that interpretation more difficult. Two fairly recent decision appear to give the phrase "all minerals" and extremely expansive interpretation, including sand and gravel. On the other hand the other terms of the leases rather clearly contemplate that whatever is being produced will be produced by use of a well. This should serve to limit the construction of the lease.

In the absence of any express provision, the lessee implicitly is authorized to use so much of the premises for such activities as may be necessary to the enjoyment of his rights. The pervasiveness of unitization has however, in many cases permitted lessors to effectively restrict the

kinds of activities that the lessee may conduct upon the leased premises. This is sometimes accomplished in two ways. First, a provision that the lessee will conduct no activities on the leased premises and that any wells drilled thereon will be commenced from the adjacent lands and will only penetrate the leased premises at a depth sufficiently below the surface as to provide no interference with the ordinary use of the premises by the lessor. Second, a provision that all operations will be conducted upon other lands and that all production will be obtained from wells on units comprising the leased premises that are located off the premises. From the lessee's point of view a combination of the two ordinarily would be preferable -- particularly if there is some possibility that future wells may be located close to the leased premises and unwittingly drift under them.

Another restriction on use that is frequently encountered includes requiring minimal distances for wells from houses, barns and other structures, requiring approval for the location of roads, requiring fencing of well sites, maintenance of gates and similar restrictions become more common as the value of the land increases. These clauses are perhaps more out of date than most, because of the change in the relative value of the lands in the state, and perhaps also because of increasing bargaining power by lessors and are the subject of frequent modification by lessors today. In areas where tracts are relatively small and units are large (as in many gas fields) lessors frequently can obtain agreement that if a well or other facility is placed on the land, an additional, cash rental will be paid during the term of the lease -- on the grounds that in a unit, the lessee whose land is burdened by the facility should be compensated for the increased burden on his property when others in the unit are sharing the revenues without incurring any of the inconvenience. Leases customarily provide that the lessee will pay the lessor for "damages" to crops and timber incurred in the course of his operations. These, strictly speaking are not "damage' provisions, since the lessee has the right to cut the timber and destroy the crop in the course of his operations. Rather it is simply an additional rent to compensate for losses or diminution to the premises from the exercise of the lessee's rights which cannot be directly ascertained at the time the leases is given.

II. The Obligations of the Lessee

Early courts in other states, noting that the lessor's return from the ordinary oil and gas lease was a royalty consisting of a fraction of the minerals produced, concluded that the principal consideration for the lease was the development of the premises for their mineral value. They then concluded from the nature of the arrangement that the lessee had impliedly obligated himself to promptly enter upon the premises to begin exploration for and mining of the minerals that might be found therein, and to diligently continue, during the term of the lease his efforts to mine them. Louisiana courts accepted this general theory as to the nature of such leases although

no case involved the issue of whether immediate exploration was required.[10] The delay rental provisions found in modern leases were originally designed to permit the lessee to defer or "delay" the immediate undertaking of such exploration. Before discovery of oil and gas, the obligations of the lessee are generally regulated by express provisions as to the necessity for drilling or paying rentals to defer the drilling of the initial (or subsequent) wells. After production begins, the matter of the lessee's obligations is still largely regulated by implication in most leases.

The Mineral Code expressly codifies the prior jurisprudence by providing that the lessee is "bound to perform the contract in good faith and to develop and operate the property leased as a reasonably prudent operator for the mutual benefit of himself and his lessor." (M.C. 122). The lessee is not a fiduciary. (M.C. 122). Thus, he is not required to place the interests of the lessor ahead of his own, nor is he bound by the traditional fiduciary restraints of full disclosure, lack of self dealing or prohibition against profiting from the affairs of ones principal. The lessee's duty is to act as a "prudent" operator having due regard to the mutual interests of himself and the lessor. This may generally be defined to mean that he must, in exploring and mining the property, do those things and exercise that judgment expected of one who is knowledgeable of the industry; is actively seeking to profitably explore for and mine the premises, and who possesses resources adequate to do so in light of the accepted practices and technical capabilities existing from time to time in the industry.

Because controversies over the propriety of lessee's actions (or failure to act) tend to fall into fairly consistent categories, the courts have characterized the lessees implied obligation to act prudently as encompassing several discrete duties. These are the obligation: (a) to diligently develop the reservoirs discovered; (b) to explore the leased premises for undiscovered deposits of oil and gas; (c) to protect the premises from drainage from wells on adjacent lands and (d) to diligently market the oil and gas produced. At the same time it has been recognized that the stated obligations are but particularized expressions of the more pervasive obligation defined by Article 122, and that all of the provisions of the lease and their performance by the lessee are to be measured by the "prudent operator" standard articulated by that article. Thus a lessee has been held to have breached the lease by failing to utilize newly developed production techniques.[11]

The first "obligation" distinctly recognized by the courts was that of diligently developing known deposits of oil and gas that had been discovered by drilling on the premises. It was held that lessee must drill

10 See Caddo Oil & Mining Co. v. Producers Oil Co., 134 La. 701, 64 So. 684 (1914).

11 See: Waseco Chemical and Supply Co. v. Bayou State Oil Corp., 371 So.2d 305 (La. 1979).

such wells as are reasonably required to profitably extract all of the oil and gas contained in such deposits.[12] To establish a breach of the obligation, the lessor was required to establish that the lessee has failed to drill an additional well or wells to the reservoir that a "prudent operator" in the same situation would have drilled. This, in turn, ordinarily required the lessor to prove the reservoir extended under the place where the well was to be drilled; that existing wells were not adequate to drain the reservoir, and that if drilled, such additional wells would be profitable to the lessee.

In recent years the application of this obligation in Louisiana has been much influenced by the Louisiana Conservation Act. The Commissioner of Conservation almost invariably unitizes lands when wells are drilled on them. A unit established for a well under the act, by definition, represents the area that can "economically and efficiently be drained" by the well. If the Commissioner determines a reservoir is greater than the area that will be drained by then existing wells, he ordinarily establishes units for such future wells as he finds will be necessary to fully develop the reservoir. Such an order affords strong, if not almost irrefutable, evidence of the extent of existing development and the necessity for additional wells to fully develop the reservoir and, to some degree, may also be viewed as indicative of their economic practicability. A lessee holding leases he believes may be underlain by a reservoir or that may be unitized the Commissioner is virtually forced to participate in unitization proceedings brought for the reservoir to protect his interest. To do this he will have to present his views as to the size of the reservoir; the extent of existing development; the desirability of additional units, and their feasibility. He will be hard put to later deny the necessity for drilling such additional wells as may be indicated by the findings of the Commissioner (or his own testimony) as a consequence of the proceedings.

The courts of other states originally held a lessor was obligated to immediately begin exploration of the leased premises in search of oil and gas. The provision for delay rentals permitted the lessee to defer his exploration indefinitely during the primary term. Modern leases generally make no provision for payment of such rentals after production is obtained. Consequently, question has arisen as to the extent of the lessees duty to explore non-productive areas after finding and beginning to produce one or more reservoirs under the premises. Cases in other jurisdictions indicate such an obligation exists, but that the lessor, to prove its breach has to meet the same test as for development wells and thus prove the lessee has failed to drill a well that would be both successful and profitable. Given the speculative nature of exploratory drilling, this tends to make the duty pragmatically unenforceable and doubt has even been expressed as to

12 Gennuso v. Magnolia Petroleum Co., 203 La 529, 14 So2d 445 (1943).

whether the duty exists.[13]

Recent Louisiana cases appear to have abandoned the requirement that the lessor prove the lessee has failed to drill a potentially profitable well in favor of one based upon a broader view of the lessees duty. These cases indicate the lessor has a continuing duty to prudently investigate the possibility that additional reservoirs exist under the land and that it comprehends more than the mere drilling of apparently profitable wells. A failure by the lessee to demonstrate he has engaged in diligent, continuous efforts to determine the premises' mineral potential or his asserted unwillingness to do so, or an assertion that further efforts would be useless, may in themselves now give rise to an action to dissolve the lease as to the unexplored and unproductive areas.[14]

The jurisprudential development of the implied obligations requiring the development of known reservoirs and the exploration of undeveloped areas, coupled with the effect of conservation units in virtually defining the developed areas, pragmatically force upon a lessee the continuing obligation to ultimately drill the portion of the leased premises lying within the potential reservoir but outside of the existing productive units or suffer its loss. On the other hand, a lessor seeking to obtain from an unwilling lessee a dissolution of a lease for failure to develop or explore the premises is faced with the necessity of winning a perhaps expensive and protracted lawsuit. If he loses he may be deemed to have extended the lease for the period of time he was contesting his lessee's rights. In either event, development of the premises will have been delayed and actual drainage to the adjacent productive units may have occurred.

The uncertain and unsatisfactory nature of the implied drilling and development obligations to both the lessee and lessor has given rise to a widely adopted modification of the customary form of lease by the addition of a provision that is known as the "Pugh" clause after a prominent Louisiana attorney who first advocated its usage. The clause, although a matter of contract, and varying in detail from lease to lease, is ordinarily understood to encompass the following features: (1) a well located upon a unit comprising a part of the leased premises will maintain the term of the lease only as to the area within the unit; (2) as to the part of the premises outside the unit, the lessee must continue to maintain the lease by paying delay rentals or drilling additional wells (each of which will only maintain the part of the premises unitized with it); (3) the lessee is given a minimum time after completion (or unitization) of the first well in which to develop the entire premises even if the original primary term has expired or will expire before then. (In short--the primary term is in effect extended, if

13 See the Official Comments to Article 122 entitled "Further Exploration."

14 See: Vetter v. Morrow, 361 So.2d 898 (La. app. 1978); Sohio Pet. Co. v. Miller, 237 La 1013, 112 So.2d. 695 (1959).

necessary, for a stated period from completion of the first well.); and (4) at the end of such extended period the lease will terminate as to those areas not then included within producing units.

Another modification of the customary form of lease that is intended to regulate the same matter and that is sometimes encountered is the "continuous drilling" clause. This provides that if by the end of the primary term (or sometimes during it) a productive well is drilled on the premises (or on a unit encompassing part of the premises) the lease will continue only as long as the lessee continues drilling additional wells without allowing more than some fixed period of time to elapse after the completion of one well and the beginning of another. If (and when) such a lapse in drilling occurs the lease terminates as to all lands except as to a stated area (such as 40 or 80 acres) surrounding each producing well. Customarily, such clauses also provide that if any well is unitized the lease will continue as to the portion of the premises included in the unit in lieu of the otherwise stated area.

Pugh clauses and continuous drilling clauses require highly sophisticated drafting and may present difficult problems of interpretation if (for example) multiple, overlapping reservoirs are encountered, unitization occurs after wells are drilled, or unit boundaries are subsequently changed or modified.

The lessee is generally held to be under a duty to prudently market the oil or gas produced or that is capable of being produced in paying quantities (M.C. 122).[15] The current litigation in this area is pervasive and being discussed elsewhere that further not will not be mentioned at this time.

Section Four. Transfers by the Lessee of the Lease or Interests Therein

I. General Considerations

A Lessee may assign or sublease the lease, absent a prohibition in the lease. (M.C. 127). The lessee may also convey a right to share in the production from the lease ("an overriding royalty") (M.C. 126).

II. Assignments and Subleases--Nature of Distinction

Louisiana Law distinguishes between the assignment of a lease and the sublease of the leased premises by a lessee. An assignment is the transfer of all of the rights of the lessee under the lease. It implicitly obligates the assignee to perform all of the obligations of the lessee under the lease, and directly vests in him the rights of the lessee under the lease. A sublease is viewed as a separate and distinct lease of the premises by a lessee. A consequence of the distinction, under prior law, was that an assignee became directly obligated to the lessor for performance of the lease and was

15 *See also*: Risinger v. Arkansas Louisiana Gas Company, 198 La. 101, 3 So.2d 289 (1941); Lelong v. Richardson, 126 So.2d 819 (La, App. 1961).

entitled to directly enforce the lease against the lessor. A sublessee to the contrary, was not deemed to have any contractual relationship with the original lessor. To use common law terminology, no privity of contract existed between a sublessee and the lessor.[16] Thus, payment of delay rentals by a sublessee was held to be ineffective. *Baird v. Atlas Oil Co.*, 146 La. 1091, 84 So. 366 (1920)]. The subleasee could not be sued by the lessor for breach of the lease, nor did the sublessee have to be a party to a suit to cancel the lease. *Berman v. Brown*,224 La. 619, 70 So.2d 433 (1953). A release of the lease by the lessee would extinguish the sublease. This was deemed by the courts to be a harsh rule and it has also been held that an agreement by a lessor accepting a release from the lessor to recognize and continue a sublease may be found by implication, as where the existence of the sublease had been expressly recognized by the lessor receiving the release. *Kleas v. Mayfield*, 404 So.2d 500, (La App 1981). Conversely, a release of the sublease was not deemed to release the lease and the lease would continue unencumbered by the sublease. Again courts might find an implicit agreement in the sublease to permit the sublessee to release the lease itself where the sublease transfers "all of the rights" in the lease to the sublease, although reserving additional or overriding royalties, thus making the transaction a sublease.[17]

III. Assignment and Sublease — Theory of the Distinction

An assignment entails a complete transfer of the rights and assumption of all of the obligations of the leasee. A transfer of rights implies a relinquishment of all interest in them. Ordinarily a partial assignment of an obligation is not permitted. A transfer of less than all of the rights or the assumption of less than all of obligations of a lease by an "assignee" makes the transfer a sublease. Broussard Hassie Hunt Trust, 231 La. 474, 91 So.2d 762 (1956). Based upon the above principles the courts held that a transfer that imposes upon the transferee new or different obligations from those contained in the original lease or that reserves to the transferor any continuing right with respect to the premises leased (or the lease transfered) also makes the transfer a sublease. Thus, a transfer of rights to only part of the property leased; to mine only some of the substances leased; or that reserves an overriding royalty to the assignor is deemed to constitute a sublease. Johnson v. Moody, 168 La. 799, 123 So. 330 (1929).

A commonly encountered exception to the general rule that all of the lessees rights must be transferred for assignment to occur is found in a clause inserted in modern leases providing that if all of the lessees rights in a given geographic area are assigned, the failure to pay delay rentals by the lessee of the rights to one area will not cause termination of the lease to the other area if the other lessee has properly paid rentals with respect to it.

16 Broussard v. Hassie Hunt Trust, 231 La. 474, 91 So.2d 762 (1956).

17 See: Cameron Meadows Land Co. v. Bullard, 348 So.2d 193 (La. App. 1977).

This type of clause has been construed as evidencing an implied agreement of the lessor to an assignment of part of the lease and, consequently, to effect both an assignment and division of the lease. *Tyson v. Gulf Oil Co.*, 195 La. 248, 196 So 336 (1940). An assignment of less than all rights in such an area does not have this effect and still creates a sublease. In the absence of such a clause (or other consent to a "partial" assignment of the lease by the lessor) such an "assignment" should be construed as a sublease.

IV. Effect of Assignments or Subleases under the Mineral Code

While continuing to recognize the theoretical distinction between a sublease and assignment and codifying most of the previously existing rules, the Mineral Code to some degree also modifies some of the consequences of the distinction. A "partial" assignment or "partial" sublease does not divide a lease. (M.C. 130). This may be modified by the parties and thus perpetuates the interpretation of the delay rental division clauses mentioned in paragraph C.3 above.[18]

A lessee remains responsible to the lessor for the obligations of the lease even after assignment of his rights therein. (M.C. 129). A sublessor also remains responsible to the lessee for performance of the lease. (M.C. 129). This does not change the law, although in the case of an assignment it was widely (and incorrectly) believed that an assignor was relieved of the obligations of the lease accruing after the assignment. This also means that one who acquires a lease and "sells" or transfers all of his rights in it remains responsible to the lessee for the performance of the lease by the lessee, and can be made to respond for failure to pay royalties, damages for drainage and in all likelihood, damages to the lessors property. A release of the assignor may be expressly consented to by the lessor in writing. (M.C. 129). This would include an express stipulation in the lease. The retention of an overriding royalty or similar continuing interest in an "assignment" is still viewed as creating a sublease. A lessor must now "accept performance by a sublessee whether or not the assignment or sublease is filed for registry". (M.C. 131). "To the extent of the interest acquired" an assignee or sublessee "acquires the rights and powers of the lessee and becomes responsible directly to the original lessor for performance of the leases obligations." (M.C. 128). This obviously is intended to functionally eliminate the distinction between a sublease and assignment insofar as they imply a different relationship between the lessor and assignee or sublessee. In the case of a sublease that transfers all or definable part of the lessees rights (such as an "assignment" reserving an overriding royalty) it presents few problems. In the case of a more complex arrangement such as a "farmout" that imposes new or different obligations on the sublessee that are not be identical to the obligations of the lessee to the lessor, it is unclear how, or to what extent the lessor may enforce the

18 See Comments to M.C. 130.

sublease. A provision of great significance added by the Mineral Code is that a sublessee or assignee is bound by notices given or demands made by the lessor upon the orginal lessee unless the assignment or sublease is filed for record and written notice thereof is given to the lessor (M.C. 132). Failure to serve such written notice, even after recordation of an assignment or sublease means that demands for release, claims of default, etc., may continue to be made upon an assignor who, believing he has disposed of all of his interest in the contract, may not communicate them to the assignee.

Section Five. Miscellaneous Provisions

There are a number of other clauses, customarily found in leases, dealing with termination that perhaps should be mentioned. At the outset is should be recognized that several purport to deal with the rights of the lessee upon breach or termination of the leases. To the extent they deal with the rights of the parties upon breach they are subject to the argument that if one party has breached the contract, the other party may rescind it, and is thus no longer bound by any of its terms. Such provisions thus involve matters of public policy as to the extent to which parties to a contract may, by contract, regulate the consequences of their default.

Four of the most common of these provisions are the following:

(1) a provision that before a suit can be brought for a breach of the lease, the lessor must put the lessee on notice of the failure complained of, and give him a chance to remedy the deficiency. These have been always been recognized as legitimate provisions regulating the affairs of the parties and serve an extremely useful purpose for the lessee. Their provisions have been codified in Mineral Code Art. 136, added in 1995. One would assume that the lease provisions will be held to be a reasonable and conventional alterations of this article;

(2) A second, also of value and reasonably sustainable is a provision that in the event of the release or cancellation of the lease as to a part of the premises, the lessee will continue to have the right to use the "surface" of the part released to facilitate operations on the remaining portion. This also would seem to be valid -- since there is a contract in effect between the parties, and geography should have little effect upon their rights to use and occupy the premises;

(3) the third, and somewhat more difficult to sustain is a provision that in the event of the cancellation of the lease (presumably for breach, or error) the lessee may nonetheless have the right to retain an area (usually 40 acres in the case of oil and 160 for gas) around each producing well. The second circuit quite properly refused to apply the clause in a case where there was but one well on the premises, which themselves covered less than 40 acres and the complaint was that the lessee had failed to develop the premises in question. The clause should be defensible to some extent, as a recognition by the parties that a mineral lease, by contractual understanding, is

essentially divisible. Therefore, if the breach is a result of a failure to comply with the obligations as to a part of the premises the lessee should not necessarily lose the benefits of those parts as to which he has satisfactorily performed his contract. On the other hand, if the breach relates to the operation of the very well he is attempting to retain, the clause should, it is suggested, be unvailing. Certainly one should not be able to retain his leasehold rights when he has completely and utterly failed to pay the royalties on the production from the well in question; and

(4) The last clause is sometimes referred as the "judicial ascertainment clause" provides that the lease cannot be cancelled until after the lessee has been judicially declared to be in default and then is given an opportunity to remedy the breach. This has been, properly the writer suggests, summarily rejected.

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