

LANDOWNER GUIDELINES FOR EVALUATING OIL AND GAS PRODUCTION CONTRACTS

David B. Schweikhardt
Stephen B. Harsh

Department of Agricultural, Food and Resource Economics
Michigan State University Extension
Michigan State University
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The process of evaluating an oil and gas development contract can be complex, and the signing of such a contract involves a long-term commitment by a landowner. Contracts can be of various lengths, and, as a general rule, longer documents provide more detailed responsibilities for the contracting parties and are more likely to provide specific answers for disputes that arise in the future. It is also important to note that nearly all contracts are option contracts and do not guarantee that oil or gas production will be developed on the property. A rental fee per acre is paid for the option of developing the property for oil and gas production. Whether this option is exercised, and whether oil or gas is produced on the property, will depend upon a number of factors (e.g., adequacy of the oil or gas resource, oil or gas prices, proximity to a pipeline, etc.).

In the case of oil and gas development, the contracts deal with the developer's rights to use portions of the property's surface and subsurface. The issues involved in such contracts – the duration of the contract, the landowner's compensation payments, the liability of each party, the transfer of the contract to third parties, and many other issues – must be resolved between the parties negotiating the contract. In addition, it is important to note that some states (e.g., Pennsylvania) have highly-detailed state statutes that set specific requirements for oil and gas contracts. State statutes in Michigan provide much less detail. As a result, the wording of the contract will determine the outcome of many legal disputes that arise. Consequently, great care should be taken to investigate the meaning of the contract's provisions.

This worksheet is designed to help landowners examine some important legal issues that should be considered when negotiating a contract and some of the alternatives that might be considered to address those issues. It is strongly advised that you obtain legal assistance to better understand the provisions presented in the contract. **This worksheet is not a substitute for obtaining legal counsel regarding a contract – it is intended to help focus your discussions with qualified legal counsel.**

I. Basic Details of the Contract and Introductory Land Use Issues

Name of agent/company offering the contract _____

Description of land parcel(s) and portions of parcel(s) included in the contract _____

Contact person/company _____

A. What are your long-term (i.e., the remaining time you will own the property, the remainder of your lifetime, or the lifetime of you and your heirs) plans for the land parcel(s) covered by the contract?

- | | |
|---|--|
| ☐ Retain in farming | ☐ Commercial or residential development |
| ☐ Recreational use (e.g., hunting) | ☐ Keep as "natural" as possible |
| ☐ Sell to others | ☐ Other _____ |

Oil and gas contracts are long-term contracts, with a potential landowner commitment for several years. If you

or your heirs have plans to use these parcels for another purpose during the life of the contract, you may be prevented from doing so by the contract or because the parcel is less desirable for the purpose you envision in the future.

B. To what degree will the contract payments help or hinder your plans and goals?

- | | |
|--|---|
| ☐ Very important for plans or goals | ☐ Somewhat hinders plans or goals |
| ☐ Somewhat important for plans or goals | ☐ Significantly hinders plans or goals |
| ☐ Limited importance for plans or goals | ☐ Neither helps nor hinders plans or goals |

The contract payment might help achieve your plans or goals and will likely affect your financial options in the future. If the contract payments help achieve your financial objectives, then the contract might be useful in meeting your future goals. On the other hand, if the contract prevents your use of the property for other purposes, then the contract could hinder your long term goals or plans.

C. Who is offering the contract?

- | | |
|--|---|
| ☐ A leasing agent | ☐ An out-of-state oil and gas developer/utility firm |
| ☐ A Michigan oil and gas developer or utility firm | ☐ Other _____ |
| ☐ An international oil and gas developer/utility firm | |

There are many firms offering oil and gas contracts. Some firms act as leasing agents that assemble contracts for a block of land that could be developed into an oil and gas project and then sell the contracts to an oil and gas developer for a fee. Another firm may offer contracts and intend to develop the oil and gas project itself. Issues to consider are: Does the firm have prior experience in developing oil and gas projects and, if not, is there evidence it will succeed with the project? Would you prefer to have a contract with an in-state firm or a firm located in another state or foreign country? Regardless of who offers the contract, there may be an assignment clause in the contract. Be sure to see section VI below for details about assignment clauses. If you are dealing with a firm from outside Michigan, see section IX below for issues related to out-of-state firms.

D. Does the contract have a confidentiality clause?

- | | |
|------------------------------|-----------------------------|
| ☐ Yes | ☐ No |
|------------------------------|-----------------------------|

Some legal analysts advise against signing a contract containing a confidentiality clause. This clause may prevent discussion of the contract with other landowners involved in the project or inhibit family communications. In any case, the contract should specify exactly what is required by the confidentiality clause.

II. Duration of the Contract

Oil and gas contracts can last for various durations. A contract can have a series of specified or open-ended time periods. Landowners should be aware that a contract that includes language such as “permanent easement” or “agreement in perpetuity” could be a permanent transfer of property rights. The typical time periods of an oil and gas contract are (a) the primary term (usually in the range of 5 to 10 years), (b) the secondary term (usually an open-ended period), and (c) an option for the extension of these periods. The sum of these periods can be quite long, and landowners should be aware of the duration of each period and the total duration of the contract.

A. Primary term

1. What is the length of time for the primary term? _____ Years

The primary term is “the number of years that the [developer] has to commence the drilling of a well to keep the lease in effect” (Cameron, p. 34). If the drilling of a well has taken place by the end of the primary term, the lease will then enter a secondary term. It is important to note that Michigan courts have ruled that a developer must show “reasonable diligence” in an effort to drill a well on the property (or on the property of a “pooling unit” that includes the property (see section V below for discussion of pooling units). Michigan courts have also ruled that actual drilling does not have to take place by the end of the primary term for developer to extend the lease to a secondary term. Instead, “activities that precede drilling, such as securing a permit, moving equipment onto the land, or preparing to drill” could all be considered activities that would satisfy the

definition of “commence drilling” (Cameron, p. 35). Consequently, if a landowner desires a more specific definition of “commence drilling,” such a definition must be negotiated into the contract.

2. If the developer is permitted to extend the primary term, how long is the extension and what is the procedure for activating the extension?

Some contracts will permit the developer to extend the primary term of the contract if drilling has not commenced by the end of the primary term. It is critical to determine the actions that must be taken by the developer. Can the developer extend the primary term by sending a letter of notice to the landlord? Is the developer required to pay additional rent (sometimes called “delay rental”) for the right to extend the primary term? Is the landlord permitted to seek bids from other developers to gauge their interest in leasing the property? If other developers make offers to lease the property, will the original developer have a “right of first refusal” to match their bids? Failure to examine these terms in the contract could commit the landowner to a very long period in which the oil and gas resources are undeveloped.

B. Secondary term

Once drilling (or, as noted above, any activity defined as having “commenced drilling”) has occurred on the property (or the property in a pool), the secondary term of the contract will begin. The length of the secondary term continues “so long as oil and gas are produced in paying quantities” (Cameron, p. 34-5). Again, there is no specific language required in Michigan contracts, and this language may include such phrases as “so long as operations are conducted” or “so long as a well is capable of production.” This language is extremely critical and can have many complex legal interpretations. Assuming that you do want oil or gas produced on your property (so that you can receive royalties), then some of these phrases might mean that there would be very little gas produced until several years into the future (i.e., the language could permit the developer to meet the language of the contract while producing very little marketable product). Consequently, the landowner should be sure to discuss this issue with qualified legal counsel. In some cases, the landowner might prefer a shorter primary term in the contract as a means of increasing the probability that oil or gas production will begin in the near future. In addition, a shorter primary term might be desired because this provides an earlier opportunity for the landowner to renegotiate the terms of the contract, seek another developer, or use the land for other purposes.

III. Granting Clause

- A. What property rights to natural resources (e.g., oil, gas, minerals) are transferred from the landowner to the developer by the contract? List all: _____

The granting clause “describes the extent of the [property] interest granted to the [developer]” (Cameron, p. 33). There are two aspects of the granting clause that are especially important to landowners. The first is the “bundle of rights” transferred to the developer to conduct activities that are related to the production of oil and gas, such as exploration, drilling, or building of pipeline to remove the product. In the case of oil and gas contracts, this clause usually grants to the developer (a) the right of exploration/evaluation, (b) the right of production/removal, and (c) right to construct other facilities/structures on the land’s surface or subsurface that are reasonably necessary for production activity (Cameron, p. 33). It is important that these provisions specify the activities that are permitted under the contract and those rights that are not being transferred to the developer if the landowner is seeking to limit the activities permitted on the land.

Second, the granting clause determines which natural resources the developer may remove from the land to sell. Once again, small differences in language can create significant differences in the legal meaning of the contract. For example, under MCL 324.63301(a), “mineral” is defined as “every inorganic substance that can be extracted from the earth...whether it is solid, as rock, fire clay, the various metals and coal, or fluid as mineral waters. Mineral does not include oil or gas.” At the same time, some Michigan courts have held that the phrase “of all minerals” does include oil and gas in some contexts (and depending on the contract language) (Cameron, p. 24-25). In any case, the landowner should be aware of exactly which property rights are being

transferred to the developer by the granting clause and the impact of those transfers on (a) the surface use of the land and (b) the financial payments that will be received as compensation for those rights.

B. Does the granting clause contain a “Mother Hubbard” provision?

☐ Yes

☐ No

A “Mother Hubbard” provision permits the developer to obtain “the right to develop all contiguous or appurtenant lands owned by the [landowner] if the parcel to the lease is inadequately described or the [landowner] subsequently claims ownership to the adjacent property” (Cameron, p. 34). If the contract contains such a clause, it could, for example, permit the developer to claim the right to develop the neighboring property if the landowner becomes the owner of the neighboring property at some point in the future. Whether the landowner wants to accept this provision or reserve the right to negotiate the rights to the additional property in the future should be considered at the time of signing the contract on first property.

IV. Compensation Issues

Though landowners often think only of the issue of oil and gas royalties, several aspects of compensation deserve careful consideration when negotiating an oil and gas contract. These issues include (a) bonus payments made at the time of signing, (b) rental payments made during the primary term of the contract, (c) royalty payments during the secondary term of the contract, and (d) compensation for other issues.

A. What is the payment offered as a bonus payment at the time of signing the contract? _____ \$

This payment is offered at the signing of the contract. This payment will be taxable income during the year in which it is paid to the landowner. In addition, a larger bonus at signing might mean that other compensation will be less generous if oil is actually produced on the property at a later time. Thus, the landlord might want to compare two offers – one with the bonus, and one without the bonus and a higher royalty payment. In addition, the landowner should consider the tax consequences of each offer.

B. What is the payment offered as a rental payment during the primary term of the contract? _____ \$/Acre

This payment will be made at a specified time (e.g., quarterly, annually) during the primary term of the contract before the production of oil or gas has begun.

C. What is the delay rental payment offered as a rental payment during the extension period of the primary term of the contract? _____ \$/Acre

This payment will be made at a specified time (e.g., quarterly, annually) during an extension of the primary term of the contract before the production of oil or gas has begun

D. What is the landlord’s royalty share offered by the contract? _____ (e.g., 1/8, 3/16, 1/4, etc.)

This will be the landowner’s share of the total revenue from the sale of the oil or gas produced on the property. The three factors that will determine the landowners’ royalty payments are (a) the market price for oil or gas that is used to determine the value of the oil or gas produced, (b) the fraction of the revenue specified as the landowner’s share in the contract, and (c) production costs that are deducted from the landowner’s share of the royalty

First, the contract should specify the method of establishing the market price at which the oil or gas will be sold. In addition, the landowner might want to consider the following scenario: Assume the gas is produced by a legal entity (Driller A) and then sold to a second legal entity (Distributor B), but Driller A and Distributor B are both part of a third legal entity – Corporation C. In this case, what is the price at which the gas is “sold” from A to B? In this instance, would the price reflect the true market value of the gas produced – or could B buy the gas from A at an artificial (lower) price? The landowner might want to specify that such sales will reflect an “arms length price” (i.e., the price that would occur between an unrelated buyer and seller).

Second, the landowner's royalty share should be examined in combination of other aspects of the contract. For example, a higher royalty share that requires the deduction of more postproduction costs (discussed below) could provide a lower net royalty payment in the future. As noted above, a large bonus payment at the signing of the contract could also mean that the royalty share will be lower in the long term. Thus, future royalty payments would be reduced. Only by considering these in combination can the landowner determine the best offer for the long run.

Finally, it should be noted that the issue of compensation is so critical that some states have enacted statutes that require a minimum royalty share for all oil and gas contracts (e.g., Pennsylvania's statute provides a minimum share of 1/8 for all oil and gas contracts). Michigan has no such minimum royalty share law, nor is there "an industry standard" that is applicable to all contracts. Consequently, the terms of the contract a landowners signs in Michigan will be the terms that a Michigan court is likely to enforce,

E. What postproduction expenses will be deducted from the landowner's share of the production royalty? List all:

In order to be marketed, natural gas must have impurities removed and must be transported to a pipeline system or other facility for shipment. Under Michigan law (see MCL 324.61503b) the lessee (developer) "shall not deduct from the lessor's [landowner's] royalty any portion of postproduction costs unless the lease explicitly allows for the deduction of postproduction costs. If a lease explicitly provides for the deduction of postproduction costs, the lessee may only deduct postproduction costs for the following items, unless the lease explicitly and specifically provides for the deduction of other items:

- (a) *The reasonable costs of removal of carbon dioxide (CO₂), hydrogen sulfide (H₂S), molecular nitrogen (N₂), or other constituents, except water, the removal of which will enhance the value of the gas for the benefit of the lessor [landowner] and lessee [developer].*
- (b) *Transportation costs after the point of entry into [a pipeline system]."*

Given this statutory language, the contract language on postproduction costs will be critical in determining the net royalty payment the landowner will receive. Again, small difference in contract language can create significant differences in the net royalty payments received by the landowner. Such issues should be discussed with qualified legal counsel.

F. Does the contract include a "shut in" royalties clause?

☐ Yes ☐ No

A "shut-in" well is a well that has been drilled and "is capable of producing oil and/or gas but is not yet in production." (Lawler, p. 97). There can be several reasons why a well is not producing. For example, between the time that a well is drilled and oil or gas is discovered, and the time that a pipeline is installed to remove the products to a larger pipeline system, the well will not be operating. Thus, the primary term has been satisfied (drilling has not only commenced, it has been successfully completed) but the secondary term (production of oil or gas) has not been satisfied (there is no pipeline connection to remove the oil or gas to sell it on the market). Thus, at the very least, a shut-in period is almost certain to arise while a pipeline is built. Wells may be shut-in at other times during the life of the contract for a wide variety of other reasons (e.g., market prices do not make production profitable, etc). Thus, the landowner should consider (a) the circumstances that will permit the developer to shut-in the well and (b) the payments that the landowner will receive during the shut-in period.

G. Do any of the compensation clauses have an inflation adjustment provision?

☐ Yes ☐ No

Because of inflation, a dollar received ten years from now will have less value than a dollar received today. It may be desirable, therefore, for the landlord to have a compensation clause in the contract that increases those payments of a fixed value that will be paid in the future. For example, if the primary term is for 10 years, and the rental payment (or the delay rental payment during an extension of the primary term) is a fixed number of

dollars per acre, inflation will reduce the buying power of those payments made in year ten. An inflation adjustment clause (based on, for example, the Consumer Price Index or CPI) can protect the buying power of these payments. Other compensation payments (such as royalties paid on oil or gas produced) are likely to be based on the price of gas at the time it is sold.

- H. Do any of the compensation clauses include payment for the surface land removed from existing uses by the developer (such as roadways or structures) during the primary or secondary terms?

☐ Yes

☐ No

During the primary and secondary terms, the developer must have access to the wells and may need to construct other structures or roads on the land. The contract should specify the landowner's payment per acre for the use of this land or the method to be used to calculate this payment. Particular attention should be paid to the compensation that will be paid to the landowner if income-producing land (e.g., farmland in crops or timber land) is removed from production.

- I. Do any the compensation clauses include payment for the land used by the developer on a temporary basis during the drilling or production (e.g., temporary roadways, temporary structures, space for large equipment such as drilling equipment, etc.)?

☐ Yes

☐ No

During the drilling operation, the developer might need access to land on a temporary basis. If such use interferes with existing uses of the land (e.g., prevents the planting of a crop or destroys an existing crop), does the contract specify the landowner's payment per acre for the use of this land during this period? In addition, does the contract specify that land used on either a temporary or permanent basis will be returned to its original state by the developer when the activity is concluded? How soon will such restoration of the land take place? (See section X below on termination of the contract.)

- J. Does the contract include compensation for other uses of the property?

☐ Yes

☐ No

For example, a pipeline from the well to a larger pipeline system is necessary to remove gas or oil for shipment in the larger pipeline system, but will that pipeline also be used to transport production from other properties? If so, is the landowner compensated for the use of the property for this purpose? Similarly, once the oil or gas is removed from the deposit, can the empty underground space be used for storage of gas from another location? If so, is the landowner compensated for the use of the property for this purpose? Some analysts envision the sequestration of CO₂ in vacant oil or gas deposits is a means of addressing the issue of climate change in the future. If such an operation were to take place after the production of oil or gas terminates, would the landowner be compensated for the use of the property for this purpose?

- K. Does the contract provide an offer of "free gas" to landowner?

☐ Yes

☐ No

Some contracts offer "free gas" to the landowner if a productive well is developed on the property. Landowners should be aware that they could be liable for the cost of installing a pipeline to the property's residence and for the cost of making the gas useable. In addition, at the end of the well's (commercially) productive life, the landowner might be offered a chance to continue the use of the remaining gas. If the landowner accepts this offer, will the landowner also be liable for the cost of plugging the well at the end of its life? (See section X below for discussion of well-plugging issues at the conclusion of the contract.) Some legal authorities suggest that the landowner should consider a provision that provides for a choice of (a) the free gas or (b) the cash equivalent of the free gas, with that choice to be made at the time the well becomes productive.

- L. Does the contract contain a Force Majure clause?

☐ Yes

☐ No

A Force Majure clause permits the developer to extend the duration of the contract if a delay is caused by any law, legal action, or requirement of a government agency, court, or utility. The clause might also apply to

natural causes that prevent the development or use of the project. During the time this clause is in effect, any payment due or action required of the developer could be delayed or avoided by the developer. For example, the circumstances under which the Force Majeure clause could come into effect could be critical in determining whether the primary term of the contract could be extended by the developer. Consequently, the wording of this clause can be important in such issues as contract extensions, payment of royalties, etc.

V. Pooling

- A. Does the contract permit the developer to use “pooling” as a means of combining the properties of various landowners into a single “drilling unit”?

☐ Yes

☐ No

The issue of pooling arises because underground oil and gas deposits do not conform to the property lines on the surface of the land. Because two or more properties often share the same deposit, a means must be established to divide the use of this shared resource. Pooling (or “communitization”) is a means of sharing the rights to the subsurface resource among landowners. In Michigan, the laws applicable to the pooling issue are specific and established by statute “to authorize the [developer] to combine several adjoining [properties] into one producing unit to maintain a producing well” (Cameron, p. 40) This process is intended to reduce the cost of drilling (rather than having several wells drilled into the same deposit) and to guarantee the sharing of the deposit among all the landowners whose property resides over the deposit. In most cases, each landowner’s share of the oil or gas resource will be equal to that landowner’s proportion of the total acreage included in the pool (e.g., if a landowner owns 10 percent of the total acreage in the pool, then the landowner would receive 10 percent of the oil or gas produced by the pool (Cameron, p. 40). Pooling can be done in a voluntary manner (by agreement of all landowners, i.e., all landowners in the pool sign leases the permit the developer to pool the properties) or in a compulsory manner (over the objection of at least one landowner).

In a voluntary pool, all landowners whose property shares an oil or gas deposit will form a “drilling unit” (usually ranging from 40 to 640 acres). In a voluntary pool, the Michigan Supervisor of Wells will examine the drilling unit for the appropriate size of the drilling unit and the spacing of the wells drilled. If all of the landowners with a right to a particular deposit do not sign a lease with a developer, or do not consent to pooling, the developer may request that the Michigan Supervisor of Wells order a compulsory pooling plan. Such a plan must be designed to (a) avoid “the drilling of unnecessary wells” and (b) afford “so far as it is practicable to do so ... the owner of each property in a pool the opportunity to produce his or her just and equitable share of the oil or gas in the pool” (MCL 324.61513(1) and (2)). Under a compulsory pooling order, a landowner who did not sign a lease or consent to pooling will be given the choice of (a) paying “that owner’s proportionate share of the actual cost of drilling...and operating the well in the pooled unit [regardless of] whether the well is drilled as a producer or a dry hole,” or (b) if the well is completed as a producer “the operator of the well [may deduct] the nonparticipatory [landowner’s] share of production from the well [the landowner’s] share of the cost of drilling and operating the well, plus an additional percentage of the costs that the supervisor considers appropriate compensation for the risks associated with drilling a dry hole and the mechanical and engineering risks associated with the completion ... of each well” (MCL 324.12064(a) and (b)) (see Michigan Department of Natural Resources and Environment (2006 and undated) for additional details on compulsory pooling).

- B. Does the contract include a “Pugh clause”?

☐ Yes

☐ No

The best way to understand the importance of a Pugh clause is through the use of an example. Assume that the landowner owns 200 acres and signs a contract with a developer for the entire 200 acres. Before the end of the primary term, 20 acres of the property are included in a pool with a neighboring property, and a well is drilled (thus, drilling has commenced for the pooled land). At the end of the primary term, the 20 pooled acres have entered the secondary term. Have the 180 acres also entered the secondary term (and are still under the control of the developer) or has the contract terminated for the 180 acres and the landowner is now free to sign a new contract with a second developer for the 180 acres? A Pugh clause deals with this issue by providing for “the

severance [separation] of the lease between the pooled and unpooled acreage whenever less than [the entire] lease tract is included in a pooled unit” (Fambrough.1997, p.8). Thus, a Pugh clause preserves the landowner’s right to offer to property outside the pool to another developer at the end of the primary term. If the contract does not have a Pugh clause, the entire property is likely to remain under the control of the developer at the end of the primary term, even if drilling has not commenced on the unpooled acreage. Some legal analysts advocate the use of a “modified Pugh clause” for a large tract of land that is all unpooled but is only partially included in a drilling unit (see Fambrough (1997, p. 8) for further discussion of Pugh clause issues on large tracts of land).

VI. Assignment Clause

A. Does the contract have an assignment clause?

☐ Yes

☐ No

An assignment clause permits the developer to sell or transfer its contract rights to another party. Thus, a contract with this clause might mean that a different company will own the rights to the contract in the future. If the contract has an assignment clause, landowners might want to consider at least two options. First, the landowner might want to negotiate a higher payment rate as compensation for the risk faced in dealing with another party in the future. Second, the landowner might want to negotiate a provision in which the developer is liable if the contract is assigned to a third party and the third party fails to satisfy the terms of the contract (especially the payment terms). In a similar matter, does the contract permit the developer to mortgage the contract rights to a third party without the landowner’s permission? If the developer mortgages the property under contract to a third party, and the developer then defaults to the third party, the landowner’s rights relative to the developer and the third party might be affected. A contract should specify the conditions under which a mortgage may be exercised by the developer and the landowner’s right of approval in such a case. In addition, the contract should limit the landowner’s obligations to the third party. At the same time, the assignment clause can also be valuable to the landowner if the landowner wants to transfer the contract to a third party (e.g., giving the contract to a child while the landowner continues to use the surface of the property, or selling the contract to an investor as a means of gaining immediate income).

VII. Liability Issues

A. Who is liable for the various forms of personal or property liability that could arise during the project?

☐ Developer

☐ Landowner

Several liability issues should be considered in the negotiation of an oil and gas contract. First, is the landowner liable for damage he/she commits to production-related equipment or facilities on the property? Second, is the landowner liable for damages caused by a third party whom the landowner grants permission to use the property? For example, assume the landowner gives permission for a third party to hunt on the land. If the hunter damages equipment owned by the developer, is the landowner liable for those damages? Third, is the developer liable for damages to the landowner’s property during the life of the contract? Fourth, who is liable for damages that occur to a third party? For example, assume a third party is injured by equipment located on the property. Is the developer or the landowner liable for the third party’s damages? Fifth, who is liable for enforcing trespass laws and for damages caused by trespassers? Sixth, who is liable for the injury of a worker employed by the developer that occurs on the landowner’s property? Finally, does the contract require the developer to carry insurance on the equipment and associated facilities located on the property? In addition to consultation with an attorney, the landowner should have the contract reviewed by an insurance agent for potential liability issues.

B. Who will pay the cost of any litigation with a third party?

☐ Developer

☐ Landowner

Litigation with a third party can arise in many situations. For example, assume a neighbor, claiming to be affected by the noise of the developer's production equipment, sues to halt the operation of the equipment. Will the cost of responding to that lawsuit be borne by the developer or the landowner?

VIII. Other Land Use Issues

A. Does the contract contain restrictions (e.g., a prohibition of hunting) that prevent the landowner from using the property for other desirable purposes?

☐ Yes

☐ No

The contract may contain provisions that limit the landowner's use of the land. While some restrictions might be necessary to permit the efficient operation of the project, landowners might want such clauses to be narrowly written to prevent interference with other activities on the property. At the same time, does the contract grant broad access and use of the land parcel to the developer? In general, such provisions should be narrowly written to limit the use of the land to those portions necessary for the conduct of the project.

B. Who will pay the cost (e.g., fines, etc.) for violations of land use regulations caused by the project?

☐ Developer

☐ Landowner

Oil and gas projects can be subject to many local or state land use and zoning regulations (e.g., setback regulations). If the project violates a regulation, and a fine or other penalty must be paid, which party will be liable for such a violation? The contract should specify (a) each party's responsibility in complying with such regulations during the life of the contract and (b) each party's responsibility in the case of violations of such regulations.

C. Does the contract permit the developer to use the water resources of the property in the well drilling or gas recovery processes?

☐ Yes

☐ No

The well drilling and recovery processes often require the use of significant quantities of water. If the contract permits the developer to use the property's water resource, will existing sources be used or will a water well be drilled for the purpose of producing oil or gas? Is the developer liable if the quantity or quality of water resources on the property is affected by the drilling process?

D. Does the contract permit the landowner to approve the location of drilling activity or the location of roads, pipelines, or other equipment?

☐ Yes

☐ No

Though decisions regarding the location of equipment or structures might be determined, in part, by geographic factors, landowners might want to include a provision that requires the developer to obtain the landowner's consent regarding the location of such facilities. Landowners might also want to address issues in the contract such as the depth at which pipelines are located.

E. Could production equipment or a structure associated with oil and gas production be located on land enrolled in USDA commodity programs?

☐ Yes

☐ No

If equipment or a structure is located on land enrolled in USDA commodity programs, how will the developer's use of that land affect the landowner's eligibility for farm program payments? Does the contract payment compensate the landowner for loss of commodity program payments? Landowners should consult the Farm Service Agency to determine the impact of the developer's use of the land on commodity program payments.

F. Could production equipment or a structure associated with oil and gas production be located on land enrolled in the USDA Conservation Reserve Program (CRP)?

☐ Yes ☐ No

Landowners should consult with the Farm Service Agency and/or the Natural Resources Conservation Service regarding the signing of an oil and gas contract on CRP acreage. The contract should also specify which party is liable for any penalties or fines imposed for violations of CRP regulations.

IX. Choice of Law, Choice of Venue, and Arbitration Clauses

A. Does the contract contain a choice of law clause or choice of venue clause?

☐ Yes ☐ No

If a landowner is considering a contract with a developer from outside Michigan, the contract should be examined for both a choice of law clause and a choice of venue clause. A choice of law clause might specify that any litigation that arises under the contract must apply the laws of the state in which the developer is located. While the dispute might be heard in a Michigan court, the court would be required to apply the laws of the developer's home state. If the contract contains a choice of venue clause, the case would be heard by a court in the developer's home state. Landowners should consider whether it is in their best interest to have all legal disputes resolved under Michigan law by a Michigan court. Finally, does the contract require that disputes be submitted to mediation or arbitration before a lawsuit can be filed? If so, what is the mediation/arbitration process? Is the process binding on the parties?

X. Termination of the Contract

A. Does the contract specify the events that permit the developer to terminate the contract?

☐ Yes ☐ No

A particularly important issue is whether the developer is permitted to terminate the contract "at any time without cause." If so, what are the landowner's rights to any remaining payments under the contract?

B. Does the contract specify the events that permit the landowner to terminate the contract?

☐ Yes ☐ No

What actions by the developer would trigger the landowner's right to terminate the contract? For example, if the developer fails to make a scheduled rental or royalty payment, does the landowner then have the right to terminate the contract? Particular attention should be paid to how the landowner must exercise the right of termination (including the issue of whether arbitration – including binding arbitration – is required).

C. Does the contract specify a time limit for the removal of equipment and facilities (i.e., structures, roads), the restoration of the surface land to its original condition, and the plugging of the well at the conclusion of the contract?

☐ Yes ☐ No

In some states, such issues are determined by state statute. In Pennsylvania, for example, the developer is required to remove all equipment and restore the land's surface to its original condition within 9 months after the completion of production activity. In addition, the developer is required to maintain funds for such purposes in an escrow account until the completion of production activities. Michigan has no such statutes and the terms of the contract will dictate the resolution of these issues. Thus, a contract that states that equipment will be removed and the surface land restored within a "reasonable" time period could give the developer a great deal of discretion in performing such duties.

D. Does the contract specify who must pay the costs of removing the equipment and facilities and plugging the well hole at the conclusion of the contract?

☐ Developer ☐ Landowner

The cost of removing oil and gas equipment can be substantial. The contract should specify which party will pay the costs of removing the equipment and any associated facilities when the contract is terminated. Some contracts require the developer to pay these costs and to retain funds in escrow that will be sufficient to pay

these costs. The contract should also specify the condition of the land after the removal/clean up process.

XI. Other Issues

There are many more issues that should be considered in negotiating an oil and gas contract. Only the assistance of competent legal counsel can address the full list of issues that should be considered. The following is a partial list of other issues that should be considered.

- A. Does the contract address the issue of default during the project? What are the landowner's rights if the developer defaults, leaving an unfinished project or unpaid compensation?
- B. Does the contract or a local zoning regulation require bonding by either party during the project?
- C. Does the contract require the developer to include the landowner on the developer's insurance policy?
- D. Is the landowner an LLC or other form of business organization other than a sole proprietorship? Michigan contract law might treat contracts between an LLC and a developer in a different manner than discussed here.
- E. If a change in a law invalidates one portion of the contract, does the remainder of the contract apply as written?

XII. Conclusion

The oil and gas industry is an important industry in Michigan. To participate in this industry, landowners should be aware of the economic benefits and the potential legal consequences of a contract for the production of oil and gas. Above all, landowners should be aware that signing an oil and gas contract should be a matter of negotiation. The landowner should be aware of the terms of the contract and should seek terms that are appropriate for the landowner's financial and land use objectives. The contract provisions listed above, along with many other aspects of the contract, should be considered carefully given the long term of commitment required by many contracts. Negotiation of an equitable contract requires the assistance of effective legal counsel. If satisfactory terms or compensation are not provided in the contract, new or additional terms should be negotiated or an alternative offer should be sought from another developer.

XII. Other Resources

Cameron, John G., Jr. *Michigan Real Property Law: Principles and Commentary*. 3rd Rev. Ed. Ann Arbor: The Institute for Continuing Legal Education. 2005.

Cunningham, Roger A., William B. Stoebuck, and Dale A. Whitman. *The Law of Property* 2nd Rev. Ed. St. Paul, MN: West Publishing, 1993.

Fambrough, Judon. *Oil and Gas Leasing*. Powerpoint presentation, Real Estate Center, Texas A&M University, Undated. (Contains references to Texas law that would not be applicable in Michigan, but contains excellent discussion of concepts for landowners in any state). <http://recenter.tamu.edu/speeches/JF090309S1127.pdf>

Fambrough, Judon. *Hints on Negotiating an Oil and Gas Lease*. Real Estate Center, Texas A&M University, Technical Report 229, July 1997. (Contains references to Texas law that would not be applicable in Michigan, but contains good discussion of concepts for landowners in any state). <http://recenter.tamu.edu/pdf/229.pdf>

Michigan Department of Natural Resources and Environment. *Michigan's Oil and Gas Regulations*. April 2006. http://www.michigan.gov/documents/deq/ogs-oilandgas-regs_263032_7.pdf

Michigan Department of Natural Resources and Environment. *Pooling of Properties for Oil and Gas Production*. Undated. http://www.michigan.gov/documents/deq/ogs-oilandgas-pooling_257974_7.pdf

Oil and Gas Mineral Services. (General information for landowners). <http://www.mineralweb.com>

Pennsylvania Department of Agriculture. *Negotiating Oil and Gas Leases on Pennsylvania Farmland*. July 2008. (Contains references to Pennsylvania law that would not be applicable in Michigan, but also contains good discussion of general concepts useful to landowners in any state). <http://www.agriculture.state.pa.us> (Click on “Publications” link and go to “Select by Publication Name”)