Oil and Gas Leasing in Michigan: Essential Considerations for Landowners

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"Is there a 'standard' oil and gas lease for Michigan?" The answer is no, but there are some standard questions to ask yourself and the leaseman before signing.

With oil and gas leasing activity on the upswing throughout Michigan's lower peninsula, a great deal of material has and is being written about leasing. But most landowners are still at a disadvantage when dealing with oil company landsmen. The intent of this bulletin is to summarize available literature and, by doing so, highlight the most important points to negotiating a lease and suggest where landowners can secure more detailed advice.

Key Thoughts on Leasing

1. Read a lease out loud, paragraph by paragraph, with all parties involved present.
2. Don't be in a hurry to sign; don't be pressured into an agreement.
3. Never sign something you don't understand.
4. There is no "standard" lease form; each is an individual contract.
5. All provisions of a lease are negotiable within reason.
6. "Landowners in areas considered 'hot' will have more negotiating power than landowners in areas with unproven reserves." (1)
7. Take time to talk to neighbors considering, or under, a lease to compare your offer with the terms that they have negotiated.

Intent of a Lease

Before considering individual aspects of an oil and gas lease, consider the underlying purpose of the agreement. As Veryl Meyers, a well-known Michigan oil and gas lawyer, states:

The purpose of the oil and gas lease is to embody and define the relationship between the producer (lessee) and the landowner (lessor), and the rights and duties of each (2). It gives the producer the right to: (1) explore for oil and gas, (2) produce it from subsurface formations, (3) store it, and (4) transport and market the product. The lease also defines the period during which its provisions will continue in effect and the terms of compensation to the landowner or mineral owner for the rights to share in the oil and gas produced from his land... (3).

Clearing Title

Before leasing land for oil and gas exploration, the title to the property must be cleared. The mineral rights to a piece of real estate may have been sold separately from the surface rights (i.e., severed), so ownership can be complex. How the title is held determines who signs the lease and how. Title holders are responsible for providing clear title to the property leased, but the leasing oil company will usually stand the expense of the costs of "curing" any title defects found, although landowners may be asked to assist in such efforts.

The Granting Clause

Almost any typical oil and gas lease (although there is no "standard" lease form) opens with the granting clause.

This clause expressly grants to the lessee the right to prospect and explore the leased property by geophysical and other methods and the right to drill and operate for oil and gas (4).

The language of this clause is generally quite straightforward. It is recommended, however, that two key factors be considered relative to this portion of the lease.

1) "With few exceptions, the grant of an oil and gas lease carries with it the implied right to use as much of the surface area as is reasonably necessary to explore and produce the oil and gas." (5) Landowners are advised to either: (a) require their prior written consent relative to the location and construction of individual structures (pipes, storage tanks, etc.) associated with production operations, or (b) insert specific, carefully considered guidelines relative to such structures into the lease.

2) Be sure that the lease covers only oil and gas, or their by-products as opposed to other mineral types. The terms negotiated for petroleum may fail to serve your best interests.
relative to other minerals that may be on your property. The
strip mining of coal, for example, may be allowed by some
leases being circulated in Michigan that include produc-
tion of "other related hydro-
carbons."

Bonus Payments

Company representatives attempting to lease your land will generally
offer an initial one-time bonus payment for signing the lease. This "up
front" payment is a great temptation to landowners, especially those in
financial need. With rental rates for subsequent years usually low, and
with the chances of hitting a producing well on your property typically
"less than good," the bonus may be the only real benefit you receive
from your lease.

At the same time, however, the
bonus should not be overem-
phased at the expense of royalty
rates or the duration of the contact.
"Essentially, it boils down to balan-
cing the 'sure' bonus payment
against the chance of a successful
well and the high royalty returns a
producing well can bring" (6). A
producing well could easily yield
royalty payments 10 to 20 times the
bonus payment in the first producing
year alone.

Royalties

Every lease allocates to the land-
owner, or mineral owner, some por-
tion of any hydrocarbons produced.
Terms of this apportionment consti-
tute the royalty clause. In those
lucky cases where production oc-
curs, royalties usually comprise the
crucial portion of the lease. Most
leases traditionally provide the les-
sor with a 1/8 royalty share. "How-
ever, royalty payments can be any
percentage that the landowner is
able to negotiate, and he or she
should not accept arguments that oil
companies will refuse royalty per-
centages higher than 1/8" (7). But
remember that by choosing to
negotiate for a higher royalty rate
you may have to do so at the ex-
 pense of your bonus payment, and
vice versa.

Several points are worth mention-
ing concerning the royalty clause of
a lease.

1) Be sure that it is clear exactly
what costs, if any, can be de-
ducted from the landowner's
royalty payment. Generally all
expenses incurred through
production are borne solely by
the lessee, but this issue should
be clear. Royalty shares should
be based on gross proceeds or
market value "at the well-
head." Especially with gas,
"The language 'at the well-
head' is of considerable sig-
nificance since in numerous
instances the cost of gathering
and processing the gas and
transporting it to a point of sale
at a gas transmission line may
be considerable" (8).

2) "Sometimes the prices posted
at wells or fields are discrimi-
nately or artificially set and
hence may prove to be sub-
stantially less than the prices
paid for comparable oil and
gas at other locations" (9).
Such adjustments of value will
obviously affect royalty re-
turns. "To avoid such prob-
lems, always try inserting some
formula for determining how
the market price or value will
be established" (10).

3) Another option is to receive
your royalty "in kind". This ar-
rangement lets the lessors take
actual possession of their share
of the physical product of their
lease, thereby eliminating val-
uation problems.

Duration of the Lease

Leases specify the number of years
that the agreement shall remain in
effect. This is called the primary
term. They will generally state that
"...if drilling operations are not
commenced within one year after
the lease is entered, the lease will
terminate unless an agreed sum is
paid the lessor" (11). This sum is the
rental, which "...must be paid on
each subsequent anniversary date of
the lease's primary term if drilling
operations have not yet begun by
that date" (12).

If the lessee begins to drill a well
before the primary term has expired,
the lease will be extended for as long
as diligent efforts to find oil or gas
continue. Exactly what constitutes
such "due diligence" has been a
matter of considerable legal conten-
tion, however, when leases appear
to procrastinate on the develop-
ment of their lease tracts.

If exploration or production has
not commenced by the end of the
primary term, the lease will end. "If
production has been established, the
lease will continue into its sec-
ondary term and last so long as [hypo-
carbon or other] substances covered
by the lease continue to be pro-
duced" (13). Therefore, it is to the
landowners advantage to:

1) Keep the primary term as short
as possible. "The sooner the
lease can be completed, the
sooner the lessor has the
commitment on his or her
property removed" (14).
In general, a five-year term might
be considered a fair arrange-
ment for both parties in the
lease; it allows a reasonable
amount of time for drilling, but
at the same time encourages
exploration to start.

2) Strive to negotiate a higher an-
nual delay rental payment (15).

3) Consider placing a time limit
on the shut-in clause. A gas
well may be "shut-in," or
production legally postponed
until gas pipelines are ex-
tended into the area, but you
can limit this, too.

4) Insert a clause in the lease
specifying that if oil is discov-
ered on the leased property,
the company will drill on re-
aining land under the lease
or relinquish it at the end of
the primary term of the lease (16).

Surface Damages

Oil and gas leases carry the im-
plied right to use as much surface
acreage as is reasonably necessary
for the development of the mineral interest.

Only when the lessee goes beyond what is reasonably necessary and negligently injures the surface area will the lessee become liable for damages to the holder of the surface estate. Likewise, the lessee is under no legal obligation to restore the surface area to its condition prior to the commencement of operations (17).

For protection, landowners are advised to insert specific provisions in their leases regarding surface damage. Texas oil and gas lease specialist Judon Fambrough suggests:

1) Full compensation for all surface damages.
2) A requirement for the lessee to restore the property to its condition prior to any development operations.
3) Designation of specific items for which lessees will be liable, and the manner by which costs will be assessed, in the event of any damages (might include crops, livestock, structures, pollution of water, etc.).

Conclusion
This bulletin is not the final word in oil and gas leasing. Instead, it should be a first step in the landowner's prudent effort to take the best possible advantage of what may be a once-in-a-lifetime opportunity. Be sure to carefully think through the "big three" trade-offs of bonus, royalty, and term of lease, and how they can best work for you.

It's a matter of give and take, benefits and concessions. The points discussed, and a great many others that haven't been, are all worth considering before the landsman "comes knocking." Once you've received that first offer, it's time for you to knock on the door of a good oil and gas lawyer and start working out the details of what will best serve your needs.

References
3. Ibid.
4. Ibid.
5. Fambrough, p. 9.
7. Ibid.
8. Meyers, p. 35.
10. Ibid.
11. Ibid., p. 9.
12. Ibid.
13. Ibid.
15. Fambrough, p. 9.