

## Top O&G Leasing Issues: Pooling And Pugh Clauses

*Law360, New York (June 19, 2014, 10:41 AM ET) --*

The primary document which governs the contractual and real property rights, privileges and obligations of the landowner (i.e., lessor) and the energy company (i.e., lessee) is the oil and gas lease. Before a landowner grants an O&G lease to a lessee, he should carefully consider some key provisions to protect himself and to maximize economic benefit. This article will discuss in greater detail the inclusion of a pooling clause and a Pugh clause in an O&G lease.

This article will discuss in greater detail the inclusion of a pooling clause and a Pugh clause in an O&G lease as briefly discussed in "Top Issues Facing Landowners of Oil and Gas."

### Pooling Clause: Joining the Leased Land with Other Land

The typical O&G lease allows the lessee to join or pool various adjacent tracts of land together to form a larger pooled unit on which it can operate.

The area formed is called a "pool" or sometimes a "pooled unit." Pooling permits the lessee to prevent waste by avoiding unnecessary drilling and to protect the correlative rights of the mineral owners in the common reservoir. Pooling also permits the lessee to drill a site that may be otherwise prohibited by state spacing rules or does not meet the minimum acreage requirement for a drilling permit.

A lessor may be subjected to two types of pooling: voluntary pooling or compulsory pooling. Voluntary pooling requires the consent of the lessor. Depending on the state law involved, compulsory pooling can be established by a lessee or operator or by a mineral owner if certain statutory prerequisites are satisfied. The statutory prerequisites for compulsory pooling vary from state to state and are beyond the scope of this article.

A lessor's two main concerns relating to pooling should be: (1) dilution and (2) exclusion of portions of the property from a pooled unit.

Dilution occurs when the lessor's leased tract is smaller than the pooled unit. If the lessor owns a 10-acre tract of land, and the lessee creates a 20-acre pooled unit with an adjacent 10-acre tract of land, the lessor's royalty would be 50 percent of the collective royalty for the 20-acre unit as compared to the



Gregory C. Cox

previous 100 percent of the 10-acre tract. The lessor's royalty is proportionately reduced by an amount equal to his tract acreage divided by the pooled unit's total tract acreage. In order to limit dilution, a lessor may want to limit, during the negotiation of the O&G lease, the size of a pooled unit in which his tract may be included.

The other concern is that the lessee will not pool all of the lessor's property into a pooled unit. This situation typically occurs when the lessor owns a very large tract of land. To limit this risk, the lessor may condition the power to pool in the O&G lease upon including a certain percentage of his land in the pooled unit or, as discussed below, provide for a Pugh clause in the O&G lease.

### **Pugh Clause: Releasing Land from the O&G Lease Before it Terminates**

The primary purpose of any Pugh clause is to protect a lessor from the situation where the leasehold acreage is held under an O&G lease during the secondary term by production from only a small portion of the total acreage. The implied covenant to develop the leased property, which is beyond the scope of this article, is far less strict than a specifically crafted Pugh clause.

A Pugh clause limits the rights of the lessee to hold the entirety of the leased acreage with only limited development. There are two kinds of Pugh clauses: the "vertical" and "horizontal."

The vertical Pugh clause operates to release all depths below the deepest producing zone, typically at the end of the primary term or after cessation of continuous drilling operations, if the lease provides for same. The vertical Pugh clause may also release all depths except the producing zone or any other zone(s) to which the lessor and the lessee may agree.

The horizontal Pugh clause operates to release all lands not included in a pooled unit, typically at the end of the primary term or after cessation of continuous drilling operations, if the lease provides for same. The horizontal Pugh clause releases land at the surface as to all depths.

A lessor should consider the addition of a Pugh clause when negotiating an O&G lease. It is typically not offered by the lessee in an initial O&G lease proposal.

A typical horizontal Pugh clause provides as follows:

If at the end of the primary term, a part but not all of the land covered by this lease, on a surface acreage basis, is not included within a unit or units in accordance with the other provisions hereof, this lease shall terminate as to such part, or parts, of the land lying outside such unit or units, unless this lease is perpetuated as to such land outside such unit or units by operations conducted thereon or by the production of oil, gas or other minerals, or by such operations and such production in accordance with the provisions hereof.

At the end of the primary term, the O&G lease will terminate as to any part of the land that is either: (1) not producing oil, gas or other minerals, (2) not included in a pooled unit that is producing oil, gas or other minerals or (3) not otherwise maintained by the terms of the O&G lease.

By way of example, without a Pugh clause, if an O&G lease covered 50 acres of land and the lessee, at the end of the primary term, only pooled 20 acres of land in a pooled unit for a producing well, the O&G lease would remain in effect as to the 30 acres of land not being used as well as the 20 acres of land included in the pooled unit. Even though the lessor is receiving no production and no royalty from the

undeveloped 30 acres of land, the undeveloped acreage could remain held by the O&G lease indefinitely.

With a Pugh clause, the undeveloped 30 acres of land would be released from the O&G lease at the end of the primary term. In other words, the O&G lease would terminate as to the undeveloped 30 acres of land and would survive as to only the productive 20 acres of land pooled by the lessee.

Depending on the additional language in the O&G lease, the lessor must be mindful that the lessee may be able to hold the 30 acres of undeveloped land through methods other than actual production of oil, gas or other minerals. One of the typical ways that land covered by an O&G lease can be maintained, absent production, is through continuous drilling operations.

A continuous drilling operations provision allows the lessee a certain period of time in which to begin drilling the next well after completion of the current well. The lessee is given a reasonable amount of time to continue to develop the acreage prior to the Pugh clause causing the release of any acreage covered by the O&G lease.

The Pugh clause should be carefully drafted to provide maximum opportunity for the lessee while also providing maximum protection for the lessor.

## **Conclusion**

This article does not attempt to provide a comprehensive discussion of all of the issues a lessor may want to consider when negotiating an O&G lease, including, without limitation, the pooling clause and the Pugh clause. It merely highlights a few issues which can have a significant impact on a landowner.

Every existing or potential provision in an O&G lease is negotiable. A landowner should seek the advice of knowledgeable legal counsel when negotiating the terms of an O&G lease with a potential lessee.

—By Douglas C. Atnipp, Francis R. Bradley III and Gregory C. Cox, Greenberg Traurig LLP

*Douglas Atnipp is co-chairman of Greenberg Traurig's global energy and infrastructure practice group in the firm's Houston office.*

*Francis Bradley III is a shareholder and Gregory Cox is an associate in Greenberg Traurig's Houston office.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*