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**LANDOWNER INFORMATION FOR OIL/GAS/MINERAL
LEASES**

An oil/gas/mineral lease is an important legal document that defines the relationship between the Lessor – the landowner (or the owner of the mineral rights) and the Lessee – the party interested in producing/extracting the oil, gas or other minerals. The lease defines the rights, privileges and responsibilities of the parties. Landowners should seek professional assistance in reviewing the lease terms prior to signing a lease because provisions contained in leases offered by Lessees may be unfamiliar and will not necessarily be in the best interest of Lessor.

Negotiating an Oil and Gas Lease

Before any exploration can begin, the landowner (Lessor) and the oil company (lessee) must agree to certain terms regarding the rights, privileges and obligations of the respective parties throughout the exploration and possible production stages. Negotiation of these terms may be a landowner's first exposure to an oil and gas lease. Because of the complex legal nature of the leasing arrangement, novice landowners may be at a disadvantage when dealing with an experienced landman or oil company. An oil and gas lease is both a contract and a conveyance of an interest in land. When you sign an oil and gas lease, you have essentially "sold" a part of your property. Obtaining a good lease is a negotiation. Almost everything is negotiable. Don't be rushed into making a decision. To obtain a good lease it may take a long time, but last a long time. You may not come to an agreement – that is OK if it is not what you feel is fair.

Get verbal promises in writing. Leases are bought and sold. The company that actually explores for minerals may not be the company that negotiated the lease. If it is not in writing it cannot be enforced.

No standard lease form is universally recognized and used by the oil and gas industry. Instead, each company (or independent lessee) has a pre-drafted agreement that has proven suitable to them in the past. These agreements may not necessarily be in the best interest of the landowner.

Landowners should remember that all provisions of a lease are negotiable within reason. Even though the oil company representative or landman soliciting the lease may not have the authority to make changes, this does not mean certain clauses, or the complete lease itself, may not be altered. However, one's ability to negotiate more favorable terms will vary in each situation. Naturally landowners in areas considered "hot" will have more negotiating power than landowners in areas with unproven reserves or in "wildcat" areas.

The Granting Clause

The opening paragraph of most leases is the granting clause. It will outline the purpose of the lease and describe the substances that can be explored and produced. Typically, limit it to: exploring, drilling, and producing oil and gas and all other associated hydrocarbons in whatsoever nature or kind. The more liberal leases state the agreement covers all other minerals and other gases and their respective vapors. Landowners should be hesitant about signing the more liberal type lease.

Their concern should be with the royalty percentage share that is allocated to the other minerals. For example, landowners should expect a greater royalty from the production of uranium or helium than from carbon dioxide or sulfur. If the lease is silent on this matter, a landowner will receive the same royalty for all minerals that are produced.

As possible alternatives, landowners should enumerate the minerals covered by the lease to the exclusion of all other, e.g., all petroleum and natural gas and related hydrocarbons and no other minerals or substances in any form. Alternatively, landowners may amend the royalty clause to denote explicitly the percentage share they will receive for the production of any substances likely to be found in commercial quantities. Finally, the Lessor may consider inserting an arbitration clause to ascertain the royalty for substances other than oil, gas, and associated hydrocarbons that may be discovered.

A Mother Hubbard clause can state... "or any other land adjacent thereto"..... or it may state "and all lands and interests contiguous or appurtenant to the land specifically described above". This permits the developer to obtain the right to develop all contiguous or appurtenant lands owned by the landowner or that the landowner may own in the future that are adjacent. Sometimes, landowners do not want to lease the lands adjacent. If the landowner accepts this provision, he is not reserving the right to negotiate a lease to the additional property in the future.

Most leases grant the unrestricted right to construct permanent facilities such as power stations, storage tanks, or employees' quarters and an unrestricted right for the surface or injection disposal of salt water. Alternatively, the lease can state that the prior written consent of the Lessor is needed for both the construction and location of such structures and sites.

1. Specify whether the lessee's structures and equipment must be removed at the expiration of the lease or be forfeited.
2. Identify the parties liable for the construction and maintenance of fences, gates, or similar structures around the premises, pits, drilling sites, and above intersecting pipelines. The

precise dimensions and characteristics of these retention devices may need to be included to prevent the erection of inadequate fences and gates.

3. “or any other land adjacent thereto” obligates the landowner to lease lands owned adjacent to the lands listed in the lease, or may own in the future. If this is not your intent, alter or delete it.

Surface Operations and Surface Damage Agreement

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. Oil companies generally desire a much broader usage of the surface area. Consequently, most leases contain provisions permitting a wide range of surface activities.

Even though the lessee may be liable for surface damages, the inconvenience of unwanted and unwarranted structures and entries upon the surface area by the lessee may be avoided to some degree by the following:

The State of Michigan lease requires a “Surface Use Agreement for Well Site”. This is a separate agreement that is an addendum to the lease and occurs when drilling is planned but before commencing. It encourages Lessee to limit surface disturbance and requires that a well not be drilled until the agreement is signed. The Lessee will be required to make payment for all damages to surface including loss of use of damaged surface, so reducing surface damage is to his benefit also. It should cover an agricultural lessee’s production losses. The agreement is used to locate roads, flow lines and other equipment to minimize disturbance. The lease can state: “No operations shall be conducted by the Lessee until a separate Surface Use Agreement is agreed to and signed by Lessor and Lessee.”

This Surface Use Agreement can require lessee to:

1. Provide a proposed development plan and map that shows proposed access route, location of well, separator, tanks, any existing pipelines and proposed flow lines or pipelines to be installed. For convenience sake, landowners generally do not permit wells within a minimum of 200 feet (or some other stipulated distance) of a dwelling.
2. Provide that all underground transmission devices such as pipelines be buried at a 48” depth, not below “plow depth” in agricultural areas. If deviations are necessary, permit them only after securing the Lessor’s written consent.
3. Landowners wishing to cultivate or graze the area immediately above any pipelines can direct the lessee to use the double ditch method for laying pipe. This method requires the top soil be placed on one side of the trench and the subsoil on the other. When backfilling, the subsoil is replaced first followed by the top soil.
4. Require compensation for ALL surface damages including the lost usage of the land required for the roads, drilling pad, oil storage tanks, separators and other equipment. This is usually a one-time upfront payment.
5. Place surface facilities at a height and location to allow operation of center pivots.

6. Control weeds, including noxious weeds.
7. Require restoration of exposed areas and if possible, require the lessee to restore the land to its condition prior to any operations.
8. Lessor input and agreement on restoration plan to reduce impact on surface uses.
9. Install fence around drilling site to keep cattle away from mud pits.
10. Control dust necessary for the health of crops and livestock.
11. On cropland, particularly irrigated cropland, consider requiring lessee to remove all materials in the reserve pits and dispose off site. These sites can become bog areas because the drilling mud does allow precipitation to drain through.
12. Describe the method or methods to be employed for determining the extent of damages suffered. For example, on cropland the damage can be based on the historic average yield and at the local market price on a certain date.
13. Describe the width, design, size and type of materials allowed and whether or not roads should be “all weather”. Cutouts in strategic locations can provide areas for traffic to pull over to allow others to pass. This keeps the width more manageable.
14. Describe the items for which the lessee will be liable – e.g., injuries to growing crops, pastures, erosion and stagnation of the soil, growing timber, livestock, fences, ditches, canals, buildings and other structures, or the pollution of any waters.
15. Whether or not gates are required at road entrances to prevent trespassing.
16. Can require a performance bond or advance payment from lessee to guarantee that restoration takes place.

The Surface Use Agreement provides the opportunity for better communication, encourages the limitation of surface damages and can prevent unexpected problems arising from assumptions about operational activities by either side. It provides a mechanism for each side to know exactly what will be happening and when on the lease.

If the proposed development area includes timber, the timber can be appraised using a consulting forester and sell by bid to insured logger where well sites, rights of way, etc. will be.

The Duration of the Lease

Leases are divided into two separate time periods. The first period, or primary term is a set number of years negotiated by the parties during which the lessee must commence drilling operations or pay an annual fee to the Lessor. The shorter the primary term the better, for example 2 or 3 years. The lease will generally state that if drilling operations are not commenced during the primary term, the lease will terminate unless an agreed sum is paid the Lessor called the delay rental. Extensions after primary term constitute secondary term. You can charge “ramp-up” delay rentals. For example, the first year can be the same rate as the original bonus, the second year can be that rate plus \$10 per acre, etc. Delay rentals constitute the secondary term. Delay rentals must be paid on each subsequent anniversary date of the lease’s primary term if drilling operations have not yet begun by that date.

Failure to receive the delay rental payment by the stipulated time automatically terminates the lease whenever the word “unless” is used in the lease to indicate the necessity of tendering the payment. Some leases contain the word “or” rather than “unless.” In the former case the lease will not terminate.

1. If production is not established by the end of the primary term, the lease will end. If production has been established, the lease will continue into its secondary term and last so long as substances covered by the lease continue to be produced. Generally the full clause will read, “This lease shall remain in force and effect for a term of ----- years (or months) and as long thereafter as substances covered by the lease are produced.” This provision could extend the lease indefinitely because the lessor may not be receiving any royalties, but the well(s) are capable of producing a little. Alternative language could be: ...”substances covered by the lease are produced in commercial and paying quantities.”

For the best protection, the Lessor should consider one or more of the following recommendations:

1. Strive to keep the primary term as short as possible. This should force earlier explorations.
2. If the primary term cannot be shortened, strive to negotiate a higher annual delay rental payment.
3. Make sure the word “unless” is employed in conjunction with delay rentals. Keep a watchful eye on the date by which the delay rental payments must be received. Acceptance of a late payment may be construed as ratification and the lease will not terminate.
4. Stipulate that the lessee must identify the governing lease and the provisions necessitating any payments made to the Lessor. This is an invaluable aid for landowners trying to keep track of several different leases on their land.

Extension of the Primary and Secondary Terms

The primary and sometimes the secondary terms of the lease may be extended contractually via shut-in provisions, dry-hole provisions or cessation-of-production provisions. Most leases will contain all three.

Shut-in provisions allow the lease to remain in effect (sometimes during both the primary and secondary terms) whenever gas from a producing well is not, for some reason, being sold or used by the lessee. In other words, a well that is shut-in is still classified as a producing well under the lease provisions and the lease will not terminate. However, a shut-in royalty (or some other stipulated sum generally approximating the value of the delay rental payment) must be paid annually to keep the lease in effect.

Dry-hole provisions, on the other hand, can only extend the primary term of the lease. Basically the lease will provide that if oil or gas *has not* been discovered when a dry-hole is struck, the

lease will not terminate even though the primary term has expired if, in the interim the lessee renews drilling or re-working operations within 60 days (or some other specified period) thereafter. In the event the primary term has not expired and more than fourteen months still remain, the lessee has two other options available. He can either pay the next delay rental payment, which comes due more than 60 days after the dry hole was discovered or commence drilling or re-working operations on or before the same date. If less than fourteen months remain in the primary term when the dry hole is discovered, the lease will continue in force to the end of the primary term even though the lessee operations remain idle and no delay rentals are paid.

Cessation-of-production provisions correspond quite closely to the dry-hole provisions, but apply only after oil or gas has been discovered. If oil and gas production should cease for any reason, the lease will not terminate if the lessee again follows one of the three options described in the dry-hole provisions. In this instance, though, there are no exceptions accorded under the fourteen-month rule.

It is quite possible for the primary term to be extended indefinitely via the dry-hole provisions. If the lessee has not discovered oil or gas and is in the process of drilling or re-working operations when the primary term expires, the lease will continue in force for so long as the lessee faithfully renews drilling or re-working operations within 60 days after striking each dry hole. However, if a producing well should subsequently be discovered and its production later ceases, the lessee must strike another producing well stemming from operations commencing within 60 days thereafter or the lease will expire. The discovery of a subsequent dry hole will terminate the lease according to its terms.

Most landowners have little quarrel with dry-hole and cessation-of-production provisions since in both cases oil and gas are being diligently sought. However, landowners may question the shut-in provisions, especially where no apparent reason for the harboring of gas (or possibly oil) exists.

While shut-in provisions may not be used as extensively as in the past, landowners should be aware of the following alternatives that clarify its possible usage.

1. Shut-in royalties can be required during both the primary and secondary terms of the lease.
2. A time limit can be placed on the shut-in clause – no more than three years or three years beyond the primary term.
3. To provide more incentive for the lessee to explore, escalate the shut-in royalty for each year the gas or oil is shut in.
4. As an alternative, permit the shut-in clause to continue after a stated period but only for a given number of acres immediately surrounding the well—e.g., 40 acres. The rest of the leased area will revert back to the Lessor-landowner. (This provision may be qualified depending on the reasons for the shut-in).
5. Specify the circumstances when the shut-in clause may be involved—e.g., for lack of market, available pipeline, or government restrictions, or permit the shut-in only when, in

6. Automatically terminate the shut-in provision whenever a well, located on adjacent land, situated within a certain number of feet of the leased premises, and completed within the same producing reservoir, begins producing and selling gas in marketable quantities.

The Royalty Clause

Each lease contains a royalty clause that allocates to the landowner a certain portion of the substances produced. The state of Michigan receives 1/6. Royalties of 3/16 to even 25% are not unheard of in private industry, depending on the situation. Economically, it is probably the most important clause to the landowner. Terms of royalty clauses vary greatly from lease to lease. Consequently, this clause should receive close scrutiny by landowners.

There is more than one method to value royalties. The first method is based on the market price or value of the mineral, generally at the mouth of the well. In the past, if there was no market at the well, then the market price prevailing in the field was used. And if there was no field market, then the value was determined by sales of marketing outlets. The market price method has been popular with landowners because it allows the royalty to follow the recent upward price trend for oil and gas. Sometimes the prices posted at wells or fields are discriminatorily or artificially set and may be substantially less than the prices paid for comparable oil and gas at other locations. This can occur if the lessee is selling to a subsidiary. To avoid this problem, always try inserting some formula for determining how the market price or value will be established. For example, some leases read, "at the highest price (or percentage thereof) posted for a field within 100 miles by any of the seven major oil companies for like grade and gravity on the day the oil is removed."

The second method of evaluating royalty payments is by way of "proceeds." This method ties the value of the royalty to the actual revenue (or sales price) received from the sale of the mineral. As such, the resulting returns may or may not equal the mineral's actual market value as discussed earlier. In the past, royalties based on proceeds were very popular. This method gave greater flexibility to the producer in marketing the product, particularly gas. By committing gas to long-term contracts, the producer could insure the landowner of a constant, dependable royalty income over time. The disadvantage was that the resulting proceeds were not immediately sensitive to a rising market price.

The following is a list of factors that also might be considered when negotiating a royalty clause.

1. Detail the time, place and frequency royalty payments are to be tendered. Outline the consequences for royalty payments being missed. Consider charging late fees and interest if the timing is not met.
2. Discuss and resolve whether royalties must be paid for wastes due to leakage, fire, or other reasons that can be attributed to the lessee's negligence.
3. Reserve the option to take "in kind" if feasible.

4. Determine if and when the landowner should have access to free gas. Many leases allow the Lessor the free usage of gas for domestic (and sometimes agricultural) purposes.
5. By the same token, decide whether the lessee should have free use of water, oil or gas produced on the leased premises.
6. As mentioned in prior sections, do not forget to include any differing royalty percentages for substances other than oil and gas that might be discovered if the landowner should choose that alternative.
7. Always state the exact costs encountered subsequent to production that may be shared regardless of whether the royalty is fixed “at the well,” “in the pipeline,” or “at the place of sale.” Ideally, negotiate a clause that requires no costs subsequent to production to be borne by the Lessor.

Post Production Costs

Post production costs can reduce the royalty received through deductions of royalty payments. These costs can include treating and processing oil and or gas to separate and remove water, carbon dioxide, hydrogen sulfide and nitrogen, transporting between the wellhead and treatment facilities, transport to the point of sale, compressing gas for transportation and delivery, metering to determine amount sold, sales charges, commissions, fees paid to third parties, and “any and all other costs and expenses of any kind or nature incurred.”

Section 324.61503b of the State of Michigan Oil and Gas Regulations states: “A person who enters into a gas lease as a lessee after 3-28-2000 shall not deduct from the lessor’s royalty any portion of post production costs unless the lease explicitly provides for the deduction of post production costs.” The regulation further states that costs allowed if in the lease: Removal of CO₂, N₂, H₂S, transport into non-affiliated pipeline system and OTHERS IF IN LEASE. Post production costs can be deducted only if the landowner allows it. There may be times that it pays to allow post productions costs, such as if they increase the market value of the product. A qualified oil and gas attorney is recommended to assist in this very important area of the lease.

Pooling

Most leases will contain some provision giving the lessee the right to consolidate the leased premises with adjoining leased tracts. The area formed is called a “pool” or sometimes a “unit.” The reason for establishing such pools is to unite under one operator all the landowners having an interest in a common underground reservoir. Sometimes pooling arrangements are necessary to meet the minimum acreage requirement for a drilling permit under state regulations.

In most states, landowners may be subjected to two types of pooling arrangements. One is voluntary; the other is compulsory or statutory. The voluntary arrangement requires the free consent of the landowner and is generally found in the context of most lease forms. The statutory arrangement, on the other hand, is mandatory whenever the specified requirements under relevant state law have been satisfied. By entering either type of pooling arrangement, the landowner may find the interpretation and application of the lease provisions materially altered.

Statutory or compulsory pooling is used when a landowner cannot, in his opinion, negotiate an equitable oil and gas lease or refuses to lease. It can only be done by holding a hearing before the Supervisor of Wells. Compulsory pooling isn't all bad. The mineral owner receives a 1/8 royalty free of any post production costs and there is no surface use of his land allowed (non-development lease). A publication titled "Pooling of Properties For Oil and Gas Production" discusses pooling in more detail. It is available from the State of Michigan Department of Environmental Quality.

The landowner may find it advisable to exercise caution in granting the lessee the unrestricted right to pool the leased premises. The following suggestions may be helpful in this regard.

1. Submit to voluntary pooling in the lease only to the extent necessary to get a drilling permit from the state. Otherwise, the landowner's written consent should be required to pool. Do not consent until the landowner understands the full impact of the pooling arrangement on the lease terms, the full description of the proposed pool area and the details on how the boundaries were determined.
2. In order to keep a pool from being overly extensive, stipulate in the lease the maximum number of acres a pool may contain. As a rule of thumb, limit the acreage to no more than that specified in a statutory or compulsory pool in your state.
3. Give some thought as to whether the lessee may alter or change the size or shape of the proposed pool after the landowner has consented.
4. Consider whether the pool is limited to certain producing strata or given for any and all producing formations which may be encountered. Also consider which substances may be pooled – e.g., oil and gas but not other gaseous substances, coal or valuable stones.

Pugh clause: All lands not receiving royalty from any unit or pool after primary term shall be considered un-leased and returned to full control of Lessor. The inclusion of a "Pugh" clause in the lease provides for the severance of the lease into separate tracts whenever less than all of the premises are included in a single pool or unit. For example, let's say you own two 40-acre tracts and 40 acres are required for a drilling permit and one well is drilled during the primary term on one of the 40 acres. Without a Pugh clause, the other 40 acre tract is held by the lease, even though there is no producing well. With a Pugh clause, this 40 acres can be released and you are allowed to lease that land to someone else or keep it unleased. The original lease keeps the 40 acres with the well. Without a Pugh clause, leases generally have language which *extends* the "leased premises" to all areas pooled with the original tract. Thereafter, if production, drilling or re-working operations are commenced on any portion of the pool (whether on the original leased tract or not), they will be construed as being undertaken on the leased land. Be cautious about allowing Lessee to create, enlarge or reform the unit or units either before or after production is obtained. This may negate the Pugh clause. For example, by utilizing a small area of a larger lease tract in a pool, the lessee can effectively eliminate the need for paying delay rentals and still maintain the full lease by drilling and possibly establishing production on any part of the pooled area, as the example above demonstrates. If possible require all pooling to occur prior to drilling operations and not afterwards.

Assignment Clause

Typically leases contain a provision permitting both the Lessor and the lessee the unrestricted privilege of assigning their rights under the lease. To a large extent these provisions are for the lessee's benefit.

A customary practice in the oil and gas industry is for independent landmen to lease a large area and assign (sell) it to an oil company. Consequently, the ultimate developer-producer may not be the original lessee-negotiator. At times the landowner may find the original lease tract being subdivided among several before-unknown developers. To keep better apprised of such changes, the landowner may seek to incorporate some of the following suggestions.

1. Deny the right of assignment without first securing the landowner's written consent. If this is not feasible, state that any assignment is not binding upon the Lessor until he or she is duly notified in writing. The landowner should keep a record of each new assignee for his or her permanent files.
2. Do not release the original lessee from liability for a default on any assigned portion of the lease or leased area. Stipulate that a default on any assigned part of the lease is a default on the whole.
3. Provide that an identification of the governing lease (or assignment thereof) must accompany each payment.

Warranty Clause

Leases generally will contain a warranty clause binding the landowners to defend their interest in, or title to, the leased premises should a dispute ever arise over ownership. To avoid any possible litigation expenses, landowners should seek to delete such language. Since most oil companies or landmen generally conduct preliminary investigations as to the ownership of the mineral interest prior to any lease negotiations, the warranty clause should not be needed anyway. During negotiations, ask to receive a copy of the title search work held by the potential lessee. This gives you the chain of title and documents when or if mineral rights were reserved.

Force Majure

A Force Majure clause allows the developer to extend the primary term if a delay is caused by any act of God, law, legal action, or requirement of a government agency that prevents or delays development. If this clause is in effect, any payment due you could be delayed or avoided by the developer. These clauses are common, but should be carefully scrutinized as they can vary and provide a means to extend the lease significantly without payment.

Lessee's Right to Free Water, Oil and Gas

Landowners should pay close attention to any provisions in a lease providing free water, oil or gas to the producer for operations. Particularly in areas where water is scarce, certain limitations should be placed on these rights. The following suggestions may be helpful.

1. Decide whether free water, oil or gas privileges will be granted to the lessee. If so, stipulate whether the substances may be used for operations conducted both on and off the leased premises. (These provisions may be incorporated into the royalty clause as mentioned earlier.)
2. Do not allow the lessee to take water from wells, tanks, ponds or reservoirs.
3. If recovery measures are undertaken by the lessee involving floodwater operations, deny the use of potable water. State that such water must come from non-fresh sources.
4. If water is to be purchased, state how the market price will be determined.

Other Factors for the Landowner's Consideration

Without going into detail, the following factors may be considered by landowners when negotiating a lease.

1. Consider requiring the lessee obtain a water quality test prior to and at completion of operations and require lessee to maintain the quality and quantity of landowner's water supply.
2. Lessee should follow all environmental laws.
3. In the event the parties cannot agree, provide for arbitration or some other means of resolving a dispute.
4. If the land contains several producing formations at varying depths, lease each strata independently.
5. Always note in the lease whether the land can be used for underground storage of gas, oil or brine. Be very careful if a request is made to use a well to inject brine water. This is not recommended.
6. Always insert provisions allowing free access to books, records, and drilling data accumulated pursuant to operations conducted on the landowner's premises.
7. If possible, negotiate some provisions whereby the landowner may assume control of the casing in the borehole when operations are abandoned. The casing can then be used to withdraw any remaining gas or extract fresh water for domestic or agricultural purposes.
8. Provide that if the lessee does not rectify any breach of a covenant contained in the lease within 30 days after Lessor gives written notice, the lessee should pay reasonable attorney fees and reasonable investigative costs incurred by Lessor in preparing Lessor's case for trial.
9. Require lessee to indemnify, save and hold Lessor harmless from all claims, demands and causes of action stemming from activities undertaken by lessee or lessee's assignees, their employees, agents, contractors and subcontractors, during operations conducted on the leased premises. As an alternative, require the lessee to post bond and carry comprehensive liability insurance of a specified amount as added security from such claims. Lessor should be named an additional insured on lessee's liability insurance.
10. Whenever someone enters into an agricultural lease or purchases surface rights to land void of any mineral interests, he or she should enter a contract with the owners of the mineral interests stating that a surface damage clause will be included in any mineral

lease that is entered. This will insure the lessee or purchaser that any damages to crops, pasture or surface will be compensated.

Summary

Negotiating an oil and gas lease requires legal knowledge, foresight and common sense. No landowner could possibly hope to have all these suggestions included in a lease. The number successfully incorporated depends largely upon negotiating power. Negotiation of an equitable lease requires the assistance of an experienced oil and gas attorney. It is not advisable to sign a lease if your understanding of the provisions is not clear. If satisfactory terms or compensation are not provided in the contract, new or additional terms should be negotiated or the contract should not be signed. The attorney can assist a landowner in understanding the lease language and negotiating terms favorable for the landowner.

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