

**LEASE FORMATION AND THE USE OF SIGHT DRAFTS:**  
**SO YOU THINK YOU HAVE A DEAL?**

Fort Worth Association of Professional Landmen  
September 20, 2012  
Fort Worth Petroleum Club

Presented by:

James E. Key  
Harris, Finley & Bogle, P.C.  
777 Main Street, Suite 3600  
Fort Worth, Texas 76102  
Telephone: 817-870-8700  
Email: [jkey@hfblaw.com](mailto:jkey@hfblaw.com)

## TABLE OF CONTENTS

I.	INTRODUCTION .....	1
II.	CONTRACT / LEASE FORMATION – GENERALLY .....	1
A.	Contract Formation – Elements to Create a Binding and Legally Enforceable Agreement .....	1
III.	SIGHT DRAFTS AS PAYMENT FOR LEASE CONSIDERATION: FRIEND OR FOE? .....	1
A.	Sight Drafts – Generally .....	1
1.	What is a sight draft? .....	1
2.	What is a condition precedent? .....	2
3.	Can sight drafts and conditions precedent be combined .....	2
4.	Some common reasons for the use of sight drafts in the oil and gas industry. ....	2
5.	Examples of typical sight draft language .....	2
B.	Legal Issues / Questions Surrounding the Use of Sight Drafts .....	3
1.	Contract formation. ....	3
2.	Lessee’s liability for non-performance. ....	3
3.	Lessor’s claims for non-performance. ....	4
4.	“No liability” exculpatory language in sight drafts. ....	5
5.	Proportionate reduction in purchase price. ....	6
6.	Extending the time for performance. ....	6
7.	Waiver of warranties by performance. ....	7
8.	How to make an offer to lease “stick” using a sight draft. ....	8
IV.	SUMMARY – LESSONS LEARNED .....	9

## I. INTRODUCTION

Using a draft to pay a lease signing bonus has been a standard practice in the oil and gas industry for many years. However, many pitfalls exist in connection with the use of drafts and those who utilize drafts should pay particular attention to the language used on the face of the draft in light of the objective to be achieved in the transaction. This paper will discuss sight drafts and their use in the oil and gas industry and will highlight some of the issues surrounding their use so that those who use drafts in leasing transactions can better manage their risks and expectations.

## II. CONTRACT / LEASE FORMATION – GENERALLY

### A. Contract Formation – Elements to Create a Binding and Legally Enforceable Agreement

1. Offer
2. Acceptance
3. Meeting of the minds – mutual assent

4. Execution and delivery of the contract with the intent that it be mutual and binding. The use of sight drafts can affect whether the parties intend to be personally bound and hence, whether a legally enforceable contract has been formed.

5. Consideration. A contract must be based upon valid consideration. Simply stated, consideration is “bargained for exchange” and consists of either a benefit to the person making the promise or a loss or detriment to the person to whom the promise is made. A contract in which there is no consideration moving from one party to another, or no obligation upon one party to another, lacks mutuality, is unilateral, and therefore, unenforceable. *Texas Gas Utils. Co v. Barrett*, 460 S.W.2d 409, 412 (Tex. 1970). Examples of consideration are promises to pay money or to provide services. The use of drafts, and the conditions and limitations contained therein, can affect whether an agreement is supported by valid consideration to make the agreement binding and legally enforceable.

## III. SIGHT DRAFTS AS PAYMENT FOR LEASE CONSIDERATION: FRIEND OR FOE?

### A. Sight Drafts – Generally

1. What is a sight draft? A sight draft is an instrument payable on proper presentment. *Black’s Law Dictionary* 1381 (6<sup>th</sup> ed. 1990). It is a demand for payment drawn by a person to whom money is owed. The draft is presented to the debtor’s bank in expectation that the debtor will authorize its bank to disburse the funds. A draft can be combined with conditional

language, which, depending on the language used, can be used to prevent an agreement from becoming binding until the condition in the draft is satisfied. In short, a draft is simply an order to pay a fixed amount of money. In the context of the modern day oil and gas leasing transaction, the draft is signed by the landman as the “drawer,” and will name the lessee as the “drawee.” It is held by the lessee’s bank as the “collecting bank,” which in effect serves as an escrow agent until the lessee (drawee) pays the draft or the time for payment expires. In this context, the draft is an instruction or order for payment by the landman (drawer) to the lessee (drawee) to pay the lessor (payee) a fixed amount of money within a specified period of time, subject to any other limitations set forth on the face of the draft.

2. What is a condition precedent? A condition precedent is something that must happen or occur before a right can accrue to enforce an obligation that is dependent upon the happening or occurrence thereof against another in favor of the person claiming the right. *Perry v. Little*, 377 S.W.2d 765, 768 (Tex. Civ. App.–Tyler 1964, writ ref’d n.r.e.). In the context of the law of contracts, a condition precedent may be a condition that must be performed before an agreement can become binding, or it can be a condition that must be fulfilled before a duty to perform arises. Accordingly, conditions may relate either to the formation of a contract or to liability under them.

3. Can sight drafts and conditions precedent be combined? Yes. Texas courts have typically held that the conditional language used on the face of sight drafts in oil and gas leasing transactions creates a condition precedent to the formation of an otherwise valid contract, *i.e.*, a valid and enforceable oil and gas lease. In other words, there is not an enforceable lease until the condition is either performed or is waived.

4. Some common reasons for the use of sight drafts in the oil and gas industry:

- a. they provide the lessee with flexibility;
- b. they allow the lessee to manage its cash flow;
- c. they allow the lessee to better assess transaction risk; and
- d. they are convenient.

5. Examples of typical sight draft language:

- a. “15 days after sight and upon approval of title;”
- b. “30 days after sight and upon approval of title and geology;”
- c. “15 days after sight and upon approval of title and lease terms;” and

- d. “30 days after sight and upon approval of title, geology, and lease terms and conditions.”

B. Legal Issues / Questions Surrounding the Use of Sight Drafts

1. Contract formation. If a sight draft with conditional language is given as consideration in a leasing transaction, when does the oil and gas lease become binding on the parties and enforceable by the court? Answer: An oil and gas lease becomes effective and is legally enforceable when the condition in the sight draft is either performed or waived. The lessee’s acceptance and recording of the fully executed lease does not waive the condition or impose any liability on the lessee in the event that the draft is later dishonored.

- a. *Sun Expl. & Prod. Co. v. Benton*, 728 S.W.2d 35 (Tex. 1987).

The lessee gave the lessor a conditional sight draft as consideration for an oil and gas lease whose title was already in question. The sight draft provided that payment was due “15 days after sight and upon approval of title.” The lessee recorded the lease, but dishonored the draft within the 15 day period. The lessor then sued the lessee for breach of contract and sought to enforce the lease and the lease bonus consideration. The trial court entered judgment for the lessor and found that the lessee had breached the parties’ agreement by accepting and recording the lease and not honoring the draft. The court of appeals affirmed. In reversing the judgment and finding for the lessee, the Texas Supreme Court held that the term “15 days after sight and upon approval of title” created a condition precedent to the formation of a legally enforceable agreement, *i.e.*, a binding oil and gas lease, and that the lease and sight draft should be read together in order to ascertain whether the parties intended to be bound. The Court reasoned that by including the “approval of title” condition, the lessee had in effect protected itself from paying for the lease in the event that title was rejected. The Court also held that the mere acceptance and recordation of an oil and gas lease does not by itself constitute such conduct “inconsistent with claiming the right to approve title to the interest conveyed.” The effect of recording an instrument is simply to provide notice to all persons of the existence of the instrument.

2. Lessee’s liability for non-performance. What is the lessee’s liability, if any, for failing to honor a sight draft that is made conditional upon the happening of a future event, *i.e.*, upon approval of title, etc.? Answer: Generally speaking, none. Unless and until the condition in the sight draft is waived or performed, no liability can arise because there is no contract to enforce. The condition in the draft is a condition precedent to the formation of a valid and enforceable contract. Liability for failure to perform could potential arise where the decision not to perform is made in bad faith or if there is an independent basis to assert a tort like fraud. *See infra*, Section III.B.3.a. *See Sun Expl. & Prod. Co.*, 728 S.W.2d at 37.

- a. *Encina Partnership v. COREnergy, LLC*, 50 S.W.3d 66 (Tex. App.–Corpus Christi 2001, pet. denied).

Landman employed by oil and gas company issued three separate sight drafts for a permit to conduct seismic testing on the plaintiff's land. The sight drafts contained the following clause:

“[o]n approval of seismic permit or lease described hereon and on approval of title to same by drawee not later than 3 days after arrival of this draft at collecting bank.”

The day after the drafts were issued, the oil and gas company refused to pay them. The mineral owner then sued alleging damages for breach of contract and that the oil and gas company was estopped to deny the existence of its obligations in connection with the permit. The trial court entered judgment for the oil and gas company. In affirming the trial court's judgment, the court of appeals recognized the factual similarities between the present case and the *Sun Exploration* case. The court then held that a contemporaneously exchanged draft and an instrument of title must be construed together. The court noted that the language on the face of the draft made the oil and gas company's liability conditional upon performance of the condition precedent, *i.e.*, on approval of the seismic permit or lease not later than 3 days after the arrival of the draft at the collecting bank because of the wording in the sight drafts that no contractual liability could attach to the oil and gas company for failing to perform. Like the *Sun Exploration* case, the Lessee had insulated itself from contract based claims.

3. *Lessor's claims for non-performance.* Arguably, the use of a condition precedent on the face of a sight draft should insulate the lessee from liability in the event that the condition for performance never occurs. See *Sun Expl. & Prod. Co. v. Benton*, 728 S.W.2d 35, 37 (Tex. 1987). However, what if the condition does not occur because the lessee acts in bad faith or simply no longer desires to obtain the leasehold acreage? Can the lessee simply ignore the transaction and allow the specified time period to lapse without incurring liability to the lessor? *Answer:* The lessee may be able to escape liability for breach of contract by arguing that the condition was not performed, but at that the same time, it could open itself to various non-contractual claims like fraud. The safest practice is to document the file with legitimate business reasons that coincide with the conditional language used in the draft.

- a. *L & B Oil Co., Inc. v. Arnold*, 620 S.W.2d 191 (Tex. Civ. App.–Waco 1981, writ dismissed).

This case involved a suit by lessors to recover unpaid bonus due under two thirty day sight drafts conditioned upon approval of title. The lessee subsequently refused to honor the drafts based on “an unacceptable title opinion.” The alleged title defects were identified and were represented to be that “nothing appears in the chain in regard to W. J. Bragg,” (Mr. Bragg was a prior owner). The lessors took action to cure the defect and pointed to an affidavit of heirship in the chain of title. Nevertheless, the lessee again rejected the title and refused to honor the drafts, which resulted in the

lessors' suit to enforce the drafts. In upholding the trial court's judgment in favor of the lessors, the court of appeals determined that the defendant had committed fraud by representing that the drafts would be paid promptly upon presentation subject only to confirmation that no title defects existed. Other factors likely contributed to the fraud findings, but from the court's perspective, it seems fair to say that the lack of a judicial determination of heirship for a prior owner in the chain of title did not justify the lessee's disapproval of title.

4. "No liability" exculpatory language in sight drafts. A lessee who uses a conditional sight draft should carefully choose the language used on the face of the draft. This is because the language used can be construed against the party who selected its use and could result in a situation where the lessee has destroyed the enforceability of a transaction that it later wants to enforce by performance. *See e.g., Arabella Pet. Co., LLC v. Baldwin*, No. 04-11-00370-CV, 2012 WL 2450803 (Tex. App.–San Antonio June 27, 2012, no pet.). Modern day sight drafts typically include a "no liability for non-payment" condition, which reads:

"In the event this draft is not paid within said time, the collecting bank shall return the same to forwarding bank and no liability for payment or otherwise shall be attached to any of the parties hereto."

Some courts have held that this condition destroys the transaction's enforceability and give the lessor the ability to backout of the transaction prior to the lessee's performance. Therefore, a lessee who wants to limit a lessor's ability to backout of a leasing transaction should consider deleting this provision from its draft form.

a. *Spellman v. Lyons Petroleum, Inc.*, 709 S.W.2d 295 (Tex. App.–Houston [14<sup>th</sup> Dist.] 1986, writ ref'd n.r.e.).

This case involved competing oil and gas leases accompanied by sight drafts for the same mineral interest. Spellman acquired an oil and gas lease from the lessor accompanied by a 10 day sight draft conditioned upon approval of the lease and title. The lease and draft were deposited in the lessor's bank the same day. The next day, a landman for Lyons Petroleum contacted the lessor and offered terms more favorable than the terms offered by Spellman. A few days later, after having a chance to reconsider, the lessor called Spellman and his bank and informed them that he wanted to cancel the lease and that he did not want to move forward with the transaction. Then –

July 8	Spellman's draft was presented to his bank (the collecting bank) for payment;
July 9	the landman for Lyons Petroleum executed a lease with the lessor, gave the lessor a draft for payment of lease bonus, and recorded the lease; and

July 10 Spellman paid his draft, recorded his lease, and caused his bank to forward a cashier's check to the lessor's bank for payment of lease bonus consideration.

Spellman later brought suit for title to the minerals covered by the two leases. The trial court found against Spellman and in favor of Lyons Petroleum. The court of appeals noted that the dispositive issue in the case was whether Spellman's lease and accompanying draft created an irrevocable and binding agreement between Spellman and his lessor. In finding against Spellman and in favor of Lyons Petroleum, the court of appeals noted that Spellman's lessor had revoked the offer to lease before the lease agreement ever took effect. The court of appeals also held, however, that the lease transaction with Spellman failed for want of mutuality as a result of the no liability clause in the last paragraph of the draft.

5. Proportionate reduction in purchase price. Where a title search reveals that the lessor owns less minerals than originally bargained for, can the lessee still enforce the lease as to the interest actually owned by the lessor and proportionately reduce the lease bonus consideration stated in the sight draft to the corresponding acreage? Answer: Yes, the lessee is entitled to have the lease enforced to the extent that the lessor could perform the transaction and thus, is entitled to enforce the lease as to the interest owned with a corresponding abatement in lease bonus. The lessor does not have the right to reject the lessee's tender of bonus even if it is adjusted to take into account the reduction of net mineral acres.

- a. *Puckett v. Hoover*, 197 S.W.2d 602 (Tex. Civ. App.—Amarillo 1946), *aff'd*, 202 S.W.2d 209 (Tex. 1947).

This case involved the sale of an undivided 1/2 interest in minerals. As consideration, the grantee gave the grantor a thirty day sight draft conditioned upon approval of title. The title search revealed that the grantor only owned a 1/4 interest in the minerals at issue. The evidence was sharply contrasted as to what happened after the grantee informed the grantor that they did not own 1/2 of the minerals in question. Nevertheless, the court of appeals held that the grantee was entitled to elect and to take and pay for the 1/4 mineral interest that the grantors actually owned. The court of appeals then remanded the case to the trial court to determine whether the grantee attempted to enforce the contract or abandoned his right to enforce the same.

6. Extending the time for performance. What should the lessee do in the event that some problem or issue remains uncured at the end of the conditional period for performance? Answer: The lessee should seek an extension of time from the lessor. Under Texas law, the parties may agree to extend the time in which the condition precedent may be performed. The extension can be oral or in writing. The best practice would be to have the extension in writing and supported by independent consideration.



- a. *Shannon v. Barbee*, No. 10-06-00414-CV, 2008 WL 802266 (Tex. App.–Waco March 26, 2008, pet. denied).

This case involved a suit by a lessor claiming that an oil and gas lease was void because the lessee had failed to timely pay three drafts given as lease bonus. The sight drafts included the following language, “on the approval of the lease and approval of title to the lease not later than 30 banking days after arrival of the draft at the collecting bank.” Each of the drafts further provided:

“The drawer, payee and endorsers hereof, and the grantors of the lease described hereon, do hereby constitute and appoint the collecting bank escrow agent to hold this draft for the time above specified subject alone to acceptance of payment hereof by the drawer, within said time, and without any right of the drawer, payee or endorser hereof, or said grantors, to recall or demand return of this draft prior to the expiration of the above specified time, and there shall be no liability whatsoever on the collecting bank for refusal to return the same prior to such expiration.

In the event this draft is not paid within said time, the collecting bank shall return the same to forwarding bank and no liability for payment or otherwise shall be attached to any of the parties hereto.”

A drill site title opinion revealed that the lessors did not own all of the mineral estate. The lessee approached the lessors and requested an extension, which was given orally but also documented by the bank teller in writing on one of the drafts. Several more extensions were allegedly given while the title issues were being cleared. During that time, the lessors ran into a local attorney who ultimately persuaded the lessors to abandon ship and to join his leasing group for a better deal. When the title issues were cleared, the original lessee had three cashier’s checks issued and delivered to the lessors’ bank. The lessors refused payment and then brought suit seeking a declaratory judgment that the oil and gas lease given to Barbee was not enforceable. The trial court found that the parties had an enforceable agreement and entered judgment of the lessee. In affirming the trial court’s judgment, the court of appeals held that the language in the drafts clearly contained conditions precedent to the formation of an oil and gas lease. The court then determined that the lessee paid the drafts within the extended period, and that the lessors had no right to reject the timely tender because they had appointed their bank as “escrow agent to hold this draft” and to collect the draft “without any right . . . to recall or demand return [before expiration of the period stated in the draft].”

7. *Waiver of warranties by performance.* Consider the situation where an “approval of title” sight draft is at first honored, but then later, the lessee discovers that the lessor does not own all or part of the minerals that were leased. By honoring a sight draft conditioned on the lessee’s approval of title, does the lessee waive its right to pursue the return of lease bonus? Answer: No. Provided that the lessor warranted title, the lessee can try to recover the bonus by

claiming that the lessor breached its covenant of warranty of title. Honoring a sight draft made conditional on approval of title does not waive a claim for breach of warranty – the warranty of title does not arise until the draft is paid.

- a. *Broughton Associates Joint Venture v. Boudreaux*, 70 S.W.3d 324 (Tex. App.–Waco 2002, no pet.)

This case involved a suit by a lessee for breach of warranty to recover an overpayment of a lease signing bonus that was given in a contemporaneous exchange of an oil and gas lease and bank draft. The draft contained the following notation:

“[o]n approval of lease or mineral deed described hereon, and on approval of title to same by drawee not later than 15 banking days after arrival of this draft at collecting bank.”

After the draft had been honored, the lessee received notice that there had been a partial title failure in that the lessors owned substantially less acreage than what they had been paid. In reversing the trial court’s judgment for the lessor, the court of appeals noted that a condition precedent to the formation of a contract may be waived expressly or by inference from a party’s conduct. However, the court of appeals determined that the language in the sight draft made approval of title a condition precedent to the formation of the lease. In funding the draft, the lessee had waived its right to approve title prior to becoming liable on the draft, but at the same time, could not have waived the lessor’s covenant of good title because the covenant did not arise until after the draft had been paid.

8. *How to make an offer to lease “stick” using a sight draft.* In order to form a valid enforceable contract, the agreement at issue must be supported by valid consideration. As previously stated, the use of a sight draft conditioned on things such as the lease and approval of title creates a condition precedent to the formation of a enforceable contract and thus, the “contract” is subject to revocation until such time that the lessee tenders performance. Therefore, in order to limit the lessor’s ability to walk-away or shop the deal for better terms, the lessee should consider purchasing a “lease-option” supported by valuable consideration independent of the lease signing bonus evidenced by the draft.

- a. *Smith v. Shar–Alan Oil Co.*, 799 S.W.2d 368 (Tex. App.–Waco 1990, pet. denied).

This involved a suit brought by two lessors seeking a declaration that oil and gas leases executed by them were unenforceable because of the failure of a condition precedent to the formation of a valid contract, *i.e.*, payment of the drafts within sixty days upon approval of title. In addition to the two drafts, the lessors were given two \$100 checks when the leases were delivered with the notation, “For Richard Davis Lease.” The evidence presented at trial was that the monies payable under the sight drafts were in addition to the \$100 checks given to the lessors. The sight draft monies were “additional” bonus. The trial court found in favor of the lessee, and the court of appeals

affirmed the judgment. The lessors' principle argument on appeal was that the language in the sight drafts created "an offer to lease" and that the lessee failed to comply with the condition within the stated time period. The court of appeals rejected this argument and found the *Sun Exploration* case inapposite. Instead, the court noted that the leases were supported by independent and valid consideration, *i.e.*, the two \$100 checks, and that the additional monies were only due within sixty days after the occurrence of the condition. In other words, construing the transaction as a whole, the lessee had in effect locked the lessor in to the transaction by paying the lessor a nominal, but valuable consideration while waiting to pay the bulk of the "additional" consideration when title was approved.

#### **IV. SUMMARY – LESSONS LEARNED**

- A. Be careful when using conditional sight drafts – the conditions in the draft can affect whether there is a binding and legally enforceable agreement.
- B. Until the draft is funded, the lessor may be able to renege on the deal because the parties do not have a mutually binding transaction. If the lessor gets a better offer or simply changes his/her mind, the lessee will have little or no recourse under most draft instruments.
- C. Sight drafts can be utilized with other independent and valuable consideration to lock the lessor into the transaction and to prevent the lessor from backing out of the deal. If structured properly, this can give the lessee time to verify title and assess and avoid other transactional risks.
- D. A lessor has no right to reject the lessee's timely performance or waiver of conditions in a sight draft.