Oil and Gas Law Outline
Fall 2000

INTRODUCTION

Petroleum: generic name for certain combustible hydrocarbon compounds found in the earth

A commercial oil deposit requires the presence of a porous, permeable rock formation containing oil of a marketable A.P.I. gravity and of producible viscosity.

Three fundamental properties of petroleum (for oil and gas production):

1. *state* (gaseous, liquid or solid)
2. *specific gravity or density* = the ratio between the weights of equal volumes of water and another substance measured at a standard temperature

   The specific gravity of oil is expressed as A.P.I degrees, oil with the least specific gravity has the highest A.P.I. gravity (inverse relationship)

3. *Viscosity* = inverse measure of the ability of a liquid to flow (the less viscous the fluid the greater its mobility)

Nearly all commercial oil and gas production is from some form of sedimentary rock due to the porosity and permeability of such rocks.

There is no way of finding oil and gas short of drilling wells. Geologists look for *reservoir traps* = underground formations favorable to the accumulation of oil and gas.

Oil and gas exploration is the search for reservoir traps. There are two types of reservoir traps: Structural and stratigraphic

Geophysical survey: an exploration method whereby devices, such as a seismograph is used to develop a contour map of an area in order to determine which land to lease and where to locate an exploratory well

There are two main methods of oil well drilling:

Cable tool drilling: an older method that operates on a hammer principle to pulverize the rock

Rotary drilling rig: the more widely used method, operates on the principle of boring a hole by the continuous turning of a bit

Three fluids may be found singly or in combination in a reservoir trap: oil, gas and water (usually salt water)

- water will be on bottom, oil next , then gas

- the lines separating these fluids are called oil-water and gas-oil contact lines

Both natural and artificial means are used to produce oil; pressure (or reservoir energy) is needed to bring the oil to the surface. Oil wells create areas of low pressure

There are three natural sources of reservoir energy: (one is always present and often all three are)

1. *gas expansion*: most common
2. *water encroachment*
3. *gravity*

Primary factors affecting recovery: rate of production, gas-oil and water-oil ratio and to some extent well spacing.

Artificial reservoir repressuring operations:

1. *pressure maintenance*: involves the injection of a fluid into a reservoir just beginning to show production and pressure decline

2. *secondary recovery*: used on worn out fields, water flooding is a common method used

3. *tertiary/enhanced recovery*: includes a number of processes such as chemical flooding, steam injection, and steam flooding

Fundamental elements of petroleum exploration:

- leasing the land
- careful geological study of it
- making a location for a test well
- clearing the legal title to the land
- drilling the well

The basic legal instrument in this area is the oil and gas lease

There are two types of interests: mineral interest and royalty interest

The unit of measurement for natural gas in the BTU (British thermal unit) which is its capacity to heat

MMBtu: the abbreviation for one million BTU's, one of the standard units of measurement for natural gas

Distillate and crude oil are measured in barrels

Distillate: the wet element of natural gas that may be removed as a liquid, used interchangeably with "condensate" and "natural gasoline"

Native gas: gas originally in place (in contrast to injected gas)

Note: In a government survey; One section equals 640 acres

THE NATURE AND PROTECTION OF INTERESTS IN OIL AND GAS

Some Basic terms and concepts:

Conversion: wrongful taking of personal property (if oil and gas is personal property, then the cause of action is conversion))

Trespass: an invasion of an interest in real property (if oil and gas is part of the realty then the cause of action for injury to real property is trespass)

Real property: land and any structures built on it

Lessor: one who rents property **to** another

Lessee: one who rents property **from** another

Easement: (an interest in land) a right of **use** over the property of another

Nature of Ownership in Oil and Gas

The Rule Of Capture: one who captures the resource has ownership and therefore there is no liability for capturing oil and gas that drains from another's lands

Under the classic rule of capture, a landowner has only one option when someone is draining oil and gas from beneath his property: drill his own offset well to intercept the flow.

The rule of capture encourages wasteful drilling and the dissipation of pressure (straws in *Ice Cream soda analogy*: everyone sticks their straws in and tries to suck up a much as possible; in oil production this leads to inefficient pumping and limits the total amount recoverable)

The Rule of Capture has been modified or limited in many states. The following case illustrates the *doctrine of correlative rights* as a limitation on the rule of capture

Elliff v. Texon Drilling Co.

Facts: P owned surface and certain royalty interests in the oil and gas. P's lands overlaid 50% of huge reservoir. D's were drilling east of P's land and caused the well to blow out and crater, which drained large quantities of gas and distillate from under P's land. P argues that D was negligent (failing to use drilling mud of sufficient weight) in permitting the well to blow out. D argued that under the law of capture, P had lost all property rights in the gas, which had migrated from their lands.

Holding: In Texas, the landowner is regarded as having absolute title in the severalty to the oil and gas in place beneath his land. However, this rule of ownership must be considered in connection with the law of capture and is subject to police regulations. An owner of a tract of land acquires title to the oil and gas which migrates onto his property as the result of reasonable production. There is no liability for reasonable and legitimate drainage from the common pool. However, the immunity does not extend to the negligent waste or destruction of oil and gas. Here D's actions were not a legitimate drainage of minerals and therefore P did not lose their right in them when they migrated to the D's property.

Correlative rights doctrine: each owner has a right to a fair and equitable share of the oil and gas under his land as well as the right to protection from negligent damage to the producing formation (gives each owner of minerals in a common source the right to a fair chance to produce the oil and gas)

Note: The trial court had awarded damages based on the value of the oil and gas as if this were a case of conversion. The proper theory should have been trespass, since the oil and gas is real property. The measure of damages should have been dimunition in value. Accordingly, the court of appeals reversed the trial court's measure of damages. However, the Supreme Court held that the issue was not properly assigned by the defendant and refused to rule on the correct measure of damages. On remand, the court of appeals read the Supreme Court opinion to hold that the trial court's measure of damages was proper.

So in Texas, the owner owns all the minerals subject to the rule of capture and subject to the police power (i.e. state regulation). In contrast to the Louisiana approach, the Texas approach facilitates the application of real property principles.

Note: Under the Louisiana Mineral Code, ownership of land does not include ownership of oil. The owner has a non-possesory right to produce oil.

There are two theories of ownership: **Non-ownership** (followed in Ok., La., Ca., and Wy.) and the **Ownership in place** theory (followed in Tx, NM., Co., and Kan.)

Non-ownership: owner of oil and gas rights did not own oil or gas until it has been captured. Until capture, the owner of oil and gas rights only has a right to explore, develop, and produce oil and gas

Ownership in place: oil and gas rights are a fee simple absolute estate in the land, and the right to individual molecules of oil and gas is a determinable interest that terminates automatically upon capture by another

State regulation and the modification of the Rule of Capture

In Texas and other states, production may be restricted by state regulatory agencies.

In Ohio, the courts have rejected the rule of capture and replaced it with a rule that includes the correlative rights of the owners over the common source of supply.

Subsurface Storage of Gas

Because of the difficulty of storing natural gas above ground, many natural gas utilities and industrial users use depleted underground formations to store gas.

Many states have enacted statutes that regulate various aspects of gas storage.

In the following case the court considered the question of whether the owner loses its ownership of recovered gas when it injects the gas into a natural reservoir and the gas migrates:

Pacific Gas & Electric Co. v. Zuckerman (CA)

Facts: Pacific acquired rights to an exhausted reservoir and began to store gas there. The injected gas migrated to the adjacent parcel and Pacific found itself paying royalties on its own gas. Pacific brought action to quite title to the gas which had migrated.

Holding: California follows the non-ownership theory, where the oil and gas is not owned until it is captured. The court held that once gas has been reduced to personal possession, the owner is not thereafter divested of ownership simply because it stores the gas underground and that gas migrates. (The oil or gas becomes personal property when produced, so that ownership is not lost by mere loss of possession.)

Note: In the above case the company sought to condemn the land through an eminent domain action. Normally such power is reserved only for the state. However, the state has given public utilities and oil companies the power of eminent domain. No one wants a natural gas pipeline on their land, but such pipelines are necessary. If the utility company had condemned all of the property overlying the common reservoir the problem in Zuckerman would not have occurred.

CLASSIFICATIONS AND CONSEQUENCES

In general, the types of interest that the landowner may create by grant or reservation in oil, gas and other minerals are leasehold interests, mineral interests, and royalty interests

Leasehold interest: (oil and gas lease) the lessees under this instrument are given the exclusive authorization to go upon the land for the purpose of prospecting for oil and gas, has the right to work on the leased property to search, develop and produce oil and gas

Mineral Interest: the owner of the full mineral interest in a particular premises has the right to go upon the premises for the purpose of prospecting for, severing and removing therefrom all minerals

Royalty interest: the owner is ***not*** authorized to go upon the premises to prospect for or remove minerals. The owner is entitled to share in such minerals as are severed or the proceeds thereof.

The surface ownership can be separate from ownership of the minerals.

The Corporeal – Incorporeal Distinction

At common law, rights to land are classified as corporeal or incorporeal, according to whether they carry with them the right of physical possession.

Corporeal right: an interest in land that includes the right of possession of the land (possessory estate)

Incorporeal right: an interest in land that only includes the right to use the land (non-possessory estate)

profit a prende: a right to make some **use** of the soil of another, an incorporeal right is subject to abandonment but a corporeal right is not. It is considered a special type of easement in that the owner can take something from the land whereas an easement is only a right of use

Gerhard v. Stephens (CA)

Facts: P was the successor in interest to two corporations that had been dissolved in 1915. The corp owned minerals rights in a parcel of land that (47 years later) was producing oil. P brought suit to quiet title to the mineral interests. D's argued that the mineral interest were in the nature of incorporeal rights and were therefore subject to abandonment. P argued that they owned an estate in fee which could not be abandoned.

Holding: The corporations had the exclusive and perpetual privilege of drilling for oil and gas. Such an interest is a *profit a prende* (an incorporeal right) that, like easements, can be abandoned. The court reasoned that the term "fee", as used in previous rulings, has two meanings: (1) to designate the duration of the estates and (2) to describe fee ownership as any estate of inheritance. So an incorporeal interest may be "in fee" (perpetual in duration) but may still be abandoned through nonuse and intent. Intent can be inferred from the "external realities". Here, a finding of abandonment was sustained on the basis of the rejection of stock and the long period of nonuse. However, those shareholders who had not rejected the stock had not abandoned their interest. The court, in considering the "economic realities" held that where many owners own a fractionated share of the mineral estate, nonuse may result because if any one owner explored for the oil and discovered oil, he would have to share that discovery with his co-owners. However, if he did not discover any oil or gas, he would bear those expenses alone. Therefore, the non-use cannot give rise to an inference of intent to abandon where such economic realities created a disincentive to drill.

Note: The *Gerhard* abandonment doctrine is useful in clearing the way for surface development.

Note: A possessory estate cannot be abandoned. To prevent gaps in title, someone has to own it.

Severed mineral interest: the mineral estate is separate from the surface estate

The following case concerns the constitutionality of a "dormant minerals act":

Texaco, Inc. v. Short (U.S. Supreme Court)

Facts: Indiana, a non-ownership state, enacted a statute that provided that a severed mineral interest that is not used for a period of twenty years lapses and reverts to the current surface owner. The mineral owner could protect his interest by engaging in actual production, collecting rents or royalties, pays taxes, or files a written statement of claim. Appellant argued that the Act was unconstitutional in that in was (1) a taking w/o compensation, (2) deprived him of his property without procedural due process and (3) deprived him of equal protection.

Holding: The court held that the statute was constitutional. It was not a taking as, after abandonment, the former owner retains no interest for which he may claim compensation. The actions required to avoid abandonment further legitimate state goals (e.g. encourage owners to develop mineral interests, collect property taxes, and locate mineral owners.) The grace period and proper promulgation of the statute provided adequate and reasonable notice. Moreover, landowners are presumed to know the law (as is everyone else). Thus, the landowner was not deprived of due process because he was not entitled to personal notice before his interest was abandoned.

Note: After the S. Ct. approved the Indiana Dormant Mineral Statute, several other states have adopted a variant of the statute.

Note: You can't abandon a corporeal right, but a state can exercise police power to take it, so you can have a dormant mineral act even in an ownership in place state

Deed-Lease Distinction

Loomis v. Gulf Oil Corporation (TX)

Facts: An owner of land sought to remove from his title a mineral conveyance executed by the previous owner of the land. P argued that the conveyance was not a conveyance of title but merely a grant to explore for and produce minerals. Moreover, he argued that since a reasonable time to begin development (26 years) had long since expired and therefore the rights under the conveyance have been abandoned. D argued that the instrument conveyed indefeasible legal title to the minerals and such an estate cannot be lost to abandonment.

Holding: The court reviewed the instrument and concluded that the terms of the instrument conveyed an indefeasible legal title to the minerals. Factors identified in the instrument that led the court to its conclusion: (1) had all the necessary elements, (2) it convey "all" minerals w/o qualification, (3) valuable consideration, (4) language manifest intention to convey fee simple title in the minerals, (5) grantor retained only a royalty interest, (6) intent of parties was to sever all minerals from the surface.

Notice that the payment of royalties to the grantor would, by itself, seem to evidence a lease.

Elements of a proper deed conveyance:

- competent parties
- proper subject matter
- apt words of conveyance
- proper words of execution
- consideration is NOT a necessary element (could be a gift)

Kansas requires the recordation of an instrument severing mineral rights or a separate return for tax purposes.

Surface and Subsurface Trespass

Owners of mineral interests and leasehold interest whose rights are infringed may receive compensation for:

1. damage to the lease value of the interest (trespass)

2. slander of title

3. assumpsit: an equitable action brought to enforce an implied contract

4. conversion and ejectment

The following case concerns the **damage to lease value** (drilling an oil and gas well is the only sure way of "proving" a property and the drilling of a dry well may "condemn" a property's lease value)

Humble Oil & Refining Co. v. Kishi

Facts: Humble held a lease dated 23 Dec 1919, but signed by the lessor on 29 Jan 1920. The lease term was for three years but could be extended by successful drilling. Oil was discovered on an adjoining tract and Humble commenced drilling on 23 Jan 1923. Humble failed to find oil. P claims the lease had expired on 23 Dec 1922 and therefore Humble had no right to enter upon the land, drill, and thereby destroy the lease value. Humble claimed that it believed in good faith that the lease had not expired.

Holding: The lease had expired three years from its date so Humble's entry upon the land was unlawful. The wrongful act destroyed the value of P's property (the market value of the leasehold interest) by proving that the land had no oil or gas. The court awarded P ¾ (his interest in the mineral estate) of $1000/acre for a total of $37,500. The measure of damages is measured by the loss in value of the leasehold interest caused by the wrongful conduct. (on rehearing the court concluded that there was no proof that the value of the leasehold interest was $1000/acre) The problem in this case was that Humble denied Kishi his right to develop the land or lease the rights by asserting the exclusive right to drill. Although Humble had permission from Kishi's co-tenant, Humble is still liable on a trespass theory because Kishi was denied his rights to develop.

Note: Normally, this type of interference requires a showing of a lost opportunity to lease. However, here the court did not require such a showing.

Note: If property is owned by co-tenant, each co-tenant has an independent right to develop the land or let a third party develop it.

In a similar case, *Martel v. Hall Oil Co*, (WY), the court rejected a claim for damage to the lease value from a trespasser who had drilled a dry hole, reasoning that there was no real damage to the true owner because the property was worthless for gas and oil in the first place. This approach seems to ignore economic realities.

Slander of title has three elements:

1. *False claim* (another recorded a lease covering the owners interest or has refused to release an expired lease)

2. *Malicious intent* (not evil intent, only have to show deliberate conduct w/o reasonable cause)

3. *Specific Damages* (must show an actual loss, a specific sale)

In *Kidd v. Hoggett*, D's lease had expired but a "shut-in" clause allowed them to pay royalties on a well producing gas to extend the lease, even though they were not selling the gas. P's became suspicious when demand for gas went up, but D's did not sell. P's entered into an agreement to lease to another provided D's gave a release. D's refused to give the release and the tract now has no value. D's argued that the P's failed to prove malice. The court held that an action for damages caused by an unreleased lease in an action for slander of title. The court found all elements for slander of title (malice is deliberate conduct w/o reasonable cause) and affirmed. If this had been a case of trespass malice would not have been a necessary element.

Note: A release is required in order to re-lease or sell the interest. Since leases is a recorded instrument you need a written release in order to remove the cloud of title.

Shut-in royalty clause: a lease clause that permits the lessee to maintain the lease while there is no production from the premises because wells capable of production are shut-in by making a payment of "shut-in royalty" in lieu of production.

Assumpsit: an equitable action brought to enforce an implied contract, in the context of a trespass to oil and gas interests, the owner sues for payment for the right of entry that the trespasser should have obtained (you waive the tort claim of trespass and sue in assumpsit since the measure of damages for trespass is the value before the trespass minus the value after the trespass and in the case below there was no reduction in value so the only way to recover damages is to sue in assumpsit for the value of the lease)

The following case adopts the minority rule that a plaintiff may waive a trespass action and sue in assumpsit.

Phillips Petroleum Co. v. Cowden (TX)

Facts: Phillips obtained permission from the surface owner to conduct a geophysical survey of the land. Cowden, the owner of the mineral estate claimed the survey amounted to trespass and that Phillips owed them damages. Phillips argued that they were using the site to obtain more data about their own property. The issues were: (1) whether there was a cause of action and (2) what is the proper measure of damages.

Holding: The right to explore for oil and gas is a valuable right and is ordinarily an attribute of the mineral estate. If the surface estate is separate from the mineral estate, then the right to conduct seismic surveys belongs to the mineral owners. Here, Phillips had no right to conduct the surveys and must pay damages. The mineral owner may sue the "geophysical trespasser" only in trespass and not for conversion. However, the landowner may waive the trespass and sue in assumpsit (as damages for trespass would only be nominal) for the reasonable value of the use and occupation. (Normally, oil companies must pay to conduct such surveys. Here, by means of their trespass, they obtained the info w/o making any payment to the mineral owners. The measure of damages is the reasonable market value of the use Phillips made of the property)

Note: Conversion may be applicable if the info obtained was valuable, here info was not valuable.

Note: If the defendant had conducted all of the geophysical surveys on adjacent property with only the sound waves crossing the boundary lines, there would have been no trespass and the plaintiff could not have recorded on a quasi-contract theory.

If the courts find "**good faith trespass**", equity will permit the trespasser to recover production costs or their reasonable value if he improves the land. Otherwise the owner would be unjustly enriched.

In *Champlin v. Aladdin*, (OK) it was decided that Champlin did not have title to land in question, although it originally thought it did. (Champlin drilled wells and began producing the land). The issues were whether the owners were (1) entitled to the highest market value (as opposed to the market value on the date of production) and whether Champlin was (2) improperly denied a credit for the expense incurred in drilling a dry branch to a producing well. The court held that (1) the owners were not entitled to highest market value. In order to receive highest market value under Oklahoma statute the owners must exercise reasonable diligence (15 months) in prosecution of their action. Here, the owners waited five years plus Champlin was a "good faith trespasser". The court further held that (2) the cost of drilling the unprofitable branch of a producing well is a reasonable cost of development and must be deducted. **Test was Good Faith**

In Texas, one who enters the land and makes improvements with knowledge of an action to enforce claim on the land, cannot be considered a trespasser in good faith.

In Kentucky, the good faith trespasser is entitled to a lien on the property in the amount by which the improvements have enhanced the value of the land.

If an oil and gas trespasser is found to have acted in **bad faith**, the trespasser is permitted no set off for expenses incurred or benefits conferred.

Edwards v. Lachman (OK)

Facts: D's well bottomed in and produced hydrocarbons from formations underlying the adjacent property, which constituted a sub-surface trespass. The trial court ordered D to plug the well and pay the value of the production with no credit for the cost of drilling the well (decision was premised on D's negligence and that the drilling conferred no benefit upon P since P already had a producing well). D argues that he was entitled to a set-off absent proof that he acted in bad faith.

Holding: Bad faith must be established by proof (evil intent or gross negligence and burden is on the party claiming bad faith). Here, D's were not guilty of bad faith when they drilled the well (but ceased to be good faith trespasser once they conducted a directional survey and found their well bottomed out in P's property). An innocent trespasser who produces the hydrocarbons of a rightful owner of the oil and gas rights, is not entitled to his drilling and completion costs if by such drilling and completion, no benefits are conferred upon the owner. The court holds that D's are entitled to credit to the extent that their drilling benefited P's. (the case was remanded to determine if D's deeper well producing from two formations conferred a benefit upon the owners). **Test was Benefit**

Adverse Possession of Minerals

Elements:

- open, notorious, and visible possession (to put other parties on notice)
- hostile
- continuous
- for the statutory period

TACKING: the doctrine, which permits an adverse possessor to add his period of possession to that of a prior adverse possessor in order to establish a continuous possession for the statutory period. Tacking requires privity between the adverse possessors.

As a **general rule**: possession of the surface gives no notice to the severed mineral interest owner because most surface use is not inconsistent with the rights of the mineral owner

In *Gerhard v. Stephens*, the issue was whether the severed mineral interests had been lost through adverse possession. The D's (in support of AP) argued that they had fenced the land, paid all taxes, excluded trespassers, negotiated and recorded oil and gas leases, and received royalties. The court holds that mere possession and ownership of the surface, in the absence of activity sufficient to

impart to the true owner of the mineral estate notice of an adverse claim, does not give rise to adverse title to rights in the underlying minerals. Here D's engaged in no subsurface activities sufficient to acquire a prescriptive title to the mineral rights (their drilling began only shortly before litigation commenced) and D's surface activities were not adverse to P's enjoyment of their interests. While mineral estates in Cal. are types of easements, an easement cannot be lost through adverse use unless there is interference with the right to enter upon the tract and explore for oil and gas.

An actual, public, notorious and uninterrupted working of the minerals for the statutory period is generally required. The mere execution, delivery, or recording of oil and gas leases or mineral deeds will not constitute adverse possession.

Effect of Divided Ownership on Oil and Gas Operations

Common-Law Concurrent Interests

TYPES

tenancy in common: have separate but undivided interest's in the property, the interest of each is discernable and may be conveyed by deed or will, no survivorship rights between tenants

joint tenancy: one estate which is taken jointly , have right of survivorship, are regarded as a single owner, joint tenants ownership interest ceases at death

tenancy by the entirety: can be created only in a husband and wife and by which together they hold title to the right of survivorship so that upon death of either , other takes whole to the exclusion of deceased heirs

The most common problem with concurrent ownership is whether one or more of the owners have the right to develop minerals, or to lease for their development without the consent of the other owners. The following case sets out the majority rule:

Prairie Oil and Gas Co. v. Allen

Facts: Goodland, the 90% tenant in common of the mineral interest, leased its interest to an oil company. Allen, who owned the other 10%, sued the purchaser of production (Prairie) and the lessee (Skelly). She wanted payment but they were deducting 10% of costs and were operating at a loss so she was not getting any money. She then claimed that since she did not join the lease (give her permission), it was void as to her and therefore Skelly was a trespasser.

Holding: A tenant in common, without the permission of his covenant, has the right to develop and operate the common property for oil and gas. Tenants in common may make reasonable use of the land, the taking of minerals is the reasonable use of a mineral estate. Moreover, if a cotenant owning a small interest in the land had to give his consent he could arbitrarily destroy the value of the land (since other adjacent landowners will suck up the oil). The proper method of accounting her share is one-tenth the NET profits (subtract

development and operational expenses from value of the gross production). Where there is a loss the other cotenants are not required to pay a share of the expenses.

Each has lessee has the right to possession, they therefore become cotenants with other owners or their lessees (the lessors retain a possibility of reverter)

Waste: permanent harm to real property, committed by tenants for life or for years, not justified as a reasonable exercise of ownership and enjoyment by the possessory tenant and resulting in a reduction in value of the interest of the reversioner or remainderman.

Prairie Oil also raises the issue of waste. The doctrine of waste prevents a holder of a present interest from substantially reducing the value of the land to the detriment of future interests or other present interests (for example by cutting down all of the timber). However, co-tenants can use up all of the oil because of the fugitive nature of oil and gas.

Note: putting up new oil wells is considered waste and therefore life tenants are not entitled to drill new wells *see discussion below*

The lease in the following case contained a drilling-delay rental cause which release the lessee from any obligation to drill provided he pays the rental fee. There are two types:

<u>The “unless” clause</u>: automatically terminates the lease unless a well is commenced or delay rentals are paid prior to the date specified

<u>The “or” clause</u>: lessee must either commence drilling ***or*** pay rentals ***or*** surrender the lease prior to the due date

The following case addresses whether the lessee under a separate lease from another cotenant is a tenant in common prior to entry

Earp v. Mid-Continent Petroleum Corp.

<u>Facts:</u> P (owner of 2/33) entered into a lease with Wagner. The lease was set to expire Nov 25 unless Wagner drilled or paid rental. Wagner paid rental and extended lease to “26, in the meantime Mid, the lessee of 31/33, commenced drilling a successful well. P now argues that the lease had expired in Nov ’26 because Wagner failed to drill or pay rentals. Wagner argues that the drilling of Mid was in effect drilling by Wagner since they were co-tenants and therefore the lease was extended.

<u>Holding:</u> Wagner and Mid were co-tenants: the lessee of a cotenant under an oil and gas lease becomes a cotenant with the cotenants of his lessor upon execution and delivery of the lease, regardless of whether he enters the premise or drills. The court reasoned that the right of possession is enough to establish co-tenancy. However, in order to claim the act of drilling as his own there must be something more than a mere passive acquiescence in the drilling by another lessee under a separate lease. Here, however the contract was somewhat ambiguous so the court relied on the contemporary construction of the parties and held that the parties treated the drilling by Mid as compliance with the terms of the lease.

Note: When there is a non-consenting co-tenant he is entitled to an accounting for his share of the profits minus production costs. However, if the well never reaches pay-out he will get nothing. But if the non-consenting co-tenant (or any lessee obliged to pay royalties) is obligated to pay royalties he would have to pay the royalties regardless of whether the well achieves payout, plus there is no reduction for production costs.

In the case above, if the well is producing but has not reached payout. Mid will owe nothing to Wagner but Wagner must still account to Earp for his royalties

> In *Anderson v. Dyco Petroleum Corp*, some of the working interest owners were selling gas to Panhandle. The others working interest owners, who were not party to the purchase agreement, were not receiving any proceeds and brought a conversion action against the purchaser. The court held that there is no tort action for conversion in favor of one owner against a purchaser who buys from one or more other owners of the same well. Each cotenant has the right to develop the property and market production. The disgruntled owners should have brought an action for an accounting of the proceeds. (It would be a conversion if there was a revocation of the power to sell and the purchaser received notice of the revocation but continued to buy).

There are two ways for a non-consenting cotenant to receive his share of the production:

1. Cash Balancing—the cotenant receives his portion of the proceeds
2. Balancing-in-kind—the cotenant may produce minerals on his own until he "catches up". (An agreement should address the remedy if the well dries up before balancing is achieved.)

Partition: the dividing of lands held by joint tenants or tenants in common. If concurrent owners cannot accomplish termination of a cotennacy through voluntary agreement the equitable action of partition is necessary

> Partition in kind: physical partition of the property (this is the preferred division as it is considered fairer)
>
> Partition by sale: property is sold and proceeds divided according to the parties respective interests

Note: In order to have a partition the estates must be of equal dignity (i.e. two fee simples, but not if one is a fee simple owner and the other a LE, because the partition would affect future interests)

> In *Schnitt v. McKeller*, one of the parties sought a partition of the mineral interests. The court held that minerals, as part of the real estate, if held in cotenancy, may be the subject of partition. Each cotenant has the absolute and unconditional right to partition. The only exception is a limited defense to prevent fraud or oppression, but this defense must be plead and proved.

Successive Interests

The most common successive interests are those of life tenants and remaindermen

At common law, neither a life tenant nor a remainderman can develop oil and gas or grant a valid oil and gas lease without permission of the other because neither possesses the full rights to the property

The life tenant has right to present use, but must conserve the estate for the remainderman (doctrine of waste)

The remainderman lacks the right to present use that any grantee will require

> In *Welborn v. Tidewater*, Smith owned a LE and Garrett owned the remainder interest. Smith, as guardian for Garret, leased Garret's interest to Welborn for ten years. Smith and Garret then entered into another lease with Tidewater. Welborn demanded that tidewater release the lease as it constituted a cloud on its own lease. The court states that it is well settled that a remainderman may not make an oil and gas lease to permit immediate exploration and production without the consent of the life tenant. Likewise, a life tenant cannot drill new oil or gas wells, or lease the land to others for that purpose. **Life tenant and the remainderman may lease the land by a joint lease**. Here, only Garret consented to the Welburn lease, so the most Welburn acquired was a contingent right to go upon the land after the death of the life tenant, if the death occurred prior to the expiration of the lease (which expired so Welburn has nothing)

If a life tenancy in the mineral interest is created by instrument, the life tenant can be specifically given the right to grant an oil and gas lease.

Note: If there is no specific agreement between the parties, the default arrangement is that the royalties are put in a trust for the future estate and the L tenant is entitled to the interest on the royalties.

> In *RLM Petroleum Corp v. Emmerich*, the Mosiers sold their property to the Emmerich's but reserved a 25 year term mineral interest which specifically gave them the right to execute mineral leases. They executed a lease that extended past the term and the term expired. The lessee sought a declaratory judgement that the lease continued. As a general rule, the owner of a term for years cannot create an interest in land to endure beyond the term. However, *a grantor of a term mineral interest who reserves a future interest may agree by express language in the conveyance to allow the future interest to be subject to an oil and gas lease granted by the term mineral interest holder (grantee) during the term of the mineral interest.* (the caveat has to be in the original instrument). Here, there is no indication that the Emmerichs agreed to be subject to any leases entered by the term mineral interest holder. A party asserting a limitation upon an estate conveyed has the burden of proving such limitation. Thus, the lease expired when the term for years expired.

As stated before, putting up new oil wells is considered waste and therefore life tenants are not entitled to drill new wells or enter into new leases (unless there is a joint

agreement with remaindermen, or instrument specifically give such right to life tenant, or open mine doctrine applies)

Rule: Life tenant is not entitled to deplete the corpus of the estate (royalties are part of the corpus of a mineral estate)

Open mine doctrine: where there is an open mine on the property the tenant is entitled to work the mine or to the lease payments. Generally a mine is held to be open when an oil and gas lease exists at the creation of the life tenancy. This doctrine creates an exception to the rule that the Life tenant cannot deplete the corpus, it allows him to collect the royalties or lease payments.

> In *Moore v. Vines* (TX), an oil and gas lease was in effect at the time the life tenancy was created but expired shortly thereafter. The life tenant then entered into another oil and gas lease. Some of the remaindermen challenged this. The court held held that 'open mine' doctrine was not applicable beyond lease in existence at time life estate vested in husband pursuant to joint will under which husband received life estate in wife's separate property at her death, thus, husband had no authority to execute lease for mineral development following wife's death and expiration of mineral lease executed during wife's lifetime and husband had no authority to enjoy proceeds from any such lease.
>
> <u>Rule</u> (TX) open mine doctrine is limited to the term of the lease in existence when the life tenancy was created, the life tenant may not grant additional oil and gas leases on the property or extend existing leases

IMPORTANT CLAUSES

Habendum and Delay Rental Clauses

<u>Habendum clause</u>: the clause in the oil and gas lease that defines how long the interest granted will extend. Modern leases contain a **primary term** (a fixed number of years during which the lessee has no obligation to develop the premises) and a **secondary term** (for so long thereafter as oil and gas is produced, once development takes place)

<u>Delay rental clause</u>: a payment from the lessee to the lessor to maintain the lease from period to period during the primary term w/o drilling

The following case involves a **no-term lease**, which is a lease that could be extended indefinitely by payment of delay rentals. Many courts refused to enforce these leases:

> In *Federal Oil Co. V. Western Oil Co.*, the landowner had entered into a no-term lease with Federal. The landowner refused to accept the delay rental and entered into another lease. Federal brought suit to quiet title to the lease. The court decided that the lease was unenforceable for three reasons:
>
> 1. *Consideration*: lessee paid only nominal consideration of $1 and was not bound by any enforceable covenant or promise. Plus the promise was illusionary as there was a promise to drill the second well but not the first.

2. *At-will lease*: Federal had the right to cancel the contract and therefore so did the lessor. At-will contracts are generally unenforceable

3. A contract must be *mutually binding* and conclusive on both parties

Note: The primary reason for no term disuse is that they are not acceptable in the marketplace, both mineral owners and lessees demand more certainty than no-term lease provide.

Primary Term

Delay Rentals – The Unless Lease

The "unless" clause: automatically terminates the lease unless a well is commenced or delay rentals are paid prior to the date specified

> In *Phillips Petroleum Co. v. Curtis*, the lease was an unless lease. The delay rental clause required lessee to pay rental by 4 Oct 47. Due to an employee error (thought the lease was "held" by production) the delay rental was not paid on time. The lessee argued that they were entitled to equitable remedies – be relieved from the termination. The court holds that the failure to pay delay rentals by the specified date is not a forfeiture, but merely a termination of the lease in accordance with the agreement of the parties. Equitable principles with respect to relief from forfeitures have no application. The lease is automatically terminated. The only time the lessee might be entitled to equitable relief is when an independent agency (Post Office, Bank) not under the supervision or control of the lessee made the mistake.
>
> The lessor of an "unless" lease receives a fee simply determinable which terminates without regard to equitable considerations.

NOTE: In this case the court applied a canon of construction (a written instrument should be construed against the drafter) even where no ambiguity in the contract exists.

Small errors can be fatal – if lessee tenders $45 when he was required to tender $50, the unless lease terminates.

Well Commencement Clause

The typical lease excuses payment of delay rentals if a well is "commenced" on the land before the anniversary date.

> In *Hall v. JFW, Inc.*, the lease provided that "if no well is commenced on the land the lease shall terminate" and "if lessee shall commence to drill a well within the term of the lease he shall have the right to drill to completion." Prior to the expiration date, the lessee signed a written contract with a driller and argued that this was sufficient to constitute commencement. The court looks to the parties' intent as evidenced by the instrument as a whole and concludes that the lease required the lessee to actually commence to drill before the expiration of lease. The court noted that if the lease had required that the lessee "commence drilling

operations" something less than actual drilling may be sufficient to satisfy a commencement clause. The lessee should be required to demonstrate what amounts to an irrevocable commitment to conduct operations – such as an enforceable contract with a third party to drill.

Note: In the above case the court refused to apply a canon of construction unless the written instrument contains an ambiguity. The court defines an ambiguity as a "genuine uncertainty."

The following case concerns a modification of the unless provision:

> In *Kincaid v. Gulf Oil Corp.* the parties entered into an unless lease but included a provision that the lease would not terminate even if the lessee had not begun production or paid a delay rental if the lessee had "made a bona fide attempt to pay or deposit rental to a Lessor." The lessee had decided not to pay the delay rental because drilling operations had already begun. However, the day before the end of the primary term, the lessee was notified that the drilling had ceased. In the rush to deliver payment by that afternoon, the lessee mistakenly made the check payable to the wrong lessor. The court held that the lease had not terminated because the lessee had made a **bona fide attempt** to make payment.
>
> Notice that this equitable consideration is inconsistent with a fee simple determinable estate which automatically terminates when a condition is broken. Even though individuals cannot create new estates in land (we are stuck with the ones that our law recognizes) the court allowed the parties in this case to contractually agree to a slightly different estate than a true fee simple determinable. Or did the parties in the case just create a new limitation?

Notwithstanding legal theory, there are cases in most jurisdictions that invoke equitable principles to maintain leases with "unless" clauses where there has been a failure to pay delay rentals properly:

> In *Humble Oil & Refining Co. v. Harrison* Otto, the lessor of a three-fourths interest, conveyed one half of the possibility of reverter to Harrison. Harrison delivered a copy of the deed to the lessee. Due to an ambiguity in the lease (the lessee thought that Harrison was entitled to one-half of Otto's interest rather than one-half of the entire estate) the lessee delivered insufficient payment to Harrison. Harrison did not notify the lessee of the insufficiency until after the lease had terminated. When Harrison claimed that the lease was terminated and refused additional payment from the lessee, the lessee brought suit to quiet title to the mineral estate. The court **estopped** Harrison from claiming that the lease had terminated because (1) Harrison had delivered an ambiguous document and (2) Harrison failed to notify the lessee of his mistaken interpretation. Thus, while a lessor does not generally have a duty to notify the lessee of insufficient payment, such a duty may arise when the insufficiency can be at least partially attributed to the lessor.

Most leases contain a *notice of assignment clause* to avoid disputes over the effect of an assignment upon delay rental payments (otherwise the lessee might be obliged to review public property records each year to determine who should be paid delay rentals)

In *Gulf Refining Co. v. Shatford* the lease provided that the lessee must be notified in writing, including certified copies of all recorded instrument, of any change in ownership before it will be obligated to send royalty payments to the new lessor. The lessor assigned a portion of his possibility of reverter to a third party, Shatford, who notified the lessee in a letter than he now owned a portion of the royalty interest. The lessee requested Shatford to send copies of the recorded instruments. Shatford did not respond for about a month a half. As the rental payment date approached, the lessee sent payment of the royalties but did not include payment to Shatford. The next day, the lessee received the recorded instruments from Shatford. The court held that Shatford was bound under the lease to send the certified copies of the recorded instruments before being entitled to royalty payment. The court further held that the lessee is not required to wait until the last minute before payment is due for the lessors to provide proof of their ownership (here Gulf made payment ten days before it was due and then received proof of the assignment after they mailed the payments but before the payment due date)

In *Atlantic Refining Co. v. Shell Oil Co.* the lease contained a similar provision as in the *Shatford* case. In this case the lessor conveyed a one half interest in the minerals to Shell subject to the lessee's lease, but did not convey the royalty interest. Thus, Shell was not entitled to royalties. However, after noticing that half the lessor's interest had been conveyed to Shell, the lessee paid to Shell half of the royalties. The court held that the lessee was bound by the lease and could not make payment to any party without receipt of the appropriate recorded instruments. Thus, the lease terminated because proper payment was not made to the proper lessor.

Note: Lessees should stick to their leases! As the case above illustrates, If the lease contains notice of assignment provisions, the lessee ignores their terms at its peril.

In *Brannon v. Gulf States Energy Corp.* the lessee missed the delay rental payment date, but the lessor cashed the lessee's late payment. The court admitted parol evidence not to show the altered meaning of the written lease, but to show that the lease had been revived. The court held that the lease was revived by the lessor's cashing of the late rental check.

Here, the court ignored the rule we looked at earlier in *Mecom* where a trespasser was per se bad faith if he drills after knowledge of the initiation of litigation over the mineral rights. Here the court held that the lessee was not a trespasser as a matter of law, but remanded the issue as a factual question.

Delay Rentals – The "Or" Lease

<u>The "or" clause</u>: lessee must either commence drilling ***or*** pay rentals ***or*** surrender the lease prior to the due date

Difference between "or" and "Unless": In an "or" lease, the lessee **covenants to do some alternative act**, usually to drill a well or to pay periodic rentals, to maintain the lease during its primary term. Simply put, the lessee must "drill or pay". Conversely, the lessee in an "unless" lease **does not covenant** to drill a well or pay rentals. However, if the lessee does neither within the time intervals specified therein, the lease automatically

expires by its own terms. In typical form, "if" no well is drilled, the lease terminates "unless" rentals are paid

> *Warner v. Haught*,
>
> Facts: The lessee agreed to pay an annual delay rental, in advance until a well is drilled. Lessee's failed to make the delay rental payment on time. They then tried to pay but lessors refused to accept and sought a declaratory judgement declaring that lessees abandoned the lease by not paying the rental on time. The state had a statute which voided the lease if after demand for payment, the lessee failed to make payment for sixty days. Lessors argue that the statue does not apply as it is an unless lease which terminates automatically.
>
> Holding: An "unless" type lease places no obligation upon the lessee. However, in the instant leases the terms clearly provide that the lessee covenants and agrees to pay rental. Moreover, with the unless type of clause the lessee does not need the protection of a surrender clause in order to escape liability for failure to drill. Here, the subject leases contain a surrender clause permitting the lessee to voluntarily surrender the leases, which indicates that it is an "or" lease. The court holds that an oil and gas lease binding the lessee to drill a well on the leased premises within a certain period, or, in lieu thereof, make periodical payments of delay rental, and containing no clause of special limitation which would effect an automatic termination of the lease for failure of the lessee to perform one of the specified obligations, is not terminable due to nonpayment of the rental without the lessor's compliance with the notice and demand provisions under the statute. However, leases subject to automatic termination for failure to pay delay rentals (i.e. "unless" leases) are unaffected by these statutory provisions.
>
> Failure to pay delay rentals under an "or" lease gives rise to a breach of contract claim but does not act as a limitation on the estate conveyed. However, the breach may result in a forfeiture of the estate. Here, equitable considerations are relevant. Thus, a delay rental clause in an "or" lease creates a fee simple on condition subsequent.

Dry Hole Clause

A dry hole clause prevents implication of condemnation or abandonment of a lease from the drilling of an unproductive well on the leased premises. The clause affirms the lessee's right to maintain the lease for the remainder of the primary term by paying delay rentals. (before such clauses, lessors successfully argued that drilling operations resulting in a dry hole constituted an irrevocable election of the drilling option of the delay rental clause.)

> In *Superior Oil Co. v. Stanolind Oil*, the parties disputed over the construction to be given to the dry hole clause in an "unless" lease. The delay rental anniversary date was 3 MAR. The dry hole was completed on 3 FEB. On the following 28 JAN, the lessee (Richfield) made a rental payment for the period of 3 FEB '46 to 3 FEB '47, and interpreted the clause as requiring payment 12 months from the completion of the dry hole. The lessee then assigned the lease, and the next lessee interpreted the dry hole clause as requiring payment on the lease anniversary date (3 MAR). The court concluded that the dry hole clause was ambiguous and

therefore the court must look to the construction the parties of the lease gave to the provision. Here, the original lessor and lessee construed the provisions to date from 3 Feb. Not having paid the delay rentals by the date they were due under the 'dry hole' provisions of the lease, as construed by Richfield and the lessors, the determinable fee title held by Superior, et al, automatically came to an end.

Note: While real property interests normally cannot be abandoned, a Texas court has held that a leasehold on a mineral interest is abandoned once production and drilling ceases after drilling a dry hole.

Extension of the Lease beyond the Primary Term

Drilling Operations

Production and Discovery

Except in a few states, actual production (marketing) is required to extend an oil and gas lease to the secondary term. (unless some other provision dictates otherwise)

In *Baldwin v. Blue Stem Oil Corp*., the primary term of the oil and gas lease was for three years. However, the lease would end after one year if no well was **completed** unless the lessee paid delay rentals. The lease would extend beyond the primary term "as long thereafter as oil or gas . . . is produced." No well had been completed and no well was commenced until 7 DEC 18 (just before the end of the primary term). The lessees argued that on account of excuses (inadequate rainfall, flooding, blizzard, could not get coal, employees were sick) given by them, the leases should not be forfeited by reason of failure to complete the well. The court states that this is not an action for a breach of contract where excuses for its nonperformance might be pleaded. It is an action to cancel leases that by their own terms had expired on account of the lessee's nonperformance of the conditions. Actual production (i.e. marketing/sales) is required to extend an oil and gas lease to the secondary term.

The requirement of actual marketing is derived from the lessee's implied duty to market.

If no sale then the lease terminates

Minority view: (OK, WVA) an oil and gas lease will not terminate if oil and gas is discovered prior to the end of the primary term, actual production is not necessary but discovery requires completion and capability of production

In *McVicker*, the lessee of an "unless" lease completed a gas well but had not marketed or sold any gas from the well. The lessor argued that the lessee had abandoned the lease and that the lease had expired on its own terms. The lessors claim that there is an implied duty to market the oil and gas. The lessees claimed that "producing" does not include "marketing" The court applies common notions of reasonableness and holds that when the extent of performance is not fixed, the law implies that such act shall be performed diligently. Here, the lessees had a reasonable time after completion of the well to start marketing its product (Ct affirms trial court ruling that lessees made reasonable efforts to

market the gas.) The court also holds that the rule of reasonableness here applied is not 'unlimited in the face of diligent effort' and that such a lease may be cancelled regardless of the intensity of the lessee's efforts, where there is no reasonable probability that same will be successful, or it appears that others, with less effort, would succeed where they have failed (this limitation is not as clear as to when the lease ends or terminates).

Courts will look at each case and see whether lessee exercised reasonable and diligent efforts and whether such efforts have a reasonable probability of being successful.

In Sum, the case above says that you don't have to market but have to exercise diligence, but you can't hold onto a lease forever w/o marketing.

Lessor Interference

In *Greer v. Carter Oil Co.*, the lessor deeded her premises to Greer but did not record it. She then leased the premises to Carter for three years. Two years prior to the expiration of the lease, the deed was recorded and Greer brought suit to declare the lease invalid. During suit, Carter ceased operations as they did not want to be held liable for damages as a bad faith trespasser. The lease was considered valid by the trial court and Carter was given a reasonable time to perform the terms of the lease as it had expired during the course of the litigation. The court holds that where it was within grantees' power to prevent fraud being perpetrated on others by recording their deeds, and lease to oil company was recorded more than two years before grantees' deeds were placed of record, and during all that time grantees had notice that there was an outstanding title created by their grantor, and they did not bring suit until insufficient time was left to have litigation terminated prior to expiration of the oil and gas lease, they were "estopped" to claim that the term had expired, and an extension of the time of the lease was proper.

Kramer notes that the facts that give rise to an estoppel should take place before the lease expires. In other words, estoppel cannot be used to retroactively validate an already-lapsed lease. Here the facts that gave rise to the estoppel was the failure to record.

Note: Normally if one deeds the property away and then makes a lease, they have nothing to transfer so lease would be invalid. Here, however, Carter was a Bona fide purchaser for value under the state's recording statute, which is why lease was still valid.

Production in Paying Quantities

A literal construction of "production" in the habendum clause of an oil and gas lease would mean that small amounts of production would suffice to extend the lease indefinitely. With a few exceptions, however, the courts that have considered the issue have concluded that production must be "in paying quantities to the lessor." The reason is that if you don't have production in paying quantities (though able to) you are holding the lease for speculative purposes (hope price will go up) and the lease is executed for productive purposes.

As the following two cases illustrate, courts use two tests to determine whether the lease terminated due to cessation of production:

(1) Mathematical test: a well is profitable if operating revenues are greater then operating costs. If the well is profitable then there is not a termination. If the well is operating at a loss then you go to the second test: (drilling costs are not included as operating costs as the lessee should be allowed to recoup as much of his original investment as possible). Operating and marketing costs are deducted from revenue.

(2) Reasonable Prudent Operator Test (RPO): whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated

> In *Clifton v. Koontz*,(TX) the lessor seeks the cancellation of an oil, gas, and mineral lease on the theory that after the expiration of its ten-year primary term, the lease terminated due to cessation of production. The lessors specifically allege that for a period of time, the total expenses of the operation exceeded the income, and thus there was a loss. The court states that the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated. In determining paying quantities, in accordance with the above standard, the trial court necessarily must take into consideration all matters which would influence a reasonable and prudent operator. Some of the **factors** are: The depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes. (Depreciation of drilling equipment is not considered because the original investment is not considered. But royalty payments to the lessor are included as costs.) Drilling costs are not included.

Note: The lease instrument involved in this suit provides by its terms that it shall continue in effect after commencement of production, 'as long thereafter as oil, gas, or other mineral is produced from said land.' While the lease does not expressly use the term 'paying quantities', it is well settled that the terms 'produced' and 'produced in paying quantities' mean substantially the same thing

> In *Stewart v. Amerada* (OK), the court applied a two-part test (as did Clifton) to determine if the lease terminated. A lease may be cancelled if (1) the well was not producing in paying quantities and (2) there are no compelling equitable considerations to justify continued production from the unprofitable well operations. Here, if equipment depreciation is included as a production cost, then well operations would have been unprofitable. The court concludes that depreciation of lifting equipment must be considered an expense in determining paying quantities. The court reasons that production related equipment has a value that is being reduced through its continued operation.
>
> In OK, an unless is considered a fee simple on condition on condition subsequent

As a general rule a well is profitable if operating revenues are greater then operating costs (states are split over what to include as operating costs, but drilling costs are not included)

Note: While many states have attempted to deal with the harsh consequences of the fee simple determinable rule by overruling it by treating it as a fee simply on condition subsequent, as was done in Oklahoma, or by modifying the interpretation of the habendum clause to only require discovery plus reasonable attempts at marketing, Texas employs the ***temporary cessation of production*** rule. The TCOP doctrine was developed to deal with the practical effects of applying the doctrine to an enterprise where continuous production is not physically or economically possible.

Rule: upon ***permanent*** cessation of production after the primary term, a mineral lease automatically terminates

> In *Cobb v. Natural Gas Pipeline Co of America* (TX), the lessor argued that during either of three different periods there was a cessation of production that automatically terminated the lease. The court applied the test that the TCOP doctrine can only be triggered by "sudden stoppage of the well or some mechanical breakdown . . . or the like." In addition, the court required the lessee to remedy the problem within a "reasonable time". Since the lease was silent the court stated that a TCOP clause is necessarily implied in the lease. In TCOP cases, once the lessor shows a period of non-production, the lessee has the burden of producing evidence that the cessation of production was only temporary. Here the lessee presented expert testimony that sought to explain the lack of production in the three periods as being caused by a lack of sufficient pressure in the pipeline from the well to the main pipeline system. Since the lessor offered no evidence in rebuttal, the court found that it satisfied the lessee's burden of producing evidence. (even though such evidence was not a classic mechanical breakdown)

Savings Clauses (clauses that save the lease from expiration)

Continuous Operations Clause

In the absence of a continuous operations clause, there must be actual production within the primary period of the lease, and w/o such production, the lease will expire by its own terms.

> In *Sword v. Rains*, the lessee commenced a well during the primary term and completed two weeks later (after primary term expired but this was allowed under well completion clause). 8 months later he began producing. Lessor argued that the lease had expired. The lease contained a continuous drilling provision which provided that the lease shall continue as long as operations are prosecuted. The court holds that a continuous operations clause extends the lease for so long as the lessee-operator exercises due diligence in equipping the well and getting in into production, which includes marketing the gas. Here, lessee acted within a reasonable time and exercised due diligence (he encountered adverse weather and chaotic and uncertain market conditions but still tried to find the best deal).

Courts will look at each case and consider the totality of the circumstances (time is but one factor) Plus, you don't have to accept the first offer.

Continuous operations clauses sometimes provide a time limit to avoid some of the problems in Sword.

In *Sunac Pertoleum Corp. v Parkes*, Parkes granted lease to Sunac that allowed lessee to pool other tracts of land to extend lease into the secondary term for gas purposes only. The lease also provided that in case of a dry hole or production should cease, lease would not terminate if *additional drilling or reworking operations* commenced within 60 days. If no production but there was *drilling and reworking* operations at the end of primary term, lease would remain in force so long as no cessation in operation for more than 30 days. Lessee drilled on the pooled land but well only produced oil. 13 days later Lessee drilled on originally leased tract and produced oil (68 days after primary term ended). The issue was whether the original lease continued. The court held that lease terminated. The drilling and completion of the pooled land oil well after the primary term did not end in production of gas so as to prolong the lease under the 30-day provision (30-day provision was a well completion clause rather than a continuous operations clause, so only a completed gas well would extend the lease) and there was no cessation of production or dry hole to activate the 60-day sentence. (if the well on the pooled land was a dry well it would have extended the lease for 60 days).

Effect of express savings provisions on temporary cessation of production doctrine: (if there is an express savings provision the TCOP doctrine will not apply)

In *Samano v. Sun Oil Co*., the habendum clause provided that the lease

(1) shall remain in force for a term of ten years from this date, called primary term,
(2) and as long THEREAFTER as oil, gas or other mineral is produced from said land,
(3) or as long THEREAFTER as Lessee shall conduct drilling or re-working operations thereon with no cessation of more than **sixty consecutive days** until production results, so long as any such mineral is produced.

The lessor argued that lease had expired; because, during the secondary term, there was neither production nor any drilling or reworking operations for a continuous period of seventy-three days. The lessee argued that the 60-day limitation only applied to operations in progress at the end of the primary term (and therefore TCOP doctrine, with its more vague standard of "reasonable time" should apply). The court held that second "thereafter" referred not only to extension of primary term but to both of prior statements about duration of the lease. Hence when production stopped, during the secondary period, the lessee had an express sixty days to drill or rework the well. When it failed to do so, the lease by its express terms automatically terminated

Shut-in Gas Royalty Clause

The shut-in clause typically only applies to gas production.

The effect of the shut-in royalty clause is to provide for a substitute for production under the habendum clause.

A shut-in royalty clause provides for constructive production, typically in the form of shut-in royalty payments.

> In *Gard v. Kaiser* (OK), the lease was in its secondary term and for a two-year period no gas was sold and no shut-in royalty payments were made. Lessor argued that the failure to pay the shut-in royalty terminated the lease. Lessee argued that the lease remained in effect as long the lessee diligently sought a market for the gas. In OK production does not include marketing, so as long as lessee is diligently pursuing a market the lease continues. Failure to pay a shut-in royalty will only terminate the lease if the lease clearly indicates that was the parties intention. (remember OK is a discovery jurisdiction). Thus, the shut-in royalty provision did not operate as a limitation on the estate. Therefore, a shut-in royalty clause is virtually meaningless in a discovery jurisdiction.
>
> The shut-in royalty clause will not even give rise to a claim for breach of contract unless the lease contains promissory language as in an “or” lease.

In Texas, a delay in several months in tendering the shut-in royalty automatically terminated the lease, is like a delay rental clause *Freeman v. Magnolia Petroleum Co.* (Remember TX is discovery plus marketing/sales jurisdiction)

The shut-in royalty clause’s major purpose is to substitute payment of the shut-in royalty for actual production when there is no market

> In *Tucker v. Hugoton Energy Corp*., (KA) the wells involved encountered mechanical problems and production from the wells ceased. Lessee elected not to repair and produce those wells because of the high cost of maintenance. The wells remained off production for more than three years and the lessee tendered "shut-in" royalty payments, which were accepted by the lessors. Lessee was under a gas contract but the purchaser was buying less gas. Lessors argued that leases had automatically terminated because the leaseholds had failed to produce gas in commercial quantities. The court states that generally, under the habendum clause of an oil and gas lease, oil or gas must be produced in "paying" or commercial quantities in order to perpetuate a lease beyond its primary term. Paying quantities is synonymous with commercial quantities. The "shut-in" royalty clause applies to circumstances where "a well capable of producing a profit is drilled but for the time being no market exists." To obtain the maximum profit from its use of gas, the lessee chose not to produce gas from the wells that required constant maintenance. Because, in this case, at the time of shut-in there was a limited market available to defendants-lessees for the gas producible from the six wells at issue, the shut-in royalty clauses could not be invoked to perpetuate the leases. Thus, the trial court erred in finding the shut-in royalty clauses were properly invoked.

Leasehold Savings Clauses in Discovery Jurisdictions

Pack v. Santa Fe Minerals

Facts: Mineral right owners/lessors brought suit against oil and gas lessees to quiet title, asserting that leases terminated by their own terms when wells failed to produce for 60-day period and lessees neither commenced drilling operations nor paid shut-in royalty payments. Each of the leases contained similar provisions including a habendum clause, a shut-in clause, and a 60-day cessation of production clause. The lessees chose to overproduce the wells during the winter months when the demand for gas is higher and the price for gas increases. Because the Oklahoma Corporation Commission imposed annual allowable limitations as to how much gas may be produced from the wells, the lessees curtailed the marketing of gas from the wells during the summer months when prices were lower so as not to exceed the annual allowable limits. The issue was whether a lease, held by a gas well which is capable of producing in paying quantities but is shut-in for a period in excess of sixty (60) days but less than one year due to a marketing decision made by the producer, expires of its own terms under the "cessation of production" clause unless shut-in royalty payments are made.

Holding: (1) the lease in the case at bar cannot terminate under the terms of the habendum clause because the parties stipulated that the subject wells were at all times capable of producing in paying quantities. (2) The cessation of production clause only requires the well be capable of producing gas in paying quantities. A gas lease does not terminate under the cessation of production clause for failure to market gas from the subject wells for a sixty (60) day period. (3) the failure to pay shut-in royalties in and of itself does not operate to cause a termination of the lease. Rather, it is the failure to comply with the implied covenant to market which results in lease cancellation. (4) the lessees in the cases at bar may voluntarily cease removal and marketing of gas from the subject wells for a reasonable time where there are equitable considerations which justify a temporary cessation. Here the lease did not terminate because the lessee's decision to not market the gas was reasonable.

THE ROYALTY CLAUSE

The royalty clause is the main provision in an oil and gas lease for compensation for the lessor.

Except in Louisiana, the lessors royalty interest under a lease is classified as an interest in real property.

Lessor may have a right to take production in kind (lessor get physical control of his share and lessee has duty to deliver – oil) or a right to a share of the price for which the production is sold (gas).

Note: The royalty is an interest in real property and is subject to *ad volerem* property taxation

Market Value

In the following case the issue was whether market value was the contract price or the current market value:

> In *Henry v. Ballard & Cordell Corp.*, the lessors sought to recover outstanding royalty payments allegedly due under several gas leases. Defendants have paid royalties based upon the price received from an interstate purchaser pursuant to a long term sales contract executed in 1961. In essence, lessees maintain that the 1961 contract price is equal to the market value of the gas under the royalty provisions of the gas leases. Lessors assert that royalties are to be calculated on the basis of the current market value of the gas, a value greatly in excess of the 1961 contract price. The court determines that the lease is ambiguous and states that ambiguity in royalty provisions such as those at issue in this litigation cannot be resolved without consideration of the necessary realities of the oil and gas industry. The court holds that considering the circumstances which surrounded the parties at the time of contracting, the known obligation of the lessee to market discovered gas reserves, and the accepted, universal practice of marketing such reserves under long-term gas sales contracts, "market value" in the context of these leases could only mean the "market value of the gas when it was marketed under the 20 year gas sales contract.

*Tara Rule (**minority** rule)*: Market value is equivalent to the price assigned in the sales contract, at least as long as that contract was prudent and entered into in good faith. The underlying rationale of this rule is that it is unfair to require the lessee to pay increasing royalties out of a constant stream of revenues. It also perceives the relationship between the lessor and the lessee as a cooperative venture. (Both assume the risks of price fluctuations.)

The **majority** of jurisdictions construe any ambiguity in the royalty provisions against the lessee. *Vela Rule(TX)*: market value refers to market value at the time of production and delivery rather than when the applicable sales contract is made. The rule is based on the notion that a gas sales contract is only executory until the gas is delivered.

Two ways to calculate royalty amount:

1. Amount realized (or proceeds): royalty is based on actual sale price (costs incurred after production are deducted)

2. Market value: royalty is based on market value – what a willing buyer pays a willing seller

The following case deals with a number of issues (and follows the Vela Rule):

> *Piney Woods Counrty Life School v. Shell Oil Co*
>
> Facts: The case concerns the interpretation of a certain royalty clause in the lease. Since 1961, the gas in the lease had been committed for sale under long term contracts at pre-OPEC prices (actions of OPEC caused gas prices to rise and many lessors to litigate their royalty provisions). The royalty clauses prescribed different formulas for the calculation of royalties depending on whether the sale

is "at the well" or "off the premises." The royalty on gas "sold at the well" is based on the amount realized from sale, while on gas sold "off the premises" the royalty is based on "market value at the well." **Lessee argues**: The gas sale contracts provided that title to the gas passes in the field (even though buyer does not take control of the gas until it is processed and redelivered) and therefore it is sold at the wells. **Lesssor argues**: that the place where title formally passes is not necessarily the place where gas is sold for the purposes of the royalty provisions.

Holdings:

"*at the well*": gas in its natural state, describes not only location but quality as well. Market value at the well means market value before processing and transportation, and gas is sold at the well if the price paid is consideration for the gas as produced but not for processing and transportation.

Here, the gas sold by Shell was not "sold at the well" as Shell processed it into Sweet gas before determining the sale price, gas is "sold at the well" only if its value has not been increased before sale by transportation or processing. The lessee and gas buyer, based on UCC, can contract to pass title at the well. However, where title passes between lessee and purchaser is not necessarily binding on the lessor. Otherwise lessee can determine where gas is sold – "off premises" or "at the well" and hence unilaterally determine the price. The lessee is obligated to consider the interest of the lessor.

"*market value*" refers to market value at the time of production and delivery rather than when the applicable sales contract is made. The court reasons that the Tara Rule is unfair to lessors as it deprives the lessor of their expected market value royalties and chance to renegotiate the lease, plus the

The court holds that the gas was not sold until it was produced. Therefore the basis of the royalty should be market value at the well

Market value has to be placed at a location – here it is market value at the well

Proof of market value: (number of ways, is a fact question and method of proof will vary case by case)

- actual sales: sales at the wellhead at the time of production (rare – occurs when there are the same well – two owners and they have split stream sales)
- comparable sales – look at other similar sales that occurred in the area
- net- back/working back from amount actually realized from downstream sale to the wellhead value, deducting costs along the way

Processing costs: on royalties to be calculated "at the well" the lessors may not be charged processing costs, because the price of such gas is based on its value before processing (but in order to determine how much lessor gets have to subtract the value of processing and transportation as sour gas is not worth as much as sweet gas). Under "amount realized" clauses, processing expenses are deducted from the amount realized from the sales of the gas

NOTE: Strict application of the Vela rule could result in a lessee who must pay the lessor more in royalties than he is receiving under the sales contract. Some scholars suggest that the lessee should never be forced to pay royalties over the contract price.

In *Wood v. TXO Production Corp*.(OK), the issue was whether a lessee is entitled to deduct the cost of gas compression from the lessors royalty interest. The court holds that a lessee must bear the cost of compression where compression is required in order to market the gas. The court reasons that the lessee's duty to market includes the cost of preparing the gas for market. (the only exception is for transportation costs where the point of sale is off the leased premises). The court here looked more to the implied covenant than to the lease to allocate the compression costs.

Other states (Tx, La) make a distinction between production and postproduction costs and require the lessor to bear its proportionate share of "post production" costs.

Overriding royalty: a share of production, free from costs of production, carved out of the lessee's interest under an oil and gas lease. Overriding royalty interests are frequently used to compensate those who have helped to structure a drilling venture. An overriding royalty interest terminates when the underlying lease terminates.

In *Garman v. Conoco*, Garman owned an overriding royalty interest from which the lessee was deducting the cost of certain post-production operations. Garman argued that the post-production costs incurred to convert raw gas into a marketable product should not be deducted. Lessee argues that all post-production costs incurred after the gas is severed from the ground should be deducted. The court holds that the implied covenant to market obligates the lessee to incur those post-production costs necessary to place gas in a condition acceptable for market. Overriding royalty interest owners are not obliged to share in these costs (*upon obtaining a marketable product, any additional costs incurred to enhance the value of the marketable gas can be deducted*.) The court ignores the written instrument and looks solely to the implied covenant to allocate the costs. In this case the gas had to be compressed and injected into the purchaser's pipeline. The court held that these expenses are necessary to render the gas "marketable." However, there is a market available for low-pressure gas. Thus, the court creates a fuzzy line between what expenses are incurred in preparing the gas for market and what expenses are value added costs. The court here sets a high standard for "marketable" gas.

But see XAE Corp. v. SMR (OK), which holds that implied covenant of marketability does not extend to overriding royalty interest owners and hence lessee can deduct post-production costs.

The following case states the Texas View on calculating royalties:

In *Heritage Resources, Inc. v. NationsBank*, NationsBank, lessor, sued Heritage, lessee, contending that Heritage deducted transportation costs from the value of NationsBank royalty in violation of the leases. Each lease stated that the royalty should based on the market value at the well and that there should be no deductions for transportation from the value of lessor's royalty. The lessee

(Heritage) argued that the clauses simply mean that Heritage cannot deduct an amount from the sale price that would make the royalty paid less than the required fraction of market value at the well. Court agrees and holds that the commonly accepted meaning of the "royalty" and "market value at the well" terms renders the post-production clause in each lease surplusage as a matter of law. The court looked more to the trade meaning of the words "market value" than to the meaning they may have had to these parties.

Royalty: the landowners share of production, free of expenses of production, but is subject to post-production costs

Market value: the price a willing seller obtains from a willing buyer

The obligation to pay royalty upon the receipt of take or pay or settlement monies

A gas contract take-or-pay clause obligates a purchaser to pay for a percentage of the gas that the producer can produce, whether or not the purchaser actually takes it.

When gas prices went down in the early eighties, the take-or-pay liabilities of pipeline companies soared as consumers turned to the spot market for cheaper gas. Litigation followed:

In *Kilam Oil Co. v. Bruni*, the lessee's gas purchase contract with the purchaser contained a "take or pay" provision obligating the purchaser either to take a specified annual quantity of gas or pay for the gas not taken. In one year no gas was taken, lessee sued to enforce the "take or pay " provision and collected $6.8 million. The lessor sued to get a royalty share of the settlement proceedings. The court states the lease entitled the lessor to royalty payments on gas actually produced. In Texas the term 'production' as used in an oil and gas lease means the actual physical extraction of the mineral from the soil. Here, **since the gas was not actually produced the lessor, as a matter of law, is not entitled to royalties on the settlement proceeds arising from the take-or-pay provisions**.

TranAmerican Natural Gas Co. v. Finkelstein (TX)

Facts: the lessee executed a take or pay agreement with a gas purchaser (El Paso). The purchaser did not take or pay, so Lessee sold the gas on the spot market and sued El Paso for the difference (repudiation damages). El Paso settled with lessee. Finkelstein, who owned an overriding royalty interest, argued that he was entitled to royalties from the settlement. He had already received royalties from the sales on the spot market. Fink argues that he is entitled to such payment (attempts to distinguish his case from Bruni) on the basis of the royalty clause (he is entitled to net revenue interest) and production (gas was actually produced and sold so he should get best price like lessee got). Lessor argues that overriding royalty interest owner is not entitled to share in proceeds from a take or pay settlement.

Holding: A royalty owner, absent specific language, is not entitled to take or pay settlement proceeds, whether or not the gas is sold to third parties on the spot market. Take or pay is not a benefit which flows from the marketing covenant of a lease. The pay option under a take or pay contract is payment for the exclusive

dedication of reserves for a fixed period of time. Take-or-pay payments represent compensation for producing and storing the gas (royalty owner does not shoulder any burden for producing and storing and therefore cannot share in the payment). Moreover, the language of the lease is tied to production and makes no mention of settlement proceeds.(Fink should have included a settlement royalty clause)

The above case involved a **farmout agreement** which is similar to an assignment: farmee agrees to drill and only if he finds gas/oil is there an actual assignment of a portion of the leasehold interest

Tx view (majority view): Looks at the language of the written instrument, which says royalty is due on gas/oil that is produced. Unless gas is produced there is no royalty payment, therefore take-or-pay settlement payments do not have to be shared with royalty owners.

In the next case (which represents the minority view), the court looks beyond the words of the royalty clause and assumes that the lease royalty provisions are ambiguous so that the royalty clause must be given meaning by looking behind the language of the lease to its underlying intent or to implied covenants:

In *Frey v. Amoco*, The lease provided that the royalty on gas was a certain fraction of "the amount realized at the well from such sales." The **lessee** argued that the clear language of the lease required a "sale" before the royalty obligation was triggered, and that the take-or-pay proceeds were payments for gas not produced. The **lessor** maintained that the take-or- pay payments were part of the price or total revenues received by the lessee in return for the purchase of gas under the contract, and were also economic benefits flowing from the lease and carrying a royalty obligation .

The court looks at the general intent of the parties (because parties did not contemplate that the price of gas would fall and that producers would receive take-or-pay payments in settlement of suits) in executing the lease for their mutual benefit. ***The court describes the lease as a "cooperative venture" in which economic benefits accrued from the land should be shared between the lessors and lease in the fractional division contemplated by the lease.***

La view (minority view) Court looks at the underlying motive: The lessee and lessor enter into in a lease agreement for their mutual benefit, therefore any benefits that "flow from" the lease should go to both parties.

Remedies for Nonpayment

In general, courts will not terminate leases for non-payment of royalties. A lessor's remedy against a lessee is to sue for the royalty plus interest.

In *Cannon v. Cassidy*, the lessee's were required to pay quarterly royalties but did not pay royalties for eleven months (even though gas was produced and sold). The lessor argued that nonpayment was a breach of the implied covenant to market and therefore sought to cancel the lease. The court holds that lessee's failure to pay royalty as provided by the lease will not give lessors sufficient grounds to declare a forfeiture unless by the express terms of that lease they are

given that right and power. The court reasoned that the lessors had a remedy at law (damages plus interest) that would fully compensate them.

Division and Transfer Orders

Division order: provide a procedure for distributing the proceeds -- a statement executed by all parties who claim an interest stipulating how proceeds of production are to be distributed (purpose is protect the distributor of such funds against liability for improper payment)

Transfer order: a direction and authorization to change the distribution provided for in a division order

In *Exxon v. Middleton*, three groups of lessors filed suits alleging a deficiency in the amount of royalties paid by the lessees. The lessee was paying amount realized. Lessor argued that leases call for market value for "gas sold or used off the premises." Exxon first argues that a sale in the same field, but off the premises, is a sale at the wells. The court disagrees and holds that "gas sold at the wells" means within the lease, not within the fields. *When was gas sold*: when it was delivered, not when Exxon's gas contracts became effective. *How is market value determined*: the court rejected Exxon's "field price" method (as it included interstate gas which was not comparable to the intrastate nature of the gas in question) and held that market value is determined from sales comparable in time, quality, quantity, and availability of markets (there was some evidence to support upholding lessors determination of market value). Based on the language of the lease, the lessors should have received market value. However, the lessors or their successors executed division orders, which calculated payments of royalties on the amount realized. The court holds that the division order modified the gas royalty clause until revoked, Here, they were not revoked until commencement of the suit, so prior to commencement lessor are entitled to amount realized, after commencement they are entitled to market value.

The general rule in Texas, is that division and transfer orders bind underpaid royalty owners until revoked. However, division and transfer orders do not convey royalty interests; they do not rewrite or supplant leases or deeds. Division and transfer orders are not supported by consideration, but are enforced on the theory of promissory estoppel.

In *Gavenda v. Strata Energy, Inc.,* the Gavendas reserved a fifteen-year one-half non-participating royalty interest. Strata hired an attorney to perform a title examination, and he erroneously informed Strata that the Gavendas were collectively entitled to a 1/16th royalty. The Gavendas signed division and transfer orders that reflected the error. On discovering this error, the Gavendas revoked the division and transfer orders. They argued that the rule that division orders are binding until revoked does not apply when there is unjust enrichment. The court holds that the division and transfer orders do not bind any of the Gavendas. Because of its error, Strata underpaid the Gavenda family by 7/16 th royalty, retaining part of the 7/16th royalty for itself. It profited, unlike the operators in Exxon v. Middleton, at the royalty owner's expense. It retained for itself part of the proceeds owed to the royalty owners. Therefore, Strata is liable to the Gavendas for whatever portion of their royalties it retained, although it is not liable to the Gavendas for any of their royalties it paid out to various

overriding or other royalty owners.

In *Judice v. Mewboume Oil Co.*, the royalty owners claimed that Mewbourne had improperly paid royalties on gas by deducting post-production compression costs from the proceeds from the sale of the gas. The **leases** provided that royalty shall be based on "market value at the well", **TWO** of the division orders stated that settlement shall be based on "the gross proceeds"…, the **3rd division order** stated that "settlement shall be based on net proceeds realized at the well." The court holds that (1) in calculating royalty payment due to owners, holder was entitled to allocate to owners their proportionate share of reasonable cost of post-production compression, under leases which provided that royalty was to be determined based on "market value at the well" of all gas produced; (2) evidence supported finding that ambiguous division orders covering **two** gas wells provided for royalties to owners to be based upon price received by holder from purchasing pipeline, without deduction for compression charges; and (3) division order covering **third** gas well allowed holder, in calculating royalty payment, to deduct post-production compression costs from proceeds received for sale of gas, despite handwritten deletions of language respecting deduction of costs incurred in compressing, treating, transporting, or dehydrating gas for delivery.

Force majeure clause: makes defined events that cause a lessee to fail to perform specific actions a substitute for production (historically such clauses only covered acts of God but now the clause is utterly dependent upon the terms of the contract in which it appears)

In *Sun Operating Limited Partnership v. Holt*, the lease had a explicit cessation of production clause that allowed 60 days for reworking or drilling, it also contained a force majure cluase which provided that "When drilling or other operations are delayed or interrupted by … failure of carriers to transport (among other things) … the time of such delay or interruption shall not be counted against Lessee, anything in this lease to the contrary notwithstanding." Because of major repairs made on the pipeline by the purchaser, production ceased for more than 60 days. The lessor argued that the lease terminated due to cessation of production. Lessee claimed it was excused by the forece majure clause. Court holds that the FM clause has the effect of extending the habendum clause. So there were three options for lessee, he could (1) pay shut in royalties, (2) use FM clause if applicable or (3) restart production before the 60 day period ended. If the FM clause applied lessee was not required to make shut-in payments. However, the particular event causing the cessation must be outside the reasonable control of the lessee based on language in the lease(here, lessee had advance notice of the repairs and could have had them incrementally implemented).

COVENANATS IMPLIED IN GAS AND OIL LEASES

A lease is a relation contract: the typical relational contract involves a situation in which an asset (or something of value) is managed by the performing party, with the income (or return on capital) of the passive party solely dependent on the performing party's action.

Relational promisees (lessors) are often victimized by opportunistic behavior: when lessee acts to manipulate the contract so as to maximize its wealth at the expense of the lessor.

The judicial implication of covenants into oil and gas lease is a response to the problem of lessees acting opportunistically.

The implied covenant and the prudent operator standard seek to eliminate lessee opportunism by requiring the lessee to act for the common advantage of both lessor and lessee.

The main implied covenants:

(1) to protect from drainage
(2) reasonable development and further exploration
(3) market

Underlying all implied covenants is the **reasonable prudent operator standard** which requires the lessee to conduct itself as would a reasonable prudent operator under the circumstances (For example, to determine if lessee has breached the implied covenant to protect from drainage by not drilling an offset well, the inquiry is whether a reasonable prudent operator would have done so – similar to Tort law reasonable man standard).

Implied Covenant to Protect From Drainage (the Off-Set Well Covenant)

Elements: (there must be)

(1) substantial drainage from the leased premises and
(2) probability of profit

The duty (to protect from drainage) only arises if a reasonable prudent operator would protect from such drainage by drilling a well and a reasonably prudent operator would have a reasonable expectation of producing gas in paying quantities.

Note: under the habendum clause "production in paying quantities" mean production sufficient to exceed lifting costs. Under the implied covenant, "production in paying quantities" means in such quantities as would give the operator a reasonable profit after deducting all costs.

In *Sundheim v. Reef Oil Corp*, the lessee's did nothing for a period of 4 years. The lessors argue that during that period, 145,000 barrels of oil was drained from their leasehold and that the lessee breached its implied covenant to protect from such drainage (says they should have drilled off-set wells to capture the oil). Lessee argued that they were entitled to written notice or demand to drill as a precondition to the duty to drill. Court agrees, but holds that the notice requirement is satisfied if the lessees had knowledge (actual or constrictive) of the drainage (if the lessor is seeking money damages). (Here there was some evidence that lessee had knowledge, court remands for factual determination). The court notes that the burden is on the lessor to show the lessee knew of the drainage. An operator is deemed to have constructive knowledge when he is in possession of all the relevant facts and circumstances.

Note: RPO standard is not a separate cause of action, it is applied in conjunction with and serves to define the other implied covenants.

In *Amoco Production Co. v. Alexander*, the lessors argued that the lessee breached its duty to protect the lease from drainage by increasing production on up-dip leases (where royalty was1/8) and decreasing production on down-dip lease (where royalty was 1/6) and that they should have sought a permit to drill an off-set well. The lessees argued that it had no obligation to protect from field-wide drainage (only local drainage), it had obligation to look after all of its lessors (which included up-dip lessors), and there is not duty to seek admin relief (obtaining permit). Court holds that the lessee has an obligation to protect against both local and field wide drainage. Moreover, the lessee's status as a common lessee does not affect its liability to Alexander (Amoco created its own conflicts of interest). The lessee's duty is do whatever a reasonably prudent operator would do (which in this case included a duty to seek favorable admin action).

Amoco was not a classic case of a common lessee because there was an intermediary between the leaseholds. Some courts place no significance on common-lessee status, while other courts will increase liability when a common lessee causes the drainage.

In Amoco, the court refused to award exemplary damages for breach of the implied covenant because the court characterized the implied covenant as implied-in-fact. The court would have been more likely to award punitive damages if it had held that the implied covenant were implied-in-law.

The RPO standard is less than that of a fiduciary, but more than an obligation to act in good faith.

In *Finley v. Marathon*, lessors brought suit asserting breach of contract and breach of fiduciary duty, arising from lessee's alleged failure to prevent drainage of oil from lease property by failing to drill additional well on property between lessee's injection well and adjoining property boundary. The Finleys owned two adjacent parcels of land entered into a "communitization" agreement with Marathon, which consolidating the two leases into one. They now claimed that the "communitization" agreement was the equivalent to a unitization agreement. In Illionois, Unitization makes the owners of the rights in the unitized field joint venturers, and joint venturers owe fiduciary duties to one another. The court holds that this is not a case of unitization. The two leases were owned by the same people and operated by the same producer, Marathon. The communitization agreement merely formalized the ownership and operating arrangements. The court reaffirms that that Illinois (like most jurisdictions) has expressly declined to make the oil and gas lessee a fiduciary of the lessor. Instead, the RPO standard will apply. (court notes that royalty owners are indifferent to costs which could be a source for much of the implied covenant litigation).

Implied Covenants of Reasonable Development and Further Exploration

Upon securing production of oil and gas from the leasehold, the lessee is bound thereafter to drill such additional wells to develop the premises as a reasonable and prudent operator, bearing in mind the interests of both lessor and lessee, would drill under similar circumstances.

Elements: Lessor must prove

(1) Probability of profit: additional development probably would have been economically viable

(2) Imprudent operator: the lessee has acted imprudently in failing to develop

In *Davis v. Ross Prodcution Co*., Oil and gas lessee (Ross) petitioned to remove cloud on its leasehold and quiet title under lease and to cancel top lessee's top leases on drilling unit. Top lessee (Davis) counterclaimed, seeking cancellation of portion of lessee's lease on unit, and requested quiet title in him through his top leases for unit. Davis contends Ross Production had a continuing duty to develop the B-1 unit for the benefit of the royalty owners. Here, Ross held the B-1 unit for eleven years w/o further production even though there was evidence that the proposed well would produce oil. Ross claimed to be waiting for the price of oil to increase. The court states that the lessee has the duty to develop the entire leasehold and must do so with reasonable diligence. The oil and gas lease is not executed for speculative purposes, but for present benefits or for benefits to be obtained within a reasonable time. Despite the relatively stable oil prices over the years, Ross Production did not become interested in further developing the B-1 unit until it discovered Davis had filed his top leases. The court holds that Ross's action were actions not those of a prudent operator who exercised reasonable diligence in exploring and developing the entire leasehold.

Note: Normally, production from one well will hold the entire leasehold as it is indivisible.

In *Gulf Production Co. v. Kishi*, the leases stipulated the number of wells to be drilled following a successful well (12 on the first tract and four on the other, Gulf drilled 15 and 6). Kishi argued that Gulf failed to develop with reasonable diligence by not drilling more wells. The court holds that the implied covenant arises only out of necessity and in the absence of an express stipulation to the development of the leased premises. Since the leases provided for development, no implied covenant arose.

Note: If lessee does not want to develop a portion of the lease, he can always surrender that portion of the lease and relive himself of the duty to develop that portion.

The courts have recognized three separate remedies for breach of the covenant of reasonable development:

- Cancellation: cancel the lease, save for a small area surrounding the existing producing wells

- Conditional decree of cancellation: the lease is cancelled unless a specified number of wells are drilled within a fixed period of time

- Damages: The normal, or logical, measure of damages under development covenant is interest on royalties (since oil is presumably still in the ground and can be recovered). However, most courts give royalties as damages (but then royalty owner has to give a set-off if oil is later produced)

There has been considerable debate whether the law recognizes an implied covenant for further exploration separate from the covenant for reasonable development (*Gillette* recognizes one, *Sun* does not)

When the lessor complains of an alleged breach of the implied covenant for further exploration, the lessor argues that the lessee has not explored undeveloped parts of the land or formations under the land, rather than that the lease has failed to develop known deposits. Some cases have recognized a separate implied covenant to explore:

> In *Gillette v. Pepper Tank Co*., the lessee's efforts, over 20 or so years, consisted of one marginally producing well, one plugged well, and an unsuccessful water-flood operation. (some portions of the lease were covered by a unitization agreement) The lessors argued that lessee breached the implied covenants. The trial court granted conditional cancellation and gave lessee 60 days to file a plan of development. Lessee appealed and argued that there was not sufficient evidence (since breach of the implied covenant of reasonable development requires a finding that additional development would be profitable). The court draws a distinction between the covenant to develop and covenant to explore and noted that the covenant to explore only requires lessee to show unreasonableness by the lessee in not exploring further. *Factors to consider*: period of time that is lapsed since last well was drilled, size of tract and number and location of existing wells; favorable geological inferences; attitude of lessee toward further testing of land; and feasibility of further exploratory drilling as well as willingness of another operator to drill. Trial court's finding of breach of implied covenant in oil and gas lease to further explore was supported by evidence, including evidence that a well was drilled and abandoned in 1972, that a water-flood project was abandoned, that there was a deliberate failure to clear title, and that third parties had some interest in drilling and developing lease.

Note: Unitization relieves the lessee of the obligation of the implied covenant for reasonable development for each tract separately.

> In *Sun Exploration and Production Co. v. Jackson* (TX), the lessors argued that Sun breached its duties to develop and explore the entire lease. Specifically they complained that only the Oyster Bay field had been developed by Sun and that Sun had neglected to explore and develop the rest of the lease. The jury found that Sun had not failed to reasonably develop the Jackson lease, but that Sun had failed to reasonably explore the portions of the lease that were outside the Oyster Bayou Field. Court say that the jury's finding that Sun did not fail to develop the lease is dispositive of the case. The law of Texas does not impose a separate implied duty upon a lessee to further explore the leasehold premises; the law recognizes only an implied obligation to reasonably develop the leasehold. The covenant of reasonable development encompasses the drilling of all additional wells after production on the lease is achieved. "Additional wells" includes both additional wells in an already producing formation or stratum, or additional wells in "that strata different from that from which production is being obtained." The critical question was whether the lessor could prove a reasonable expectation of profit to lessor and lessee.

Other Implied Covenants

Implied covenant to market

The implied covenant to market imposes upon the lessee the duty to use due diligence to market oil and gas produced within a reasonable time and at a reasonable price

In *Robbins v. Chevron* (KS), the lessee extended its gas contract with the purchaser. Prices went down and a dispute developed between lessee/purchaser and the lessee shut-in the well for two years. The lessors argued that lessee (Chevron) breached its implied obligation to market their gas by extending the gas purchase contract through 1990 and by the lack of sales during the shut-in period. The trial court granted summary judgement for lessors and cancelled the lease.

Holding: There is an implied obligation to market oil and gas under a lease agreement. In determining whether Chevron acted imprudently (in entering into the 1978 amendments, in refusing to renegotiate for lower prices in 1984-85, in shutting in the wells in 1985, in seeking alternative markets thereafter, and in the other complained-of acts,) Chevron's conduct must be judged upon what an experienced operator of reasonable prudence would have done under the facts existing at the time. The wisdom of hindsight cannot be utilized in making such determinations. The individuals claiming imprudence have the burden of proving same. Here, the claim that Chevron acted imprudently is hotly contested, and such claim, by its very nature, must be supported by expert testimony.

Court also noted that as a general rule, **forfeiture** of oil and gas leases for breach of implied covenant is disfavored. Forfeiture of oil and gas leases should only be granted where prevailing party's damages cannot be determined with reasonable certainty.

Note: The standard set out in the above case is something less than RPO (which would allow trier of fact to use hindsight) and is closer to a business judgement rule. That is, the lessee will not be punished for “bad” marketing decisions as long as he exercised business judgment.

Most favored nations clause: provides for adjustment of the contract price upward if any other producer in the area receive a higher price for gas of similar quantity and quality

In *McDowell v. PG & E Resources*, (LA) the well produced “wet gas” which was combined w “dry gas” and then sold. The dry gas ran out, so the purchaser would not take it, so the lessee shut-in the well and tried to find another buyer. Eventually lessee built another pipeline and continued production. The lessor brought suit and claimed that the lease expired by its own terms (as production ceased for 90 days). The court held that the lease did not expire on its own terms. In a shut-in situation production continues constructively (although lessee must still diligently seek a market). Moreover, the court states that the breach of implied covenant to market must be shown to be substantial. The most that can be required of lessee is an effort to market the gas within a reasonable time.

In *HECI v. Neel* (TX), the adjacent lessee illegally overproduced a common reservoir. This resulted in a permanent loss of oil and damaged the reservoir. HECI (the lessee) sued the other lessee and recovered damages. The lessor was not involved in the suit. The lessor found out (4 years later) and claimed that the lessee should have told them so they could sue. More specifically, the lessor alleged that the lessee breached its implied covenant to protect against drainage, which includes an obligation of the lessee to use on behalf of the lessor. The court disagrees and holds that there is no duty to give notice of lessee's intent to sue. The lessor has an obligation to protect his own interests. The court stresses that a covenant will not be implied unless they are justified on the grounds of legal necessity. ("it must be necessary to infer such a covenant in order to effectuate the full purpose of the contract")

Remedies for Breach of Express Drilling Agreements

Canon of construction: if lease is ambiguous or conflicting it should be construed against the drafter

In *Joyce v. Wyant*, the provisions of the lease obligated the lessee to drill initial well within sixty days and three subsequent wells within sixty day intervals following completion of each preceding well but provided that term of lease should be sixty days from date and as long thereafter as oil, gas or other minerals were produced in paying quantities. The lessee only drilled one well. The lessor sought to recover damages. Lessee said additional wells would not be profitable and claims that the lease expired once they did not drill additional wells and so they owe no damages. The court agrees and holds that the lease, when considered in its entirety, did not indicate an intention to hold the lessee liable for damages upon failure to drill. Court determined that this was an "unless" lease. (Under an "or lease", which obligates lessee either to drill a well or pay rental, lessee is obliged either to drill or pay; but under an "unless lease", which merely provides for termination in absence of stipulated performance, he is not obligated to do either.)

In *Fisher v. Tomlinson Oil Co.*, Tomlinson, assignee, agreed to drill the leases before a certain date. He did not commence drilling by that date. Fisher, assignor, sued for damages and was awarded the cost of drilling. Fisher claims that cost of drilling was an improper measure of damages. The court states that damages for breach of a contract to drill oil well are measured by the same standards as are damages for breach of other contracts; the measure of damages is that which arises naturally from the breach itself. (In some instances this might entail the value of lost royalty interest) Here, the best evidence available to measure damages was the stipulated cost of drilling an oil well.

The damages really should have been based on the value of Fisher's estate that was lost due to Tomlinson's failure to drill. Since this is difficult to measure, the court takes the easy way out and awards the cost of drilling a well.

TITLE AND CONVEYANCING PROBLEMS ARISING FROM TRANSFERS BY FEE OWNERS AND LESSORS

The owner of land may sever minerals from the surface interest and create a mineral estate.

An interest can be conveyed by either grant (interest goes to someone other than grantor) or by reservation (interest goes to grantor)

The owner of the mineral estate has the same rights and privileges as the surface owner had, the rights are the right to sell, the right to lease, and the right to explore and develop.

The right to lease is called the executive right.

A usual oil and gas lease creates a number of interests:

> *Bonus*: cash or royalty bonus
>
> *Rentals:* consideration paid for the privilege of delaying drilling operations
>
> *Royalty*: a share of the product or the proceeds
>
> *Reversionary interests*: The reversion held by a lessor after executing an "unless" lease is a possibility of reverter. The insertion of a delay rental clause creates a possibility of reverter in an "unless" lease and a right of entry in an "or" lease.
>
> *Benefits of covenants*

Often parties to an oil and gas conveyance prefer that the executive right be lodged in the hands of one person. So they may create a non-executive interest.

The following interests are commonly created by landowners in sales or trades:

> <u>Mineral Interest</u>: created by deed or reservation. Owner has same rights as landowner before severance, Rights include:
>
> 1. right to develop
> 2. right to lease
> 3. right to receive bonus payments
> 4. right to receive delay rentals
> 5. right to receive royalty payments
>
> <u>Royalty interest</u>: owner has right to receive a certain part of the oil and gas. No rights to develop or lease
>
> <u>Non-executive mineral interest</u>: Created by grant or by reservation in a deed with specific language that governs the sharing of bonus, rental and royalty and excluding one party from participation in the execution of lease. Owner has rights as spelled out in the creating instrument, has no right to develop or execute lease.
>
> > In *Altman v. Blake*, the issue was whether a mineral interest conveyed in a deed by Jr to Sr is a 1/16 royalty interest or a 1/16 interest in the mineral fee. If it is a mineral interest would get 1/16 of the 1/8 royalty, if it a royalty interest Sr would get ½ of the 1/8 royalty interest. The dispute arose because deed conveying the interest to Sr (grantee) did not convey the right to participate in any rental or lease (right 2 and 4). So Sr's heirs argue that this limiting language conveyed a

royalty interest. The court holds that the deed conveyed to Sr a 1/16 interest in the mineral fee (so he gets 1/16 of the 1/8 royalty). The court follows the rule that a mineral interest shorn of the executive right and the right to receive delay rentals remains an interest in the mineral fee. ***The developmental right is the key right to identifying a mineral estate.***

Interpretation of the word "Minerals"

Most conveyances contain the language "oil, gas and other minerals". There has been considerable litigation over what "minerals" is

The traditional approach is to look for the specific intent of the parties by objective tests

Prior to '83 Texas employed the <u>Surface destruction test</u>: when production of a substance requires destruction of the surface, the substance is not a mineral because the original parties would not have intended that the mineral interest owner be given the right to destroy the beneficial use of the property by the surface owner. The purpose of the test is to prevent mineral owner from the destroying the surface estate. The problem with this test is that it is uncertain: ownership of minerals is magically transferred if a new method of extraction does not destroy the surface.

In "84 the court gave up trying to make the surface destruction test work and adopted another rule: Ordinary and Natural Meaning Test

In *Moser v. US Steel*, the issue was whether uranium is included in a reservation or conveyance of "oil, gas, and other minerals." The court abandons the surface destruction test and holds that uranium is a mineral as a matter of law. The court reasons that a ***severance of minerals includes all substances within the ordinary and natural meaning of that word, whether or not their presence or value is known***. The court also holds that a mineral owner has the right to take minerals even if removal causes destruction of the surface as long as the surface destruction is not negligent. However, if the substance was not specifically mentioned in the grant or reservation, the mineral owner must compensate the surface owner for any surface destruction.

Court sets out two exceptions to new test (ordinary and natural meaning test):

(1) substance that the court had previously held to be non-minerals (water, limestone, caliche, surface shale, sand and gravel, near surface lignite, iron, and coal, and building stone) are still property of the surface owner
(2) new rule only applies prospectively to deed executed after June 8, 1983

The rationale behind the ordinary and natural meaning test is that you should be able to look at the title and determine who owns what.

Note: Moser really only affects Uranium, since in Tx the only other valuable minerals are coal, lignite, iron and uranium and they still belong to surface owners.

The court above refers to the "accommodation doctrine": where a severed mineral interest owner or lessee asserts rights to use of the surface that will substantially impair existing surface uses, the mineral owner or lessee must accommodate the surface uses if he has reasonable alternatives available.

> In *Noffsinger v. Brown*, the landowners conveyed the coals rights, they then conveyed the surface rights with the following reservation "the coal and mineral rights are reserved, they having been conveyed by a former deed." Landowners heir argues that the oil and gas rights were never conveyed and are therefore his. Court agrees and says there is no ambiguity; the word "minerals" includes oil and gas.
>
> In *US Steel v. Hoge*, the issue was whether the surface owner or the coal owner owned the "coal bed" gas. (the court notes that coal bed gas is always present in coal). The court states that gas is a mineral and belongs to the owner in fee. That is, a general rule, subterranean gas is owned by whoever has title to the property in which the gas is resting. Here, when such gas is present in coal it belongs to the coal owner so long as it remains within his property. The landowner has title to the property surrounding the coal, and owns such of the coalbed gas as migrates into the surrounding property. The court states that although the deed conveying the coal reserved all gas rights, it is highly unlikely that the grantor intended to reserved the right to extract a valueless waste product (since at the time of the deed coalbed gas was considered valueless)

Note: the above case represents the minority view, The majority view is that if there is gas, it does not mater where it is, the gas is owned by the owner of the gas estate. However, the gas owner would not be able to go in and destroy the coal estate, the court would have to balance the interests.

Easements

The right to the minerals carries with it the right to enter and extract them, and all other such incidents thereto as are necessary to be used for getting and enjoying them. This common law right was created "because a grant or reservation of minerals would be wholly worthless if the grantee or reserver could not enter upon the land in order to explore for and extract the minerals granted or reserved." Although the mineral estate is the dominant estate, the rights implied in favor of the mineral estate are to be exercised with due regard for the rights of the surface owner.

In Tx, the mineral lessee possesses the dominant estate and the lessor, or surface owner, has the servient estate. As such the lessor cannot unreasonably interfere with lessees rightful use. However, the lessee's use of the land must also comply with the ***accommodation doctrine***:

> where a severed mineral interest owner or lessee asserts rights to use of the surface that will substantially impair existing surface uses, the mineral owner or lessee must accommodate the surface uses if he has reasonable alternatives available

Under the doctrine there must be (1) an existing surface use, (2) the proposed use must substantially interfere with the existing surface use, and (3) the lessee must have reasonable alternatives available.

However, if there is but one means of surface use by which to produce minerals, mineral owner has right to pursue that use, regardless of surface damage.

The following two cases concern the scope on the implied easement.

> In *Sun Oil Co. v. Whitaker* (TX), the lease said "Lessee shall have free use of … water from said land." The lessee wanted to use the water for a secondary water recovery project. As such operations would deplete the ground water reserves which were used for irrigation, the surface owner sought to enjoin Sun. Surface owner argued that it was not reasonably necessary for Sun to use the water because water could be purchased from a nearby river at a moderate cost. Sun argued that the water-flood project was a reasonable and proper operation for the production of oil and that it had the implied right to use such part of the surface as may be necessary to effectuate the purposes of the lease.. The court agrees and states that Sun has the implied right to free use of so much of the water in question as may be reasonably necessary to produce the oil from its oil wells. The court holds that alternates available to the lessee, in order to be reasonable, must be available on the leased premises.
>
> *Scope of easement*: as long as lessee is not negligent and use is related to O/G production the scope is almost unlimited

Note: Gates put up by surface owner are not an unreasonable interference

The next case somewhat narrows the scope of the implied easement (at least in relation to Sun Oil case)

> In *Tarrant County v. Haupt*, the county constructed a reservoir and condemned all the surface estates. However, the mineral estates were not condemned. P's brought suit and argued that since surface drilling was the only reasonable manner of production, there was an inverse condemnation and they are entitled to damages (since underwater surface wells were not allowed because the reservoir was used for drinking water). The county argued that the court must first consider the accommodation doctrine before it can determine that an inverse condemnation occurred. (that is, P's must show that they had no reasonable alternate drilling methods available). The court holds that the "Accommodation" doctrine applies and must be considered in determining whether inverse condemnation of mineral estate has occurred when governmental entity that owns surface estate restricts use of surface by mineral owner and lessee. The court remands the case for a determination of whether a reasonable alternative drilling method exists that protects the reservoir (e.g. directional drilling).
>
> Implied covenants extend to geophysical surveys.

Mother Hubbard Clause: a lease clause to protect the lessee against errors in description of property by providing that the lease cover all the land owned by the lessor in the area

Such clauses were especially necessary in Texas lease as many deficiencies existed in many early surveys.

Grants and Reservations of Fractional Interests

A mineral acre is the full mineral interest under one acre of land. Sometimes conveyances are made by reference to "mineral acres" or "royalty acres." This can create problems of interpretation. The following case refers to "royalty acres" which are generally defined as the full lease royalty (whatever percentage may be specified in present or future leases) under one acre of land.

The court below holds that a royalty acre is the full 1/8 royalty on each acre of land.

In *Dudley v. Fridge*, P owned ½ mineral estate in 100 acres of land. P sold to D a "one-tenth royalty interest" which at the time of the sale would have constituted 1/10 of 1/8 or five royalty acres. The old lease expired and P executed a new lease that gave P a ¼ royalty interest. D now say they are entitled to 1/10 of ¼. P argues that they only sold (or intended to sell) five royalty acres and therefore D is only entitled to 1/10 of 1/8. Plaintiffs' contend that the phrase "and to be subject to any and all further leases at Grantor's option " means that plaintiffs could choose whether or not to extend the benefits of a more favorable lease to defendants. P's also argued that subsequent references in deed to "the said royalties" and "the royalty rights herein conveyed" referred to existing lease and permanently fixed the royalty at 1/10 of 1/8. Court disagrees and holds that (1) Language in mineral royalty interest deed that the mineral interest conveyed was "to be subject to any and all further leases at Grantor's option" meant that grantor could choose whether to execute leases in the future, not that grantor could choose whether to extend benefits of more favorable lease to grantee and (2) subsequent references in deed to "the said royalties" and "the royalty rights herein conveyed" referred to existing lease and to future leases. Thus, the instrument conveyed a "1/10 royalty interest" whether or not it continues to equal 5 royalty acres.

The following case deals with over-conveyance—transactions in which the total of the fractions reserved and conveyed is greater than 100%.

In *Body v. McDonald*, Edwards conveyed the property to McDonald, reserving an undivided ¼ mineral interest. McDonald then conveyed the property, by warranty deed, to Body reserving an undivided ¼ mineral interest. Body now claims that he owns ¾ interest, Edwards owns ¼ and McDonald owns nothing. The court agrees and holds that the McDonalds are estopped from claiming that the grantees (Body) have less than ¾ s of the mineral rights in the land. A warrantor of title may not question the validity of the title warranted, nor may he assert an outstanding hostile title. (court cites Duhig case)

Note: The court placed no significance on Body's actual knowledge of Edward's outstanding interest. Most courts have not distinguished those cases where the grantee had actual or constructive knowledge of the outstanding title. However, see the *Gilbertson* case below.

Duhig Rule: where full effect cannot be given both to the granted interest and to a reserved interest, the courts will give priority to the granted interest (rather than to the reserved interest) until the granted interest is fully satisfied. In *Duhig*, the court applied the doctrines of estoppel by deed and after-acquired title.

There are three classes of deeds:

1. warranty deed – promise that you own the interest you are transferring
2. quit claim deed – no warranties; grantor says if I own its yours if not then you get nothing
3. limited warranty deed – has some warranties

In a warranty deed you are presumed to be transferring the whole interest, so if your reserve ¼ then you warrant ¾, if you reserve 3/8 you warrant 5/8.

Duhig says that if you describe an interest as "blackacre" (i.e. 100% of the estate) and reserve ½, then you purport to transfer ½. So if there are other reservations (in addition to your ½ and ½ you warrant) the Duhig rule applies.

The rule is significant in O/G conveyancing because of the element of certainty that it brings to titles

There are two ways to avoid Duhig problems:

(1) describe the granted estate as less than 100% ("I hereby grant ½ of Blackacre")
(2) reserve all previous reservations plus yours (so in the case above if McDonald would have reserved a ½ interest he would have received a ¼ interest and Body would have got a ½ interest) ("I hereby grant Blackacre subject to 1/2 reservation")

The following case rejects the Duhig rule where grantee had notice of the outstanding interests:

> In *Gilbertson v. Charlson*, the state owned a 5% interest and three siblings shared the remaining 95%. Two of the siblings (D's) conveyed their interest in the surface to the third sibling (P) but expressly reserved 50% of the mineral estate. P argued that D's impliedly warranted a conveyance of 50% of the minerals and so P owns 81 2/3 % (31 2/3 % plus the 50%). The court states that the party claiming estoppel must have no knowledge of the true state of the title. Here, the grantee (P) had actual notice of her own interest and constructive notice of the states interest (is a matter of public record). Since the grantee knew or ought to have known of the outstanding interests, she was not misled by the improper warranty.
>
> In *Black v. Shell Oil Co*., the deed stated that it conveys an " undivided one-half interest" *out of* the interest owned by grantors. Grantors claim this conveyed ½ of grantors ½; a ¼ mineral interest. Court disagrees and says that the granting clause is unambiguous and conveys a ½ mineral interest in the land. The "out of" language merely refers to the source of payment for the conveyed interest.

Therefore, grantor conveyed a ½ mineral interest to be "paid" out of her ½ interest, which leaves grantor with nothing.

The grantor should have just used "of" instead of "out of" (i.e. we grant ½ of ½)

Does Duhig apply to leases?

In *McMahon v. Christmann*, the lessor owned a 1/6 mineral interest and granted a lease, which contained a proportionate reduction clause, that provided for a 1/8 landowners royalty and an overriding royalty of 1/32 of the O/G produced "without reduction." The lessee contended that the lessor was barred by the Duhig rule from enforcing the overriding royalty "without reduction" since the lessor had warranted full title but had possessed only 1/6. The court declines to extend Duhig to oil and gas leases. Leases commonly grant the whole mineral interest, which is then reduced by the proportionate reeducation clause. Moreover, the court reasoned that OG lease are prepared by the lessee (unlike deeds which are prepared by grantor) so estoppel does not really apply. Here, the parties only intended the covenant of warranty to extend only to the 11/96th interest in the mineral title, which passed to lessees under the lease.

Note: Granting clauses in leases almost always describe the interest as "Blackacre" rather than a fractional share.

Proportionate reduction clause: the effect of the clause is to permit the lessee to reduce benefits to the extent that the lessor owns less than the full mineral interest described

In *Gresham v. Turner*, the lessor (who owned 1/80) executed a lease that provided for a 1/8 royalty. The proportionate reduction clause was deleted. The lessors argue that they are entitled to a royalty of 1/8 the total production (1/8 of 8/8). Lessees claim they are only entitled to a royalty of 1/8 of 1/80. Court agrees and holds that the royalty can only be reserved out of that which was granted; out of the 1/80, lessor reserved a 1/8 royalty. The court states that it does not think it is reasonable that one would make a business deal agreeing to give up 10/80 in exchange for 1/80 of the oil. It is impossible to reserve 10/80 out of 1/80.

Note: you can reserve up to the amount you own (IN one case the grantor owned 9/40 and reserved a 1/8 (5/40ths) royalty and the proportionate reduction clause was crossed out. Court said parties are free to contract for higher royalties)

Characteristics of Mineral and Royalty Interests

The following case addresses how to determine when royalty vs. mineral interests are transferred

In *Thornhill v. Systems Fuels, Inc*, the deed purported to convey 20 mineral acres but reserved the right to lease rentals or bonuses. The issue was whether it was a mineral conveyance or a nonparticipating royalty. The court outlines a number of principles: (1) particular words in a mineral transfer should not control, but the entire instrument should be examined, (2) the rights to delay rental and bonuses can be separated without changing the character of the instrument from a mineral estate to a royalty interest only, (3) under ordinary rules of construction, all that

was not unequivocally and specifically reserved was conveyed by the granting clause. The court held that this is a mineral deed and not a royalty conveyance.

NOTE: The court considered the "surrounding circumstances" of the transaction in ascertaining the intent of the parties in the written instrument. There is a scholarly debate on whether such evidence is parol evidence and therefore only admissible if the written instrument is ambiguous. Some argue that it is not parol evidence because the "surrounding circumstances" only include those events occurring before the instrument is executed.

In *French v. Chevron U.S.A., Inc.* the Grantor conveyed an undivided interest in the mineral estate to the Grantee. However, the deed further stated that "[I]t is understood and agreed that this conveyance is a royalty interest only" and expressly reserved in the grantor the rights to delay rentals and bonuses and the executive right. The court held that the deed conveyed a mineral estate stripping it of all rights except the rights to royalties. Since the deed did convey a mineral interest, the Grantee had a right to a fractional share of the minerals (for which he may receive royalties) rather than a fractional share of the royalties.

NOTE: This illustrates the Texas approach. The court will tend to find that a mineral interest is conveyed if attributes of mineral ownership are reserved under the theory that reserving these attributes from a royalty interest would be redundant (since the attributes of mineral ownership do not attach to a royalty interest).

EXECUTIVE/NON EXECUTIVE OWNERS

The executive right is the power to lease minerals. Frequently, the executive right is severed from the other incidents of ownership.

A frequent dispute is the duty owed by the executive to the non-executive.

In *Gardner v. Boagni, Whithall Oil Co. v. Eckart* four children who had each received an undivided one-fourth interest in a mineral estate entered into a partition agreement whereby they agreed that each child would receive the exclusive right to lease the land partitioned to them but that any royalties received from any leases on any of the four parcels would be shared among all four children. However, any bonus payments were not to be shared. One of the children executed an oil and gas lease on his property reserving a 1/8 royalty interest. Then the lessee executed an overriding royalty assignment in which he transferred a stated percentage of the 7/8 working interest back to the lessor. The lessor argued that the overriding royalty interest was executed in lieu of a bonus payment and therefore does not have to be shared with the other children. The other children argued that the royalty interest must be shared whether or not it is paid in lieu of a bonus. The court held that the overriding royalty interest should be treated as a bonus in applying the partition agreement. Thus, the other children were not entitled to share in the overriding royalty. The court rejected any fiduciary duty or agency relationship between a mineral owner and an owner of a royalty interest.

NOTE: As a result of this case the Louisiana Mineral Code was amended to provide that "the owner of an executive interest is not obligated to grant a mineral lease, but in doing

so, he must act in good faith and in the same manner as a reasonably prudent landowner or mineral servitude owner whose interest is not burdened by a nonexecutive interest."

> In *Allison v. Smith* Clark had granted a ½ interest in the mineral estate to Neely reserving the executive right. Neely then conveyed a ¼ interest in the mineral estate to Allison. Clark then conveyed all of her interests to Key (including the executive right). Key leased the minerals to Smith. Smith paid the delay rentals to Neely but did not pay Allison his share. Allison brought suit to cancel the leases. He argued that Key's power to execute leases was not coupled with an interest thus making the power revocable. Allison further argues that the power was actually revoked by a letter sent to Key. (As an unleased lessor Allison could claim his ¼ interest in all of the production rather than merely a ¼ royalty.) The court held that Key's executive right was coupled with an interest because he retained a possibility of reverter in the minerals leased. To render a power irrevocable the interest must be one that if revoked would deprive the holder of the power of a substantial right. Here, a ½ interest in the possibility of reverter in the minerals was sufficient to render the power to execute leases irrevocable.

> In *Federal Land Bank of Houston v. U.S.*(TX) the Federal Land Bank ("FLB") conveyed property reserving a 1/16 nonparticipating royalty interest for a term of 20 years. Grayson Co. obtained the land through *mesne* conveyances and conveyed the land to the United States for the establishment of Perrin Air Force Base. The U.S. noticed that oil had been discovered on adjoining lands. The U.S. transferred jurisdiction over the mineral estate to the Department of the Interior so that the minerals could be leased. The U.S. then offered to lease the minerals, but withdrew the offer so that it could combine with this mineral interests other minerals interests and lease them all together. As a result of the withdrawal of the offer, production was not achieved until just after FLB's terms interest expired. The court held that the mineral fee owner owes an implied duty of "utmost fair dealing and diligence" toward royalty owners. The court further held that the U.S. had breached its duty to FLB by withdrawing the offer to lease at FLB's detriment. Thus, the court suggests that the mineral fee owner may have to sacrifice his interests in order to protect the interests of the royalty owners. This standard resembles a fiduciary obligation.

> In TX, the holder of the executive right has an obligation to lease (whereas in LA the executive can decline to lease)

Another issue of executive rights is what obligation does executive owe non-executive to negotiate a "good" lease?

> In *Manges v. Guerra* Manges and Guerra were mineral co-tenants and Manges held the executive right. Under the deed Manges could not lease the Guerra's interest for less than a 1/8 royalty, and Guerra was to participate "in all bonuses, rentals, royalties, overriding royalties and payments out of production." Manges later put up his executive right as security for a personal loan. Guerra brought suit arguing that encumbering the executive right would preclude Manges from leasing the Guerra's minerals, effectively removing Guerra's mineral interest from the market. After suit was filed Exxon drilled producing wells on an adjoining tract of land, draining the oil from under the Manges-Guerra tract. Because of the *lis pendens* notices (i.e. a recording in the real estate records

indicating that the property is subject to pending litigation) no one was willing to lease the property from Manges, so he leased it to himself, drilled three producing offset wells, and then entered into a farm-out agreement with Schero. Under the farm-out agreement Manges received a 1/8 royalty and ½ of the working interest. The trial court held that Manges had breached its duty to Guerra and (1) canceled the lease Manges made to himself, (2) awarded Guerra actual damages for Manges's failure to lease the property to a third party, (3) awarded Guerra punitive damages, and (4) took the executive right from Manges.

The Supreme Court of Texas held that Manges had breached his duty owed to Guerra by (1) burdening Guerra's mineral interest by subjecting the executive right to a security interest for a personal loan, (2) taking 100% of 7/8 of the three producing wells, and (3) taking ½ of the working interest by his farm-out to Schero. In sum, he had dealt with entire mineral interest so that he received benefits that the non-executives did not receive. The court upheld the trial court's decision except the decision removing Manges as the executive. The court held that Guerra had elected to retain Manges as the executive by requesting damages for Manges breach of duty. (Guerra could have sought to have Manges removed as executive, but could not also recover damages for Manges' breach.)

The court found a fiduciary duty of utmost good faith that requires the executive to acquire for the non-executive every benefit that the executive rights owner exacts for himself.

NOTE: This court refers to the executive owner's duty to the non-executive as a fiduciary duty. However, this is not really the standard that the court applied.

In *Day & Company v. Texland*, Keaton conveyed 80 acres and all executive rights to Day but reserved a ½ mineral interest. Day then conveyed 10 acres to Shoaf and reserved a ½ mineral interest. Day now argues that he owns a ¾ executive right in the 10 acres (Day says the executive interest is a power and should transfer only by express assignment). Texland (Shoafs lessee) argues that the executive right is an interest in property and is governed by property law principles. The court holds that the executive right is an interest in property and part of the mineral estate. A warranty deed passes all interests owned by the grantor unless there are exceptions or restrictions. Here, the ¾ executive right in the 10 acres passed to Shoaf as it was not reserved in the grant.

Normally if you reserve a ¾ mineral interest, you reserve the whole bundle of rights. In the case above, however, the executive right was severed from the mineral interest and therefore had to be expressly reserved.

TERM INTERESTS

<u>Term interest</u>: an interest in oil and gas created by a landowner for a less than perpetual duration. Can be fixed term (for 20 years) or defeasible term interest (for 20 years and so long thereafter as oil and gas is produced).

In *Clark v. Holchak*, the deed conveying a term interest stated "if there is no production on 10 Dec, and for six months thereafter, the grant is null and void …

but if there is production the grant shall remain in force until such production ceases." There was paying production before the six months expired. The issue was how to interpret the deed provision. The court held that the provision did not effect a reversion if there was no production on December 10, 1945, but provision was the same as if it had read that in case there was no paying production on the land on December 10, 1945, and no paying production thereon for six months thereafter, then grant should become null and void. Essentially, the court rewrites the provision to read "if there is no production on 10 Dec., *or* for six months thereafter . . ."

Does TCOP doctrine apply to term interests ?

In *Beatty v. Baxter* (OK), P owned 80 acres (of which was held by a 180 leasehold) and conveyed term mineral interest to the D's (20 years and so long thereafter as there is production). The 20 years had expired and there was a temporary cessation of production (well rehabilitation was delayed by war conditions). P now argues that the term mineral interests terminated and expired. The court held that defendants' estates were not terminated by a temporary cessation of production. The court reasoned that while oil and gas leases are construed against the lessee, grantees of royalty interest are in a different position from that of lessees. They have no right or duty to effect production, therefore the court will look at the surrounding facts in each case. Court says TCOP applies (even though it is a discovery jurisdiction)

In *Amoco Production Company v. Braslau* (TX), Amoco owned the term royalties (15 years and as long as …). Amoco drilled a producing well during the primary term. The well went through a number of sands. Amoco ceased producing from Zone and then tried to shift to sand C but the well was lost. Amoco then drilled another well and began producing from Sand C. The owners of the term royalties (Amoco) contend, as the trial court held, that there was but a temporary cessation of production from known sands or zones. The owners of the reversionary interests contend that there had not been any production from Zones A and C; and that it is impermissible to call it a temporary cessation of production if it is necessary to drill a second well to produce from a separate zone. The court held that where temporary cessation of production was due to operator's attempt to move up in well to another zone and well was lost after which operator promptly obtained production from new well drilled with due diligence on said lands, term royalties did not expire. Court says TCOP doctrine is implied and applies.

In *Fransen v. Eckhardt* (OK), the grantors reserved a ¼ term interest for 30 year and as long thereafter as there is production in paying quantities. At the end of the 30 year period a well was capable of production but did not begin actual production until 5 months after the expiration. The owners of the reversionary interest claimed the term interest had expired. They argued that even though OK is a discovery state, more is required than discovery and completion of a well to extend the term mineral interest. The court agreed and held that the rules regarding production in paying quantities applicable to oil and gas leases do not apply to the reservation contained in the warranty deed). The apparent general intention of parties as discerned from examination of warranty deed, which stated that reservation would continue and be in full force and effect as long as

production continued, was that if speculation resulted in production of oil and gas, interest would continue, and if lease were unimproved, grantors would be divested of ownership so that future development would not be prejudiced, Moreover, production means actual enjoyment of tangible economic benefits which result from marketing. The court reasoned that leases contemplate development while term interests are held for speculation, therefore a stricter definition should apply to defeasible term interests than for leases.

Summary of Treatment of Term Interests: The interpretative tools used in construing oil and gas leases may not apply with the same affect to identical provisions in mineral deeds. The above cases illustrate, for example:

(a) In Oklahoma the discovery rule will not apply to minerals deeds even though it applies to mineral leases (*Fransen*). Also, the temporary cessation of production doctrine will apply to mineral deeds (*Beatty*).

(b) In Texas, however, the temporary cessation of production doctrine applies to mineral deeds as it does to mineral leases (*Braslau*).

The Rule Against Perpetuities and Top Leases

The Rule: "no interest is good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest"

An interest is invalid unless it can be said, with absolute certainty, that it will either vest or fail to vest, before the end of the period equal to: (1) a life in existence at the time the interest is created plus (2) an additional 21 years

If, at the time the interest is created, it is theoretically possible that the interest will vest later than 21 years after the expiration of lives in being, the interest is invalid

In *Peveto v. Starkey*, Jones conveyed a ¾ term royalty interest to Peveto for 15 years and as long thereafter as oil is produced. Before the 15 year period expired, Jones conveyed a ¾ "top term royalty interest" to Peveto with a stipulation that it only became effective upon the expiration of the first term royalty interest. Peveto argued that the royalty deed to Starkey violated the RAP. The court held that the deed to Starkey created springing executory interest in plaintiff which might not vest within period of rule against perpetuities, and thus, deed was void.

If a term royalty deed does not contain a shut-in clause, shut-in royalty payments will not equal production for purposes of extending the term interest past the primary term.

In *Hamman v. Bright & Co.*, Grantors (Hamman) brought action pursuant to oil and gas top leases for unpaid royalties, excessive fees, fraud, and conversion. Grantees or their assignees (Bright) counterclaimed alleging that top leases and deed were void. The Grantors argued that the top leases conveyed vested possibilities of reverter. The words of the grant of top lease said "a term for 10 years upon expiration of previous lease." The court held that: (1) oil and gas top leases, which were to become effective if and when existing oil and gas leases expired or were terminated, violated rule against perpetuities, but (2) perpetual nonparticipating free royalty interest reserved by grantors in subsequent deed did not violate rule against perpetuities. The court reasoned, as to the top leases, that

the conveyed interest would only vest when bottom lease expired and the bottom lease could continue for an indeterminate amount of time.

The RAP does not apply to present interests or vested future interests. A possibility of reverter is a freely assignable vested right and is not subject to the RAP.

In *Earle v. International Paper Co*., Earle sold some land and "Excepted and reserved" a ½ term mineral interest in the land for a period of 15 year "or so long as …" The 15 year period expired without production. Later oil was found and the Trustees of a testamentary trust (established by Earle) sought declaration that claim to mineral estate originally reserved by testator was a springing executory interest, subject to and voided by rule against perpetuities. The court noted that a severance under a deed can either be an "exception" or a "reservation". An ***Exception*** withholds an interest for the grantor and creates an executory interest in the grantee. A ***Reservation*** creates an implied regrant from the grantee to the grantor and leaves grantee with a possibility of reverter. The court must determine which concept describes the nature of the transaction as a whole. The Court held that deed clauses "EXCEPTING AND RESERVING" an undivided one- half interest in minerals for 15 years, subject to extension if minerals were being produced in paying quantities, operated as a reservation rather than an exception and grantee's future interest in the one-half mineral interest reserved was vested in interest at time of its creation and was not subject to the rule.

Court applies two rules of construction: (1) deeds of bargain and sale for valuable consideration are to be construed against the grantor and in favor of the grantee, when ambiguous and (2) when a deed is ambiguous the construction most favorable to its validity will be adopted (specially where doing so would avoid any perpetuities problem)

NOTE: The court noted that the more the deed reserving and excepting an interest describes the interest, the more it looks like a reservation rather than an exception because an exception is an already existing interest in the property that has already been defined.

Williams v. Watt

<u>Facts</u>: Land Bank sold some land to Williams and reserved a ½ mineral interest (for 20 years and as long thereafter). Williams then sold the surface estate to Watts, but reserved all the minerals. The twenty year period expired without production. Watts now argues that Williams held an executory interest in ½ of the minerals (from Land Bank) and since that violated the RAP the ½ interest went to Watts.

<u>Holding</u>: The court first looks to the intent of the parties which was to give all mineral interest to Williams and then determines the interests. The court states that land bank held a fee simple determinable. If a mineral interest may endure for an indefinite period it is a fee estate. Williams held a vested remainder. The court held that held that: (1) conveyance by land bank, excepting undivided one-half interest in oil, gas and mineral rights for an indefinite term, namely, 20 years and as long thereafter as oil, gas, or other minerals continued to be produced

therefrom, created in the land bank a fee simple defeasible estate in the excepted interest and not merely a term for years; (2) interest held by land bank's grantee in that excepted estate was a remainder, rather than an executory interest, in light of unique attributes of mineral estate; and (3) land bank grantee's remainder interest was vested and, therefore, not subject to being rendered void by rule against perpetuities.

Kramer says that the court "wiped out over 1,500 years of Anglo-American law" in holding that a vested remainder follows a fee simple estate. The court ignores the basic estates in property law and the Wyoming constitutional and statutory directive to apply the RAP in order to give effect to the intent of parties.

TRANSFERS SUBSEQUENT TO A LEASE

What are the consequences of transfers by the lessor or lessee?

Conveyances of property subject to oil and gas lease have led to a number of disputes;

Three common problems are (1) the "subject to" problem (2) apportionment of royalties and (3) top leasing.

Transfers by the Lessor: The "Subject-To" Clause and the "Two-Grants" Theory

The "subject to" clause in a mineral deed states that the deed is subject to existing oil and gas leases.

Its purpose is to avoid Duhig problems and makes clear that grantee is intended to receive an interest in rentals and royalties under the lease.

In *Hoffman v. Magnolia Petroleum Co.*(TX), the lessors who owned ½ the mineral interest in 320 acres subject to an oil and gas lease, conveyed to Hoffman their mineral interest in 90 acres. The granting clause was followed by a subject to clause that stated "the sale is made subject to said lease, but covers and includes ½ of all the oil royalties to be paid under the terms of the lease." Hoffman argued that he is to receive ½ of the royalties from the whole 320 acres and not just the 90. Lessor argued that the language in "subject to" clause referred only to the smaller tract. The court looks at the instrument as a whole in order to determine the intent of the parties. The court holds that the instrument contained two grants (1) the deed conveyed an undivided ½ interest in the possibility of reverter in the oil in place under the 90 acres and (2) conveyed a ½ interest in the royalty to accrue under the terms of the lease as an entirety (the whole 320 acres). The court reasoned that by using the word "all" the conveyance can only refer to the lease as a whole.

"Subject to" Clauses now normally include the words "in so far as the lease covers the above described land" to take care of Hoffman problems.

Note: Now, even if you don't have a "subject to" clause, when you transfer ½ of the mineral interest, you give grantee all of the present leasehold interest. The modern view is that everything not specifically reserved is transferred.

In *Garrett v. Dils Co.*(TX), there was a granting clause that gave grantee a 1/64 mineral interest and a 1/8 of the 1/8 royalty. There was also a future lease clause that stated that:

> "in event that the above described lease for any reason becomes cancelled or forfeited, then and in that event an undivided one-eighth of the lease interest and all future rentals on said land for oil, gas and other mineral privileges shall be owned by said Grantee, he owning one-eighth of one-eighth of all oil, gas, and other minerals in and under said lands, together with one-eighth interest in all future rents."

The court that held that where owner of fee simple had executed mineral deed which stated it conveyed 1/64 interest in oil, gas and other minerals produced but which provided that in event existing lease should terminate an undivided 1/8 of lease interest and all future rentals on land for oil, gas and minerals should be owned by grantee, the deed conveyed an undivided 1/8 interest in royalty and future rentals. The court said that the intention of the parties, as ascertained from the instrument as a whole, prevails. Here, a different and greater estate was conveyed upon the reversion of the outstanding lease.

The following case rejects the "two grants" reasoning:

In *Alford v. Krum* (TX), the granting clause provided "one-half of the one-eighth interest in and to all of the oil, gas and other minerals" while the future lease clause provided "one-half interest in all oil, gas and other minerals in and upon said land." The grantees argued that they were entitled to an undivided ½ mineral interest after the lease expired. The court states that a court must attempt to harmonize all parts of a deed. However, if there is an irreconcilable conflict between clause in a deed, the granting clause prevails over all other clauses. The court reasons that the "controlling language" in a deed is found in the granting clause. Here since an irreconcilable conflict exists between the granting clause and the future lease clause; the former should control. Moreover, the future lease clause, as a whole, is unclear, and it is improper to give effect to it, especially at the expense of the granting clause. We must resolve the conflict and lack of clarity in favor of the clear and unambiguous language of the granting clause and hold that the deed conveyed only a perpetual one- sixteenth mineral interest to grantee.

More recently, the Texas Supreme Court overruled Alford and went back to the two-grants theory in the following case:

In *Luckel v. White*, the granting clause provided for a conveyance of 1/32 royalty interest, while the future lease clause provided for "1/4 of any and all royalties." At the time of the conveyance, 1/8 was the standard royalty and ¼ of 1/8 is 1/32. So the successors to the grantors argued that the grantees were only entitled to 1/32 of the royalties under a new lease that provided for a 1/6 royalty. Grantees argued that they were entitled to 1/24 (1/4 of 1/6). The court agreed and stated that courts must harmonize all of a deed's provisions. Here, the deed unambiguously conveyed a ¼ interest of the royalties derived from future leases. The court overrules the Alford decision. Court says the 1/32 language sets forth the minimum royalty.

In *Jupiter Oil Co. v. Snow*, a deed conveyed "1/16 interest in all the oil and gas" and if the present lease was cancelled "1/2 of all the oil." The new lessee argued that the (under rule of Alford) the grantee only received a 1/16 mineral interest. The court says that whenever a lessor enters a lease he retains a possibility of reverter. That possibility of reverter is freely assignable. The court then applied the two-grants theory and held that the deed immediately gave the grantee a 1/16 interest in the mineral estate, and upon termination of the lease the other 7/16 (so grantee received a ½ possibility of reverter).

In *Concord Oil Co. v. Pennzoil*, action was brought to determine size of mineral interest conveyed by deed executed while grantor's interest was subject to producing lease. The granting clause of the mineral deed in controversy describes the interest conveyed as a 1/96 interest in minerals, but a subsequent clause states that the conveyance covers and includes 1/12 of all rentals and royalty of every kind and character. The granteee (Concord) argued that the deed conveyed a 1/12 mineral interest. The grantor (Pennzioil) argued that the deed conveyed a 1/96 mineral interest and a 1/12 interest in the rents and royalties under the existing lease (but not future leases).

Court of Appeals: applied two-grant theory and held that the deed in question unambiguously conveyed two estates of different sizes and duration: a 1/96 perpetual interest in the minerals, and a 1/12 interest in rentals and royalties which ended with the existing lease.

Holding: (Plurality as to reasoning, majority in judgment only) court held that the deed created a single estate of 1/12 of all rentals and royalties, covering existing lease and any future leases. Apparent inconsistencies in instrument conveying mineral interests must be harmonized, if possible, by looking at document as whole. Considering document as whole, mineral deed with granting clause describing interest conveyed in oil and gas property as 1/96 interest in minerals, but with subsequent clause stating that conveyance covered and included 1/12 of all rentals and royalties of every kind and character, created single estate of 1/12 of all rentals and royalties, covering existing lease and any future leases, rather than two separate estates with differing durations.

Transfers by the Lessor: Herein of the Assignment Clause and Related Lease Provision

Assignments by lessors can have a number of consequences:

The following case concerns whether term royalty owners were necessary parties in a suit to terminate the lease.

In *Royal Petroleum Corp. v. Dennis*, the lessor brought an action in trespass to declare that the mineral lease terminated on ground that lease had expired by its own terms upon cessation of production of oil and gas. The lessee argued that (and trial court agreed) that term royalty owners were necessary parties. The term royalties were in the secondary term and expired upon lack of paying production. The court states that *Necessary parties* to a suit are those who have or claim a direct interest in the object and subject matter of the suit and whose interest will necessarily be affected by any judgment rendered therein. The court held that

where interests of part owners of royalty interest were to terminate if oil and gas production ceased, such part owners of royalty interest were necessary parties. The court reasoned that if the lease was terminated the judgement would not be binding on them, but would terminate their rights for all practical purposes (as point would be moot). Therefore, in the interests of equity, trial court has broad discretion to join such necessary parties. However, the royalties owners were not indispensable parties.

Apportionment of Royalties

What happens if lessor transfers a subdivided part of the leased land? If there is production form the subdivided plot, how should the royalties be paid?

There is a split of authority:

Non-apportionment rule: (majority rule – followed in TX and most other states) lease royalties are not apportioned among the owners of subdivided property. Instead the owner of the tract where the well that produces the oil and gas is located is entitled to all royalties due under the lease.

Apportionment rule: (Pa., Ca) treats royalties like rents (rents on royalties are apportioned)

In *Central Pipline Co. v. Hutson*, a 114 acre tract was covered by a lease. The lease agreement contained no proration clause. The tract was then subdivided into a 74 and 40 acre tract. Oil was produced from wells on the 74 acre tract. The issue was whether the royalty belongs only to the owner of the particular portion upon which the well is located, or does the royalty belong to all the owners of all the portions upon a prorata basis? The court rejects the rent analogy and adopts the non-apportionment rule. The court reasoned that royalties are different from rent. Royalties are not payments that issue from every part of the land; they are rights to production if and when it occurs.

Note: The lessee still maintains the whole lease as a result of the one producing well (is a harsh rule to owner of the non-producing tract)

Insertion of a proration (or **entirety**) clause into the lease can contractually provide for the apportionment of royalties. For example:

"in the event the leased 114 acres shall thereafter be owned in severalty or in separate tracts, that the entire 114 acres shall be developed and operated as one lease, and that all royalties accruing thereunder shall be treated as an entirety, to be divided among and paid to the separate owners in the proportion the acreage of each separate owner bears to the entire leased acreage."

In *Ruthven & Co. v. Pan American*, Mermis (and successive interests) owned a quarter section of land (160 acres) and conveyed to Ruthvens predecessors an undivided ¼ mineral interest in the west half of the quarter section (20 mineral acres). Mermis then executed a lease for the whole quarter. The lease contained an entirety clause which stated:

> 'If the **leased premises** are now or hereafter owned in severalty or in separate tracts, the premises, nevertheless, may be developed and operated as an entirety, and the royalties shall be paid to each separate owner in the proportion that the acreage owned by him bears to the entire leased area.

Production was obtained on the east ½ and for roughly 11 years all royalty payments were made to the owners of the east ½. Ruthven now argues that they are entitled to an apportionment of royalties. The court states that the purpose of an entirety clause is to overcome the nonapportionment rule. If the lease is executed before the division of the land, then a lease containing an entirety clause would defeat the non-apportionment rule. Here, however, the lease was executed after the conveyance of the ¼ interest. The term "leased premise" included only the interest owned by Mermis (east ½ and ¾ of the west ½). The court holds that the term "leased premises" means the lessors's interest which is the subject of the lease.

Note: The mineral interest owner (unlike royalty owner) has more options as they can go and execute a lease.

Transfers by Lessee: Relationship of Transferor and Transferee

As noted previously, when parties enter into an oil and gas lease, there are implied covenants that benefit the lessor.

Is a lessee who assigns the working interest but retains an overriding royalty or other non-operating interest entitled to protection of implied covenants?

As a general rule, contract rights were not generally assignable or enforceable against persons who are not a party to the contract, there is exception to the rule of nonassignability. Where there is privity of estate or privity of contract the contract is enforceable against subsequent parties. For the running of the burden of covenants you must have:

1. must be in writing
2. parties intended covenants to run to successors
3. the burden must touch and concern the land
4. there must be privity; two types

   Horizontal privity = meaning privity between the original covenanting parties

   Vertical privity = meaning privity between one of the covenanting parties and a successor in interest

The conceptual difficulty is that the original lessor/assignor cannot claim the protection of the covenants implied in the oil and gas lease. Lease implied covenants benefit the

lessor and burden the lessee. Thus, if courts are to protect the original lessee/assignor they must imply covenants in the *assignment of the lease*.

One view: Original lessee (lessee assignor) who reserves overriding royalty interest is entitled to implied covenants (TX, NM)

> In *Cook v. El Paso Natural Gas* (NM), the plaintiff (who was the original lessee) owned an overriding royalty interest and sued her sub-lessee for causing drainage. Lessor of both tracts was the US. Lessee held leases for both tracts. Cook claimed that lessee was in breach of its duty to protect from drainage. Lessee argued that an overriding royalty interest owner does not have standing to enforce the obligation of the lease. The court held that plaintiff had standing to bring suit claiming violation of the implied covenant to protect against drainage. The court reasoned that in view of the relationship of the parties, defendants being the assignees of plaintiff's oil and gas lease and also being the owners of a gas well located on an adjoining lease, there existed an implied covenant running to the plaintiff, who had retained a 5% overriding royalty interest in her lease, to refrain from any action which would deplete her property in the lease.
>
> The court in Cook treats the overriding royalty owner as an assignee of the lessor
>
> Under traditional covenant law, the only ones who can sue for the benefit of the lessor are successors in interest to the lessor. But overriding royalty owners get their interest from the lessee.
>
> Cook essentially creates a new implied covenant when there is a creation of an overriding royalty (in order to protect the royalty owners interest, otherwise he is at the mercy of the lessee) and says that implied covenants that run with the land extend to overriding royalty owners.

Another view: Overriding royalty owner is not entitled to implied covenants

> In *McNeil v. Peaker* (ARK), the original lessee assigned the lease to Peaker, but retained an overriding royalty. P alleged that Peaker breached the implied covenant to reasonably develop and to prevent drainage. The court holds that the law in Arkansas does not recognize implied covenant on the part of an assignee of an interest in an oil and gas lease to an oil payment owner or overriding royalty owner who is not a lessor. Court says that the overriding royalty does not create a real covenant that runs with the land.
>
> In *XAE Corp. v. SMR* (OK), Overriding royalty interest owners in gas from wells sued lessee to recover post-wellhead expenses for marketability, which lessee had deducted from royalty payments. The Plaintiffs argued that they were entitled to gas without any deductions for treatment, as lessees are required to bear the costs of making the gas marketable. The lessee argued that the implied covenants of the oil and gas lease do not apply to the overriding royalty owners, who are not parties to the oil and gas lease. The court held that the duty placed upon the lessee to deliver gas in marketable form arises from the lessee's implied duty, arising out of the oil and gas lease, to market the product. No such duty exists toward the overriding royalty interest owner unless such obligation is created by the assignment. Here, the obligation is merely to deliver the gas in-

kind when production is obtained. Absent express agreements, implied covenants do not go to the overriding royalty interest.

Protection of non-operating interests against "wash out"

A frequent problem after a lessee has transferred operating rights in a lease and retained a non-operating interest is the "wash out" A wash out can occur if the transferee permits the lease to terminate and then re-leases the property. The question is whether the original lessee's non-operating interest should be recognized under the new lease.

Some jurisdictions have extended the transferor protection on the grounds that either (a) a constructive trust is created by a special or confidential relationship between the parties as shown by the particular facts or (b) the facts give rise to an inference of bad faith by the transferee.

Most cases have held that one who transfers operating rights but retains a non-operating interest is not protected by implied covenants against wash out.

> In *Sunac v. Parkes*, the plaintiff Parkes was granted an oil and gas lease in 1948. Subsequently, Parkes assigned the lease to Sunac, but retained for himself an overriding royalty interest. Significantly, this assignment expressly provided that " 'the overriding royalty [would] apply to any extensions or renewals of the lease assigned.' " In 1959, the lessor "asserted that a question existed as to whether or not said lease had been maintained in force and effect. Apparently in an effort to resolve all doubts, the lessor and Sunac entered into a new lease on substantially different terms. Sometime thereafter, Sunac ceased paying Parkes his overriding royalty. Parkes sued for a judicial declaration that the 1959 Lease was burdened by his overriding royalty interest and for the royalties allegedly due. The court first determined that the 1948 Lease terminated by its own terms, and the 1959 Lease was not a renewal or extension of the 1948 Lease. The court next considered whether the 1959 Lease should be treated as a renewal or extension of the 1948 Lease under a constructive trust theory such that Parkes' overriding royalty interest continued. The court recognized that Parkes' assignment to Sunac contained the magic "phraseology" applying his overriding royalty to any extensions or renewals of the 1948 Lease. However, the court declined to employ this ground to justify a constructive trust theory in Parkes' situation because his assignment expressly provided that Sunac was under "no duty to develop the land or continue the lease in force; to the contrary, the assignment expressly gave it the right to surrender the lease at any time without Parkes' consent."

Normally, when the first lease expires, the overriding royalty is cut off. Often, however, the assignments contain extension/renewal clauses. An extension is a continuation of the old lease, whereas a renewal is a different lease but has essentially the same terms as the first lease.

> In *Sasser v. Dantex Oil and Gas*, Sasser had an overriding royalty interest in the '74 lease. The lessor and lessee said the lease had expired because the production was not in paying quantities. The lessor and lessee then entered into another lease (the '90 lease). Sasser interest was cut off and he argued that (1) the 1990 Lease was ineffective to release the 1974 Lease and, therefore, to extinguish his overriding royalty interest under the 1974 Lease because Dantex failed to strictly

comply with the 1974 Lease's surrender clause and (2) by entering the 1990 Lease, Dantex wrongly attempted to eliminate or "washout" Sasser's overriding royalty interest, thereby breaching its duty of good faith and fair dealing or other fiduciary- type duty. The court held that: (1) initial lease, along with overriding royalty interest under that lease, terminated when lessee and lessor signed subsequent lease with intent and understanding that, by doing so, they would effect release of initial lease, and (2) lessee was not in special or confidential relationship with owners and, thus, lessee did not owe owners duty of good faith and fair dealing or any other fiduciary type duty.

Transfers by Lessee: Relationship of Lessor and Transferee

General rule: the rights and duties of the lessor and the lessee are set when the lease is originally granted; lease obligations are not divisible

In *Berry v. Tidewater Associated Oil*, the original lessee had assigned a portion of the lease. The original lessee drilled a producing well on the land he retained. The lessor argued that upon assignment the portion became a separate lease and assignee was required to drill (and since he did not the lease terminated). The court held that held that where portion of land subject to an 'unless' oil, gas and mineral lease was assigned to defendants, and original lessee brought in a producing well within primary term of lease on part of leased land retained by original lessee and original lessee paid the shut-in gas royalty, the lease as to the defendants did not end under Mississippi law merely because no well was drilled during primary term on portion of leased land assigned to defendants.

Berry states the majority rule: the habendum clause is normally indivisible so that production or drilling operations anywhere on the leased premises keeps the entire lease alive in the secondary term (the rationale for such a rule is that the only obligation the lessee originally assumes with reference to development is to develop the leased premises as a whole)

Some courts make an exception to the general rule for the implied covenants to reasonably develop and to explore further. An issue is whether the obligation of the lessee and his assignee is to be judged by reference to the lease as a whole or whether each must stand on its own.

In *Cosden Oil Co. v. Scarborough*, the lessee assigned Cosden 400 acres of the 10,000 acre lease. The lessor argued that the assignee breached the implied duty to reasonably develop the 400 acres. The assignee argued that its portion of the lease must be looked at as part of the whole. The court holds that the lease is indivisible as to the fixing of the term, but divisible as to the implied covenant to develop. The court reasoned that the purpose of an oil and gas lease is to develop for oil. While the lease is entire as to the vesting not only in the original lessee, but in all of his assigns, of a determinable fee in each as to the part of the land he owns, that determinable fee as to each owner stands or falls, is abandoned or ceases, according to his own acts, subjecting him to the obligation for damages not at all for what is being done or not done upon the tract in general, but only for what he does. Any other construction would lead to interminable confusion.

Where you have a geographic/area subdivision, the implied covenant to develop is divisible.

What about delay rentals, are they divisible? Yes – if there is a geographic subdivision (but if lease is fractionally divided – delay rentals are not divisible and if you underpay the lease will terminate).

> In *Hartman Ranch v. Associated Oil Co.*, Associated was the lessee/sub-lessee of two adjoining tracts: the Hartman lease and the Lloyd lease. The contention of plaintiff is that the defendant by active and intensive drilling operations on this southern tract, referred to as the Lloyd lease, is draining oil from the Hartman property. Plaintiff contends that the failure of the defendant to drill additional wells on the Hartman property constitutes a breach of an implied covenant in the Hartman lease to protect the lands from drainage. The defendant argued that : (1) That the parent lease upon which this action is brought makes express provision for the number of wells to be drilled, with which provision defendant has fully complied, and this express provision negatives the existence of an implied covenant to drill additional wells to protect from drainage; (2) that defendant is a sublessee and as such is not subject to an action by the original lessor for breach of covenants of the parent lease. The court held that (1) compliance with an express well drilling provision on one lease does not authorize the lessee to drain the oil from an adjacent tract and that (2) Lessor was not precluded from suing sublessee who had assumed obligations of the parent lease, as a third party beneficiary, because lessee retained an interest in continuance of parent lease by reason of the royalty received by lessee.

In the above cases, the defendant argued that since he is the sub-lessee there is no vertical privity between him and the lessor so therefore the lessor could not use him. (normally a landlord cannot directly sue the sub-lessee, the lessor would have to sue the original lessee who could in turn sue the sub-lessee). Here, the defendant is a sublessee because he did not take his assignor's entire estate. (The assignor retained a right of re-entry, amounting to a contingent reversionary interest, and an overriding royalty interest.) Therefore, there is no privity of estate. But court here says they can sue directly because (1) there was an assumption of liability clause in the sub-lease (making the plaintiff a third-party beneficiary, thereby establishing privity of contract) and (2) in the case of an oil and gas lease, the court will not apply common laws which would allow the lessee to avoid its obligation. Thus, even if there had not been privity of contract between the lessor and the sublessee, the lessor could sue the sublessee for royalties where they are calculated as a percentage of production because the lessor has a property right in the royalty.

Transfers by Lessee: Relationship of Lessor (or his successors in interests) with Lessee-Transferor

> In *Kimble v. Wetzel*, the lessor leased a tract of land. The lease contained a clause that provided for free gas for the lessor's dwelling. The lessee assigned the lease. The lessor sought an injunction to require defendant to furnish plaintiffs natural gas for heating and lighting purposes free of charge under gas lease. Assignee of the lease argued that the covenant runs with the surface estate and not with the mineral estate when there has been a severance. The court held that covenant to furnish free gas ran with mineral estate (i.e. the possibility of reverter) and was

> transmissible by descent or assignment, and that it was not prerequisite to validity of covenant that there be production of gas from leased premises.

In order for a benefit (free gas) to run you have to identify the benefited estate. In the above case, the court said that the owner of the possibility of reverter was the benefited estate

POOLING AND UNITIZATION

Well Spacing and Allowables

Proration/allowable order: the formula that sets out how much you can produce (usually based 50/50 on the number of wells/acreage)

Spacing order: have to have so much land to drill or have drill a certain footage away from property lines (but can get exception or have forced pooling)

Pooling order: pools the land for the purpose of efficiently developing common formation

States regulate the rate and volume of production for two reasons: (1) prevention of waste and (2) protection of correlative rights.

Well spacing is concerned with the location of wells and the density of drilling into a reservoir.

Spacing regulations have the effects of protecting correlative rights in areas of diverse ownership and of limiting the number of wells that may be drilled into a reservoir in a given area. This avoids the drilling of unnecessary wells. Well spacing is done both by statewide order and by individual field or reservoir rules.

Two types of well-spacing: (1) minimal acreage requirements (e.g. one well per 40 acres) or (2) operator must stay a certain distance away from the property line

Oil and gas conservation laws also regulate production to prevent waste and protect correlative rights. Production allowables are one kind of production regulation. Allowable rules put daily, weekly or monthly limits on production of oil and gas to prevent overproduction.

> In *Stack v. Harris*, the operator got a permit to drill an exception well. State rule provided that intentional deviations must have a permit, and in the case of directionally drilled wells the board may impose penalties. The operator made some intentional deviations and the well drifted.. The Oil and Gas Board approved the well as completed, but, provided that, because of the intentional deviations and the location of the bottom of the well, the exception well should have an allowable of only 150 barrels per day (as compared to the normal allowance of 400 barrels) The court held that Code section providing for full allowables for an exception well does not render such a well absolutely immune from any penalty in the reduction of allowables regardless of what happens; rather, such section contemplates that the well shall be drilled in accordance with Board rules and regulations, and the section applies only in cases where the

driller or operator does drill his well in accordance with such rules and regulations. If it is drilled in accordance with such rules and regulations, and there is no question about it, then the allowable cannot be reduced because it is an exception, but where it is not so drilled, the said section does not apply.

Court tries to minimize the damage caused by deviated well (in that it is now close to other wells and will be draining from them) by limiting the amount of production allowed.

Spacing rules modify the rule of capture (and modify voluntary agreements).

Spacing does not combine interests; it regulates where you can put a well. If landowners do not have enough land to meet spacing requirements they can: sign an operating agreement (voluntary pooling), get an exception, or be forced to pool.

If a spacing rule requires a landowner to own or control 640 acres in order to drill then if X and Y each own 320 acres of the 640, neither can drill unless they enter into an operating agreement or the Commission forces pooling.

In OK, a spacing order will automatically pool the interests.

Texas and the Problem of the Small (unpooled) Tract

The problem arises when a mineral owner owns mineral rights in a tract too small or the wrong shape to conform to applicable spacing rules. The correlative rights of the small tract owner will be destroyed unless the owner is allowed to drill or share in the production from the well drilled on the spacing unit. (if he is not allowed to drill, there is a taking)

Since there was no forced pooling, the Railroad Commission had to grant well-spacing exceptions to these sub-standard tracts.

The Railroad Commission granted exception tract wells a production allowable sufficient to permit them to recover their costs plus a reasonable profit.

The problem that arose was the inequity that resulted when the small tract was given an allowable making it possible for it to produce a disproportionate amount of oil and gas in relation to the amount of land owned. (The typical allowable is ½ well and ½ acreage.) If allowable is only based on acreage then small tract owner gets only his “fair share” regardless of whether he can make a profit.

In *Halbouty v. Railroad Commission*, the Texas Supreme Court recognized that the costs plus profit allowable was a license for small tract owners to drain other properties and that it seriously conflicted with well spacing rules. Now, production allowables for exception tract wells allow permit owners to only recover their “fair share” based on acreage.

In *V-F Petroleum v. A.K. Guthrie*, V-F sought and received a permit to drill a well on a sub-standard tract within the Sara-Mag field (which had a 50/50 allocation formula) The adjacent operator sought to amend the formula to a 100%

acreage and argued that the 50/50 formula was illegal because it used a per-well factor. The application for an amendment was denied because (1) V-F could not voluntarily pool (Guthrie would not) or compulsory pool (Mineral Interest Pooling Act did not apply retrospectively). Applicant filed petition seeking judicial review of Railroad Commission's denial of application for amendment to allocation formula for prorating oil production among wells in field. The Court of Appeals, held that substantial evidence supported Commission's findings of fact and conclusions of law when denying applicant's request to amend field rules to change allocation formula based 50% upon surface acreage and 50% upon the number of wells producing to an allocation formula based 100% upon acreage.

Exception wells are granted to prevent waste or prevent confiscation of property (oil in place is property and if landowner cannot drill his property will be drained by adjacent landowners). Prior to Mineral Interest Pooling Act, the commission did not have the right to force pooling so it had to give exceptions in order to prevent confiscation.

The Texas legislature enacted the Mineral Interest Pooling Act to allow forced pooling. This does not mean that Rule 37 exceptions are no longer of any consequences because the act only applies to new formations.

The next case involves an exception well that was not a small tract exception well application:

In *Texaco v. Railroad Commission of Texas*, the lessor owned two tracts (9 and 10). TXO, the lessee of section 10, sought a rule 37 permit to drill a well at an exception location. Tract 10 is not a substandard sized tract, but the remaining oil is the far southern part of the tract so TXO would need to drill there in order to recover its fair share. Texaco, the lessee of tract 9, argued that the permit was not necessary to prevent confiscation since the lessor is the same for both tracts. The court held that held that: (1) mineral lessee has property interest which is entitled to protection against confiscation, and (2) Railroad Commission correctly granted exception permit to oil and gas lessee to protect it against confiscation by oil and gas lessee of adjoining tract.

Creation of Pooled Units

Exercise of pooling power by Lessee

The courts have implied a requirement that the pooling or unitization power be exercised in good faith. The purpose of pooling clauses is to give the lessee flexibility to operate efficiently, and the power to pool is limited by that purpose. A lessee should not be able to pool a portion of one leased property with another leased property for the purpose of maintaining two leases by the drilling of one well unless the action is pursuant to a plan of development.

In *Amoco Production Co. v. Underwood*, the lessors contend that the lessee had “gerrymandered” a drilling unit of 688 acres which, under the terms of the leases, would extend eight lease covering a total of 2,250 acres. The lessee formed the unit approximately two days prior to the end of the primary terms of several of the leases. The lessors alleged that some clearly nonproductive land was included in the unit and some clearly productive property was excluded. A jury found that

the unit was established in bad faith, and the trail court cancelled the unit and declared that some of the leases had terminated. On appeal, the appellate court held that good faith is a n issue of facts, and that the jury had properly decided that the lessee had acted in bad faith on the basis of the configuration of the unit and the timing of the designation.

Canons of Construction

Canons of construction are merely statements of judicial preference for the resolution of a particular problem. They are based on common human experience and are designed to achieve what the court believes to be the "normal" result for the problem under consideration. Thus, their purpose is not to ascertain the intent of the parties to the transaction. Rather, it is to resolve a dispute when it is otherwise impossible to ascertain the parties' intent.

However, the courts primary function is to interpret the document as the parties have expressed in the written instrument.

General Intent Canon: Intent of the Party Must Be Sought and Ascertained

"Intent as Expressed Controls" Canon: The intention is to be ascertained as expressed by the language used, and not the intention which may have existed in the [maker's] minds . . ., but is not expressed by their language

Intent Prevails Over Canons/Rules" Canon" The intention of the parties, when ascertained, prevails over arbitrary rules of construction

Four Corners Canon: court must look at the entire instrument to ascertain the intent of the parties

Harmonizing Canon: that every part of the instrument should be harmonized and given effect to, if it can be done. If that cannot be done, and it is found that the deed contains inherent conflict of intentions, then the main intention, the object of the grant being considered, shall prevail

"*Non-Printed Prevails Over Printed" Canon*

Party Canons

"Construe Against the Scrivener" Canon To the extent the court can identify a party who has either drafted an instrument or has provided the particular form used, the canon requires that the uncertainty be resolved against that party

"Construe Against the Lessee" Canon oil and gas lessee was usually the provider of the lease form, or the scrivener of the lease

"Construe Against the Grantor" Canon (sometimes referred to as "construe in favor of the grantee" canon) grantor normally writes the deed

Greatest Estate Canon the largest estate, both in terms of duration and area, will be conveyed when the language is in doubt.