

LEGAL ISSUES OF INTEREST TO THE KANSAS GEOLOGIST

by

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Presented to the Western Kansas Geological Society
May 14, 1987
Hays, Kansas

I. WHO "OWNS" THE MINERALS?

A. Owner Of Land Owns Minerals On Or In The Land.

1. Landowner has right to all that lies within the confines of the surface boundaries.
2. Ownership of minerals can be separated from ownership of the surface.
 - a. Creates a mineral estate and surface estate.
 - b. Unless the landowner has conveyed minerals in the property, unrestricted conveyance of the land will convey all minerals.
 - c. Document used to convey mineral estate called a "Mineral Deed."

B. Must Capture Minerals To "Perfect" Ownership

1. No problem with coal or other solid minerals.
2. Oil and gas, depending upon the degree of porosity and permeability of the reservoir, will move toward low pressure zones in the reservoir.
 - a. Drilling into the reservoir creates low pressure zones and causes the oil and gas to migrate toward the area affected by the well bore.
 - b. Oil and gas underlying one tract of land can be "drained" into another tract.
3. Courts had to determine the respective ownership rights of the parties.

4. Rule of Capture fashioned to allocate rights in minerals which could migrate within the reservoir.
 - a. When oil and gas move across surface boundaries, ownership, in effect, "shifts" to the landowner overlying the oil and gas.
 - b. However, to "perfect" ownership, the minerals must be reduced to possession through operations conducted within the surface boundaries of the land.
 - c. Properly conducted operations will vest ownership in the owner of the land from which the oil and gas are brought to the surface and "captured" - placed in a tank or pipeline.

C. Limits On Capture.

1. Correlative Rights Doctrine

- a. Recognizes that a person operating a well properly located on his land can significantly affect the rights of other property owners in the same reservoir.
- b. In an effort to protect the common rights of all owners overlying the reservoir, the Kansas Corporation Commission restricts each owner's right to produce from a reservoir so they will not:
 - (A) injure the reservoir to the detriment of others;
 - (B) take an undue proportion of the obtainable oil or gas; or
 - (C) cause undue drainage between developed leases.

Kan. Admin. Reg. §82-3-101 (16) (1987)
printed in 6 Kan. Reg. 501 (April 2, 1987).

2. Conservation Regulation

- a. Rule of Capture causes much of the oil and gas in the reservoir to be wasted through inefficient development practices.
- b. "Conservation" regulation required to protect the public, and producers, from the wasteful effects of an unrestrained rule of capture.

- c. Primary goal - to prevent "waste."
- d. Techniques used to prevent waste:
 - (1) Well location restrictions - spacing.
 - (2) Production limitations - prorationing.
 - (3) Coordinated development of the reservoir - unit operation (unitization).
- 3. Critique of the Rule of Capture - See D. Pierce, Coordinated Reservoir Development - An Alternative to the Rule of Capture for the Ownership and Development of Oil and Gas, 4 Journal of Energy Law and Policy 1-79, 129-170 (University of Utah College of Law 1983).

II. WHAT IS A "MINERAL?"

A. Defining The Scope Of "Minerals."

- 1. A mystery in most states. Courts addressing the issue have not successfully defined the term "minerals" or the phrase "other minerals."
- 2. A conveys to B "all the minerals in Section 30." What substances does B receive by this grant? What does A own?

Who owns the oil and gas? Helium, hydrogen, and carbon dioxide? Is coal, recoverable only through surface mining, included in the grant?

Do we classify everything as animal, vegetable, and mineral so that B owns the soil on the surface of Section 30?

- 3. Interpretive guides:
 - a. Construe against grantor - If the minerals are severed as part of a conveyance of real property, construe the deed against the grantor so as to pass the largest estate possible to the grantee. Kan. Stat. Ann. §58-2202 (1983).
 - b. Community knowledge test - Include the substance in the definition of minerals only if it was generally known to exist at the time of the conveyance. See Roth v. Huser, 147 Kan. 433, 76 P.2d 871 (1938).

- c. Surface destruction test - Include the substance in the definition of minerals only if it can be extracted without significant destruction of the surface. See Payne v. Hoover, Inc., 486 So.2d 426 (Ala. 1986).

- d. Miscellaneous factors -

Some courts focus on the unique character of the mineral and refuse to include common varieties of minerals such as sand, gravel, and stone, which require destruction of the surface to mine.

Some courts look to extrinsic evidence of what the parties were attempting to do when the conveyance was made. For example, a conveyance of all minerals to an oil and gas operator may be more limited than a similar conveyance from a father to his son. Some courts declare the conveyance ambiguous and consider extrinsic evidence of each party's intent.

- 4. Most cases addressing this issue (like the "other minerals" issue addressed below) concern mineral conveyances as opposed to mineral leases. When the scope of a mineral deed is at issue, courts are more inclined to construe ambiguous language in favor of the grantee. However, courts will favor the grantor (lessor) when the language appears in an oil and gas lease.

- 5. Observation - courts often inclined to adopt a rule for determining "title" to a substance which will not surprise the owner of the surface estate. Scope of the grant often restricted to protect surface estate from a claim to mine unspecified minerals which would cause significant surface damage.

B. What Minerals Are Included In A Grant Of Oil, Gas, And "Other Minerals?"

- 1. Texas' attempt to define "other minerals."

- a. Refuse to apply ejusdem generis. Southland Royalty Co. v. Pan American Petroleum Co., 378 S.W.2d 348 (Tex. 1964).

- b. If the severance is made after June 8, 1983 (or if the surface and mineral estates were divided prior to June 8, 1983 but merge and are separated again after June 8, 1983) - the

phrase "other minerals" includes "all substances within the ordinary and natural meaning of that word, whether their presence or value is known at the time of the severance." Moser v. United States Steel Corp., 676 S.W.2d 99 (Tex. 1984).

- (1) However, previous Texas decisions holding a substance belongs to the surface owner, as a matter of law, are still effective. Court in Moser lists cases on building stone, limestone, caliche, surface shale, water, sand, gravel, "near surface" lignite, iron, and coal.

Must still use Acker v. Guinn test to determine what is "near surface" lignite, iron, and coal.

- (2) No free "reasonable use" surface easement for substances included under the "other minerals" definition. Must pay for all surface destruction caused when extracting unspecified substances included in the grant.

c. If the severance is made on or before June 8, 1983, the tests created by Acker v. Guinn, 464 S.W.2d 348 (Tex. 1971); Reed v. Wylie, 554 S.W.2d 169 (Tex. 1977) (Reed I); and Reed v. Wylie, 597 S.W.2d 743 (Tex. 1980) (Reed II) must be used. Friedman v. Texaco, Inc., 691 S.W.2d 586 (Tex. 1985); Atlantic Richfield Co. v. Lindholm, 714 S.W.2d 390 (Tex. App. 1986).

- (1) Acker v. Guinn - Surface Destruction Test: if you have to destroy the surface to remove an unspecified "mineral," it is not a mineral included in a grant of "other minerals." It belongs to the surface owner.
- (2) Reed I - if substantial quantities of the mineral lie so near the surface that extraction, at the time of the conveyance, would consume, deplete, or destroy the surface, the mineral belongs to the surface owner. (holding revised by Reed II)
- (3) Reed II - substances "near the surface" are part of the surface estate if any

reasonable method of production, at the time of conveyance or thereafter, would consume, deplete, or destroy the surface.

(i) Any deposit within 200 feet of the surface is "near the surface" as a matter of law.

(ii) If surface owner establishes ownership of substance at or near the surface, the surface owner owns the substance at all depths.

4. Oklahoma has applied the ejusdem generis maxim. Vogel v. Cobb, 193 Okla. 64, 141 P.2d 276 (1943); West v. Aetna Life Ins. Co., 536 P.2d 393 (Okla.App. 1974).

5. The Kansas approach to the "other minerals" problem.

a. Kansas courts have applied the community knowledge and surface destruction tests to the "other minerals" situation, but have relied more strongly on the ejusdem generis maxim.

b. Ejusdem generis - where a general description follows a more specific description, the general is limited to items encompassed by the specific. Keller v. Ely, 192 Kan. 698, 702, 391 P.2d 132, 135 (1964).

c. Example: in Keller v. Ely a reservation of "all of the oil, gas, casing-head gas and other liquid semi-solid and solid minerals . . ." was held not to include gypsum because " . . . the general terms contained in the reservation must be deemed to embrace and include only those things similar in nature to those previously specifically enumerated - that is, oil, gas and kindred minerals." Keller, 192 Kan. at 703, 391 P.2d at 136.

d. Court in Keller also purports to apply the community knowledge test, surface destruction test, and Kan. Stat. Ann. §58-2202. Similar analytical sequence used in Wulf v. Shultz to hold a lease, granting the right "to dig, drill, operate and procure natural gas, petroleum and other mineral substances," does not include the right to mine limestone. [Note: Kan. Stat. Ann. §58-2202 not

applicable to a mining lease; construe against drafting party - usually grantee instead of the grantor].

- e. Problem with the current state of the law in Kansas - what sequence should be followed in deciding which test or maxim to apply before resorting to other tests or maxims?

C. Substances Encompassed By Terms "Oil and Gas."

1. A conveys to B "all the oil and gas in Section 30." What substances are included in the grant of "oil and gas?" Does it include helium or carbon dioxide - which are non-hydrocarbon gases? Does it include substances which are produced as a component of the oil and gas stream?
2. Northern Natural Gas Company v. Grounds, 441 F.2d 704 (10th Cir. 1971), cert. denied, 404 U.S. 951, 1063 (1971), rehearing denied, 404 U.S. 1065 (1971). Court had to determine whether a lease covering "oil and gas" included helium extracted from the gas stream by the lessee's gas purchaser.
 - a. Court refuses to apply ejusdem generis maxim to limit the term "gas" to oil-like hydrocarbon substances. Court holds: "absent specific reservations, the grant of gas by the leases covered all components of the gas, including helium." Northern Natural Gas Company, 441 F.2d at 715.
 - b. Here the helium was initially being produced as an impurity incidental to production of natural gas. It would have been impossible, or uneconomic, for the lessee to separate the helium and produce only natural gas at the well. The court apparently thought the fair and workable result would be to find helium, produced as a component of the gas stream, would be included in the grant of the major gas stream substance - natural gas. The lessor would be obligated to specifically exclude component substances from the grant.
3. Northern Natural Gas Company v. Grounds analysis would not apply when the substance in issue is not a "component" of the specifically conveyed substances ("oil and gas").
 - a. Example: A conveys to B the "oil and gas" in Section 30. B, drilling for oil, strikes an

almost pure deposit of carbon dioxide gas. Who owns the carbon dioxide under Section 30, A or B? Here the substance is not a component of the oil or gas stream. Instead the issue is the scope of the term "gas." Does it include a non-hydrocarbon gas like carbon dioxide?

(1) Kansas courts may be more inclined to apply ejusdem generis maxim in this situation.

(2) Community knowledge test may also be determinative - if the court chooses to apply it in this situation.

b. Where the substance is not a component of a listed substance, essentially have an "other minerals" interpretive problem.

III. THE DEVELOPMENT PROCESS

A. Persons Involved.

1. Landowner (Owner of the Oil and Gas Mineral Estate)

a. Geologist theorizes where accumulations of oil and gas are likely to occur.

b. Target area is identified and landman goes out to procure the right to explore for oil and gas in the target area.

(1) May obtain permit to conduct exploration activities - such as seismic surveys.

(2) Usually go ahead and obtain an Oil and Gas Lease which permits the developer to conduct exploration activities and to drill for, produce, and retain a share of oil and gas produced from the land.

c. Attorney involved to ensure an oil and gas lease is obtained from the proper persons owning an interest in the mineral estate.

Often the attorney does not review title until the developer has decided to drill on the leased land. Attorney then prepares a document called a "drilling opinion" or "drill site title opinion" which identifies all owners of the mineral interest and any title problems.

2. Developer

- a. Landowners seldom develop their minerals. Instead, they authorize others to enter their land to explore, develop, and market minerals.
- b. Contract used to state rights between landowner and developer called an "Oil and Gas Lease."

(1) Landowner is the lessor.

(2) Developer is the lessee.

3. Other Working Interest Owners

- a. Developer, under the oil and gas lease, is said to have a "leasehold" or "working" interest in the property. Developer has the right to enter the property and "work" or "develop" it.

- b. Original lessee (developer) often leverages the risk of development by bringing in other developers or investors.

- c. May divide up the working interest and sell part of it to other developers or investors.

(1) An "assignment" is a transfer of all or part of the rights created by a contract.

(2) Oil and gas lease assignment is a transfer of all or part of the rights created by the oil and gas lease.

- d. Can create operating and nonoperating rights in the oil and gas lease.

(1) Operating interest - undivided share of the working interest.

(2) Nonoperating interest - right to a share of production payable out of the production allocated to the working interest under the oil and gas lease.

Most common forms of nonoperating interests: Overriding Royalty and Production Payment.

- e. Operating and nonoperating interests often

created to compensate persons for services or investment capital.

f. Where more than one person owns part of the working interest in a lease, they coordinate development and operation of the lease through a contract called an Operating Agreement.

(1) Designates one party as the operator responsible for the day-to-day operation of the well.

(2) Specifies rights of working interest owners in the operation and development of the well.

4. Contractors, Subcontractors, Suppliers

a. Major contractor will be the drilling company.

(1) Drill well pursuant to various types of drilling contracts.

(2) Drilling company may be entitled to a "lien" on the leasehold to "secure" payment of work it provides on credit.

b. Other interested parties will be those who perform labor or provide material or services in conjunction with the drilling and operation of the leasehold.

5. Transporters of Production

a. Traditionally, purchaser of production also the transporter.

b. This is changing, particularly with the "new" deregulated gas market. FERC Orders 436 and 451.

c. May enter into a transportation agreement to move oil or gas from field to the ultimate purchaser.

6. Purchasers of Production

a. Gas Sales Contracts and Oil Sales Contracts govern the transaction.

b. Division Order is a contract between the seller of the production and the purchaser.

Specifies the share of production the owner agrees to accept as compensation for their ownership interest. Also contain other terms concerning the sale.

- c. Transfer Order is a direction to the purchaser to pay production proceeds to a transferee of the current owner of production identified in the division order.

7. Other Interest Owners

- a. Banks may have loaned money to any one of the interest owners and taken a security interest in their oil and gas rights as collateral for the loan.
- b. Other contractual rights may exist in the oil and gas interests. For example: a farmout agreement where the original lease owner assigns the lease to the developer retaining various rights in the event the developer finds production and is able to recover the costs of drilling and completing the well.
- c. Tax liens, other creditors of the parties.

IV. THE OIL AND GAS LEASE

- A. Basic transaction for developing oil and gas in America is for the landowner to "lease" the minerals, and associated surface easements, to a developer.
- B. Generally, the relationship created by the oil and gas lease is not governed by landlord/tenant law.
 - 1. Special rules have been developed by the courts to govern the oil and gas lessor/lessee relationship.
 - 2. There has also been some statutory intervention governing the relationship. For example: Kan. Stat. Ann. §§55-223 through 55-229 (1983) address the lessee's implied obligation to explore and develop the lease.
- C. No standard "form" of oil and gas lease. Veverka v. Davies & Co., 10 Kan.App.2d 578, 584, 705 P.2d 558, 563 (1985) (concurring opinion; no such thing as a "standard" oil and gas lease form, reference to "Producer's 88" is meaningless). Fagg v. Texas Co., 57 S.W.2d 87 (Tex.Com.App. 1933) ("the character of printed matter contained in any designated class of oil and gas lease form depends on what matter various designers of such forms may deem appropriate - and may vary accordingly.").

- D. Although there is no standard form of oil and gas lease, oil and gas leases create a standard relationship. See D. Pierce, Rethinking the Oil and Gas Lease, 22 Tulsa Law Journal 445-481 (University of Tulsa College of Law 1987); See generally M. Merrill, Covenants Implied in Oil and Gas Leases §§220-223 (2d ed. 1940).
1. The relationships created by varying oil and gas lease forms are typically identical in structure.
 2. Courts and legislatures have fashioned rules to respond to the relationship, not necessarily the terms of a particular lease form.
- E. The basic structure of the standard relationship consists of the following:
1. Lessee given option to conduct operations on the leased land for a specified term.
 2. Lessee must pay a "rental" if development is not immediately pursued. This is an interim fee to maintain the option in effect.
 3. If lessee discovers oil or gas during the option period, the grant is extended until it is no longer profitable for the lessee to produce existing wells.
 4. Lessee pays all the costs and keeps all the revenue, subject to an obligation to pay or deliver a cost-free share of production to lessor.
- F. The basic structure of the oil and gas lease, like the relationship it creates, has become standardized, consisting of the following clauses:
1. Granting Clause.
 2. Habendum (Term) Clause.
 3. Drilling/Delay Rental Clause.
 4. Royalty Clause.
- G. Granting Clause - defines the scope of the rights conferred upon lessee.
1. Land encompassed by the grant. Surface and subsurface extent.
 2. Purpose of the grant.

3. Substances encompassed by the grant.
 4. Easement burdening the surface estate necessary to exercise the grant.
- H. Habendum (Term) Clause - defines the duration of the grant.
1. Primary term - the period of time, specified in the lease, during which it will remain in effect. (Subject to the operation of other clauses which may extend or reduce the specified term.)
 - a. Example: "This lease is for a term of three years from the effective date"
 - b. Also known as the "term" clause.
 2. Secondary term - a contingency which extends the lease beyond the primary term.
 - a. Example: "This lease is for a term of three years from the effective date and so long thereafter as oil or gas, or either of them, is produced from the leased land."
 - b. Also known as the "thereafter" clause.
- I. Drilling/Delay Rental Clause - limits the duration of the lease unless the lessee develops the leased land or pays a "rental" to delay development.
1. Limitation on the primary term of the lease.
 2. Lessee has the option to either drill or pay delay rental. Unless the lessee drills or pays rental, the lease terminates.
- J. Royalty Clause - specifies the lessor's share of production, substances subject to the royalty obligation, costs chargeable to lessor's share, how it will be valued and paid, and when it is payable.
- K. Miscellaneous Express Clauses - most of the remaining clauses found in the typical lease are designed to expand or qualify the operation of the four basic clauses. For example:
1. Pooling Clause provides a mechanism to expand the scope of the habendum clause and modify the drilling/delay rental and royalty clauses.

2. Completion, dry hole, cessation, shut-in royalty, and force majeure clauses are designed to expand the duration of the lease under the habendum clause.

L. Judicially-Defined Implied Obligations - express lease clauses are affected by judicial attempts to balance the relative positions of the lessor and lessee under the standard relationship created by the oil and gas lease.

V. KEEPING THE LEASE ALIVE

A. Habendum Clause Establishes Duration Of The Lease.

1. Other clauses, such as the drilling/delay rental clause, may limit the duration of the lease.
2. Other clauses may extend the lease.

B. Consists Of A Primary Term And Secondary Term.

1. Primary term is the definite period of time, stated in the lease, that the lease will be in effect.

a. Example: "This lease is for a term of two years from the effective date"

b. Also called the "term clause."

2. Secondary term is the indefinite period during which the lease will be extended by its express terms.

a. Example: "This lease is for a term of two years from the effective date and as long thereafter as oil or gas, or either of them, is produced from the leased land."

b. Also called the "thereafter clause."

C. Habendum Clause Creates A "Special Limitation" On The Grant.

1. This is an area where the lease "contract" is treated more like a conveyance.
2. If the requirements of the habendum clause are not met, the lease terminates. The terms of the habendum clause are a "special limitation" on the leasehold grant. Kansas courts will not extend the grant beyond the period stated in the lease. Reese Enterprises, Inc. v. Lawson, 220 Kan. 300,

310, 553 P.2d 885, 894-95 (1976).

- a. Not a forfeiture; no equity to mitigate.
- b. Acts of God and the lessee's good faith will not mitigate the termination. Kahm v. Arkansas River Gas Co., 122 Kan. 786, 791-92, 253 P. 563, 566 (1927).

3. Similar approach followed in Oklahoma and Texas.

D. Production Requirement.

- 1. Typical habendum clause extends the grant "for so long as oil or gas is produced."
- 2. Kansas - Must be actual production at the end of the primary term.
 - a. Substance must be produced and marketed on the date the primary term ends or the lease terminates. Baldwin v. Oil Company, 106 Kan. 848, 850, 189 P. 920, 921 (1920).
 - b. Similar rule applied to defeasible term mineral interests. Home Royalty Ass'n v. Stone, 199 F.2d 650, 653 (10th Cir. 1952).
- 3. Oklahoma - Discovery of production satisfies the habendum clause. A reasonable time is allowed to initiate marketing of production. McVicker v. Horn, Robinson & Nathan, 322 P.2d 410 (Okla. 1958) (contrasts the Kansas position).
- 4. Texas - Follows the Kansas rule. Production requires marketing.
- 5. Well not completed by end of primary term - Lessees responded with express lease provisions allowing lessee to "complete" a well which was "commenced."
- 6. Well completed but unable to market production by end of primary term - Lessees responded with shut-in royalty clause to avoid situations like Elliott v. Oil Co., 106 Kan. 248, 187 P. 692 (1920), where lessee had, during the primary term, completed several productive gas wells on the land but was unable to get it hooked up to a pipeline prior to the end of the primary term. Held: lease terminated.
- 7. Most leases have a shut-in royalty clause to address the delayed marketing of gas. Consider

Collins v. Oil & Gas Co., 85 Kan. 483, 487-89, 118 P. 54, 56 (1911) where the lessee completed five oil wells but failed to produce because of the depressed price of oil. Held: lease terminated.

8. Even though the lease is producing when the primary term ends, lease remains in effect only so long as production continues.
9. Lease forms often expand the habendum clause by specifying events which will extend the lease without actual production or discovery of production. For example, gas storage, pooling, unitization, shut-in royalty, commencement of a well, operations, completion of a dry hole.

E. Paying Quantities.

1. Phrase "so long as oil or gas is produced" means produced in paying quantities. Pray v. Premier Petroleum, Inc., 233 Kan. 351, 353, 662 P.2d 255, 257 (1983); Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959).
 - a. Same rule applied to defeasible term mineral interests. Texaco, Inc. v. Fox, 228 Kan. 589, 582, 618 P.2d 844, 847 (1980).
 - b. Commercial quantities = paying quantities. Texaco, Inc. v. Fox.
2. Depending upon the context in which it is used, "paying quantities" may have different meanings.
 - a. When used in habendum clause of lease or defeasible term mineral interest, it requires "production of quantities of oil or gas sufficient to yield a profit to the lessee over operating expenses, even though the drilling costs, or equipping costs, are never recovered, and even though the undertaking as a whole may result in a loss to the lessee." Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 311, 553 P.2d 885, 895-96 (1976).
 - b. When used in a drilling or development contract, or continuous development covenant in a lease, the costs of drilling and completing the well would be included to determine whether a party was required to drill or continue development. Wolf Creek Oil Co. v. Turman Oil Co., 148 Kan. 414, 419-20, 83 P.2d 136, 139-40 (1938).

3. To maintain a lease, or defeasible term mineral interest, the lessee must:

"[O]perate the lease to produce those quantities of oil or gas which will produce a profit, however small, over operating expenses, after eliminating the initial cost of drilling and equipping the well or wells on the lease which are required to prepare the lease for production."

Reese, 220 Kan. at 314, 553 P.2d at 897.

4. To determine profit, Kansas courts use an objective test which employs a mathematical computation. If gross income exceeds lease operating costs, there is production in paying quantities.

- a. Lessee's good faith judgment regarding profitability immaterial.

- b. Objective approach goal - keep lessee from holding unprofitable leases for speculation.
Reese, 220 Kan. at 314, 553 P.2d at 897.

- c. NOTE: waiting for the price of oil to rise to make the operation profitable would seem to be the sort of speculation the objective approach is designed to prevent.

5. Texas Approach - Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959):

"In the case of a marginal well, . . . 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."

Whether there is a reasonable basis for the expectation of profitable returns from the well is the test."

6. Two major problems in determining profitability:

- a. What items to charge as expenses and include as income; and

- b. The period of time over which profitability should be considered.

F. Cessation Of Production.

1. If lessee quits producing during the primary term, absent other lease clauses or implied covenant problems, the cessation will not affect the lease. Baker v. Huffman, 176 Kan. 554, 557, 271 P.2d 276, 278 (1954).
2. If lessee quits producing during the secondary term, the lease will terminate if the cessation is "permanent" as opposed to "temporary." Wrestler v. Colt, 7 Kan.App.2d 553, 556, 644 P.2d 1342, 1345 (1982).
3. If cessation is temporary, lessee has "only a reasonable time, under all the circumstances, to return the leasehold to production in paying quantities." Wrestler, 7 Kan.App.2d at 558, 644 P.2d at 1347.
4. Reason for the temporary cessation exception - parties to the lease, recognizing the realities of oil and gas operations, must have intended "production" to mean production with its normal interruptions for well maintenance, reworking, and similar activities which require a temporary cessation of actual production. Wilson, 164 Kan. at 236, 188 P.2d at 905-06.
5. To determine whether cessation is permanent or temporary, Kansas courts will consider evidence addressing the following three questions:
 - a. How long has the lease failed to produce in paying quantities?
 - b. What caused the cessation of production?
 - c. What was the lessee's intent when operations were discontinued?
6. Duration of the lessee's failure to produce.
 - a. Time alone is not determinative. Kelwood Farms, Inc. v. Ritchie, 1 Kan.App.2d 472, 479, 571 P.2d 338, 344 (1977).
 - b. The time factor will be significantly influenced by the cause of the cessation and lessee's actions during the cessation.

7. Cause of the cessation.
 - a. Often it is the decisive factor.
 - b. For example, all recoverable production has been obtained.
8. Lessee's intent.
 - a. Court tends to look at objective acts as opposed to subjective intentions. Lessee's conduct during the cessation is important.
 - b. Even though all recoverable production has been obtained through primary and secondary operations, lessee's conduct may indicate the cessation is temporary because of immediate acts to commence tertiary recovery. Contrast Wrestler v. Colt.
9. Cessation problem often addressed by special lease clauses.

G. Shut-In Royalty Clause.

1. What happens if a well is drilled, it is not a dry hole, it is capable of producing, but lessee is unable to produce the well because there is no market for production? Lease terminates unless there is production. Shut-in Royalty Clause designed to substitute a periodic cash payment for actual production.
2. Traditional Approach - Limit scope of clause to gas. Make payment of shut-in royalty the event which maintains the lease in effect.
 - a. "[I]f there is a gas well . . . on the . . . land . . . and such well or wells are shut in before or after production therefrom, lessee . . . may pay . . . at the end of each yearly period during which such gas well or gas wells are shut in, as substitute gas royalty, a sum equal to the amount of delay rentals . . . and if such payments or tenders are made it shall be considered under all provisions of this lease that gas is being produced" Paragraph #3 - Form 88.

- b. "Where there is a gas well, or wells on the lands covered by this Lease . . . and such well or wells are shut-in, and there is no other production [or other clause] keeping this Lease in force . . . , Lessee shall pay as royalty to Lessor . . . the sum of \$1.00 per year per net royalty acre . . . and upon such payment it shall be considered that this Lease is maintained in full force and effect." Paragraph #4 - Form 690.

3. Major Problems:

- a. Often special limitation language is used in shut-in royalty clauses. This seems odd since a lessee will seldom want to surrender a well, or wells, capable of producing in paying quantities. See, e.g., Amber Oil & Gas Co. v. Bratton, 711 S.W.2d 741 (Tex. Ct. App. 1986) (lessee accidentally paid shut-in royalty to wrong party - lease terminated).
- b. When can lessee declare a well shut in and for what purposes?
- c. Clause limited to gas.
- d. Should there be a limit on how long it can be shut in?

VI. ASSIGNMENTS

A. Working Interest In Property Often Owned By Many People.

- 1. Lessee can divide and convey the working interest much like the mineral interest owner divides and conveys the mineral interest.
- 2. Can convey or except divided and undivided interests, can divide the leasehold horizontally and vertically, limit it to a specified term or until the occurrence of a specified event, can convey or except operating and nonoperating interests.
- 3. Since we are conveying rights in personal property, represented by a contract, the conveyance instrument is generally termed an "assignment."

4. Convey less than all the lessee's rights under the lease - call it a "partial assignment."

B. Ability to Assign.

1. Unless expressly prohibited by the lease terms, the oil and gas lease is freely assignable. Matthews v. Ramsey-Lloyd Oil Co., 121 Kan. 75, 81-82, 245 P. 1064, 1067 (1926).
2. Lessee, and intended assignee, must carefully review the lease to determine if it limits lessee's ability to assign. Consider Moherman v. Anthony, 103 Kan. 500, 175 P. 676 (1918).

C. Requirements for a Valid Assignment.

1. Although oil and gas lease not a real property interest, it still creates an interest in land and is governed by the same conveyance formalities required for a conveyance of real property. Therefore, requirements similar to those required for a conveyance.
2. Parties to the assignment:
 - a. Lessee (assignor) and grantee (assignee).
 - b. Lessor not a necessary party - unless lease requires lessor's consent.
 - c. Lessee's spouse, unless a named grantee in the lease, is not a necessary party. Since lease is personal property, interest not subject to spouse's homestead or inchoate statutory rights.
3. Words of conveyance should be appropriate for an interest in personal property - "assigns" or "transfers."
4. Leases subject to the assignment must be adequately described. State the real property covered by the lease and assignment, followed by a description of each lease by its date, the names of the lessor and lessee, and the book, page, and county where the lease is recorded.

See generally Luthi v. Evans, 223 Kan. 622, 576 P.2d 1064 (1978).

5. Normally not signed by the assignee. However, since the assignment is not effective unless and until assignee accepts the conveyance, may be advisable to include an acceptance line for the assignee's signature.
6. Record to provide constructive notice. K.S.A. §58-2221 (1983) provides: "any estate or interest created by an oil and gas lease, or whereby any real estate may be affected . . . may be recorded"

D. Identifying the Interest Assigned.

1. Can limit assignment by area, substance, and duration. Can impose new obligations on assignee.
2. Depth Limitations.
 - a. Try to eliminate uncertainty concerning where the division begins and ends. Requires technical assistance concerning the location and configuration of underlying rock.
 - b. Goal is to use descriptions which avoid the possibility of splitting a reservoir.

E. Nonoperating Interest Problems.

1. Most problems relate to the limited nature of the nonoperating interest.
2. Overriding royalty and production payments are dependent upon the continued validity of the leasehold interest from which they are carved.
3. If the lease is cancelled, surrendered, or terminates, the working interest from which the nonoperating interest is carved, and the nonoperating interest, terminate. See Campbell v. Nako Corporation, 195 Kan. 66, 402 P.2d 771 (1965) and 198 Kan. 421, 424 P.2d 586 (1967).
4. To protect the nonoperating interest, they must try and obtain, through the assignment document, some measure of control over the working interest owner.

F. Preventing Intentional Destruction Of The Nonoperating Interest.

1. Working interest owner may, through collusion with the lessor, attempt to terminate the lease to extinguish a nonoperating interest.

a. What is the nature of the relationship between operator and nonoperator? Fiduciary?

b. Robinson v. Eagle-Pitcher Lead Co., 132 Kan.860, 297 P. 697 (1931). No fiduciary relation created by sublease. Court notes, however, if sublease contained provision making sublessor's rights [overriding royalty retained by sublessor] applicable to modifications, renewals, or extensions of the sublease, a fiduciary relationship may have been created - citing Probst v. Hughes, 143 Okla. 11, 12, 286 P. 875, 876 (1930).

c. Howell v. Cooperative Refinery Ass'n, 176 Kan. 572, 271 P.2d 271 (1954). Howell assigned interest to CRA, reserving an overriding royalty. Assignment expressly provided override would burden the "oil and gas leasehold estate, or any extension or renewal thereof" CRA permitted the lease to expire in September 1950 and obtained a new lease directly from the lessor in October 1951. Howell asserted a breach of fiduciary duty and therefore CRA's new lease was burdened by Howell's override.

Court finds that under certain factual settings the relationship of the parties may be fiduciary. Here the court finds Howell and CRA had a form of "joint interest" in the enterprise because Howell was obtaining leases for CRA. Therefore, a fiduciary relationship existed between Howell and CRA and the new lease was burdened by Howell's override. Howell, 176 Kan. at 577, 271 P.2d at 275.

2. Prevent problems by placing a broad extension and renewal clause in the assignment. For example:

The obligation to pay the overriding royalty required by this assignment shall exist for the

life of the oil land gas lease plus any extensions and renewals of the lease. For purposes of this paragraph, any leasehold interest covering any portion of the Assigned Property, acquired by assignee within 2 year(s) following the termination, cancellation, or surrender of the oil and gas lease, shall be deemed an "extension or renewal."

G. Unintentional Destruction of Nonopertaing Interest.

1. Can impose duties upon assignee to maintain the lease. Establish a standard of care so that if the assignee, for example - misses a delay rental payment, the assignor will be entitled to compensation.
2. Best way to protect assignee's interest is to impose a reassignment obligation upon the assignor. For example:

Assignee will not surrender, abandon, or otherwise permit or cause the lease to terminate without offering to reassign the lease to assignee at least thirty days prior to any action or inaction by assignee which would terminate the lease.

- a. Will assignee warrant title to the reassigned interest? Will it be subject to burdens created by assignee prior to reassignment? How will assignor's damages be calculated in the event assignee fails to reassign the lease and it terminates? Market value of the override or market value of the leasehold?
- b. Should address these matters in the reassignment provision. For example:

If assignor [A] elects to have the lease reassigned to it, assignee [B] will immediately prepare an assignment of the lease containing a special warranty that the lease is free of any encumbrances or defects caused by B and that B will warrant and defend title against anyone claiming by, through, or under B. Any liens, encumbrances, or burdens created against the Assigned Property after the date of this ASSIGNMENT, shall terminate upon reassignment to A.

- c. See suggested form - D. Pierce, Kansas Oil and Gas Handbook §7.25 (Kansas Bar Association 1986).

H. Working Interest Owner's Implied Obligations To Nonoperating Interest Owner.

1. To what extent can the nonoperating interest owner assert, for example, an implied obligation to drill an initial well, further develop the leased land, or have it protected from drainage?
2. Matthews v. Ramsey Lloyd-Oil Co., 121 Kan. 75, 245 P. 1064 (1926). Assignor retained a \$30,000 production payment. Court holds no obligation on assignee to drill well to try and obtain production to satisfy the production payment. No express provisions in assignment so look to the lease - delay rental clause allows assignee to delay development by paying lessor. NOTE: court found primary consideration for the assignment was a \$12,000 cash payment, not the \$30,000 production payment. May have a different result if the only consideration for the assignment was the production payment.
3. Assignee may want express language in assignment to negate the possibility of implied obligations to nonoperating interest owner.
4. Nonoperating interest owner may want express covenants to protect their interest, or at least the right to enforce the express and implied obligations created by the oil and gas lease.
5. See sample form - Handbook §7.25.

VII. THE MECHANIC'S LIEN

A. Lien Defined

1. An interest created in property to secure payment of a debt. The lien entitles the lien holder to sell property subject to the lien (foreclose) and apply the proceeds towards payment of the debt.
 - a. Lien can be created by agreement.
For example:

Real estate mortgage - in return for

Bank lending you money to buy a house, you agree to give the Bank a mortgage on the house to secure repayment of the amount due.

The "note" specifies the terms of the loan and payment obligations. The "mortgage" is the security agreement where the Bank is given rights in the property to protect it from failure or inability to repay according to the terms of the note.

- b. Lien can be created by statute.
For example:

If you agree to provide on-site geological services to a lessee, and such services relate to the operation of an oil or gas well, K.S.A. §55-207 (1983) creates a lien against the leasehold to secure payment for the services.

Retention of services without payment must result in unjust enrichment to the lessee.

Lien claimant must carefully comply with all time and filing requirements to obtain the lien.

- 2. Mechanic's Lien - Statutory right created in favor of persons who improve property by supplying labor or materials.

B. K.S.A. §§55-207 through 55-210 (1983).

- 1. Grant a statutory lien to persons who provide labor or materials in the development of an oil and gas lease.
- 2. To claim any benefits under this statutory lien, technical requirements of the relevant statutes must be strictly met.
- 3. Services of an on-site geologist - including examination and analysis of well cuttings, preparation of daily logs, and supervision of testing procedures - held in DaMac Drilling, Inc. v. Shoemaker, 11 Kan.App.2d 38 (1986) to be lienable labor under K.S.A. §55-207 (1983).

4. Definition of "labor" adopted by the court in interpreting K.S.A. §55-207:

"Work performed in the on-site advancement of the construction, repair or operation of an oil and gas well such that the leasehold owner would be unjustly enriched if not burdened by a lien shall constitute lienable labor under K.S.A. 55-207 regardless of whether it involves manual or mental toil.

C. Benefit Of The Lien.

1. If properly filed to give the public notice of your rights, the property will be subject to your lien even if sold to a third party.
2. Ability to force a sale of the encumbered property to generate proceeds to apply toward payment of your services.
3. If debtor files for bankruptcy, your claim will be paid, if assets are available, ahead of any "unsecured" creditors.
4. May want to consider additional protection through security agreements which provide broader rights in collateral than those conferred by statute.

VIII. THE FUTURE OF OIL AND GAS LAW

- A. To a great extent, oil and gas law is unresponsive to the physical nature of the resource.
- B. The evolution of oil and gas law will be largely influenced and guided by the sciences of petroleum geology and petroleum engineering.

**Title: LEGAL ISSUES OF INTEREST TO THE KANSAS
GEOLOGIST**

Date: May 14, 1987

Location: Hays, Kansas

**Program: Annual Meeting of the Western Kansas
Geological Society**

Sponsor: Western Kansas Geological Society

Duration: Three Hours