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Present

AN INTRODUCTION TO KANSAS OIL & GAS LAW

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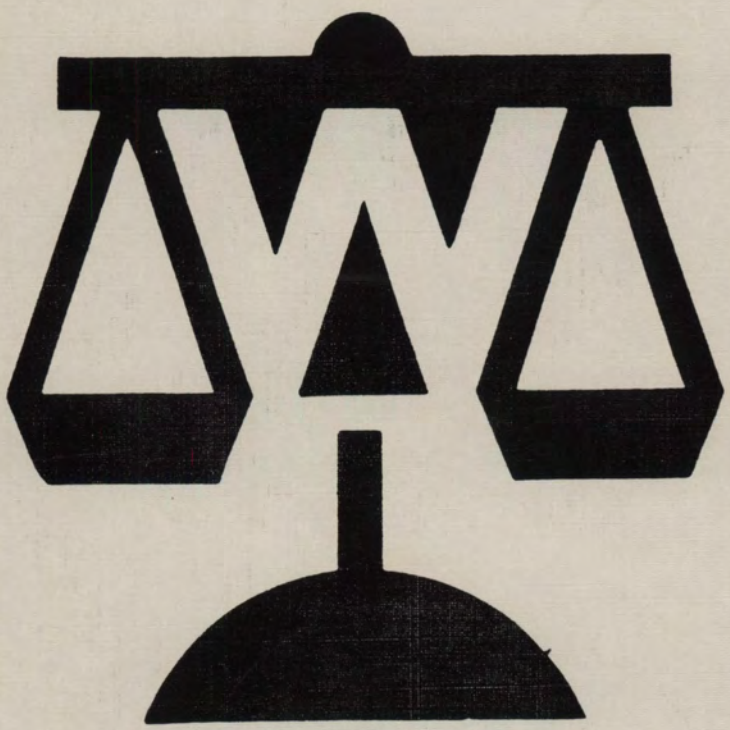

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Overland Park, Kansas

AN INTRODUCTION TO KANSAS OIL & GAS LAW

presented for the

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by

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Outline Table of Contents

AN INTRODUCTION TO KANSAS OIL AND GAS LAW

PART 1 - DEFINING THE OIL & GAS PROPERTY INTEREST

I. TECHNICAL BACKGROUND

A. Petroleum Geology

1. Organic theory of petroleum ("oil and gas") formation: Through geologic time, marine plants and animals died creating an accumulation of organic material which mixed with eroded rock material. This mixture ultimately became deposited as beds of sediment at the bottom of ancient seas. As this material became buried by other sediments, heat, pressure, radiation, bacterial action, and other processes converted the accumulated organic material into petroleum.

   a. "Source Rock" refers to the shale beds where the transformation of the mixture into petroleum initially took place.

   b. "Reservoir Rock" refers to the more porous and permeable sandstone and limestone where the petroleum is commonly found.

2. Through geologic time the petroleum is squeezed out of the shale source rock, by the compaction process, into the more porous and permeable sandstone and limestone reservoir rock.

   a. Petroleum squeezed from the source rock generally travels upward toward the surface of the earth.

   b. Typically, there will be sea water in the reservoir rock which is partially displaced by the migrating petroleum.

   c. If the migration is stopped by an impermeable rock barrier, a reservoir of oil and gas is formed.

d. If the reservoir contains gas, oil and water, these substances will separate with gas in the upper portions of the reservoir, oil in the middle, and water at the bottom.

3. Rock formed by sediments is deposited in layers called "strata." Through geologic time the earth's "crust" (the portion of the earth varying from 10 to 30 miles deep from the surface) is subjected to warping, breaking, and other movements which deform the rock strata. This process forms various types of reservoirs where commercial accumulations of oil and gas are often found.

   a. Often the movement of strata will create hills or valleys of sedimentary rock where petroleum can accumulate. These reservoirs are created by "anticlines" (hills) and "synclines" (valleys). A steep hill-like structure is called a "dome."

   b. Sometimes the reservoir rock will shift and be placed opposite impermeable rock. The resulting reservoir is created by the "fault" in the rock structure.

   c. Reservoirs are also formed when an upper portion of the reservoir rock becomes impermeable due to porosity or permeability changes.

4. Petroleum is not found in underground caverns or streams. Instead, petroleum is contained in minute spaces between the grains of material that form the rock.

   a. Petroleum is normally found in sedimentary rock which possesses the physical properties of "porosity" and "permeability."

   b. Porosity refers to the amount of space, between rock grains, in which oil, gas, and water can accumulate.

   c. Permeability refers to the interconnection of the rock spaces so that material within the spaces can be transmitted from pore to pore.

B. Reservoir Mechanics

1. The reservoir, in its natural state, is under pressure.

   a. Once the reservoir is opened (by drilling a well), the oil, gas, and water will move toward the low pressure zone created by the well.

   b. Oil is produced through a displacement process. The oil will move toward the low pressure zone created at the well bore. Gas or water will move in to fill the pore space previously occupied by oil.

2. Three types of reservoir drive mechanisms:

   Dissolved Gas Expansion (Solution Gas Drive)
   Gas-Cap Expansion
   Water Encroachment

3. Dissolved Gas Expansion (Solution Gas Drive).

   a. As reservoir pressure is reduced by the well, gas dissolved in the oil is liberated from the oil. This liberated gas then fills the pores previously occupied by the oil and begins to displace the oil.

   b. As reservoir pressure declines, larger quantities of gas will be released and increasing amounts of gas will be produced by the well as oil production declines.

   c. Least efficient reservoir drive mechanism; recover from 5% to 30% of the oil in the reservoir.

4. Gas-Cap Expansion.

   a. Oil in the reservoir is saturated with dissolved gas and excess gas is compressed and found free in a cap laying over the oil zone.

   b. Energy to move the oil to the well bore is supplied by the compressed gas cap which tends to flush the oil downward out of the upper portions of the

reservoir.

c. In addition to the energy from the gas cap, the gas dissolved in the oil will also provide energy to displace the oil.

d. Properly operated gas-cap expansion reservoir can recover from 20% to 50% of the oil in the reservoir.

5. Water Encroachment.

a. Water at the bottom and edges of the reservoir creates pressure against the upper zones of oil and gas.

b. When oil and gas are produced, water will encroach from the bottom of the reservoir flushing the oil and gas upward.

c. Properly operated water encroachment reservoir can recover from 35% to 75% of the oil in the reservoir.

6. Combination Drive Reservoir.

a. Have free gas in a cap over the oil zone and water under the oil zone.

b. Also have dissolved gas in the oil which is released when the reservoir pressure drops.

7. Reservoir development must be planned to make maximum use of the natural reservoir energy.

a. Improper location or completion of wells can reduce the efficiency of the reservoir drive mechanisms.

b. Improper rates of production can reduce the efficiency of the reservoir drive mechanism.

8. Enhanced recovery techniques are used to produce oil remaining in the reservoir after natural reservoir drive forces are no longer effective.

a. Natural reservoir drive forces - Primary Production.

b. Artificial reservoir drive forces - Secondary and Tertiary Production. Collectively called "enhanced recovery" techniques.

c. Waterflooding - common form of secondary recovery. Inject water in designated wells to flush oil toward a production well.

d. Gas Injection - another form of secondary recovery. May also reinject produced gas or water to prolong primary production from the reservoir.

e. Tertiary recovery encompasses the more exotic techniques used to recover residual oil. Can use a solvent, detergent, or heat to move the oil toward the well. For example, carbon dioxide injected into the reservoir will dissovle into the crude oil, reduce its viscosity, and move the oil, or lighter hydrocarbons, toward a production well.

9. A single oil and gas reservoir may underly hundreds or thousands of acres of surface area. This surface area may be owned by thousands of different property owners. Any overlying property owner drilling into the reservoir may impact the quantity of oil and gas other owners are able to recover from the reservoir. See Figure 7. This impact can occur in two ways:

   a. Oil and gas produced by the developer reduces the amount available for production by others owning interests in the reservoir.

   b. Improper drilling, completion, or production practices may injure, or fail to maximize, the natural reservoir drive forces causing a reduction in the amount of recoverable oil and gas.

10. A single owner drilling into the reservoir can significantly affect the amount of oil and gas that other owners can recover from the same reservoir.

II. OWNERSHIP

A. Ownership In Place Theory

1. Owner of the land owns the surface and any minerals beneath the surface.

2. Kansas, in Zinc Co. v. Freeman, 68 Kan. 691, 696, 75 P.995, 997 (1904), adopted the "ownership in place" theory of oil and gas ownership.

   a. The person vested with title to land is deemed to presently own, in addition to surface rights, any oil, gas, or other minerals which may be located beneath the surface boundaries of the land. Magnusson v. Colorado Oil and Gas Corp., 183 Kan. 568, 574, 331 P.2d 577, 582 (1958); Gas Co. v. Neosho County, 75 Kan. 335, 337-38, 89 P. 750, 751-52 (1907) (ownership in place rule applied to oil and, in a companion case, to natural gas).

   b. Upon receiving title to a parcel of land, the landowner obtains a present right to all oil, gas, and other minerals within the land.

B. Rule of Capture

1. Although the landowner has a present ownership interest in oil and gas beneath their land, rights in the resource are lost once it moves outside surface boundaries. Zinc Co. v. Freeman, 68 Kan. 691, 696, 75 P. 995, 997 (1904).

2. Oil and gas can migrate, within the reservoir, in response to pressure changes created by wells drilled into the reservoir.

3. To perfect ownership of oil and gas, it must be reduced to possession through the process of "capture."

4. The rule of capture protects the adjacent landowner who properly completes a well in the common reservoir and causes oil and gas to migrate across surface boundaries toward their land.

a. Adjacent landowners must protect their land from drainage by development of their own land. Carlock v. Krug, 151 Kan. 407, 411, 99 P.2d 858, 861 (1940).

b. Rule of capture gives landowners the right to drill wells, bottomed anywhere within the surface boundaries of their property, and to obtain legal title to all the oil and gas they could produce from such wells, even though some or most of it was drained from under land owned by others.

5. Kansas Supreme Court recently applied the rule of capture to the production of natural gas injected into a gas storage reservoir. The party injecting the gas was not a public utility authorized to condemn the reservoir for storage, nor had it obtained the right to use the reservoir underlying adjacent lands. Anderson v. Beech Aircraft Corp., 237 Kan. 336, 699 P.2d 1023 (1985).

6. Although Kansas recognizes the rule of capture, the landowner has certain rights which can be enforced to protect oil and gas while still in the reservoir - correlative rights and conservation regulation.

III. LIMITATIONS ON THE RULE OF CAPTURE

A. Correlative Rights

1. The correlative rights doctrine recognizes that a person operating a well properly located on their land can significantly affect the rights of other property owners in the same reservoir.

2. Unrestrained, an absolute right to drill and produce as one pleases from a reservoir could destroy the ability of others to try and capture oil and gas beneath their property.

3. Cannot take action which will injure the reservoir so other owners in the common resource are unable to exercise their opportunity to capture.

B. Conservation Regulation

1. Used to protect correlative rights and "prevent waste."

2. Establishes some ground rules for exercising the right to capture oil and gas.

3. Oil and gas are natural resources in which the public has a strong interest.

4. Rule of capture causes much of the oil and gas in the reservoir to be wasted through inefficient production practices. Such practices are employed to maximize the individual's self-gain at the expense of the other owners overlying the reservoir.

5. Public's interest - obtain maximum recovery of oil and gas at the lowest cost. Ensure the resource is not used for inferior purposes. Failure to obtain maximum recovery at the lowest cost is "waste."

6. Conservation techniques used to prevent or control waste include:

   a. Location Restrictions - require a minimum distance between producing wells and require wells to be drilled a minimum distance from lease or property lines.

   b. Production Restrictions - control the rate of production to achieve orderly removal of the resource.

   c. Pooling - permit separate properties to be operated as a production unit to comply with location restrictions. In Kansas pooling is not required by statute. Voluntary pooling agreements are "encouraged" by production restriction practices.

   d. Unitization - operate entire reservoir as a single property unit. Surface boundaries used only to calculate each party's share in total production from the reservoir.

7. Kansas Corporation Commission administers the Kansas oil and gas conservation program.

IV. SURFACE AND MINERAL INTEREST RELATIONSHIPS

A. The Surface and Mineral Estates.

1. Ownership of minerals underlying a tract of land can be conveyed separately from the overlying surface interest.

2. Upon conveyance of an interest in some or all of the minerals in a tract of land, two separate property interests are created: a surface estate and a mineral estate. Zaskey v. Farrow, 159 Kan. 347, 351, 154 P.2d 1013, 1015-16 (1945).

   a. Two separate fee simple estates are created. Each is potentially infinite in duration and can be disposed of by gift, sale, or inheritance. Crowe Coal & Mining Co. v. Atkinson, 85 Kan. 357, 360, 116 P. 499, 500 (1911).

   b. Severance of the mineral estate from the surface estate can occur by granting a mineral estate or by granting the surface estate and excepting (and reserving) a mineral estate. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 89, 69 P.2d 4, 7 (1937).

   c. Conveyance of a mineral estate is accomplished by a document called a "mineral deed." Hickey v. Dirks, 156 Kan. 326, 327, 133 P.2d 107, 109 (1943).

B. The Mineral Estate

1. Owner of a mineral interest has the right to enter the land encompassed by the mineral interest to explore for, develop, and produce the minerals. Corbin v. Moser, 195 Kan. 252, 257, 403 P.2d 800, 804 (1965).

   a. Can authorize others to develop the property for the mineral interest owner's benefit.

   b. Mineral owners typically do not develop their mineral interest, but instead contract with a developer to conduct exploration, development, and production operations.

2. Mineral interest includes the right to develop, the right to authorize others to develop, and the right to any benefits under development contracts with third parties.

C. Right to Use Surface Estate

1. If a mineral deed, or oil and gas lease, merely grants the right to develop oil and gas, without addressing surface access rights to conduct operations, the grantee, or lessee, has an implied right to make reasonable use of the surface to facilitate operations.

2. Texas - defines the implied easement to include the right to take materials from the leased land necessary to support reasonable operations under the grant.

   For example, in Sun Oil Co. v. Whitaker, 483 S.W.2d 808 (Tex. 1972), the lessee had the right to use fresh groundwater to conduct secondary recovery operations.

   NOTE: In Sun the lease provided: "Lessee shall have free use of oil, gas, coal, wood and water from said land except water from Lessor's wells for all operations hereunder . . . ." The Court of Civil Appeals held this language was ambiguous and the parties did not intend to allow the use of large quantities of water necessary for secondary recovery operations. However, the Supreme Court held the right to use the water was encompassed by the implied easement without reference to the express lease provisions.

3. In Kansas the scope of the surface easement remains undefined.

   a. Thurner v. Kaufman, 237 Kan. 184, 188, 699 P.2d 435, 439 (1984) ("Under an oil and gas lease, the lessee has the implied right to make reasonable use of the surface in order to develop the land for the oil and gas." - dicta).

   b. Brooks v. Mull, 147 Kan. 740, 746-47, 78 P.2d 879, 883 (1938) (implied easement when surface estate is severed from the mineral estate).

4. Dominant/Servient Estates.

   a. Most states view the mineral estate as the "dominant" estate with the surface estate being "servient" to the mineral estate. This has affected, to some extent, the scope of the developer's implied easement.

   b. Texas recognizes a limited obligation to accommodate the surface owner's interests when it can be done without unduly burdening the owner of the mineral interest. Getty Oil Co. v. Jones, 470 S.W.2d 618 (Tex. 1971). However, the Texas accommodation doctrine only applies when the lessee's proposed use unduly impairs lessor's preexisting use of the land and reasonable alternatives exist for the lessee.

   c. Kansas does not treat the mineral estate as dominant to the surface estate. The Kansas position is stated in Rostocil v. Phillips Petroleum Company, 210 Kan. 400, 502 P.2d 825 (1972):

      "The obvious intent of the parties under . . . [an oil and gas] lease is that the licensed privileges of the lessee are to run hand in hand with those reserved to the lessor with neither interfering more than need be with the continuing uses of the other - the one for the exploration, production and transportation of minerals and the other for the pursuit of agriculture."

      Although the Kansas approach remains undefined, it would appear an expanded accommodation obligation could be fashioned by the courts. Consider Hunt Oil Co. v. Kerbaugh, 283 N.W.2d 131 (N.D. 1979).

      See generally, Pierce, Toward a Functional Mineral Jurisprudence for Kansas, 27 Washburn L. J. 223 (1988).

5. Must the developer pay for surface damage caused by its exercise of the implied easement?

a. This is an area undergoing major change. See generally Polston, Surface Rights of Mineral Owners - What Happens When Judges Make Law and Nobody Listens? 63 North Dakota L. Rev. 1 (1987).

b. Oklahoma - Surface Damages Act, Okla. Stat. Ann. tit. 52 §§ 318.2 - 318.9 (West 1987).

c. See Davis Oil Co. v. Cloud, 57 O.B.J. 2885 (Nov. 22, 1986) (Oklahoma Court of Appeals applies the Act retroactively and refuses to apply a reasonable use standard for determining when surface damages are due).

d. Texas - adheres to the traditional common law rule that so long as the surface use is reasonably necessary for the exploration, production, or marketing of the granted substances, no payment for surface damage is required. (Unless the lease expressly requires payment of damages). Moser v. United States Steel Corp., 676 S.W.2d 99 (Tex. 1984).

NOTE: Moser limits the free easement rule to substances expressly identified in the grant. Substances included in a grant of "other minerals" requires that the lessee pay for any surface damage relating to their extraction.

6. Courts have attempted to protect the surface owner's interests by manipulating title to the resource. If the developer lacks title to substances that require significant surface damage for their extraction, the surface interest is protected. However, other important interests may be thwarted in the process. See Pierce, Toward a Functional Mineral Jurispurdence for Kansas, 27 Washburn L. J. 223 (1988).

V. DEFINING THE SCOPE OF A MINERAL CONVEYANCE

A. Conveyance of "All Minerals"

1. A conveys to B "all the minerals in Section 30." What substances will B receive by this grant? What will 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?

2. 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. E.g., 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 Wulf v. Shultz, 211 Kan. 724, 728, 508 P.2d 896, 900 (1973).

   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.

e. Most cases addressing this issue (like the "other minerals") 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.

For a statutory statement of this interpretive rule see North Dakota Cent. Code § 47-10-24 (1983).

f. 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. See Keller v. Ely, 192 Kan. 698, 700-01, 391 P.2d 132, 134 (1964); In re Estate of Trester, 172 Kan. 478, 483, 241 P.2d 475, 478 (1952).

B. Conveyance 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.

(3) 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).

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.

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)

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.

2. Oklahoma applies the ejusdem generis maxim. Oklahoma v. Butler, 58 Okla. B. J. 3412 (Dec. 8, 1987); Vogel v. Cobb, 193 Okla. 64, 141 P.2d 276 (1943); West v. Aetna Life Ins. Co., 536 P.2d 393 (Okla.App. 1974).

3. 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?

4. For a suggested approach to the "mineral," "other mineral," and surface damage issues, see: Pierce, Toward a Functional Mineral Jurisprudence for Kansas, 27 Washburn L. J. 223 (1988).

VI. COMMONLY CREATED OIL AND GAS PROPERTY INTERESTS

A. The Mineral Estate

1. Can divide the mineral estate as follows:

a. Divided Interest.

Example: A owns all the mineral estate in Section 30. A conveys to B all the minerals in the East 1/2 of Section 30.

b. Undivided Interest.

Example: A conveys to B an undivided one half interest in all the minerals in Section 30.

c. Term Interst.

Example: A conveys to B all the minerals in Section 30 for a term of 3 years.

d. Defeasible Interest.

Example: A conveys to B all the minerals in Section 30 for so long as oil or gas is produced from Section 30.

e. Defeasible Term Interest.

Example: A conveys to B all the minerals in Section 30 for 3 years and so long as oil or gas is produced from Section 30.

f. Future Interests.

Example: A conveys all the minerals in Section 30 to B for life, remainder to C.

g. Depth Limitations.

Example: A conveys to B all the minerals in Section 30 from the surface down to 3000 feet below the surface.

h. Substance Limitations.

Example: A conveys to B all the natural hydrocarbon gas in Section 30.

i. Nonparticipating Interests.

Example: A conveys to B 1/16th of all oil and gas produced from Section 30, free of any of the costs of production. [NOTE: under Kansas law, this conveyance violates the Rule Against Perpetuities.]

j. Combination of the noted limitations.

2. Can also subject the mineral estate to contractual limitations.

a. Most common contractual limitation is the granting of a license to explore, develop, and produce oil and gas.

b. License called an "Oil and Gas Lease."

B. The Leasehold Estate.

1. Usually the mineral interest owner transfers

their development rights to a person or entity specializing in oil and gas development.

a. Instrument used to transfer development rights called an "Oil and Gas Lease."

b. The lessee (developer) obtains the mineral interest owner's right to enter the premises and conduct exploration, development, and production operations.

2. When a lease is granted the lessor still owns all the mineral interest. None of the minerals have been conveyed to the lessee. The lessee merely has a contractual right to develop and produce minerals from the mineral estate. The mineral interest owner's property right in the minerals is subject to the terms of the oil and gas lease.

3. Under the oil and gas lease the landowner typically receives compensation in the form of a bonus, possible delay rental, and a cost-free share of any minerals produced, called a royalty.

a. Bonus - money paid by developer (lessee) to induce mineral interest owner (lessor) to enter into an oil and gas lease.

b. Delay Rental - money paid to lessor by lessee, pursuant to an oil and gas lease, as rent for the privilege of delaying drilling operations on the leased land.

c. Royalty - a share of oil and gas produced from the mineral interest free of any costs of production.

4. Leasehold estate can be fractionated much like the mineral interest. Absent limiting language in the lease, A can assign divided, undivided, term, defeasible term, and various future interests out of the leasehold. A can limit the assignment by depth or substance.

5. Any rights carved from the leasehold estate are limited by the terms of the oil and gas lease. If the lease terminates, anything created out of the lease will likewise

terminate. See Campbell v. Nako Corporation, 195 Kan. 66, 402 P.2d 771 (1965).

6. Leasehold Interest or Working Interest - refers to the rights which the lessee has under the oil and gas lease (the basic right being the right to "work" the property for the granted minerals).

   a. Assignment of an undivided interest in the leasehold gives the assignee an undivided working interest - often called an "operating" interest because the assignee can enter and work the property subject to the lease.

   b. Can also create "nonoperating" interests in the leasehold. Nonoperating means the holder of the interest does not have the power to enter the leased premises to conduct development operations. It is merely an economic interest in oil and gas when, and if, it is produced. Common nonoperating interests include:

      (1) Overriding Royalty - a right to a share of oil and gas from the leased land free of the cost of production. Payable out of the working interest from which it is carved.

      (2) Production Payment - a right to a share of oil and gas from the leased land free of the cost of production but limited to a specified quantity or value of production.

      (3) Net Profits Interest - a right to a share of oil and gas from the leased land free of the cost of production but payable only when the lessee earns a net profit from its operations. Difficulty is defining what costs will be deducted from revenue to determine whether a net profit has been realized.

7. Oil and gas lease typically requires lessee to pay lessor a fraction (traditionally 1/8th) of production as a royalty. This

would entitle the lessee to the remaining 7/8ths of production from which the lessee would pay for the costs of exploration, development, and production.

Any nonoperating interests created by lessee will be payable out of lessee's share of production.

For example: A leases his mineral estate to B. The lease entitles A to a 1/8th royalty. B is entitled to the remaining 7/8ths of production, but must pay 8/8ths of all costs of production.

To obtain funds to help pay for the drilling, B assigns an overriding royalty to C which entitles C to 1/16th of 8/8ths of all oil and gas produced from the leased land. Production and costs will be allocated as follows:

B (lessee) pays 8/8ths of the costs [under the terms of the oil and gas lease and the overriding royalty assignment].

B will receive 13/16ths of the production [7/8ths granted under the oil and gas lease less 1/16th of 8/8ths of production assigned to C].

A will receive 1/8th of the production [under the terms of the oil and gas lease].

C will receive 1/16th of the production [under the terms of the overriding royalty assignment].

VII. CONCURRENT INTERESTS

A. The Undivided Interest

1. A can convey an interest in Section 30 by conveying to B a one-half "undivided" interest in Section 30.

2. A and B would then own all of Section 30 as cotenants with each owning an undivided one-half interest in Section 30.

3. A and B each have the nonexclusive right to possession of Section 30. Mulsow v. Gerber

Energy Corp., 237 Kan. 58, 62, 697 P.2d 1269, 1273 (1985).

B. Rights of Concurrent Owners

1. In Kansas, each owner of an undivided interest in the mineral estate has the right to enter the property to explore for, develop, and produce oil and gas. Each owner can contract with a third party to develop the property. Compton v. People's Gas Co., 75 Kan. 572, 89 P. 1039 (1907).

2. If one cotenant enters the property and produces oil and gas, a portion of the production belongs to the other cotenant.

3. When oil and gas are produced by a cotenant, the producing cotenant must account to nonconsenting cotenants for their share of production. Prewett v. Van Pelt, 118 Kan. 571, 235 P.1059 (1925).

4. The producing cotenant is permitted to deduct the nonconsenting cotenants'proportionate share of the reasonable costs of development, production, and marketing. Krug v. Krug, 5 Kan.App.2d 426, 428, 618 P.2d 323, 325 (1980).

5. The burden of proving deductible costs is on the producing cotenant. Johnson v. Gas Co., 90 Kan. 565, 135 P. 589 (1913).

6. The developing cotenant is entitled to reimbursement from nonconsenting cotenants only to the extent there is production from the specific well from which they receive a share of production. Davis v. Sherman, 149 Kan. 104, 86 P.2d 490 (1939).

7. Rationale for allowing the developing cotenants to recover their costs out of the nonconsenting cotenants' share of production: unjust enrichment (quasi-contract). Krug, 5 Kan.App.2d at 429, 618 P.2d at 325.

C. Cotenant Development Problems

1. Assume A and B each own an undivided one-half interest in Section 30. Even though A has the right to develop the property without B's

consent, as a practical matter A will not develop because A must assume all the risk and, if successful, will only receive one-half the production following payment of development costs.

2. Problems in determining what are reasonable costs in the event a producing well is drilled. See, e.g., Brown v. Loriaux, 189 Kan. 56, 366 P.2d 1016 (1961).

3. Ratification: Nonconsenting cotenant may be able to ratify a favorable lease negotiated by consenting cotenant when the lease purports to lease the entire interest in the property. Depending upon the terms of the lease, this may require payment of a portion of the bonus to the nonconsenting cotenant in addition to his proportionate share of the delay rental and royalty. Brooks v. Mull, 147 Kan. 740, 78 P.2d 879 (1938).

VIII. SUCCESSIVE INTERESTS

A. Common Form of Successive Interests

1. The right to possession and enjoyment of the property is held, at different times, by different owners. The right to possession precedes or follows another person's right to possession.

2. Example - A is given a life estate in Section 30 with a remainder in B. A, as the life tenant, has the right to immediate possession of Section 30. B has a vested remainder in Section 30.

   B's interest is a future interest which becomes possessory upon A's death.

3. Major problem is determining who has the right to develop the property when there are successive interests.

B. Authority to Develop

1. Unlike cotenants, successive interest owners, absent express authorization or conduct by the grantor, do not have the authority to independently develop the mineral potential of the property subject to their interest.

2. The life tenant and all remaindermen must join in the conveyance or development contract. Neither the life tenant, nor the remaindermen, have the power to independently convey or develop the property.

3. The remaindermen lack a possessory interest to permit access to the property and the life tenant lacks the authority to do anything with the property which would be adverse to the future estate of the remaindermen. Cannot commit waste.

4. Exceptions to the rule:

   a. Express Authorization in the Deed: The instrument creating the life estate can confer upon the life tenant the power to lease or convey the property without being liable to remaindermen.

   b. Open Mine Doctrine: If the property was leased or being operated for oil and gas prior to commencement of the life estate, the life tenant can continue such operations.

   c. Consent of Remaindermen: The remaindermen can agree to permit the life tenant to convey or lease the property.

C. Dividing Proceeds of Development

1. Instrument creating the interest will govern; if it addresses the matter.

2. Instrument silent, but open mine doctrine applies, life tenant gets all the development proceeds accruing during his life. Kimbark Exploration Company v. Von Lintel, 192 Kan. 791, 793, 391 P.2d 55, 58 (1964).

3. Instrument silent, open mine doctrine does not apply, oil and gas considered part of the corpus of the estate which must be held for the benefit of the remaindermen. See Burden v. Gypsy Oil Co., 141 Kan. 147, 40 P.2d 463 (1935).

   a. Royalty is principal to be held for the benefit of the remaindermen.

b. Delay rental and interest on royalty is income payable to the life tenant.

c. Bonus - undecided how it will be treated.

4. Arguable whether the allocation rules established in Burden and Kimbark cases have been changed with the enactment of the Revised Uniform Principal and Income Act ("UPIA"), K.S.A. §§58-901 to 58-917 (1983).

a. UPIA provides "rules for the guidance of fiduciaries to determine what is principal and what is income, to determine who is entitled to income, and to determine the allocation of expenses to each." Pederson v. Russell State Bank, 206 Kan. 718, 721, 481 P.2d 986, 988 (1971).

b. UPIA expressly applies only to trustees. Other provisions of the UPIA suggest it applies to administrators and executors during estate administration. Issue is whether it applies to non-trust interests. Apparently, the UPIA will be applied when the person in possession of the non-trust interest has fiduciary obligations to manage an asset similar to those imposed on a trustee. See Kumberg v. Kumberg, 5 Kan.App.2d 640, 623 P.2d 510 (1980) and Kumberg v. Kumberg, 232 Kan. 692, 702, 659 P.2d 823, 832 (1983) (approve, without discussion, court of appeals use of UPIA).

c. If UPIA applies, K.S.A. §58-909 (1983) specifies how lease and development proceeds will be allocated.

(1) Delay Rental (and possibly Shut-In Royalty) - Income.

(2) Royalty, Overriding Royalty, Bonus:

(i) 22% of gross receipts (but not to exceed 50% of net receipts) - Principal

(ii) 78% of gross receipts (after paying all expenses from such gross receipts) -Income

d. UPIA will not apply when the instrument creating the interest provides for allocation of principal and income. K.S.A. §58-902(1) (1983).

D. Contingent Successive Interests

1. Typical successive interest does not present much of a problem for the developer, you just obtain a lease from the life tenant and all the remaindermen. However, problems arise when the interest of the remaindermen is not "vested" but instead is "contingent," "subject to divestment," or shared with members of a class who you cannot presently identify.

2. Preference for early vesting of testamentary gifts. "Where a life tenancy and remainders are carved out of an estate by will, and the remaindermen are in esse, definitely ascertained, and nothing but their death before the termination of the life tenancy can defeat their title, the remainders thus created and bestowed by the will are vested absolutely in the remaindermen." Anderson v. Wise, 144 Kan. 612, 618, 62 P.2d 805, 809 (1936).

3. However, if the interest is vested, but subject to divestment, the remaindermen cannot convey a marketable interest. See Ghormley v. Kleeden, 155 Kan. 319, 124 P.2d 467 (1942).

4. Similar problem with contingent remainders. See Robinson v. Barrett, 142 Kan. 68, 45 P.2d 587 (1935) and Pedroja v. Pedroja, 152 Kan. 82, 102 P.2d 1012 (1940).

5. Procedure for leasing or developing land subject to contingent interests:

a. Kansas has a common law procedure which has developed under traditional equity jurisdiction.

b. District court can appoint a trustee for unknown contingent executory devisees and contingent interest holders with the authority to enter into an oil and gas lease and hold the proceeds from the lease until the contingencies are

determined. Robinson, 142 Kan. at 71, 45 P.2d at 589.

(1) Proceeding "to preserve the property from immediate loss and diminution to be divided or distributed by order of the court when the contingency shall have concluded." Robinson, 142 Kan. at 73, 45 P.2d at 590.

(2) Proceeding contemplates a need for immediate action, such as development occuring in the general area. Pedroja v. Pedroja, 152 Kan. 82, 102 P.2d 1012 (1940).

IX. INTERESTS LIMITED BY DURATION OR EVENT

A. Defeasible Term Mineral Interests

1. The mineral estate, as with other interests in land, can be limited for a specified time or until a specified event occurs. The most common limitation is created by a limitation on the grant which requires production of oil or gas in paying quantities after a specified period of time.

2. Example - A grants B all the oil, gas, and other minerals in Section 30 "for a period of twenty (20) years from and after April 25, 1941 . . . and so long thereafter as oil, gas and/or other minerals or any of them are produced therefrom." Classen v. Federal Land Bank of Wichita, 228 Kan. 426, 427, 617 P.2d 1244, 1257 (1980).

3. Creates a fee simple determinable, generically referred to as a "defeasible fee" or "base fee."

   a. Title vests immediately in grantee subject to grantor's possibility of reverter in the event production of the stated substance fails to occur or continue. See Wilson v. Holm, 164 Kan. 229, 234-35, 188 P.2d 899, 904 (1948).

   b. The grant is for a fixed "term" of years, followed by a contingency which extends the stated term.

c. The grant is "defeasible" because it will terminate twenty years after April 25, 1941 unless the required production is obtained.

d. Since the subject matter of the grant is a mineral interest, A has conveyed to B a "defeasible term mineral interest."

B. Extending Defeasible Term Mineral Interests

1. To extend the defeasible interest beyond the stated term, there must be production, from the conveyed land, in paying quantities.

2. Production from the Conveyed Land.

a. Assume: A owns the Northwest Quarter in each of Sections 6, 7, and 8. A grants to B, in a single mineral deed, all the oil and gas in the Northwest Quarter of Sections 6, 7, and 8, for three years from 26 June 1986 and for so long as oil or gas is produced from "said land."

In July 1989 there is a producing well on the Northwest Quarter of Section 6. There are no wells on Sections 7 or 8.

(1) Will production from the Northwest Quarter of Section 6 satisfy the production contingency as to the Northwest Quarter of Sections 7 and 8? Yes. No interest will revert to A. "Said land" refers to the entire tract (all three quarter sections) described in the granting clause.

(2) Production from any part of the described land will extend the defeasible term mineral interest. Baker v. Hugoton Production Company, 182 Kan. 210, 212, 320 P.2d 772, 774 (1958). See also Palmer v. Brandenburg, 8 Kan.App.2d 154, 157-58, 651 P.2d 961, 965 (1982).

b. So long as there is actual production from a portion of the conveyed land, the production contingency will be satisfied for all the land included in the grant.

c. Assume: Instead of having a well on the Northwest Quarter of Section 6, the Northwest Quarter is pooled with other Section 6 lands to form a 640 acre spacing unit. A producing well is completed on the Southwest Quarter of Section 6. Pursuant to the pooling agreement, the owners of interests in the Northwest Quarter of Section 6 receive a one-fourth share of all production from the well.

(1) If no other wells are located on the Northwest Quarter of Sections 6, 7, and 8, will the production contingency be met? Only the Northwest Quarter of Section 6 is extended by production from the Southwest Quarter of Section 6. The mineral interest in the Northwest Quarter of Sections 7 and 8 revert to the grantor. Classen v. Federal Land Bank of Wichita, 228 Kan. 426, 617 P.2d 1255 (1980).

(2) Acreage included in the grant, but not participating in production from the spacing unit, will not be held by pooled or unitized operations. Classen.

d. Assume: Same facts as in c. above, but instead of pooling the Northwest Quarter of Section 6, it is made part of a compulsory fieldwide unit pursuant to the Kansas Compulsory Unitization Act. Production from wells in the unit, but not on the Northwest Quarter of Section 6, are maintaining the unit in effect. Pursuant to the unit agreement, the owners of interests in the Northwest Quarter of Section 6 receive a proportionate share of all unit production.

(1) If no other wells are located on the Northwest Quarter of Section 6, 7, and 8, will the production contingency be met?

(2) Again, only the Northwest Quarter of Section 6 is extended by production from the unit area. The

mineral interest in the Northwest Quarter of Sections 7 and 8 revert to the grantor. Edmonston v. Home Stake Oil & Gas Corp., 243 Kan. 376 (1988).

e. Different rule applies when construing the habendum clause of an oil and gas lease. Somers v. Harris Trust & Savings Bank, 1 Kan.App.2d 397, 566 P.2d 775 (1977). If the foregoing example concerned an oil and gas lease instead of a defeasible term mineral interest, production from the Southwest Quarter of Section 6 would satisfy the production requirement for all the land included in the grant. [Assuming effective pooling of the interest and no Pugh clauses].

3. Practitioner must be vigilant to distinguish the defeasible term mineral interest from an oil and gas lease.

a. Defeasible term mineral interest conveyances normally lack most of the contractual protections granted the lessee in an oil and gas lease.

b. Example: Payment of shut-in royalties under a lease covering the mineral interest does not satisfy the "production" required to perpetuate the defeasible term mineral interest. Dewell v. Federal Land Bank, 191 Kan. 258, 263, 380 P.2d 379, 383 (1963).

c. Even though the reversionary interest owner and the defeasible term mineral interest owner grant leases to a third party, this will not alter the legal relationship between the parties granting the leases. Smith v. Home Royalty Association, 209 Kan. 609, 498 P.2d 98 (1972) (lease containing unitization clause executed by grantor and grantee of defeasible term mineral interest did not change rights between grantor and grantee) overruled in part by Classen (agreement between grantor and grantee not necessary as to portion of granted acreage committed to the unit).

4. Defeasible term mineral interest owner could try and obtain protections in the grant similar to those found in oil and gas lease. For example, pooling clause, shut-in clause, operations clause. However, in absence of an effective agreement between the defeasible term mineral interest grantor and grantee, acreage outside a producing unit will not be held by unit production.

X. DEPTH AND SUBSTANCE LIMITATIONS

A. Depth Limitations

1. The grantor can limit the mineral interest to a specified depth or interval beneath the surface.

2. A can convey to B all minerals located from the surface of Section 30 to a depth of 3,000 feet, or from the surface to the base of an identifiable formation. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 89, 69 P.2d 4, 7 (1937) (owner of land can divide it vertically and horizontally).

3. The grantor can also limit the grant to the minerals within a specified formation. Gas Co. v. Oil Co., 83 Kan. 136, 140, 109 P. 1002, 1004 (1910) (stratum in which oil and gas are found can be separated from remainder of the mineral estate).

B. Substance Limitations

1. The grantor can limit the mineral interest to specified substances.

2. For example, A could grant to B only the rights to natural gas and retain the other minerals, including oil. Skelly Oil Company v. Savage, 202 Kan. 239, 447 P.2d 395 (1968) (pooling clause applied only to "gas rights"); Arnold v. Garnett Light & Fuel Co., 103 Kan. 477, 174 P. 1027 (1918) (lessees separated oil from gas rights by contract).

XI. RIGHTS ASSOCIATED WITH A MINERAL INTEREST

A. Rights in the Mineral Interest

1. Courts recognize certain rights, attributable to a mineral interest, which can be separately owned and conveyed.

2. They are property rights associated with a mineral interest and necessary to permit enjoyment of the mineral interest.

3. Unless the conveyance instrument contains an express limitation, each owner of a mineral interest has the right to:

   a. Enter the land encompassed by the mineral interest to explore for and develop the minerals. Corbin v. Moser, 195 Kan. 252, 257, 403 P.2d 800, 804 (1965).

   b. Grant the right to explore and develop to a third party. Shepard, Executrix v. John Hancock Mutual Life Ins. Co., 189 Kan. 125, 133, 368 P.2d 19, 25 (1962).

   c. Receive any rights or benefits created pursuant to the grant in item b above. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 89, 69 P.2d 4, 7-8 (1937). Typically, these rights include:

      (1) Bonus - money paid by developer (lessee) to induce mineral interest owner (lessor) to enter into an oil and gas lease. Wright v. Brush, 115 F.2d 265, 267 (10th Cir. 1940).

      (2) Delay Rental - money paid to lessor by lessee, pursuant to an oil and gas lease, as rent for the privilege of delaying drilling operations on the leased land. State v. Board of Regents, 176 Kan. 179, 190, 269 P.2d 425, 433 (1954).

      (3) Leasing ("Executive") Right - mineral interest owner's right to contract for development of the mineral interest. Drach v. Ely, 237 Kan. 654, 658, 703 P.2d 746,

750 (1985).

(4) Royalty - a share of oil and gas produced from the mineral interest free of any costs of production. Shaffer, 146 Kan. at 89, 69 P.2d at 7.

B. Participating and Nonparticipating Interests

1. The mineral interest owner's executive rights, and related rights to bonus, delay rental, and royalty, are often collectively referred to as the mineral interest owner's right to "participate." Shepard, Executrix v. John Hancock Mutual Life Ins. Co., 189 Kan. 125, 133, 368 P.2d 19, 25 (1962).

2. If one or more of these rights is separated from the mineral interest, in Kansas it is called a "nonparticipating mineral interest" as to the incidents of mineral ownership which are not granted. Drach v. Ely, 237 Kan. 654, 659, 703 P.2d 746, 751 (1985) (mineral interest nonparticipating as to executive rights and the rights to receive bonus and delay rental).

Common usage - nonparticipating refers to severance of the executive right from the mineral interest.

C. Operating and Nonoperating Interests.

1. Usually the mineral interest owner transfers his development rights to a person or entity specializing in oil and gas development.

2. The instrument used to transfer development rights is the oil and gas "lease."

3. The lessee obtains the mineral interest owner's right to enter the premises and conduct exploration and development operations.

4. The lessor will normally have rights under the lease to bonus, delay rental, and royalty. In addition, the lessor has reversionary rights in the mineral interest when the lease terminates.

5. Leasehold Interest or Working Interest -

refers to the rights which the lessee has under the oil and gas lease. The lessee often conveys part of the working interest to other parties in return for development funds and services, or to secure financing. Unless restricted by the terms of the lease, the working interest, like the mineral interest, can be divided in many ways.

a. Example: A has a lease on Section 30. A can assign all of A's working interest in the East Half of Section 30 to B. B has a divided interest in the East Half of Section 30. A can also assign B an undivided interest in the Section 30 lease; A and B will then become cotenants of the working interest in Section 30.

b. A can also limit the working interest by depth, substance, and duration.

c. Cotenants of the working interest typically coordinate development through a joint operating agreement ("JOA").

6. Granting B an undivided interest in the Section 30 lease gives B an "operating" interest in the lease. B has a concurrent right, with A, to enter Section 30 and conduct development operations.

7. A can also create "nonoperating" interests in the Section 30 leasehold. Nonoperating means the holder of the interest does not have the power to enter the leased premises to conduct development operations. It is merely an economic interest in oil and gas when, and if, it is produced. Common nonoperating interests include:

a. Overriding Royalty - a right to a share of oil and gas from the leased land free of the cost of production. Payable out of the working interest from which it is carved; will terminate when the lease terminates. Campbell v. Nako Corporation, 195 Kan. 66, 402 P.2d 771 (1965).

b. Production Payment - a right to a share of oil and gas from the leased land free of the cost of production but limited to

a specified quantity or value of production.

(1) Limitation can be stated as a certain quantity of production from the lease - such as an agreement to deliver the first 20,000 barrels of oil produced from the lease to the holder of the production payment. McCrae v. Bradley Oil Co., 148 Kan. 911, 84 P.2d 866 (1938).

(2) Limitation can be stated as certain value of production - such as a production payment of $30,000 to be paid out of 1/2 of 7/8ths of the first oil produced from the lease. Matthews v. Ramsey-Lloyd Oil Co., 121 Kan. 75, 245 P. 1064 (1926).

c. Net Profits Interest - a right to a share of oil and gas from the leased land free of the cost of production but payable only if and when the lessee earns a net profit from his operations.

Difficulty is defining what costs will be deducted from revenues to determine whether a net profit has been realized. See generally Kumberg v. Kumberg, 232 Kan. 692, 659 P.2d 823 (1983).

d. Carried Interest - a working interest owner who, pursuant to an operating agreement, or as a non-consenting cotenant, refuses to join in development operations and the other working interest owners proceed with development. In such a case the developing working interest owners may agree to "carry" the other working interest owners by paying the full cost of development.

The developing owners will have the right to receive all of the "carried interest" owner's share of production until the carried interest owner's share of costs are recovered.

e. Convertible Interest - a nonoperating interest, such as an overriding royalty, may be convertible to an operating

PART 2 - THE OIL AND GAS LEASE

I. DEFINING THE RELATIONSHIP

A. Preliminary Considerations

1. Basic transaction for developing oil and gas in America is for the landowner to "lease" the minerals, and associated surface easements, to a developer.

2. Generally, the relationship created by the oil and gas lease is not governed by landlord/tenant law.

   a. Special rules have been developed by the courts to govern the oil and gas lessor/lessee relationship.

   b. 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.

3. 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.").

4. Although there is no standard form of oil and gas lease, oil and gas leases create a standard relationship. See Pierce, "Rethinking the Oil and Gas Lease," 22 Tulsa Law Journal 445 (1987); See generally M. Merrill, Covenants Implied in Oil and Gas Leases §§220-223 (2d ed. 1940); Polston, "Recent Developments in Oil and Gas Law," 6 Eastern Min. L. Inst. 19-1, 19-2 (1985).

   a. The relationships created by varying oil and gas lease forms are typically identical in structure.

b. Courts and legislatures have fashioned rules to respond to the relationship, not necessarily the terms of a particular lease form.

5. The basic structure of the standard relationship consists of the following:

a. Lessee given option to conduct operations on the leased land for a specified term.

b. Lessee must pay a "rental" if development is not immediately pursued. This is an interim fee to maintain the option in effect.

c. 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.

d. 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.

B. Basic Structure of the Oil and Gas Lease

1. The basic structure of the oil and gas lease, like the relationship it creates, has become standardized, consisting of the following clauses:

a. Granting Clause.

b. Habendum (Term) Clause.

c. Drilling/Delay Rental Clause.

d. Royalty Clause.

2. Granting Clause - defines the scope of the rights conferred upon lessee.

a. Land encompassed by the grant. Surface and subsurface extent.

b. Purpose of the grant.

c. Substances encompassed by the grant.

d. Easement burdening the surface estate

necessary to exercise the grant.

3. Habendum (Term) Clause - defines the duration of the grant.

   a. 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.)

      (1) Example: "This lease is for a term of three years from the effective date."

      (2) Also known as the "term" clause.

   b. Secondary Term - a contingency which extends the lease beyond the primary term.

      (1) 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."

      (2) Also known as the "thereafter" clause.

4. Drilling/Delay Rental Clause - limits the duration of the lease unless the lessee develops the leased land or pays a "rental" to delay development.

   a. Limitation on the primary term of the lease.

   b. Lessee has the option to either drill or pay delay rental. Unless the lessee drills or pays rental, the lease terminates.

5. 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.

6. 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:

a. Pooling Clause provides a mechanism to expand the scope of the habendum clause and modify the drilling/delay rental and royalty clauses.

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

7. 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.

II. GRANTING CLAUSE - SCOPE OF THE GRANT

A. Describing The Affected Land

1. Surface boundary limitations.

a. Not much of a problem in Kansas when lands are described by government survey. Greater problem in Texas where many descriptions reflect Spanish units of land measurement.

b. Mother Hubbard or Cover-All Clause - introduces uncertainty into the description which can generate disputes over the areal extent of the grant. See Jones v. Colle, 709 S.W.2d 8 (Tex. Ct. App. 1986). Can also cause constructive notice problems. See Luthi v. Evans, 223 Kan. 622, 576 P.2d 1064 (1978) (assignment of "all Oil and Gas Leases in Coffey County, Kansas" owned by grantor does not adequately describe property to impart constructive notice to persons without actual notice).

2. Depth limitations.

a. Select workable divisions. Avoid splitting potentially productive reservoirs. See Carter Oil Co. v. McCasland, 190 F.2d 887 (10th Cir. [Okla.] 1951); Carter Oil Co. v. State,

205 Okla. 541, 240 P.2d 787 (1951).

b. Avoid selecting formations to define depths when the limits of the formation (geological distinguishing characteristics) are not easily identifiable. May want to use other wells in the area as marker wells to identify specific formations by log references.

c. Obtain the necessary technical advice to prepare workable depth and formation limitations.

B. Substances Encompassed By The Grant

1. Typical form of lease granting clause leases all the "oil, gas, and other minerals." Have an interpretive problem regarding what is included in the grant of "other minerals." See discussion of this problem at V.B. (page 14) of this Outline.

2. 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.

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 inlcude 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.

4. For a recent analysis interpreting the term "gas" for purposes of the royalty clause, see First National Bank of Jackson v. Pursue Energy Corp., 784 F.2d 659 (5th Cir. 1986).

D. Purpose Of The Grant

1. Typically stated in conjunction with the substances included in the grant and the lessee's surface rights under the grant.

2. For example: Form 88 - (Producers)
Kan., Okla. & Colo. 1962 Rev. Bw
Paragraph #1

[Lessor] . . . "grants, leases, and lets exclusively unto lessee for the purpose of investigating, exploring, prospecting, drilling, mining and operating for and producing oil, liquid hydrocarbons, all gases, and their respective constituent products, injecting gas, water, other fluids, and air into subsurface strata, laying pipe lines, storing oil, building tanks, power stations, telephone lines, and other structures and things thereon to produce, save, take care of, treat, manufacture, process, store and transport said oil . . . and housing and otherwise caring for its employees . . . ."

3. Exclusive Rights?

a. The right to drill for, produce, and market oil and gas are impliedly exclusive to the lessee. However, some rights, unless exclusively granted to the lessee by the express terms of the lease, may be exercised concurrently by the lessor or a third party designated by the lessor.

b. Absent express limiting language in the lease, the lessor may grant a license to third parties allowing them to conduct geophysical operations on the leased land. Mustang Production Co. v. Texaco, Inc., 549 F.Supp. 424 (D. Kan. 1982), affirmed, 754 F.2d 892 (10th Cir. 1985); Roye Realty and Developing, Inc. v. Southern Seismic, 711 P.2d 946 (Okla. Ct. App. 1985); Shell Pet. Co. v. Puckett, 29 S.W.2d 809 (Tex. Civ. App. 1930).

c. The Mustang analysis could be applied to other rights granted under the lease. If the right is not exclusively granted, and the lessee and lessor could concurrently exercise the rights without interfering with one another, the lessor may be able to license others to exercise the right.

For example: The lessor might authorize another operator to build tanks, roads, or pipelines on the leased land.

E. Rights Incident To The Grant

1. Lease typically lists a number of things the lessee can do on the leased land. Paragraph #1 - Form 88; Paragraph #1 - Form 690.

a. Other portions of the lease may expand or define the items listed in the granting clause.

b. For example: Form 88 - (Producers)
Kan., Okla. & Colo. 1962 Rev.Bw
Paragraph #7

"Lessee shall have free use of oil, gas, and water from said land, except water

from lessor's wells and tanks, for all operations hereunder, including repressuring, pressure maintenance, cycling, and secondary recovery operations, and the royalty shall be calculated after deducting any so used.

"Lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by Lessee on said land, including the right to draw and remove casing.

"When required by lessor, lessee will bury all pipe lines below ordinary plow depth.

"Lessee shall pay all damages caused by its operations to growing crops on said land.

"No well shall be drilled within two hundred feet (200 ft.) of any residence or barn now on said land without lessor's consent.

"Lessor shall have the privilege, at his risk and expense, of using gas from any gas well on said land for stoves and inside lights in the principal dwelling thereon, out of any surplus gas not needed for operations hereunder."

2. If the lease merely grants the right to develop oil and gas, without addressing surface access rights to conduct operations, lessee has an implied right to make reasonable use of the surface to facilitate operations.

3. In Kansas the scope of the surface easement remains undefined. See discussion of the developer's right to use the surface estate at section IV.C. (page 10) of this Outline.

   a. Thurner v. Kaufman, 237 Kan. 184, 188, 699 P.2d 435, 439 (1984) ("Under an oil and gas lease, the lessee has the implied right to make reasonable use of the surface in order to develop the land for the oil and gas." - dicta).

b. Brooks v. Mull, 147 Kan. 740, 746-47, 78 P.2d 879, 883 (1938) (implied easement when surface estate is severed from the mineral estate).

4. Payment of Surface Damages. See discussion at section IV.C.5. (page 11) of this Outline.

a. Kansas - no definitive statement by the appellate courts.

b. Fast v. Kahan, 206 Kan. 682, 481 P.2d 958 (1971) suggests no payment is required absent an express lease provision.

c. Jensen v. Southwestern States Management Co., 6 Kan.App.2d 437, 441, 629 P.2d 752, 756 (1981) contains language (dicta) which broadly asserts an obligation to pay for any damage - probably limited to facts. Case concerned surface mining for coal where the deed expressly provided for a per/acre surface damage payment which was interpreted to require payment of the current market value of the surface when used.

d. Prediction - when the issue is presented, courts may be inclined to require payment for all damage to the surface. This appears to be the trend of courts and legislatures addressing the issue in recent years. Lessees have contributed to the trend by voluntarily paying damages for surface use within the scope of the implied easement.

5. Even though the oil and gas lease lists a number of permissible uses, many problems are not addressed. Must resort to the implied easement/reasonable use analysis to determine the rights between surface owner and lessee.

6. Many important issues undecided under the implied right - for example: What can lessor do on the property after a lease is granted? What is an unreasonable use? Must damages be paid for the use?

7. CAUTION: If the lessor is a severed mineral interest owner, must examine the deed

severing the minerals from the surface estate to determine if there is any limitation on the lessor's exercise of the implied right.

a. Lessor of the severed mineral interest cannot expand the implied development easement created by the deed severing the surface and mineral estates.

b. For example: a lease granting the right to use the surface of the leased land to support operations on neighboring lands would be beyond the implied right held by the owner of the severed mineral interest (the lessor).

F. Title to the Grant

1. In most leases the lessor purports to lease the entire mineral interest in the described land. If the lessor owns less than all the mineral interest, their delay rental and royalty is reduced to correspond to their proportionate mineral interest ownership. Lessor also warrants and agrees to defend title to the minerals covered by the lease. Lessee is given the right to discharge liens against the leased land and become subrogated to the lienholders' claims.

May also be implied warranty arising out of the words of grant or the transfer of a personal property interest for a fair price.

Granting clause may also include any after-acquired title obtained by lessor.

2. For example: Form 88 - (Producers)
Kan., Okla. & Colo. 1962 Rev.Bw
Paragraph #10

"Lessor hereby warrants and agrees to defend the title to said land,

"and agrees that lessee, at its option, may discharge any tax, mortgage, or other lien upon said land, and in the event lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rentals and roylaties accruing hereunder toward satisfying same.

"In case said lessor owns a less interest in

the above described land than the entire and undivided fee simple estate therein, then the royalties . . . and rentals herein provided for shall be paid the said lessor only in the proportion that his interest bears to the whole and undivided fee . . . ."

3. Granting clause of the same form includes "any reversionary rights and after-acquired interest."

4. Most disputes concern the warranty and proportionate reduction clauses.

   a. Warranty - to what extent is lessor liable to lessee in the event of a title failure?

   b. Proportionate reduction - does it apply to bonus? Is it coordinated with the pooling clause?

G. Use Of Oil, Gas, And Water For Lease Operations

1. Traditional Approach - specific clause addressing these matters. For example:

   "Lessee shall have the right to use free of cost, gas, oil and water found on said land for its operation thereon, except water from the wells of the Lessor." Paragraph #8 - Form 690. Compare Paragraph #7 - Form 88.

2. Not many problems. Most common issues are:

   a. Can fresh water be used? Can surface water be used?

   b. What can the substances be used for? Can water and gas be injected to conduct enhanced recovery operations?

H. Removal Of Fixtures

1. Traditonal Approach - broad right to remove at any time before or after termination of the lease. Paragraph #7 - Form 88.

2. Problem - Courts, regardless of the express language, will limit removal rights to a reasonable time after termination. Pratt v. Gerstner, 188 Kan. 148, 151, 360 P.2d 1101, 1103-04 (1961) (29 months after production

ceased not within a reasonable time).

II. HABENDUM CLAUSE - DURATION OF THE GRANT

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 three 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. Coordinating Habendum Clause With Granting Clause

1. Should ensure production of any of the granted substances will extend the lease into the secondary term.

2. Substances should be stated in the disjunctive. Rostocil v. United Oil and Gas Royalty Ass'n, 177 Kan. 15, 274 P.2d 761 (1954).

   a. Granting clause: "oil, gas, coal, and other minerals."

   b. Habendum clause: "as long thereafter as oil and gas is produced." Reversioner

of defeasible term mineral interest unsuccessfully asserted 14 producing oil wells did not extend the interest because no gas was being produced. Ambiguity found because singular verb "is" was used with the plural subject "oil and gas."

D. Production Must Be From The Granted Land

1. Effect of pooling and unitization on oil and gas lease:

a. If, pursuant to a valid pooling or unitization clause in the lease, or by separate agreement, some or all of the leased land is included in a unit, any production attributed to any portion of the leased land will extend the lease as to all the leased land.

b. A gives B a lease on Section 30. By separate agreement between A and B, or pursuant to a pooling clause in the lease, B commits the South Half to a unit. At the end of the primary term there is no production from any wells located on Section 30. However, the South Half is sharing in production from other lands as a member of a unit. Has the lease, as to the North Half, terminated? Has it terminated as to the South Half?

(1) Somers v. Harris Trust & Savings Bank, 1 Kan.App.2d 397, 566 P.2d 775 (1977). The lease, as to both the North Half and the South Half of Section 30, would be extended by unit production attributed to the South Half.

(2) "The majority rule elsewhere is that where a portion of an oil and gas lease is committed to a unit, production anywhere in the unit extends the term of the entire lease." Somers, 1 Kan.App.2d at 400, 566 P.2d at 777.

(3) Basis for rule "conservation and public policy." Perhaps a more appropriate basis is contract.

2. Lessor can, by the terms of the lease contract, limit the area from which the required production must be obtained. See Mesa Petroleum Co. v. Scheib, 726 F.2d 614 (10th Cir. 1984).

3. Different rule applied in Kansas when a defeasible term mineral interest, as opposed to an oil and gas lease, is involved. See discussion at section IX.B. (page 28) of this Outline.

   a. Using the example in paragraph D.1.b. above, suppose A's mineral interest was a defeasible term mineral interest and X owned the reversionary interest.

      In Kansas, any portion of the interest not participating in unit production on the date the primary term expires would terminate and revert to X. Therefore, the mineral interest in the North Half of Section 30 would terminate and revert to X. Unless B has a lease from X covering the North Half, his rights will also terminate.

   b. Acreage included in the grant, but not participating in unit production, will not be held beyond the primary term by pooled or unitized operations. Edmonston v. Home Stake Oil & Gas Corp., 243 Kan. 376 (1988); Classen v. Federal Land Bank of Wichita, 228 Kan. 426, 437-38, 617 P.2d 1255, 1264 (1980).

      (1) Parties could provide for a different rule in the conveyance document.

      (2) Agreements between grantor and third parties, and between grantee and third parties, will not affect the rights created by the original grant between grantor and grantee. See Dewell v. Federal Land Bank, 191 Kan. 258, 263, 380 P.2d 379, 383 (1963).

   c. Basis for rule - judicially articulated policy favoring conservation.

4. Oklahoma and Texas follow a different rule.

Production attributable to any portion of the leased land would extend the lease as to all the leased land. See Fox v. Feltz, 697 P.2d 543 (Okla. App. 1984) and Spradley v. Furly, 157 Tex. 260, 302 S.W.2d 409 (1957).

E. 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 Texas.

F. 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.

6. 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.

7. Even though the lease is producing when the primary term ends, lease remains in effect only so long as production continues.

8. Variations in wording of habendum clause:

   a. So long as oil or gas "is produced from said land . . . , or the premises are being developed or operated." Adolph v. Stearns, 235 Kan. 622, 684 P.2d 372 (1984) (requires lessee to be engaged in the diligent and good faith development or operation of the lease).

   b. "Found in paying quantities" = "Produced in paying quantities." Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 311, 553 P.2d 885, 895-96 (1976).

   c. Production from land "or land with which said land is pooled." Martin v. Kostner, 231 Kan. 315, 644 P.2d 430

(1982).

d. Statute may extend the area from which production can be obtained and the activity required to satisfy the habendum clause. Parkin v. Kansas Corporation Comm'n, 234 Kan. 994, 1007, 677 P.2d 991, 1002 (1984) (commission's unitization order extended lease habendum clause to continue "so long as unitized substances are produced in paying quantities and as long as unit operations are conducted . . . .").

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.

G. 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.

7. Accounting Period.

   a. Must select appropriate period before considering expenses and income. The accounting period will determine what items of expense and income will be included.

   b. Well may not show a profit during a certain month or quarter, but may show a profit over a longer period of time. The test is not so "objective" when selecting the time frame for determining profitability - court may be inclined to consider whether lessee can reasonably anticipate operations will be profitable. Tertiary recovery - expenses may exceed income for long period of time before it begins paying back.

   c. Courts have not offered much guidance in this area - up to litigants to convince the trial court what is a reasonable accounting period under all the facts. See generally Texaco, Inc. v. Fox and Reese Enterprises, Inc. v. Lawson.

8. Income - Income is calculated by crediting the lessee with all income generated by the lease except for amounts attributable to the landowner's royalty.

   Amounts payable out of the working interest as overriding royalties are credited as income to the lessee. Reese, 220 Kan. at

314, 553 P.2d at 898.

9. Expenses - (Kansas Approach) Expenses include "current costs of operations in producing and marketing the oil and gas." Called "direct costs."

   a. May include more than costs actually paid. Held accountable for amounts a "prudent operator working for the common advantage of both the lessor and the lessee" would have paid. This creates certain "accrued" expenses which may not have been incurred, or paid, but should have been. Reese.

   b. Cost of plugging abandoned wells included as an accrued cost which a prudent operator would have paid. Wrestler v. Colt, 7 Kan.App.2d 553, 559, 644 P.2d 1342, 1347 (1982).

   c. Direct costs include: "[L]abor, trucking, transportation expense, replacement and repair of equipment, taxes, license and permit fees, operator's time on the lease, maintenance and repair of roads, entrances, and gates, and expenses encountered in complying with state laws which require the plugging of abandoned wells and prevention of pollution." Reese, 220 Kan. at 314-15, 553 P.2d at 898.

   d. Depreciation.

      (1) Do not include, as an expense, depreciation on the original equipment used to complete the well. Kansas courts treat this as part of the initial cost of drilling and equipping the well. Texaco, 228 Kan. at 594, 618 P.2d at 848. Oklahoma rejects this view. Stewart v. Amerada Hess Corp., 604 P.2d 854 (Okla. 1979).

      (2) Kansas undecided whether depreciation on equipment not associated with the initial cost of drilling and equipping the well will be included as an expense

item.

e. What are the "initial costs of drilling and equipping the well?"

(1) Cost of building gas pipeline required to make intial gas deliveries to a market is part of the initial cost of drilling and completing well. It will not be included as an expense item.

(2) Pray v. Premier Petroleum, Inc., 233 Kan. 351, 662 P.2d 255 (1983). When lease contains a shut-in royalty clause, or a similar provision recognizing a delay between discovery and marketing, pipeline costs will be treated as costs of drilling and equipping the well. Conceptually, the well, under a lease with a shut-in royalty clause, is never completed until production is marketed.

10. Treatment of expenses varies greatly from state-to-state.

H. 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. Same rule applied to defeasible term mineral interests. Wilson v. Holm, 164 Kan. 229, 188 P.2d 899, 905-06 (1948).

a. Special problem with the defeasible term

mineral interest owner because they may not be able to enter the lease to remedy a temporary cessation.

b. Courts will protect them from fraud where their lessee conspires with the reversionary mineral interest owner to terminate the defeasible mineral interest. Wagner v. Sunray Mid-Continent Oil Company, 182 Kan. 81, 318 P.2d 1039 (1957); Wilson v. Holm.

5. 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.

6. 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?

7. 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.

8. Cause of the cessation.

a. Often it is the decisive factor.

b. For example, all recoverable production has been obtained.

9. 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.

10. Cessation problem often addressed by special lease clauses.

I. Operations Clause - Substitute for Production

1. Must have actual production at the end of the primary term. To provide lessee with additional time to obtain production, a "completion" clause is used similar to the following:

   "[I]f the Lessee shall commence operations for drilling at any time while this Lease is in force, this Lease shall remain in force and its terms shall continue so long as such operations are prosecuted and, if production results therefrom, then as long as production continues." Paragraph #12 - 690.

2. Major problem - what action constitutes "commence operations for drilling?" Must take the appropriate action and continue it diligently.

3. Kansas - undecided what will satisfy the commencement requirement. Anything less than actual drilling is risky.

   a. Herl v. Legleiter, 9 Kan.App.2d 15, 668 P.2d 200 (1983) (interpreting similar language under drilling/delay rental clause).

   b. A & M Oil, Inc. v. Miller, 11 Kan.App.2d 152 (1986) (interpreting clause similar to the Form 690 provision).

   c. Phillips v. Berg, 120 Kan. 446, 243 P.

1054 (1926) (hauling sand and cement to land and commencing to drill a water well, which water would presumably be used in drilling the oil well, was not "commencement of operations").

d. It appears where something less than actual drilling is being relied upon, the lessee should be able to demonstrate what amounts to an irrevocable commitment to conduct operations, to completion, on the leased land.

e. Good faith of lessee no defense - "[L]essee . . . may in good faith have attempted to commence a well, but as a matter of fact the steps he took fell short of accomplishing what he was attempting to do." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.

4. Oklahoma - Actual drilling not required. In Wilds v. Universal Resources Corp., 662 P.2d 303 (Okla. 1983), the court states:

"[A] commencement clause of an oil and gas lease has been generally interpreted to mean that operations for the drilling of a well and not the actual drilling must be commenced prior to the end of the primary term with good faith intention of completing the operation."

"The commencement provision in the lease at issue did not expressly require due diligence to avoid termination of the lease, but Oklahoma law has considered the requirement implicit."

J. Dry Hole Clause - Substitute for Production

1. What happens if a well, drilled under an operations clause, is unable to produce in paying quantities? The lease will terminate unless there is a special clause addressing this problem.

2. Dry hole clause designed to address this problem by permitting lessee to commence operations to drill other wells to try and obtain production in paying quantities.

a. Generally give lessee a stated period of

time following "completion of a dry hole" to commence drilling operations on a new well.

b. Compare Paragraph #6 - Form 88 with Paragraph #6 - Form 690.

3. Common problems - Commencement issue similar to the drilling/delay rental clause and operations clause. What is a dry hole? What about multiple dry holes? What is the effect of a dry hole during the priary term? (usually this problem is specifically addressed in existing lease forms).

K. Cessation of Production -Substitute for Production

1. What happens if there is production in paying quantities when the primary term ends but the well subsequently ceases to produce in paying quantities?

a. Cessation permanent, lease terminates - absent a special lease provision covering this problem.

b. Cessation temporary - have a reasonable time to regain production in paying quantities.

2. Traditional approach - expand rights when cessation permanent and restrict rights when cessation temporary. For example:

"If, after the expiration of the primary term of this Lease, production on the leased premises shall cease from any cause, this Lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues." Paragraph #13 - Form 690.

3. Major problems: What action is required to resume "operations for drilling a well?" When did the event triggering the clause occur?

L. Shut-In Royalty Clause - Substitute for Production

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 considred 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?

M. Force Majeure - Substitute for Production

1. What happens if it rains for two weeks prior to the end of the primary term and lessee is unable to access the land to conduct operations? What happens if the state corporation commision, or the federal government, prohibits drilling on the leased land for two weeks prior to the end of the primary term? What if employees, equipment, or materials are not available? Absent a special lease clause, the lease will terminate.

2. Typical force majeure clauses: See Paragraph #9 - Form 88 and Paragraph #15 - Form 690. Note how much narrower the Form 690 provision is.

3. Typically, development of the lease is within lessee's control.

4. Development situations beyond lessee's control, but typically addressed by a lease clause:

   a. Results of development - no control so provide for possibility of dry hole or cessation with the appropriate lease clause.

   b. Market for production - no control so provide for possibility of well being shut-in awaiting a market.

5. Development situations beyond lessee's control, but often not addressed by a lease clause:

   a. Poor weather, natural disaster, disease. Acts of God.

   b. War, control of raw materials, markets, and lessee's activities. Acts of Government.

6. Regardless of the equities involved, courts will not expand the lease contract to account for unforeseen and uncontrollable occurrences which prevent the lessee from complying with the express terms of the lease. Baldwin v. Oil Co., 106 Kan. 848, 850, 189 P. 920, 921 (1920) (lessee unable to complete well within primary term because of intervening drought followed by excessive rain and a blizzard; lessee's employees became diseased; federal government, reacting to wartime needs, prohibited the use of coal or iron in drilling wells on the leased land - HELD: No excuse because the obligation undertaken was absolute).

7. Major Problems: Scope of events subject to force majeure. Effect of force majeure on lease provisions. How to calculate the duration of force majeure.

N. Pooling And Unitization Clauses

1. Lessee often wants authority to expand the area from which production can be obtained to satisfy the habendum and related clauses.

2. Often necessary because lessee will be unable, because of economic or regulatory limitations, to drill well attributed solely to the leased acreage.

3. In Kansas, pooling must be accomplished through a lease clause or separate agreement.

4. For example: Spacing or proration regulation in effect permits only one gas well per 640 acres. Lessee A has a lease on the North Half of Section 30 containing a pooling clause. B has a lease on the South Half which also contains a pooling clause.

   If A and B exercise their pooling authority to declare Section 30 a single pooled unit, a producing well anywhere within the pooled unit will, under a properly drafted pooling clause, satisfy the production requirement of the habendum clause in each lease.

5. Pooling clause should allow lessee to exercise the pooling power as to individual formations, and to exercise the pooling power whenever necessary to pool newly discovered

formations in the leased land. This avoids having to calculate participation in subsequently created units based upon prior pooling of all formations. See Rogers v. Westhoma Oil Company, 291 F.2d 726 (10th Cir. 1961).

a. CAUTION: The pooling clause should make it clear that although you are only pooling a specified formation, production from that formation will hold all leases included in the pooling declaration as to all formations. See Morgan v. Mobil Oil Corp., 726 F.2d 1274 (10th Cir. 1984).

b. See Rogers v. Westhoma Oil Company.

6. If you have a properly drafted pooling clause, the lessor's consent should be unnecessary when rights under the pooling clause are exercised. Kennoyer v. Magnolia Petroleum Co., 173 Kan. 183, 187-88, 245 P.2d 176, 180 (1952).

7. Questions the pooling clause should answer:

a. Does the pooling right apply to all substances granted under the lease?

b. Is there a geographic limit on the pooling right?

c. Is there a geologic limit on the pooling right?

d. What effect will pooling part of the leased acreage have upon leased acreage outside (not participating in) the pooled unit?

e. What effect will operations on the pooled unit have on the habendum clause and clauses which affect the habendum clause?

f. How will the royalty of each lessor subject to the unit be calculated?

g. How is the pooling power exercised? When does the unit take effect? Can the pooling power be used on a recurring basis?

8. Major Problems: Defining the extent of the pooling power and the scope of its effect.

9. Unitization - in Kansas, leases seldom give lessee authority to unitize on a field-wide basis.

   a. Have what is called "compulsory" unitization. K.S.A. §§55-1301 to 55-1315 (1983). Not of much assistance to the operator.

   b. Would be desirable to include unitization clause to permit consolidation of leases to conduct primary or enhanced recovery operations on part or all of a reservoir.

   c. When area unitized pursuant to statute, must look to the statutes, the order approving unitization, and any agreements signed by the unitized parties to determine their rights. See Parkin v. Kansas Corporation Comm'n, 234 Kan. 994, 677 P.2d 991 (1984).

IV. DRILLING/DELAY RENTAL CLAUSE - DURATION OF THE GRANT

A. Purpose

1. State lessee's development obligations during the primary term.

2. Avoid the implied covenant requiring lessee to drill a well to test the leased land within a reasonable time. See Mills v. Hartz, 77 Kan. 218, 94 P. 142 (1908).

B. Effect

1. Conditions the continued validity of the lease, during the primary term, on lessee either commencing drilling operations on the leased land or paying lessor a sum of money to delay operations.

2. Compliance with the terms of the drilling/delay rental clause, i.e. commencement of a well, will not satisfy habendum clause which requires "production" at the end of the primary term. See Perkins v. Saunders, 109

Kan. 372, 198 P. 954 (1921).

C. Special Limitation On The Grant

1. If the optional payment is not made when due, or operations commenced in lieu of the payment, the lease terminates. Gasaway v. Teichgraeber, 107 Kan. 340, 341, 191 P. 282, 282 (1920).

2. Automatic termination only applies to the "unless" form of drilling/delay rental clause which makes payment of the delay rental optional with the lessee. For example: "If no well be commenced on or before the 18th day of December, 1934, this lease shall terminate as to both parties unless the lessee on or before that date shall pay or tender . . . the sum of (Fifty Cents) per acre, which sum shall operate as a rental . . . for the privilege of deferring the commencement of a well for 12 months . . . ." Stady v. Texas Company, 150 Kan. 420, 424, 94 P.2d 322, 326 (1939).

3. If lessee obligated to pay rental, failure to pay will be a breach of covenant and will not result in automatic termination - forfeiture principles apply. Early Kansas leases made payment of delay rental an obligation; these lease forms are called "or" leases. For example: "[Lessee] . . . agrees to drill a well upon said premises within two years from this date or thereafter pay to . . . [Lessor] eighty ($80) dollars until said well is drilled . . . ." Rhodes v. Mound City Gas, Coal & Oil Company, 80 Kan. 762, 764, 104 P. 851, 852 (1909).

4. Although Kansas courts have generally followed the special limitation analysis in enforcing "unless" leases, it has, under certain facutal settings, acted to prevent what it has termed a "forfeiture." See paragraph G below.

5. To avoid automatic termination, must either commence the required operations or pay the stipulated delay rental. In keeping with the special limitation approach, courts require strict adherence to the lease terms.

D. "Drilling" To Satisfy The Drilling/Delay Rental Clause

1. Common variations of lease clauses require the lessee to "commence a well," "commence operations to drill a well," or "commence operations."

2. Problem is determining what actions, short of actual drilling, will satisfy the drilling/delay rental clause.

3. Activity to meet the clause must be taking place on the specified date.

4. Activity that will satisfy the drilling clause:

   a. Undecided in Kansas. Specific terms of each lease will control - but usually they are worded in general terms such as "commence operations to drill a well."

   b. In Herl v. Legleiter, 9 Kan.App.2d 15, 668 P.2d 200, 201 (1983), the court suggests something less than actual drilling may satisfy a commencement clause.

      It appears where something less than actual drilling is being relied upon, the lessee should be able to demonstrate what amounts to an irrevocable commitment to conduct operations, to completion, on the leased land. Such as a drilling contract with a third party to drill a well on the leased land.

   c. In Kansas, anything less than actual drilling is risky. Good faith of lessee no defense - "[Lessee] . . . may in good faith have attempted to commence a well, but as a matter of fact the steps he took fell short of accomplishing what he was attempting to do." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.

5. Once the well is properly commenced, the lessee must diligently continue operations. "[T]he duty to commence is accompanied by a duty to continue operations with due diligence." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.

E. "Paying" To Satisfy The Drilling/Delay Rental Clause

1. Kansas courts require strict compliance with the delay rental provisions of the lease. Generally, there is no allowance made for honest mistakes - inadvertent error concerning the time, place, manner, or amount of payment can terminate the lease.

2. Date of payment.

   a. A delay rental payment made after the date specified in the lease is too late. The lease terminates. Doornbos v. Warwick, 104 Kan. 102, 177 P. 527 (1919).

   b. Watch out for multiple dates in the lease.

3. Amount of payment.

   a. If you fail to pay the full amount due, and the error is not corrected prior to the required payment date, the lease terminates. See Endicott v. Phillips Petroleum Co., 172 F.2d 372 (10th Cir. 1949).

   b. Seems fair since, under the unless form of lease, lessee is not obligated to pay the balance due.

   c. Rental expressed in dollars per acre may create calculation problems.

   d. Problems when acreage is assigned or parts of a lease are surrendered. Covenant to pay delay rental not divisible unless lease provision allows it.

4. Form of payment. Is payment by check authorized by the terms of the lease? Chapple v. Kansas Vitrified Brick Co., 70 Kan. 723, 79 P. 666 (1905).

5. Recipient of payment.

   a. Payment must be to the appropriate payee. Consider Duer v. Hoover & Bracken Energies, Inc., 57 O.B.J. 1447

(June 14, 1986) (Oklahoma Court of Appeals held payment of delay rental to the wrong bank terminated the lease).

b. Change in ownership clause and designated depository bank.

F. Excuses For Improper Payment

1. Kansas recognizes a limited exception to the strict compliance special limitation operation of the drilling/delay rental clause.

2. Kays v. Little, 103 Kan. 461, 175 P. 149 (1918). Delay rental payment sent registered mail in plenty of time to arrive before payment date. Lost in mail, found, then delivered three days after the payment due date.

a. Court talks in terms of preventing a forfeiture.

b. Court considers the "equities" noting the lessee had done everything possible to make the payment on time. Held: lease did not terminate.

3. Young v. Moncreif, 117 Kan. 698, 232 P. 871 (1925). Lost in mail, check never arrived. Held: lease did not terminate. Court here, as in Kays, notes the lessee had spent "considerable sums in developing tracts in the vicinity." Young, 117 Kan. at 700, 232 P. at 872.

4. Stady v. Texas Company, 150 Kan. 420, 94 P.2d 322 (1939). Since lessee, under the unless lease, is not obligated to pay delay rental, lessee must act, prior to the payment date, to unequivocally and irrevocably manifest its intent to pay delay rental.

5. Browning v. Weaver, 158 Kan. 255, 146 P.2d 390 (1944). Applies unequivocal/irrevocable test to payment made to lessor's credit at the wrong bank.

6. Morton v. Sutcliffe, 175 Kan. 699, 266 P.2d 734 (1954). Due 22 April, paid 28 April. Court refuses to grant relief because there was no evidence of lessee's intention to

comply with the terms of the lease.

7. How would the test be applied to a payment of the incorrect amount?

8. Modern lease forms often include a clause excusing the lessee from improper payment.

G. Excuse For Nonpayment Of Delay Rental

1. If lessor is attacking lessee's title, lessee will have a reasonable time, following resolution of the case in his favor, to pay delay rental [or proceed with drilling]. Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (1984) (dicta).

2. No excuse when it is the lessor's title in issue; or when the lessee's title is being attacked by someone other than the lessor. Newell v. McMillan, 139 Kan. 94, 30 P.2d 126 (1934).

V. ROYALTY CLAUSE - LESSOR'S SHARE OF PRODUCTION

A. Purpose

1. The royalty clause determines the lessor's share of production, the substances it is payable on, how it will be valued and paid, the costs which can be deducted from lessor's share, and when it is payable.

2. In most cases the royalty clause will be silent or vague on many of these matters.

3. Standard rule of lease interpretation - lessee always loses. Ambiguities in the lease are interpreted against the lessee and in favor of the lessor.

4. Same type of problems in determining what other nonoperating interest owners are entitled to from the working interest owner.

B. Substances Subject to the Royalty Clause

1. Coordinate with the granting clause.

2. Royalty clauses generally limit the obligation to pay royalty to substances "produced and saved," "used," "sold," or

"marketed." Used to avoid liability for royalty on production which is lost through prudent lease operations.

a. Without such a clause, lessor can argue they are entitled to a royalty on all oil and gas brought to the surface.

b. Gas flaring and venting may create problems.

3. Lease often contains clause relieving lessee from paying royalty on production used to conduct operations on the lease.

4. It may be difficult to determine whether the oil royalty or gas royalty portion of the royalty clause applies to a particular substance.

a. "Distillate" and "condensate" are liquid hydrocarbons produced from a gas well.

b. "Casinghead gas" is gas produced from an oil well.

c. See generally Skelly Oil Company v. Savage, 202 Kan. 239, 447 P.2d 395 (1968) (whether condensate and distillate produced from gas well were subject to a lease clause pooling "gas rights only.").

C. Royalty On Processed Gas

1. Problem: calculating royalty when production from the lease has been altered by processing and marketed as different products.

a. "Wet" or unprocessed gas can be processed to separate hydrocarbon liquids from the remaining "dry" or "residue" gas. Value of the liquids and dry gas generally exceed value of the wet gas.

b. Gas royalty clause typically requires payment of royalty on gas sold "at the well" or sold or used "off the lease."

c. Problem is determining at what point in time will the royalty be calculated - before or after processing? The answer

will vary depending on the lease terms, but leases seldom expressly address the issue. In most cases, the matter will be determined by the way the sale of the gas is structured.

2. Consider the following situations: (Assume X, Y, and Z, are purchasers unaffiliated with Lessee)

   a. Lessee takes natural gas at the well and transports it to a processing plant where lessee, or an affiliate of lessee, separates liquid hydrocarbons from the gas stream and sells them to X. The "dry" or "residue" gas is sold to Y.

   b. Lessee sells natural gas at the well to X but retains, in his gas sales contract, the right to process the gas to recover liquid hydrocarbons. Following delivery of the gas to X at the well, X, under the gas sales contract, redelivers it to lessee at lessee's processing plant. The gas is processed, the liquids are sold to Y, and the residue gas delivered to X.

   c. Lessee sells natural gas at the well to X. Lessee then repurchases the gas from X, processes it, and then sells the liquid hydrocarbons to Y and the residue gas to X.

   d. Lessee sells natural gas at the well to X. X processes the gas, separates the liquids, and sells them to Y. Residue gas is sold to Z.

3. Possible solutions:

   a. Situation 2.a. - Pay royalty based on the market value of the gas at the wellhead or pay royalty on the market value of the liquids and residue gas. Proceeds lease - pay royalty based upon a share of the proceeds from sale of the liquids and residue gas. See Matzen v. Hugoton Production Company, 182 Kan. 456, 321 P.2d 576 (1958).

   b. Situation 2.b. - Are the reserved processing rights in the gas purchase

contract a "proceed" of the lessee's sale of the gas? See Waechter v. Amoco Production Co., 217 Kan. 489, 537 P.2d 228 (1975). Also consider Matzen.

c. Situation 2.c. - Is the repurchase a separate transaction? See Cline v. Angle, 216 Kan. 328, 532 P.2d 1093 (1975).

d. Situation 2.d. - Generally, no problem. But see Northern Natural Gas Company v. Grounds, 441 F.2d 704, 723 (1971) (the unique statutory status of helium at this time probably explains the court's holding). See also McCue v. Deerfield Gas Production Co., 173 Kan. 302, 245 P.2d 1191 (1952).

4. Processing charges.

a. If the lessee pays royalty on processed gas, the lessee will typically charge the royalty owner with a share of the processing costs.

b. Usually this processing charge is determined unilaterally by the lessee and, as might be expected, the lessee treats itself very favorably.

c. Common industry practice - lessee pays royalty based upon 1/3 of the total value of the processed liquid hydrocarbons and retains 2/3 as a processing charge. This practice is not binditng on the lessor without his prior consent. Lessor could argue, if he has to pay a share of costs, it should be calculated using the actual cost of processing.

D. Identifying Lessor's Share of Production

1. Lease may provide for delivery of a fractional share of the production (right to take in kind), the market value of a fractional share of production, or a fractional share of the proceeds from the sale of production. Still may find flat rate gas royalty leases.

2. Must define the fraction of production the

lessor is entitled to.

3. Measurement of production is critical to ensure the correct quantity of production is used in calculating royalty.

4. Other lease clauses may affect the lessor's fractional share. For example: proportionate reduction clause, entirety clause, pooling clause, and unitization clause.

E. Calculating "Gross Value" of Lessor's Royalty

1. Oil royalty.

a. Clause often gives lessor the option to take oil in kind.

b. Crude oil purchasers generally buy oil by "posting" a price, called the "posted price," which establishes the price they will pay for oil in the field or area. Generally regarded as the market price for oil in the area.

c. Not many problems with valuation of oil because the competitive crude oil sales market reflects the current value of the oil when it is sold.

(1) Oil exchanges.

(2) Payment of "premiums" by crude oil purchasers.

d. Don't have transportation problems you encounter with the marketing of gas.

2. Gas royalty.

a. Lots of litigation in Kansas, and elsewhere, over how the gross value of gas should be determined for royalty purposes. Three major issues:

(1) Does the lease clause require the calculation of royalties based upon "proceeds" for the sale of gas or the "market value" of the gas?

(2) If calculated on "market value," how will market value be determined when gas has been committed to a

long-term gas sales contract?

(3) If calculated on "market value," will the value of lessor's share of production be limited by federal regulation of natural gas prices?

3. Kansas courts classify gas royalty clauses into three categories:

a. "Proceeds" leases.

b. "Market Value" ("Market Price") leases.

c. "Waechter" leases.

4. Proceeds lease - gross royalty value calculated by multiplying the amount received by the lessee, in an actual sale of production, by the lessor's fractional royalty. For example:

"The lessee shall pay lessor, as royalty, one-eighth of the proceeds from the sale of gas, as such, for gas from wells where gas only is found . . . ."

Lightcap v. Mobil Oil Corp., 221 Kan. 448, 460-61, 562 P.2d 1, 10-11 (1977), cert denied, 434 U.S. 876 (1977), rehearing denied, 440 U.S. 931 (1979).

5. Market value lease - values production by ascertaining the "'price which would be paid by a willing buyer to a willing seller in a free market.'" Holmes v. Kewanee Oil Co., 233 Kan. 544, 551, 664 P.2d 1335, 1341 (1983). For example:

"To pay the lessor one-eighth, at the market price at the well for the gas so used . . ."

"Lessee shall pay Lessor for gas from each well where gas only is found . . . one-eighth. . . of the gross proceeds at the prevailing market rate, for all gas used off said tract."

6. Waechter lease - valuation is by proceeds or market value depending upon the point of sale. For example:

"Lessee shall pay lessor monthly as royalty

on gas marketed from each well one-eighth (1/8) of the proceeds if sold at the well, or if marketed by lessee off the leased premises, then one-eighth (1/8) of the market value thereof at the well."

Waechter v. Amoco Production Co., 217 Kan. 489, 490, 537 P.2d 228, 231 (1975).

a. Sale of gas "at the well" or "on the lease" use proceeds calculation.

b. Sale "off the lease" use market value.

c. Point of sale and transfer of title to gas will determine how gas is valued. Lessee, in cooperation with the gas purchaser, can control the Waechter lease through structuring the point of sale in the gas sales contract.

7. Determining "market value."

a. Requires payment of gas royalty calculated by using the "value or price at the current rate prevailing when the gas is delivered rather than the proceeds of amount realized under a gas purchase contract." Holmes, 233 Kan. at 548, 664 P.2d at 1339.

b. Market value can therefore be in excess of the amount paid to lessee by his gas purchaser. Gas value determined at the time it is produced - not when the gas contract was entered into.

c. Market value to be determined by what a willing seller will pay a willing buyer in a "free market." Lightcap. How does federal price regulation of gas affect this free market test?

(1) Not a limitation on what the lessor can receive as royalty.

(2) However, courts can consider the affect of federal price controls on the gas market when looking at "comparable sales" of gas from other area fields. A factor to consider in determining market value. Matzen v. Cities Service

Oil Co., 233 Kan. 846, 667 P.2d 337 (1983).

8. Kansas takes a pro-lessor position on the market value issue.

   Oklahoma takes a pro-lessee position. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981) (market value equals sales contract price).

   Texas requires payment of current market value but considers the legal status of the gas (federal price limitations). First National Bank of Weatherford v. Exxon Corp., 622 S.W.2d 80 (Tex. 1981).

9. Could the market value analysis be used to pay lessor the market value of their share of production when that amount is less than the fractional share of proceeds received by lessee?

   a. Kansas cases do not limit determination of market value to situations where market value exceeds value of the proceeds.

   b. The Kansas approach would seem to allow lessee to use the lower, market value price, to calculate royalty.

   c. In effect, the lessee is being forced to assume the risk if his gas sales contract does not keep pace with market prices. Shouldn't the lessee enjoy the benefits of his willingness to assume the risk? Especially when it is at no risk to the lessor?

   d. In Piney Woods Country Life School v. Shell Oil Co., 765 F.2d 225 (5th Cir. 1984), cert. denied, 105 S.Ct. 1868 (1985), the court observes in a footnote:

      "If the price of gas declines, a market value royalty clause would benefit a lessee who has contracted to sell gas at a favorable price."

   e. Lessor should consider lease clause which provides for an amount equal to

the greater of: (1) the gross proceeds from the sale of gas; or (2) an amount equal to the market value of the substance at the well.

F. Calculating the "Net Value" of Lessor's Royalty

1. Royalty generally defined as a cost-free share of production paid or delivered to the lessor.

2. "Cost-free" refers to costs associated with drilling, completing, and producing the well. However, the lessor may be assessed a share of costs incurred after production. Problem in Kansas is determining where the production function ends and the post-production function begins.

3. Does the production function include marketing?

   a. Implied covenant to market production.

   b. In Kansas, "production" for habendum clause purposes requires marketing.

   c. However, these rules do not necessarily mean lessee must absorb all the costs.

4. Transportation Charges - Early Kansas cases permit lessee to deduct the cost of transporting production to a market.

   a. Scott v. Steinberger, 113 Kan. 67, 213 P. 646 (1923) (can deduct cost of transporting gas to market and then calculate royalty using the net figure).

   b. Voshell v. Indian Territory Illuminating Oil Co., 137 Kan. 160, 19 P.2d 456 (1933) (can deduct cost of arranging for contract carriage of oil, by pipeline, to a market).

   c. Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943) (can deduct cost of trucking oil to market).

5. More recent cases, although not directly addressing the issue, cast doubt on whether transportation and other marketing costs are deductible, absent express lease provisions.

a. Matzen v. Hugoton Production Company, 182 Kan. 456, 467, 321 P.2d 576, 585 (1958) (concurring opinion of Justice Fatzer).

b. Gilmore v. Superior Oil Company, 192 Kan. 388, 388 P.2d 602 (1964) and Schupbach v. Continental Oil Company, 193 Kan. 401, 394 P.2d 1 (1964). Lessee not allowed to deduct "compression costs" in calculating royalty.

Court in Gilmore, without discussion, quotes the following from M. Merrill, Covenants Implied in Oil and Gas Leases:

"`If it is the lessee's obligation to market the product, it seems necessary to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the costs of marketing or of preparation for sale is chargeable to the lessor.'" Gilmore, 192 Kan. at 393, 388 P.2d at 607.

c. Cline v. Angle, 216 Kan. 328, 333, 532 P.2d 1093, 1097 (1975) (court, by dicta, suggests helium extraction and purification costs may not be deducted from overriding royalty owner's share of production unless there are express provisions in the assignment allowing for the deduction).

G. Payment Of Royalty

1. Frequency of payment generally governed by the lease. If not specified in the lease, the division order will specify when royalty will be paid.

2. Division Orders.

a. "[A]n instrument required by the purchaser of oil and gas in order that it may have a record showing to whom and in what proportions the purchase price will be paid. Its execution is procured primarily to protect the purchaser in the matter of payment for the oil or gas, and may be considered a contract between the sellers on the one hand and

the purchaser on the other." Wagner v. Sunray Mid-Continent Oil Company, 182 Kan. 81, 92, 318 P.2d 1039, 1047 (1957).

b. Have been used by lessees to try and amend the oil and gas lease. These attempts have been unsuccessful in Kansas. See, e.g., Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983) and Maddox v. Gulf Oil Corporation, 222 Kan. 733, 567 P.2d 1326 (1977), cert. denied, 434 U.S. 1065 (1978).

3. Remedies for nonpayment of royalty.

a. No legislation in Kansas.

b. Oklahoma has statute to obtain interest on late payments and attorney fees required to enforce the obligation. Okla. Stat. Ann. tit. 52 §540 (West 1987).

c. Texas - see Tex. Nat. Res. Code. Ann. §52.131(e) (Vernon 1978).

d. Action to enforce the royalty covenant.

(1) Generally, cancellation of lease not a remedy - damages adequate. Edwards v. Iola Gas Co., 65 Kan. 362, 69 P. 350 (1902).

(2) However, for a "continuous unreasonable" failure to comply with essential lease covenants, cancellation of the lease may be an appropriate remedy. Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (1984) (surface use covenant).

c. Interest.

(1) Kansas - no statutory provisions but uses a common law unjust enrichment theory to require payment of interest on suspended royalties. See, e.g., Shutts v. Phillips Petroleum Co., 235 Kan. 195, 679 P.2d 1159 (1984), aff'd in part, rev'd in part, Phillips Petroleum Co. v. Shutts, 105 S.Ct.

2965 (1985) (reversed as to conflicts of law issue).

(2) For a statutory approach see Okla. Stat. Ann. tit. 52 §540A. (West 1987).

d. Payment Information.

(1) Lessor requires information to audit lessee's payment of royalty.

(2) No statutes in Kansas. See the Oklahoma check stub law - Okla. Stat. Ann. tit. 52 §§ 567 and 568 (West 1987).

VI. IMPLIED COVENANTS

A. Function Served by Implied Covenants

1. When the lease fails to expressly address matters such as the degree or rate of exploration and development, the court will, by implication, address such matters to promote what it finds are the basic goals of the lease relationship.

2. Typical oil and gas lease suggests the lessee will attempt to develop and produce the lease to generate production from which lessor will receive a royalty.

3. Lease will be interpreted against lessee and in favor of lessor. Interpreted to promote development and against delay.

B. Prudent Operator Standard

1. Lessee's compliance with implied covenants is measured by what a "prudent operator" would do under the circumstances.

2. Lessee must act in the manner that, "in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee . . . ." Brewster v. Lanyon Zinc Co., 140 F. 801, 814 (8th Cir. 1905). See also Fischer v. Magnolia Petroleum Co., 156 Kan. 367, 373, 133 P.2d 95, 99 (1943), adhered to, 156 Kan. 722, 137 P.2d 139 (1943) (rejecting

a lessee good faith standard and adopting the prudent operator standard).

3. Balance the lessor's cost-free royalty interest with the lessee's cost-bearing working interest in determining what action is prudent.

C. Implied Covenants Recognized in Kansas:

NOTE: The prudent operator standard establishes a minimum standard of contractual performance. Therefore, duties not traditionally associated with one of the six categories of implied covenants could be asserted.

1. Implied covenant to drill an initial well.

2. Implied covenant to diligently develop the lease.

3. Implied covenant to diligently explore the lease.

4. Implied covenant to market production after it is discovered.

5. Implied covenant to protect the lease against drainage.

6. Implied covenant to operate and manage the lease efficiently.

D. Initial Test Well Covenant

1. If lease does not specify lessee's development obligations during the primary term, courts imply an obligation that lessee will drill a well on the leased land within a reasonable time. Mills v. Hartz, 77 Kan. 218, 94 P. 142 (1908).

   a. Primary reason for executing lease - prospect of royalty.

   b. Lessees responded by expressly addressing development obligations during the primary term with the drilling/delay rental clause.

2. Lessor and lessee can expressly agree that lessee is not obligated to develop the lease during the primary term - even without the

payment of delay rental.

a. Skinner v. Ajax Portland Cement, 109 Kan. 72, 197 P. 875 (1921) (lease with 99 year fixed term, express provision making it optional with lessee when development will take place).

b. Ability to disclaim covenant not affected by Deep Horizons Act because K.S.A. §55-223 (1983) applies only when a lease is "held by production." Provision which prohibits waiving covenants (§55-228) does not apply to initial well covenant.

E. Diligent Development Covenant

1. Upon discovery of oil or gas in paying quantities, the lease agreement, absent express terms on the matter, implies that lessee will diligently drill the number of wells necessary to develop the leased land.

2. Covenant operates from the date of discovery, even though the primary lease term has not expired. Berry v. Wondra, 173 Kan. 273, 277, 246 P.2d 282, 285 (1952).

3. Deep Horizons Act - §55-224 (1983) measures time from date of "initial" production.

4. Whether additional wells are required, and when they must be drilled, depends upon what a prudent operator would do under the circumstances.

5. A "continuing obligation" which lasts throughout the life of the lease. The lessee's performance of the obligation must be "judged in the light of the circumstances as they exist at various times during the term of the lease." Sanders v. Birmingham, 214 Kan. 769, 775, 522 P.2d 959, 965 (1974).

6. Courts will construe the lease "to promote development and prevent delay upon the theory that the lessor has a right to have his land developed as rapidly as possible. Adolph v. Stearns, 235 Kan. 622, 626, 684 P.2d 372, 376 (1984).

a. Lessor's "right" to rapid development

must be balanced with lessee's "right" to develop the lease as a prudent operator.

b. A prudent operator would not conduct further development unless it is likely to be profitable. Adolph.

c. "Profitable" means a reasonable profit "`over and above the entire cost of drilling, equipping, and operating the well or wells drilled.'" Wolf Creek Oil Co. v. Turman Oil Co., 148 Kan. 414, 420, 83 P.2d 136, 140 (1938) (quoting from Summers on Oil and Gas).

7. Lessor has burden of proof to show, by substantial evidence, that under the circumstances a prudent operator would have conducted further drilling. Sanders.

a. Cases governed by the Deep Horizons Act - if initial production from the lease was obtained 15 years prior to the lessor's action, and the claim is for development of formations lying below the base of the deepest producing formation, K.S.A. §55-224 (1983) creates a presumption the covenant has been breached as to such deeper formations. Burden of proof shifts to lessee to demonstrate, "by a preponderance of all relevant evidence," that a prudent operator would not have further developed the lease. K.S.A. §55-225 (1983).

b. Matters the courts will consider: quantity of oil and gas capable of being produced, demand for the production, results of area operations, costs of drilling, producing, and marketing, price being paid for production, regulatory climate, market conditions. Sanders, 214 Kan. at 776, 522 P.2d at 966.

8. Court considers technical aspects of the reservoir, the economic situation, and some special factors which tend to indicate the lessee's intent towards developing the lease.

a. Major factor - Time. How long has it

been since the last well was drilled on the lease. Nigh v. Haas, 139 Kan. 307, 311, 31 P.2d 28, 30 (1934).

b. Deep Horizons Act uses time as a factor by establishing a rebuttable presumption the covenant has been breached after fifteen years have passed since first production from the lease.

c. However, passage of time is not determinative. Sanders.

d. Another factor - statements by the lessee concerning development. See, e.g., Berry v. Wondra, 173 Kan. 273, 246 P.2d 282 (1952); Sauder v. Mid-Continent Petroleum Corp., 292 U.S. 272 (1934).

e. Another factor - willingness of others to develop the lease if given the opportunity. Berry.

9. Rate of production. Lessee must consider not only his interests, but also those of the lessor. Lessee may be content to let one well drain the lease in thirty years instead of drilling two wells to drain in in fifteen.

a. "A lessor is entitled to the benefit of oil produced from the lease at the time it should be produced and not at some remote period of time in the future." Temple v. Continental Oil Co., 182 Kan. 213, 235-36, 320 P.2d 1039, 1056 (1958), on rehearing, 183 Kan. 471, 328 P.2d 358 (1958).

b. Although an operator, considering his own economic interests, may deem it imprudent to drill the additional well, the prudent operator standard requires the lessee to also weigh the lessor's interests when deciding what course of action is appropriate under the circumstances.

10. Development obligation continues even though the lease is included within a field-wide unit or existing wells are shut in. However, the standard is what would a prudent operator do under these circumstances.

a. Parkin v. Kansas Corporation Comm'n, 234 Kan. 994, 1009, 677 P.2d 991, 1003 (1984) (field-wide unit).

b. Pray v. Premier Petroleum, Inc., 233 Kan. 351, 354, 662 P.2d 255, 779 (1977) (acreage held by shut-in royalty).

11. Requirement of prior demand for development.

a. To obtain cancellation as a remedy, generally must make prior demand on lessee for development - prior to bringing suit. [Limited to cancellation of the undeveloped part of the lease - may be depth, area, or substance]. Storm v. Barbara Oil Co., 177 Kan. 589, 599, 282 P.2d 417, 424 (1955) (demand requirement).

b. Failure to make prior demand appears to only limit your remedy - to damages or conditional cancellation [drill or lose lease]. Rook v. James E. Russell Petroleum, Inc. 235 Kan. 6, 17-18, 679 P.2d 158, 166 (1984).

c. See Amoco Production Co. v. Douglas Energy Co., Inc., 613 F.Supp. 730, 737 (D.Kan. 1985) (Deep Horizons Act does not affect existing law concerning demand for development). K.S.A. §55-229 (1983) indicates the Act does not alter or affect substantive rights or remedies under existing law.

d. Prior demand may not be required if it would be futile. Howerton v. Kansas Natural Gas Co., 81 Kan. 553, 106 P. 47 (1910) (attitude of lessee may excuse demand requirement).

F. Diligent Exploration Covenant

1. What happens when the lease, as to known reserves, has been fully developed? To what extent must the lessee engage in exploration activities to try and discover new reserves?

2. Profitability of the endeavor should not be the issue. Instead, when would a prudent operator make the decision to explore the lease - having in mind the interests of both

lessee and lessor.

3. "If there was no duty to explore for oil, a lessee could hold the oil rights forever without exploring the productivity of oil-bearing sands simply because he has developed the lease for gas." Myers v. Shell Petroleum Corp., 153 Kan. 287, 306, 110 P.2d 810, 821 (1941) (concurring and dissenting opinion of Justice Wedell).

4. Webb v. Croft, 120 Kan. 654, 244 P. 1033 (1926). Court holds lessee should have explored for oil - no mention of whether it would be profitable. Instead, court assumes since there was new oil production in the vicinity, lessee had the obligation to explore the leased land or surrender it so others could explore.

5. Alford v. Dennis, 102 Kan. 403, 170 P. 1005 (1918). Lease covered two non-contiguous tracts. One had been extensively developed, the other had not been explored during the 13 years the lease was in effect. "Since . . . [Lessor's] lands are burdened with an oil and gas lease, he is entitled to have those lands prospected for oil and gas within a reasonable time." The court does not comment on the probability of success in drilling on the tract.

6. Sauder v. Mid-Continent Petroleum Corp., 292 U.S. 272 (1934). Lessee, after holding the lease by production for over seventeen years, stated it "had no present intention of further exploring or developing, unless and until developments in the immediate vicinity should convince them that it would pay to take such action." Sauder, 292 U.S. at 277.

   a. Conditional cancellation of the unexplored portion of the lease is appropriate.

   b. "This attitude does not comport with the obligation to prosecute development with due regard to the interests of the lessor." Sauder, 292 U.S. at 280-81.

7. At some point in time the lessee is required to make a choice whether he will release undeveloped portions of the lease or conduct

further exploration. Presumably, the expectation of profit, or probability of discovering new reserves, becomes less critical to lessor's case as time passes without exploration. This premise assumes at some point in time a prudent operator will explore all parts of the leased land.

8. Kansas Legislature follows this premise in the Deep Horizons Act.

   a. K.S.A. §55-223 (1983) states that any lease held by production includes an "implied covenant to reasonably explore and to develop the minerals which are subject to the lease."

   b. K.S.A. §55-224 (1983) recognizes the covenant of exploration is separate from the development covenant.

   c. K.S.A. §55-224 adopts time as a major factor by establishing a presumption the covenant is breached if:

      (1) There are unexplored or undeveloped formations beneath the base of the deepest producing formation on the lease; and

      (2) Initial production from the lease began at least 15 years prior to commencement of the action.

9. Remedies are similar to those under the development covenant. Failure to make prior demand for development is a factor court may consider in determining whether cancellation is an appropriate remedy.

G. Covenant to Protect Against Drainage

1. Recognizes the rule of capture and that the lessor's only protection is to have the lessee act to drill protection wells - or perhaps seek pooling or unitization.

2. Prudent operator standard used to determine when protection or offset wells are required.

3. "No implied duty rests upon a lessee to offset a nonpaying well, where the offset probably would result in a loss to him."

Myers v. Shell Petroleum Corp., 153 Kan. 287, 287, 110 P.2d 810, 811 (1941) (Syllabus 3).

a. Lessee may have to take other action.

b. Prudent operator may seek pooling or some other form of protection from drainage.

4. Lessor has burden of proof to show, by substantial evidence:

a. There is oil or gas beneath lessor's land which could be drained.

b. There has been "substantial drainage" from his lease.

c. Additional drilling on the lease is likely to be profitable.

5. Must introduce technical evidence to establish each element. Corr v. Continental Oil Co., 145 Kan. 78, 84, 64 P.2d 30, 33 (1937) (lessor failed to present evidence of the porosity and permeability of the reservoir and evidence of reservoir pressures).

6. Common lessee problem. What if the operator draining the lease is lessor's lessee?

a. Early case seems to make lessee strictly liable for such drainage. Culbertson v. Cement Co., 87 Kan. 529, 125 P. 81 (1912).

b. Seacat v. Mesa Petroleum Co., 561 F.Supp. 98 (D.Kan. 1983). Adopts the rule that if the lessor is able to prove substantial drainage, and that his common lessee is the cause of such drainage, lessor will recover whatever damages he can prove - unless the lessee can prove drilling an offset well would be unprofitable. Seacat, 561 F.Supp. at 103-04.

c. Other possibilities besides drilling well: compensatory royalty agreement with lessor. Pooling, unitization.

7. Acceptance of delay rentals. Drainage claims are often made during the primary term when the lease is being held by delay rental. Does lessor have any right to complain about drainage during period when lease is held by payment of delay rental? Is lessor estopped by accepting rental?

   a. Issue raised but not addressed in Corr v. Continental Oil Co., 145 Kan. 78, 64 P.2d 30 (1937), adhered to, 147 Kan. 1, 75 P.2d 212 (1938).

   b. Storm v. Barbara Oil Co., 177 Kan. 589, 282 P.2d 417 (1955). General statements about accepting and retaining rents or royalties and then claiming a forfeiture.

   c. Rolander v. Sanderson, 141 Kan. 809, 43 P.2d 1061 (1935). Unique facts.

   d. If you intend to assert a drainage claim, do not accept delay rental.

   e. Purpose of delay rental clause not related to drainage issue.

8. Demand for a protection well.

   a. Not clear how it will be treated in Kansas.

   b. Lessee in the best position to know - has the duty to know.

   c. If you think there is drainage, or could be, demand a protection well. Help to establish a date for calculation of damages.

H. Marketing Covenant

1. After discovery of oil or gas in paying quantities, the lessee has the implied obligation to diligently produce and market production from the lease. Howerton v. Kansas Natural Gas Co., 81 Kan. 553, 106 P. 47 (1910), reversed in part, 82 Kan. 367, 108 P. 813 (1910) (reversed as to remedy for breach of covenant; damages adequate in this case).

2. When well shut in the lessee's obligation is "to diligently search for a market and to otherwise conduct himself as would a reasonable and prudent lessee under the same or similar circumstances." Pray v. Premier Petroleum, Inc., 233 Kan. 351, 354, 662 P.2d 255, 258 (1983).

3. What is an acceptable marketing arrangement from the view of the lessor?

   a. All of lessee's business relations considered when lessee makes a business decision. How will this affect my business? What is the best option for my business?

   b. Prudent operator standard - What is the best option for my business which will not adversely affect my royalty owner (not owners).

   c. Not a fiduciary - but courts will take a dim view when the benefits disproportionately favor the lessee to the demonstrable detriment of their lessor. "Ordinary" good faith in these cases tends to create some extraordinary obligations on the lessee.

4. The cases that will chart future litigation in this area:

   a. Amoco Production Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981) (obligation to protect lessor against field-wide drainage--without regard for obligation to other lessors in the field).

   b. Amoco Production Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex.Civ.App. 1979), writ refused, n.r.e., (lessee breached obligation to market gas in good faith when it marketed lessor's gas at less than prevailing prices in order to obtain collateral benefits which would not be shared with the lessor).

5. Diligence in marketing takes on new meaning when lessor isn't receiving a check but their neighbor, owning a fractional share of production in the same well, is getting

banner royalties because their lessee is selling the full production stream.

a. Not much of a problem in Oklahoma where the lessors share in all production from the well.

b. Many states (including Kansas) have never addressed the matter because they have never had split-stream connections. Everyone traditionally sold to one pipeline and the pipeline always was able to take gas.

6. FERC "Options" and the Marketing Obligation

a. Exercise rights under FERC Order 451 to enter into Good Faith Negotiations to obtain a release so you can find alternative markets?

b. FERC Order 500. Sell to other markets-regardless of cross-crediting problems?

c. FERC Order 490. Abandon expired contracts or contracts operating under a market-out clause.

d. Review transportation and marketing arrangements where lessor is being charged a proportionate share of the costs.

7. Prudence - Making The Best Deal

a. Best deal considering the interests of lessor and lessee.

b. Long-term contract? Release? Exercise GFN option or stay away from triggering a possible abandonment?

c. Any time marketing <u>options</u> are provided to the lessee there is the chance they will select the wrong option.

d. Opportunity to breach the efficient operator covenant. A "bad" choice.

8. Opportunity to breach the marketing covenant.

a. By doing nothing.

b. By losing a market.

c. By compromising lessor's position.

9. FERC Order 451 and the Marketing Covenant

a. What's best for Lessee may not be best for lessor X.

b. What's best for lessor X may not be best for Lessee's lessor Y.

c. Failure to act does not resolve the problem.

d. Contrast this with situations where the lessee, and lessee's other lessors, will not be any worse off because of a course of action.

For example, some contracts contain area rate clauses (allowing use of Order 451) but others do not have such clauses. Lumping all the contracts together for renegotiation is not necessary and adversely impacts the rights of royalty owners having area rate clauses in their contracts.

10. FERC Order 500 and the Marketing Covenant

a. If lessee refuses to offer credits and transport gas, because of adverse impact on unrelated contracts, lessor X will not receive any royalty--or perhaps a reduced royalty.

Impact will also be magnified depending upon whether lessor gets benefit of the take-or-pay rights the lessee is attempting to protect.

b. If lessee ships to meet marketing demands of lessor X, can lessor Y (who is the beneficiary of a high-priced take-or-pay contract), complain about the cross-crediting lessee has set into motion?

11. Options for lessor and lessee?

a. Try to get the lessor actively involved in the decision-making process? Not

likely.

b. Let lessor take gas in kind? If you don't like the way I'm doing it, do it yourself?

12. It appears the lessee acts at their peril when they fail to consult the lessor and obtain the lessor's actual consent to a course of action.

a. Difficult to estop the lessor.

b. Lessor can often sit back and let lessee select a course of action - and then contest the action.

c. Lessee's liability generally not limited by statute of limitations.

See Dorchester Gas Producing Co. v. Hagy, 748 S.W.2d 474 (Tex.App.-Amarillo 1988) (applying "discovery rule" to royalty payment dispute - monthly statements provided lessor did not bar lessor from claiming additional royalties for periods beyond four-year statute of limitations because lessor could not accurately audit its payments with the information provided in the statements).

13. So what should a lessee do? If a party to a relational contract desires to do something affecting the relation, they must consult the other parties - unless the contract specifically provides otherwise.

I. Covenant of Efficient Operation

1. Requires the lessee to take the appropriate action at the appropriate time to protect the collective interests of lessee and lessor.

2. Shaw v. Henry, 216 Kan. 96, 531 P.2d 128 (1975). Lessee improperly disposing of salt water cited by State Board of Health. Must take appropriate action to remedy the problem and put the lease back on production.

PART 3 - COMMON PROBLEMS CONCERNING THE OIL AND GAS PROPERTY INTEREST

I. CLASSIFICATION OF THE PROPERTY INTEREST

A. Mineral Interest

1. Surface and mineral estates are real property. Froelich v. United Royalty Co., 178 Kan. 503, 507, 290 P.2d 93, 96 (1955), modified, 179 Kan. 652, 297 P.2d 1106 (1956).

2. Granting an oil and gas lease covering the mineral estate does not change ownership of the minerals. Merely burdens the mineral estate with contractual obligations specified in the oil and gas lease.

B. Oil and Gas Lease

1. A "hybrid" property interest.

2. Classified as personal property. Burden v. Gypsy Oil Co., 141 Kan. 147, 150, 40 P.2d 463, 466 (1935).

   a. Peculiar classification probably adopted to exempt oil and gas leases from K.S.A. §79-420 (1984).

   b. K.S.A. §79-420 does not apply to "leases" (although it was probably intended to do so). Gas Co. v. Neosho County, 75 Kan. 335, 337, 89 P.750, 751 (1907).

3. Oil and gas lease has been, in effect, reclassified by statute and judicial opinion to be treated as a real property interest in specified situations.

C. Royalty

1. A right to share in oil and gas when, and if, actually produced. Magnusson v. Colorado Oil and Gas Corp., 183 Kan. 568, 571, 331 P.2d 577, 580 (1958).

2. Classified as personal property. Magnusson.

3. However, courts consider the context in which the term "royalty" is used and, when

appropriate, interpret references to royalty as an incorrect reference to the mineral interest - real property. In re Estate of Sellens, 7 Kan.App.2d 48, 637 P.2d 483 (1981).

D. Nonoperating Interests - Carved From The Leasehold

1. Common nonoperating interests:

a. Overriding Royalty. A right to a share of oil and gas from the leased land free of the cost of production. Payable out of the working interest from which it is carved; will terminate when the lease terminates. Campbell v. Nako Corporation, 195 Kan. 66, 402 P.2d 771 (1965).

b. Production Payment. A right to a share of oil and gas from the leased land free of the cost of production but limited to a specified quantity or value of production. McCrae v. Bradley Oil Co., 148 Kan. 911, 84 P.2d 866 (1938) (quantity of production); Matthews v. Ramsey-Lloyd Oil Co., 121 Kan. 75, 245 P. 1064 (1926) (value of production).

c. Net Profits Interest. A right to a share of oil and gas from the leased land free of the cost of production but payable only if and when the lessee earns a net profit from his operations. Difficulty is defining what costs will be deducted from revenues to determine whether a net profit has been realized. Kumberg v. Kumberg, 232 Kan. 692, 659 P.2d 823 (1983).

d. Convertible Interest. A nonoperating interest, such as an overriding royalty, may be convertible to an operating interest after the occurrence of a specified event, such as recovery of costs from a well. Commonly used in farmout transactions.

2. Nonoperating interests carved from the oil and gas lease, and representing the right to share in production when, and if, obtained, are personal property interests. Right to share in production when produced - like a

royalty interest. Right created out of an oil and gas lease - a personal property interest.

II. CLASSIFICATION AND CREATING A SECURED POSITION

A. Governing Law Depends On The Nature Of The Property Subject To The Security Interest

1. Classification problems abound. See generally D. Pierce, Kansas Oil and Gas Handbook §4.10 (K.B.A. 1986).

2. Real property - Mortgage law applies. K.S.A. §§58-2301 to 58-2336 (1983).

3. Personal property - Article 9 of the Uniform Commercial Code (UCC) applies.

4. Other laws apply to the transaction depending upon the classification of the collateral as real or personal property, or as a speical type of interest within the general classification of real or personal. For example:

a. Oil and gas lease in Kansas is personal property but statutes, for certain purposes, treat it as a real property interest. E.g., K.S.A. §§58-2221 and 58-2222 (1983) (oil and gas treated as real property for recording purposes).

Special-purpose judicial reclassification - Ingram v. Ingram, 214 Kan. 415, 521 P.2d 254 (1974) (security interest in oil and gas lease treated like a mortgage of real property).

b. Applicable UCC provisions may depend upon further classification of the personal property interest.

(1) Is the collateral "equipment" or "inventory?" K.S.A. §84-9-109 (2) and (4) (1983).

(2) Is the collateral an "account" or "general intangible?" K.S.A. §84-9-106 (1983).

(3) Is the collateral a "fixture?" K.S.A. §84-9-313 (1983).

B. Governing Law Depends On How The Security Interest Is Created

1. If created by agreement between the parties - mortgage law, Articles 2 and 9 of the UCC, and general contract law will apply.

2. If created by statute, the terms of the statute will apply. For example:

a. Mechanics' lien statutes. K.S.A. §§55-207 to 55-210; 55-212 to 55-215 (1983). K.S.A. §§60-1101 to 60-1110 (1983 and Supp. 1986).

b. Judgment lien statutes. K.S.A. 60-2202 (Supp. 1986).

III. THE DEVELOPMENT PROCESS

A. Persons Involved

1. Landowner.

a. Owner of land - if title to oil and gas has not been previously severed from the surface estate.

b. If oil and gas has been severed, the owner of the mineral interest in oil and gas must grant the development rights.

2. Lease Promoter.

a. Acquires right to develop a block of acreage from the appropriate landowners.

b. Usually assigns development rights to the developer.

c. Usually retains an economic interest in the rights assigned.

3. Lease Developer.

a. May or may not be the same person who initially obtains the right to develop from the landowner.

b. In Kansas, development is often done through a "promoted" deal with many (usually up to 32) investors invovled.

4. Contractors, Subcontractors, and Suppliers.

   a. Provide services and supplies to develop the lease.

   b. Provide services and supplies to maintain the lease in production.

5. Transporters of Production.

   a. Traditionally, purchaser of production also the transporter.

   b. May have a third party providing gathering, treatment, processing, and compression services. May require delivery and redelivery of the production.

   c. New transportation role emerging for natural gas. See FERC Orders 436 and 451.

6. Purchasers of Production.

   a. Usually the producer will sell production to a third party purchaser at or near the field where produced.

   b. Changes in gas market structure may result in sales by producer directly to an end user.

7. Other Participants.

   a. New interests can be created by parties owning rights in the oil and gas.

      (1) Assign rights in the property interest.

      (2) Give third parties a secured position in the property interest.

      (3) Have third parties obtain a secured position by statute.

   b. New interests can be created by involuntary action. For example, judgment in a divorce or other civil action. Death of an interest owner; probate of an estate.

B. Relationships and Documents Involved

1. Mineral Deeds.

a. Concerned with mineral deeds and other documents, such as estate and other property-related court proceedings, which determine ownership of the oil and gas mineral estate.

b. Problem is to account for all the rights which authorize development of the oil and gas in the tract of land you wish to develop; or in which you wish to obtain a secured position.

2. Oil and Gas Leases.

a. Basic document which is used to grant landowner's oil and gas development rights in the land to the lease promoter.

b. Under the typical oil and gas lease the landowner (Lessor) retains a right to a cost-free share of oil and gas produced from the land - called a "royalty."

Landowner (Lessor) also retains a reversionary right in the land in the event the oil and gas lease terminates.

c. Lease promoter (Lessee) obtains the right to develop the property subject to the express and implied terms of the oil and gas lease.

3. Assignment of Lease Rights.

a. Often the lease promoter has no intention of developing the lease. Instead, they plan to obtain leases on a block of acreage and then sell them to persons interested in development or resale.

b. Lease promoter often retains an interest in the assigned lease.

(1) May be a fractional share of the "working interest" - an undivided share of the right to develop ("work") the lease pursuant to its

terms. Also called an "operating interest."

(2) May be a right to a share of production from wells on the lease. No right to work the lease - merely a right to receive a share of production. For example: an overriding royalty, production payment, or net profits interest. Also called a "nonoperating interest."

4. Development of the Lease - Joint Development.

a. Lease owner may want to leverage the cost and risk of development by conveying undivided working interests to others willing to participate in development. For example:

A agrees to give B a 50% working interest in the leased land if B will provide 50% of the development costs and assume 50% of the risk of development.

Same situation could arise where 640 acres is required to obtain a full allowable. A owns a lease on the North 320 acres and B owns a lease on the South 320 acres.

b. To coordinate the development of the leased land, or the drilling unit, the cotenants of the working interest usually enter into an Operating Agreement.

Designates the person responsible for the day-to-day operation of the lease and provides guidelines for sharing development decision-making and for sharing revenues and expenses.

c. Lease owner may want to entice another developer to drill on the leased land. A Farmout Agreement is often used to authorize another developer to drill on the leased land and acquire rights in the working interest.

All or a portion of the working interest is usually assigned, subject to various

reassignment obligations depending upon the success of drilling operations.

Operating Agreement usually required since there is a possbility of joint ownership of the working interest.

5. Development of the Lease - Promoted Development.

   a. Instead of sharing the risk of development with another developer, the lease owner may seek direct financial assistance from investors.

   b. Developer sells undivided working interests in the lease pursuant to a Development Agreement whereby the developer agrees to drill one or more wells on the lease.

      Development Agreement is often oral; it should always be written.

      Often the Development Agreement is incorporated into an Operating Agreement.

   c. Developer may retain an operating or nonoperating interest in the lease, or both. The deal is said to be "promoted" because the developer will generally make money from the sale of interests even though the well is a dry hole. For example:

      A owns a lease. The lease cost A $1,000. A enters into a contract with Drilling Company which agrees to drill a well to a specified depth for $100,000. Other costs associated with development will require $9,000. A sells an undivided 1/32nd of the lease to each of 32 investors for $5,000 per 1/32nd. A's promotion fee is $50,000.

      A may also retain a nonoperating interest in the lease, such as an overriding royalty. A may retain part of the working interest and use some of the promotion fee to pay the share of development costs allocated to his share of the working interest.

d. Investors will usually enter into an Operating Agreement either with the promoter or someone hired by the promoter to operate the well.

6. Contracts for Services and Supplies.

a. Major contractor - drilling company. Rights of parties specified by the Drilling Contract.

b. Other service contracts. Developer and drilling company will each contract with various persons to drill, complete, test, equip, and operate wells on the leased land.

c. Supply contracts. Developer and drilling company will each contract with various persons to provide supplies needed to drill, complete, test, equip, and operate wells on the leased land.

7. Transportation Agreements.

a. Transportation agreement may be required where production will be sold at a point off of the lease.

b. Transporter may provide a number of services in addition to transportation - treatment, processing, storage.

8. Treatment and Processing Agreements.

a. Production from the well may be delivered to other persons to treat or process production.

b. In some instances title to production will pass subject to redelivery to the developer. For example, developer may sell gas at the well subject to an obligation to redeliver the gas to developer so liquid hydrocarbons can be removed through processing.

9. Production Purchase Contracts.

a. Most oil and gas sales occur in the field where they are produced. Title passes to the purchaser in or near the field.

b. Gas is beginning to be sold at points far removed from the field where produced. Likely to have more direct sales by the producer to the end user.

C. Assets Involved

1. The development process creates two basic types of assets which can be used to secure an obligation:

a. Intangible property interests. Contractual rights under the various agreements. For example:

(1) The Oil and Gas Lease is an asset of the developer which may be used to secure an obligation.

(2) The right to receive a share of production from land is an asset.

(3) The drilling company's right to payment under a Drilling Contract is an asset.

(4) A gas purchaser's agreement to purchase gas in specified amounts at a specified price is an asset.

b. Tangible property interests. Real and personal property associated with the development of the land for oil and gas. For example:

(1) Unextracted oil and gas.

(2) Pumping unit, tubing, casing.

(3) Flow lines, pipelines.

(4) Separator, heater-treater, stock tanks.

(5) Dehydrator, compressor.

(6) Saltwater disposal tanks, saltwater injection well.

(7) Equipment and supplies on the lease.

(8) Extracted oil and gas.

IV. CLASSIFICATION UNDER UCC ARTICLE 9

A. Oil and Gas Prior to Extraction

1. Before oil or gas are produced from the land they are classified as real property.

2. Article 9 applies to any transaction intended to create a security interest in personal property or fixtures. K.S.A. §84-9-102 (1) (a) (1983).

   a. Personal property includes goods, documents, instruments, general intangibles, chattel paper, or accounts.

   b. Term "goods" does not include "minerals or the like (including oil and gas) before extraction." K.S.A. §84-9-105 (1) (h) (Supp. 1986).

   c. "Security interest" is defined by K.S.A. §84-1-201 (37) (Supp. 1986) as: "[A]n interest in personal property or fixtures which secures payment or performance of an obligation." Under certain circumstances a "lease" intended as security will create a security interest.

   d. Goods are "fixtures" when "affixing them to real estate so associates them with the real estate that . . . a purchaser of the real estate . . . would reasonably consider the goods to have been purchased as part of the real estate." K.S.A. §84-9-313 (1) (a).

3. Article 9 does not apply to "the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder . . . ." K.S.A. §84-9-104 (j) (1983). See Ingram 214 Kan. 415.

4. CAUTION: K.S.A. §84-9-102 (3) (1983) provides:

   "The application of this article to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this article does not apply."

a. See Official UCC Comment #4 to K.S.A. §84-9-102.

b. Although the underlying obligation is secured by collateral not subject to Article 9, for example a mortgage on an oil and gas lease, a pledge of the mortgage note as collateral for a loan will be subject to Article 9. See In re Southworth, 22 Bankr. 376 (1982) (right to receive payments under land sale contract is a personal property right); Wellsville Bank v. Nicolay, 7 Kan.App.2d 172, 638 P.2d 975 (1982) (assignment of rights in contract for sale of oil and gas lease).

B. Oil and Gas After Extraction

1. In Kansas, oil and gas, while in the ground, are part of the real estate. When the oil and gas is actually produced, it becomes personal property. Anderson v. Beech Aircraft Corp., 237 Kan. 336, 342, 699 P.2d 1023 (1985).

2. Produced oil and gas are "goods."

a. "[T]hings which are movable at the time the security interest attaches or which are fixtures . . . ." K.S.A. §84-9-105 (1) (h) (Supp. 1986).

b. §84-9-105 (1) (h) also states oil and gas, prior to extraction, are not "goods."

C. Classification of "Goods"

1. Must classify to determine where to file the financing statement. K.S.A. §84-9-401 (Supp. 1987).

2. Classify to determine priority issues. K.S.A. §84-9-312 (Supp. 1987).

3. Classify to determine rights of purchasers of the goods. K.S.A. §84-9-307 (1983).

D. Oil and Gas as "Inventory"

1. "Goods are . . . 'inventory' if they are held by a person who holds them for sale . . . ."

K.S.A. §84-9-109 (4) (1983).

2. Principal test - are the goods held for immediate or ultimate sale? If so, they are inventory. Official UCC Comment #3, K.S.A. §84-9-109.

3. When oil is produced, and put in tanks prior to sale, the oil is "inventory" since it is being held by the producer for sale.

4. Traditionally, seldom have an inventory of gas because it is sold at the wellhead. However, if the producer gathers gas and transports it through its pipeline to a delivery point, gas, prior to delivery, would be inventory of the producer.

5. With the emerging deregulated gas market, sales of gas may not take place until <u>after</u> transportation. Producer could have a considerable amount of gas in transit in a pipeline.

E. Oil and Gas as "Accounts"

1. "'Account' means any right to payment for goods sold . . . ." K.S.A. §84-9-106 (1983).

2. Account also includes the right to payment under an executory contract. See Kansas Comment to K.S.A. §84-9-106.

3. When oil or gas (inventory) is sold to a production purchaser, a "buyer in ordinary course of business," a creditor's right in the sold inventory is extinguished. The purchaser takes free of any security interest created by the seller; even though the security interest is perfected and the purchaser has knowledge of the perfected interest. K.S.A. §84-9-307 (1) (1983).

   a. K.S.A. §84-1-201 (9) (Supp. 1987) defines "buyer in ordinary course of business" means:

      "[A] person who in good faith and without knowledge that the sale to the person is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of

selling goods of that kind . . . . ."

b. §84-1-201 (9) further defines "a person in the business of selling goods of that kind" as follows:

"All persons who sell minerals or the like (including oil and gas) at the wellhead or minehead shall be deemed to be persons in the business of selling goods of that kind."

4. Although a security interest in the inventory will be extinguished to the extent of a proper sale, the account created by the sale can be used as collateral.

5. If the sale is made under a contract which obligates the purchaser to buy the production at a stated price, the creditor's rights may extend to the gas sales contract instead of the extracted gas as inventory. Like other accounts, upon payment by the production purchaser, the account becomes a right to the proceeds of the sale.

F. Oil and Gas as "Proceeds"

1. "'Proceeds' includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds . . . . Money, checks, deposit accounts, and the like are 'cash proceeds' . . . ." K.S.A. §84-9-306 (1) (1983).

2. Upon payment of an account, the creditor's interest shifts to the proceeds paid to satisfy the account.

G. Oil and Gas "Equipment"

1. Goods are "equipment" if: "[T]hey are used or bought for use primarily in business . . . and are not included in the definitions of inventory, farm products or consumer goods . . . ." K.S.A. §84-9-109 (2) (1983).

2. Major problem, in the oil and gas context, is distinguishing equipment from "fixtures."

H. Oil and Gas "Fixtures"

1. Goods become "fixtures" when they are affixed to the real estate to such an extent that a purchaser of the real estate would reasonably believe the affixed goods are included in the real estate sale. K.S.A. §84-9-313 (1) (a) (1983).

2. Security interest perfection requirements for equipment and fixtures are different.

I. Oil and Gas as "General Intangibles"

1. "General intangibles" include: "[A]ny personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments and money." K.S.A. §84-9-106 (1983).

2. In Kansas, because of their unique classification as personal property, it is arguable that a royalty, overriding royalty, production payment, and net profits interest are general intangibles.

V. THE ARTICLE 9 SECURITY INTEREST

A. Creating the Security Interest - "Attachment"

1. Unless debtor authorizes the creditor ("secured party" under the UCC) to take possession of the collateral, an effective security interest can be created only after:

a. The parties enter into a written "security agreement" which manifests their intent to create or provide for a security interest.

b. The agreement contains a description of the collateral sufficient to inform third parties of the scope of the security interest.

c. The agreement is signed by the debtor.

d. The creditor has given "value" for the agreement.

e. The debtor has "rights in the collateral."

K.S.A. §84-9-203 (1) (Supp. 1987).

2. The security interest "attaches" when all the events in 1.a.-e. have occurred; unless the parties agree to a later attachment. K.S.A. §84-9-203 (2) (Supp. 1987).

3. "Value" is defined broadly by K.S.A. §1-201 (44) (Supp. 1987) to include traditional "consideration" as well as other interests which may not constitute consideration at common law. For example, security for a pre-existing claim.

4. "Rights in the collateral" is not defined by the UCC. Probably means the debtor must have some sort of ownership interest or right to use the collateral.

B. Perfecting the Security Interest

1. Most oil and gas transactions require perfection by filing a "financing statement." K.S.A. §§84-9-302, 9-304, 9-305 (Supp. 1987); §84-9-303 (1983).

2. A security interest is perfected when: "[I]t has attached and when all the applicable steps required for perfection have been taken." K.S.A. §84-9-303 (1983).

3. The requirements for "perfection" of the security interest can vary depending upon the classification of the collateral.

C. The Financing Statement

1. All financing statements must be in writing and contain the following:

a. The names of the debtor and the secured party.

b. Address of secured party who is able to provide additional information regarding the security interest.

c. Debtor's mailing address.

d. Statement indicating the types, or describing the items, of collateral.

e. Debtor's signature.

K.S.A. §84-9-402 (1) (1983).

2. The typical financing statement used in an oil and gas transaction must also contain:

   a. A statement [as appropriate]:

      (1) That it covers minerals, including oil and gas, before extraction and which attaches to such minerals as extracted, or which attaches to an account resulting from the sale of extracted minerals.

      (2) That it covers goods that are or are to become fixtures.

   b. Contain a legal description of the real estate concerned.

   c. Identify the name of the record owner of the real estate concerned.

   K.S.A. §84-9-402 (5) (1983); K.S.A. §84-9-313 (1983) (fixture filing).

3. NOTE: Kansas deviates from the 1978 Official Text of the UCC by not requiring that the financing statement "recite that it be filed for record in the real estate records." UCC §9-402 (1978).

4. Filing effective upon presenting the financing statement for filing and tendering the filing fee to the appropriate filing officer. K.S.A. §84-9-403 (1) (Supp. 1987).

5. Filing effective for five years from the date of filing. K.S.A. §84-9-403 (2) (Supp. 1987).

6. To maintain perfection of the security interest, must file a "continuation statement" within six months prior to expiration of the five-year effective period. K.S.A. §84-9-403 (3) (Supp. 1987).

7. Continuation statement not required for a real estate mortgage which is effective as a fixture filing. K.S.A. §84-9-403 (6) (Supp. 1987).

Not much help because, without filing a

continuation statement, you will lose rights to your other personal property collateral - accounts, inventory, etc.

E. Where to File?

1. Must file in the correct place to perfect the security interest.

2. Two possible places to file:

   a. Office of the Secretary of State.

   b. Register of Deeds in the appropriate county.

   K.S.A. §84-9-401 (Supp. 1987).

3. General Guide for Oil and Gas Property:

   a. Inventory, Accounts, Proceeds, Fixtures - file with the Register of Deeds in the county where the real estate concerned is located. K.S.A. §84-9-401 (1) (b) (Supp. 1987); K.S.A. §84-9-103 (5) (Supp. 1987); K.S.A. §58-2221 (1983).

   b. Equipment - File with the Secretary of State. K.S.A. §84-9-401 (c) (Supp. 1987).

   c. Interests Carved from the Working Interest - Treat same as oil and gas lease and file as a mortgage, treat as an interest "in minerals or the like . . . before extraction and which attaches thereto as extracted, or with attaches to an account resulting from the sale thereof . . . " and file under the UCC with the Register of Deeds.

      Could they be "general intangibles?" If so, must file with Secretary of State. K.S.A. §84-9-401 (c) (Supp. 1987).

   d. Pipelines - if "primarily engaged in the . . . transmission of goods by pipeline" debtor may qualify as a "transmitting utility" under K.S.A. §84-9-105 (1) (n) (Supp. 1987). Perfect security interest in collateral by filing with Secretary of State. K.S.A. §84-9-401 (5) (Supp. 1987).

CAUTION: May be special statutes concerning perfection of a security interest in collateral owned by a public utility. See, e.g., K.S.A. §17-630, §17-631 (1981); K.S.A. §66-1217 (1985).

NOTE: Most oil and gas producers will not be "primarily engaged in the transmission of goods by pipeline." To perfect security interest in gathering lines must file with Register of Deeds in each county where the lines are located.

e. Multi-state transactions; Conflicts problems. K.S.A. §84-9-103 (Supp. 1987).

4. Practical Guide for Oil and Gas Property:

a. You never know when a "fixture" might be classified as "equipment." Also run the risk that various interests in oil and gas may be classified as "general intangibles." Therefore, FILE WITH THE REGISTER OF DEEDS AND THE SECRETARY OF STATE.

b. Since the oil and gas lease, and probably interests carved from the oil and gas lease, must be filed as a mortgage on real property, consider the following practice:

PREPARE ONE DOCUMENT TO SERVE AS THE MORTGAGE, THE SECURITY AGREEMENT, AND THE FINANCING STATEMENT.

RECORD THE DOCUMENT "MORTGAGE, SECURITY AGREEMENT, FINANCING STATEMENT" WITH:

(1) REGISTER OF DEEDS AS A MORTGAGE.

(2) REGISTER OF DEEDS AS A UCC FINANCING STATEMENT (Ensure it is cross-indexed with the real estate search files).

(3) SECRETARY OF STATE AS A UCC FINANCING STATEMENT.

MAINTAIN UCC FILINGS WITH CONTINUATION STATEMENTS. K.S.A. §84-9-403 (2).

VI. INTERPRETIVE ISSUES - THE MINERAL/ROYALTY PROBLEM

A. Distinction and Importance of the Distinction.

1. Mineral Interest - a right to oil and gas in place with the right to develop or authorize development.

2. Royalty Interest - a right to share in oil and gas when it is produced; no right to develop or authorize development of the minerals.

3. Importance of the Distinction:

   a. Royalty owner need not be included as a party to the oil and gas lease. No right to develop, so no right to authorize development.

   b. Value of interest affected by whether it is cost-free or whether it must pay a proportionate share of the development costs.

      (1) 1/8th royalty entitles owner to a 1/8th share of production.

      (2) 1/8th mineral interest entitles owner to 1/8th share of production <u>less</u> 1/8th of the costs of production.

   c. If at the time the 1/8th interest is conveyed the mineral interest is subject to an oil and gas lease providing for a 1/8th royalty to the landowner:

      (1) Conveying a 1/8th royalty will entitle the grantee to a 1/8th cost-free share of production.

      (2) Conveying a 1/8th mineral interest will entitle the grantee to a 1/64th (1/8th x 1/8th royalty payable under the lease) cost-free share of production.

   d. If found to be a mineral interest, it must be recorded or listed in accordance with K.S.A. §79-420 (1984).

   e. If found to be a royalty interest, it

may be void as a violation of the rule against perpetuities.

B. Labels Not Determinative.

1. The term "royalty" is often inaccurately used to refer to a mineral interest owner's reversionary interest in minerals which are subject to an oil and gas lease. Lathrop v. Eyestone, 170 Kan. 419, 440-41, 227 P.2d 136, 140 (1951).

a. Since mineral owner receives 1/8th royalty pursuant to an oil and gas lease covering the minerals, mineral owner might refer to their mineral interest as a "royalty."

b. Problem becomes compounded when they view their mineral interest as constituting a 1/8th royalty.

Mineral owner intending to convey an undivided one-half mineral interest may, in error, express it as a conveyance of 1/16th royalty in the land. See Powell v. Prosser, 12 Kan.App.2d 626 (1988).

2. True nature of the instrument determined by the intent of the parties as expressed in the specific terms of the instrument.

C. The Interpretive Process.

1. Primary goal - ascertain the intention of the parties.

a. Look at all language used anywhere in the instrument. (Four-corners rule). Terms of the granting clause given particular weight.

b. The title given an instrument is not determinative. However, the contents of the instrument must make it clear it is something other than what its title indicates.

2. Factors Kansas courts have focused on to resolve the mineral/royalty issue include:

a. Does the instrument convey an ownership interest in oil and gas prior to its

actual production?

b. Does the grantee have the right to enter the property to conduct development operations?

c. Does the grantee have the right to lease or otherwise authorize others to develop the property?

3. Courts look for a conveyance or exception of rights commonly associated with a mineral interest.

4. Any Right to Oil and Gas Prior to Production?

a. Mineral Interest - Look to granting clause, and the other parts of the instrument, to determine if it conveys any right to oil and gas "in and under" the land, or any similar language which indicates a right to oil and gas prior to its severance from the land. Shepard v. John Hancock Mutual Life Ins. Co., 189 Kan. 125, 132, 368 P.2d 19, 24-25 (1962).

b. Royalty Interest - Conveys a right to oil and gas when "produced" or otherwise severed from the land. Lathrop v. Eyestone, 170 Kan. 419, 422, 227 P.2d 136, 142 (1951).

c. Many times the instrument conveys an undivided portion of "the oil, gas and other minerals in an under, and that may be produced from" the land.

(1) Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 91-92, 69 P.2d 4, 9 (1937). Court finds that the phrase "and that may be produced from" is not a limitation on the grant of "oil, gas and other minerals in and under the land."

(2) Drach v. Ely, 237 Kan. 654, 658, 703 P.2d 746, 750 (1985). Court finds similar language used in a will "refers to a mineral interest rather than a royalty interest and standing alone does not create any ambiguity."

(3) Powell v. Prosser, 12 Kan.App.2d 626 (1988). Conveyance of oil and gas "in and under and that may be produced from" certain land creates a mineral interest.

5. Right to Enter the Property to Conduct Development?

   a. Mineral Interest - The presence of language giving grantee the right to enter the property (right of ingress and egress) has been relied upon as indicating a mineral interest was intended. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. at 90-91, 69 P.2d at 8 ("statement of the right of the owner of the oil to have some means of getting it.")

   b. Royalty Interest - Lack of right to enter property found significant in holding an instrument excepting "a one sixteenth (1/16) Royalty interest in all oil, gas, or mineral in place" reserves a royalty interest. Corbin v. Moser, 195 Kan. 252, 257, 403 P.2d 800, 804 (1965).

6. Right to Develop the Property or Authorize Others to Develop?

   a. Similar analysis to the presence of right of ingress and egress. If these rights are identified as being part of the interest conveyed, the conveyance creates a mineral interest.

   b. If the interest does not possess these rights, the conveyance may create a royalty interest.

7. What inferences should be drawn from the presence or absence of the right of ingress and egress, the right to develop the property, or the right to authorize others to develop?

   a. For example, if the instrument is silent regarding the grantee's right to enter and develop the property, or to lease it and receive bonus, delay rental, and royalty, should we infer the grantor

intended to convey a royalty interest instead of a mineral interest?

However, since these are all incidents of a mineral interest, why should we state them at all? Would this tend to indicate we are creating something other than a mineral interest?

b. Contrast the two most recent statements by the Kansas Supreme Court on the subject:

Cosgrove v. Young, 230 Kan. 705, 642 P.2d 75 (1982). Holding an instrument granting "one-half (1/2) of the royalty in Oil and Gas produced upon the . . . land" creates a royalty interest, the court considers the following factors:

"No right of ingress and egress is granted. No reference is made to oil, gas and other minerals in and under the land. In short, no further reservations were made in the contract relating to transferability, leasing rights, or other factors previously considered significant by the court. There is nothing in the instrument indicating that more than a bare royalty interest was intended to be conveyed."

Cosgrove, 230 Kan. at 712-13, 642 P.2d at 81-82.

Drach v. Ely, 237 Kan. 654, 703 P.2d 746 (1985). Will devised undivided interest in "the oil, gas and other minerals in and under and that may be produced from" six quarter sections of land. However, excluded from the grant were "any of the oil, gas or mineral lease rentals, delay rentals or bonuses which may be payable under any leases upon said real estate . . . ." Drach, 237 Kan. at 655, 703 P.2d at 748.

Holding this creates a mineral interest, the court notes:

"If the testator had intended to convey only a royalty interest to his children, there would have been no reason to

specify that each surface owner would receive the rentals and bonus paid on his or her property. The other five children would have no claim to such payments and they would inure to the benefit of the surface owner without any such provision." Drach, 237 Kan. at 658-59, 703 P.2d at 750.

D. Recognition of the Nonparticipating Mineral Interest

1. Perhaps the major reason for mineral/royalty problem is a general lack of understanding regarding the nonparticipating mineral interest. However, recent cases recognize the nonparticipating mineral interest - when the document adequately reflects that is what was intended by the parties.

2. In Powell v. Prosser, 12 Kan.App.2d 626 (1988), Ansel, by a document, titled "Oil and Gas Royalty Conveyance," granted "an undivided one sixteenth (1/16) interest in and to all the oil, gas and other minerals in and under and that may be produced from" described land to Adrian. However, Ansel retained the right to lease the entire mineral interest. In the event the property was leased, Adrian would, in addition to royalty, be entitled to 1/2 of all the bonus and delay rental provided for in the lease.

a. Concluding that Adrian had been conveyed a mineral interest instead of a royalty interest, the court observes:

"The above wording, [making it unnecessary for Adrian to join in the execution of an oil and gas lease covering the property] taken by itself, would be indicative of the granting of a royalty interest. However, the conveyance further explains and justifies the court's conclusions that a mineral interest is intended by includig the following provision conveying to the grantee [Adrian] a share of the bonus and delay rentals:

'[T]he grantee, . . . shall be entitled to one hald (1/2) of all bonus or consideration paid for any oil and gas

lease that may be made covering said premises and one half of all rentals that may be paid thereunder.'

"The provision for giving the grantee one-half of the bonus and delay rentals without the right to lease is totally consistent with the intention of granting a present interest in the minerals while leaving with the grantor the sole discretion as to the time and conditions under which a lease might be granted."

Powell, 12 Kan.App.2d at 631.

b. The court concludes its analysis stating:

"Ansel . . . reserved control of the executive or leasing rights, but the granting of one-half of the bonuses and rentals shows the conveyance was of a mineral interest."

Powell, 12 Kan.App.2d at 631.

c. Adrian received a nonparticipating mineral interest as to the leasing or executive rights; he had, however, the passive right to receive income attributable to the mineral interest: bonus, delay rental, and royalty.

VII. INTERPRETIVE ISSUES - FRACTIONAL CONVEYANCES

A. Conveying Minerals Subject to an Oil and Gas Lease

1. Frequent problems in this area because the person drafting the conveyance document fails to recognize the landowner's continued ownership of an 8/8ths mineral interest even though it is under lease providing for a 1/8th royalty.

2. The error typically occurs as follows:

A wants to convey a one-half mineral interest to B. A owns all the mineral interest in Section 30, but it is under lease to C. The lease provides that A will receive 1/8th of the production from the lease as royalty.

A's conveyance to B states:

"A grants unto B an undivided 1/16 interest in and to all the oil, gas and other minerals whatsoever in and under Section 30. If such land is covered by a valid oil and gas or other mineral lease B shall have an undivided 1/2 interest in the royalties, rentals, and proceeds therefrom."

a. Does B have a 1/16th or a 1/2 interest in the Section 30 minerals?

b. Presented with a similar conveyance, the court in Heyen v. Hartnett, 235 Kan. 117, 679 P.2d 1152 (1984), found the conveyance ambiguous and employed rules of construction to ascertain the parties' intent. Holding the instrument conveyed a 1/2 mineral interest, the court was influenced by the "widespread confusion" associated with expressing fractional mineral interests which are under lease.

2. Confusion relates to what the grantor has when their mineral interest is leased. They still own all or 8/8ths of the mineral interest. The interest is merely limited by the terms of the lease contract. A cannot develop, because he has granted that right, by contract, to C. One of A's rights under the contract is receipt of a fractional share of all oil or gas produced from the lease. However, A can still convey all, or part, of his mineral interest.

3. Kansas courts will look at all provisions in the instrument, the surrounding circumstances, and applicable rules of construction [such as K.S.A. §58-2202 (1983)] to ascertain the intent and purpose of the parties in using fractions to describe the interest conveyed.

4. The court in Powell v. Prosser, 12 Kan.App.2d 626 (1988), recently applied the Heyen v. Hartnett reasoning and held a conveyance of 1/16th of the oil and gas in and under certain land should be interpreted to convey a 1/2 mineral interest. Other portions of the conveyance document, following the granting clause, gave the grantee rights to

at least a 1/16th royalty and 1/2 of any bonus and delay rental. The court obeserves:

"This difficulty is occasioned where it is not understood that owners of mineral interests still own all of the minerals even if they are subject to a lease reserving to the mineral interest owners one-eighth or some other fractional royalty. As a consequence, the conveyancer wishing to convey a one-half mineral interest expresses it by conveying one-sixteenth of the minerals, erroneously believing, since the land is under lease, one-half of his interest is one-half of the one-eighth royalty or one-sixteenth."

Powell, 12 Kan.App.2d at 632.

5. Drafting to avoid the problem - when conveying fractional mineral interests, refer to the fraction conveyed without reference to the landowner's royalty.

   a. Example: A wants to convey B a 1/4th mineral interest, the land is under lease providing for payment of a 1/8th royalty. The instrument should refer only to the 1/4th mineral interest without addressing the grantee's resulting interest in royalty.

      A conveys to B an undivided 1/4th of 4/4ths of the oil, gas, and similar hydrocarbon substances in Section 30 . . . .

   b. A general statement, concerning the incidents of mineral ownership, can be used if it is phrased in terms of a "1/4th interest in all rights under existing leases on the property" as opposed to a "right to a 1/32 cost-free share of production from the property."

B. Fractional Royalty vs. Fraction "Of" Royalty

1. Landowner conveys "1/16th royalty," landowner conveys 1/16th of all production from the land. If mineral interest is leased giving landowner a 1/8th royalty, the landowner is deemed to have conveyed 1/2 of his 1/8th royalty. Bellport v. Harrison, 123 Kan. 310,

311, 255 P.52, 54 (1927) (contract for purchase of "1/16th royalty" in land conveyed 1/2 of landowners' 1/8th royalty).

2. Landowner conveys "1/16th of his 1/8th royalty," the landowner is deemed to have conveyed 1/16th of 1/8th or a 1/128th royalty. Hickey v. Dirks, 156 Kan. 326, 133 P.2d 107 (1943). Problem: 1/16th of 1/8th of royalty. Does this mean 1/16th of 1/8th of 1/8th? Or 1/16th of 1/8th?

3. Guide: If there is no limitation on the source for the fractional interest, it will be calculated based on an entire (8/8ths) mineral interest. See Corbin v. Moser, 195 Kan. 252, 403 P.2d 800 (1965).

C. Conveying Fractional Interests When Grantor Owns A Fractional Interest

1. A owns a 3/4ths mineral interest in Section 30. A conveys a 1/2 mineral interest in Section 30 to B. Does B get a 1/2 mineral interest (1/2 x 4/4) or a 3/8ths mineral interest (1/2 x 3/4)?

   a. B gets a 1/2 mineral interest.

   b. K.S.A. §58-2202 (1983) dictates that B receive a 1/2 mineral interest, even though A only owns a 3/4ths mineral interest and intended to convey only a 3/8ths (1/2 x 3/4) mineral interest.

   c. K.S.A. §58-2202 requires that A's intent "to pass a less estate shall expressly appear or be necessarily implied in the terms of the grant."

2. Using the same facts in item 1. above, suppose A excepts from his conveyance to B a 1/2 mineral interest in Section 30. What will A have? A 1/2 or 3/8ths mineral interest? - or perhaps a 1/4th interest? What will B receive? A 1/4th, 3/8ths, or 1/2 mineral interest?

   a. Problem is A has failed to designate the source which should be used to calculate the fractional mineral interest reserved to A.

b. Drafting - simple remedy is to state the base fraction from which the excepted or conveyed fraction is to be taken. For example, A could state:

(1) A conveys to B a 1/2 of 3/4ths mineral interest in Section 30. A could also make the same conveyance by giving B a 3/8ths of 8/8ths mineral interest.

(2) A excepts a 1/2 of 8/8ths mineral interest in Section 30.

3. Interpreting Fractional Conveyances.

Although the drafting solution is simple, the process of interpreting inartfully drafted fractional conveyances is difficult. Consider the following case:

In 1985 A conveys Section 30 to B, with A retaining an undivided 1/2 mineral interest; B records the conveyance. In 1986 B conveys, by warranty deed, Section 30 to C "retaining unto B an undivided 1/2 interest in the minerals."

a. B, immediately prior to the conveyance to C, has only an undivided 1/2 interest in the minerals. Will C receive:

(1) No interest in the minerals;

(2) A 1/2 interest; or

(3) A 1/4th (1/2 of B's 1/2) interest?

b. Apparently, the Kansas appellate courts have not addressed this issue.

c. Texas Supreme Court dealt with a similar factual issue in Duhig v. Peavy-Moore Lumber Co., 135 Tex. 503, 144 S.W.2d 878 (1940), which spawned the Duhig Doctrine.

d. Under the Duhig Doctrine C gets a 1/2 mineral interest, leaving B with no mineral interest.

e. In Duhig, since B made a warranty

conveyance to C, the court, applying estoppel and after-acquired title principles, takes from B's excepted 1/2 mineral interest the amount (1/2) required to satisfy the warranted conveyance to C - a 1/2 mineral interest.

f. Commissioner Smedley, applying principles similar to K.S.A. §58-2202, notes: "the language of the deed as a whole does not clearly and plainly disclose the intention of the parties that there be reserved to the grantor Duhig an undivided one-half interest in the minerals in addition to that previously reserved to Gilmer's [A's] estate . . . ." Duhig, 135 Tex at 506-07, 144 S.W.2d at 879.

g. Supporters of Duhig Doctrine - can look at record title and determine who owns what. Duhig attackers - it seldom comports with the intent of the parties; should examine the subjective intent of the parties to determine intent.

h. What if C has knowledge, at the time of the B/C conveyance, of the 1/2 mineral interest previously reserved to A?

(1) K.S.A. §58-2222 (1983) - if properly recorded "all subsequent purchasers . . . shall be deemed to purchase with notice."

(2) Imputing notice to C still does not resolve the ambiguity surrounding B's intent. To determine B's actual intent, you would have to declare the deed ambiguous. On its face, it is not ambiguous.

(3) Should the court, as a matter of law, declare such conveyances ambiguous and allow extrinsic evidence of B's actual intent? Or should the court interpret the conveyance using rules similar to those employed in Duhig and leave B to seek relief through reformation?

VII. INTERPRETIVE ISSUES - NONAPPORTIONMENT RULE

A. Apportionment of Royalty

1. Suppose A purchases a divided mineral interest in the West Half of Section 30 when all of Section 30 is subject to an oil and gas lease. A well is subsequently completed as a producer on the East Half of Section 30. Assuming no implied covenant problems, production from the East Half will perpetuate the lease as to all of Section 30.

2. Unless the lease contains an "entireties clause," or special provision is made for apportionment in the conveyance document, A will not receive any royalties from production on the East Half - even though the West Half is subject to the lease. Carlock v. Krug, 151 Kan. 407, 99 P.2d 858 (1940).

3. Apportionment becomes an issue anytime there is a conveyance of a divided interest in minerals which are subject to an oil and gas lease covering the divided interest and other lands.

B. Entirety Clause

1. To achieve an apportionment of royalties in the event the leased land is subsequently divided into separate tracts, oil and gas leases often contain an entirety clause similar to the following:

"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."

Brubaker v. Branine, 237 Kan. 488, 489, 701 P.2d 929, 920-31 (1985).

2. Example: A, owner of Section 30, leases it to X on 1 January 1987. On 2 January 1987 A conveys the SW1/4 to B and the SE1/4 to C. On 1 February 1987 a producing well is drilled on A's retained N1/2 of Section 30.

a. If the lease does not contain an

entirety clause, in Kansas A would receive all the royalty. B and C would receive nothing.

b. If the lease contains a Brubaker type entirety clause, royalty would be divided as follows: A 1/2, B 1/4, C 1/4.

IX. ROYALTY CALCULATION PROBLEMS

A. The Royalty Clause

1. Defines the share of production which must be allocated to the mineral owner either in kind or money.

2. Basic problems:

   a. Share of the market value of production or a share of the proceeds from the sale of production.

   b. Once the gross royalty figure is determined, can any expenses be deducted from the gross figure to arrive at the amount due the royalty owner.

3. Problems associated with calculation of royalty under the royalty clause are discussed at section IV. (page 71) of this Outline.

B. Other Lease Clauses Affecting Royalty Calculation

1. The typical form of oil and gas lease will contain clauses which affect how delay rental, shut-in royalty, and royalty will be calculated. These clauses may significantly reduce the amount due under the clause authorizing the payment. The three most common of such lease clauses are: the proportionate reduction clause, pooling clause, and entirety clause.

2. Proportionate Reduction Clause - also called a "lesser interest" clause.

   "If said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided shall be paid the lessor only in the proportion

which his interest bears to the whole and undivided fee."

a. Regardless of the lessor's actual mineral ownership in the leased land, the oil and gas lease typically states the lessor owns, and leases, 100% of the mineral interest in the leased land.

b. Lessor's right to lease benefits is then reduced to reflect their actual ownership of minerals in the leased land.

c. Protects lessee's net revenue interest in the lease by ensuring lessee does not contract to pay more than the specified royalty (e.g. 1/8th) to gain control of all the minerals encompassed by the lease.

d. For Example: Using the proportionate reduction clause in paragraph IV.E.2., A grants X an oil and gas lease which purports to cover all the mineral interest in Section 30. Assume A owns 50% of the mineral interest in Section 30.

Although the lease, on its face, indicates A will receive $640 in delay rental and shut-in royalty, and a one-eighth royalty on production, the proportionate reduction clause will reduce each item ("royalties and rentals") to "the proportion which his [A's] interest [50%] bears to the whole undivided fee [100%]."

Therefore, the lease entitles A to only $320 in delay rental and shut-in royalty (50/100 x $640) and a one-sixteenth royalty on production (50/100 x 1/8).

3. Pooling Clause

a. Many times oil and gas leases contain a pooling clause which authorizes the lessee to combine the leased land with adjacent lands to permit development in accordance with state spacing and prorationing laws.

b. The effect of a pooling clause is to combine leased acreage in a designated area to form a "pooled" unit. Mineral owners contributing acreage to the pooled unit will share in production from the unit. Each mineral owner's share of production, however, will generally be proportionate to their share of the acreage included in the pooled unit. See generally Tiller v. Fields, 301 S.W.2d 185 (Tex. Civ. App. 1957).

c. For Example: A owns the minerals in the Southwest Quarter of the Southwest Quarter of Section 30 (40 acres). Lessee X, pursuant to pooling clauses in X's leases with A, B, and C, declares a pooled unit consisting of Section 30 (640 acres). B owns the minerals in the East Half of the Southwest Quarter (80 acres) and C owns the remainder of the minerals in Section 30 (520 acres).

A well is completed on the Southwest Quarter of the Southwest Quarter of Section 30. Assuming each lease provides for a lessor's royalty of one-eighth, the typical form of pooling clause will adjust each lessor's royalty as follows:

A: 1/8 x 1/16 (40/640 acres) = 1/128
B: 1/8 x 2/16 (80/640 acres) = 2/128
C: 1/8 x 13/16 (520/640 acres) = 13/128

This assumes, as is typically the case, each party's participation will be determined according to the surface acreage they contribute to the pooled unit.

4. Nonapportionment and the Entirety Clause

a. Leases sometimes contain an "entirety clause" which provides that if ownership of the leased minerals is divided into separate tracts, after the lease is entered into, the lease benefits, including royalty, will be apportioned among the various tract owners on a surface acreage basis.

b. See discussion at section VII. (page 127) of this Outline.

X. RULE AGAINST PERPETUITIES

A. The Basic Rule

1. No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest.

   McEwen v. Enoch, 167 Kan. 119, 124, 204 P.2d 736, 740 (1949).

2. Must vest within a specified period of time from creation of the interest.

   a. Created by will, clock begins upon testator's death. See generally In re Freeman's Estate, 195 Kan. 190, 404 P.2d 222 (1965).

   b. Created by an inter vivos transaction, clock begins when delivery is complete or the interest otherwise becomes effective. Kenoyer v. Magnolia Petroleum Co., 173 Kan. 183, 186, 245 P.2d 176, 179 (1952).

3. If there is any possibility the interest will not vest within the time required by the rule, it is void. McEwen, 167 Kan. at 124, 204 P.2d at 740.

B. The Rule and the Oil & Gas Property Interest

1. Mineral interest vests immediately when the conveyance is complete. Lathrop v. Eyestone, 170 Kan. 419, 423-24, 227 P.2d 136, 141 (1951).

2. In Kansas a royalty interest vests only when oil or gas is actually produced.

   a. Example: A assigns B a 1/16th royalty interest in oil and gas produced from Section 30.

   b. This grant will not vest until oil or gas is produced from Section 30. Cosgrove v. Young, 230 Kan. 705, 715,

642 P.2d 75, 83 (1982). This is not certain to occur within 21 years from the conveyance so it is void.

3. Same result if A assigns to B one-half the royalty provided for under existing and future oil and gas leases on Section 30. No interest will vest until production. Lathrop, 170 Kan. at 428-29, 227 P.2d at 143-44.

4. My prediction - Kansas Supreme Court will reconsider this rule.

XI. STATUTES AFFECTING THE OIL & GAS PROPERTY INTEREST

A. Listing Mineral Interests for Taxation

1. K.S.A. §79-420 (1984) requires severed mineral interests to be recorded or "listed" for taxation. Recording must occur within 90 days after the conveyance is executed or the interest will be deemed void if not listed for taxation.

2. Compliance with the statute is a condition precedent to title vesting in the grantee. Becker v. Rolle, 211 Kan. 769, 774, 508 P.2d 509, 513 (1973).

B. Notice Of Producing Leases - Affidavit Of Production

1. K.S.A. §55-205 (1983) limits the constructive notice effect of a recorded oil and gas lease to its primary term.

2. Most oil and gas leases will terminate unless a contingency in the lease is satisfied - usually production in paying quantities.

3. To maintain the constructive notice provided by the recorded lease, beyond the primary term, the lessee can file an affidavit indicating a contingency required to continue the lease has been satisfied.

4. Since production is the typical contingency, the lessee files what has become known as an "Affidavit of Production."

5. Affidavit must state:

a. Description of the lease;

b. Affiant is the owner of the lease; and

c. Facts showing the required contingency has occurred.

6. Failure to file an affidavit may result in a third party attaining the status of a bona fide purchaser or encumbrancer (without actual notice of your continued rights) and defeating or subordinating lessee's leasehold interest.

C. Kansas Mineral Lapse Act

1. Under K.S.A. §§55-1601 et seq. (1983) any "unused" "mineral interest" can be terminated and become vested in the surface owner.

2. "Uses" defined in K.S.A. §55-1603 (1983).

3. Broad definition of "mineral interest" to include "an interest of any kind" in minerals. K.S.A. §55-1601 (1983).

4. Period of continuous nonuse - 20 years.

5. Mineral interest owner can prevent lapse by:

a. "Using" the interest within the 20 year period.

b. Filing a statement of claim to the interest within the twenty-year period.

c. Filing a statement of claim within 60 days of the surface owner giving notice of the lapse.

6. Surface owner initiates the process by sending a notice of lapse to the mineral interest owner. If they fail to respond and file a statement of claim within the 60 day period, the interest is "extinguished" and vests in the surface owner. K.S.A. §§ 55-1604 and 55-1605 (1983).

7. Following the lapse procedure will not vest surface owner with marketable title to the lapsed interest. Still must quiet title to give mineral interest owner an opportunity to establish that the interest was "used" and

therefore not subject to the Mineral Lapse Act proceeding.

XII. 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 cosideration 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.

PART 4 - REPRESENTING THE INVESTOR AND END USER

I. REPRESENTING THE OIL & GAS INVESTOR

A. What Type of Deal?

1. Can classify most oil and gas development deals into three general categories:

   a. Exploration Drilling

   b. Development Drilling

   c. Producing Properties

2. Risk factor greatest with exploration drilling - odds are you will not get any return on your investment.

3. Lowest risk investment is in producing properties.

B. The Major "Risk" Factor - The Promoter

1. Questions you should pose to the promoter:

   a. How much of their own cash is being invested in the venture.

   b. What has been their past development record.

   c. Will they make money even if the venture results in a dry hole.

d. References from other developers and prior investors.

2. Obtain a copy of the proposed investment contract and the proposed operating agreement.

   a. If there is no written investment agreement, propose one.

   b. Operating agreement should protect investors from having their interests encumbered by the developer's failure to properly apply investment funds.

   c. Consider escrow arrangement to ensure investment funds are properly applied.

   d. Ensure all material aspects of the transaction are contained in the investment agreement. This should include incorporating a copy of the operating agreement that will be used.

3. Obtain professional assistance to evaluate the proposal.

4. Ensure you obtain title to your interest and have it properly recorded.

C. The Second Major Risk Factor - Personal Liability

1. To the extent possible, leverage your risk through contract (operating agreement, indemnity provisions), by obtaining insurance, by structuring the transaction to coincide with your expertise and the amount of risk you are willing to assume.

2. Beware of the "mining partnership." See generally Blocker Exploration v. Frontier Exploration, 740 P.2d 983 (Colo. 1987). Depending upon the terms of the agreements between the operator (promoter) and the nonoperators (investors), and the degree of control the nonoperators exercise, the nonoperators may become personally liable for debts incurred by the operator in conducting the "mining partnership."

II. REPRESENTING THE INDUSTRIAL "END USER"

A. The Natural Gas Act of 1938

1. 15 U.S.C. §§ 717 et seq. establishes a comprehensive scheme of federal regulation over:

a. The transportation of natural gas in interstate commerce;

b. The sale in interstate commerce of natural gas for resale; and

c. Natural gas companies engaged in such transportation or resale.

2. Exemption in § 1(b) for the "production" and "gathering" of natural gas.

3. Administered by the Federal Power Commission (FPC) until jurisdiction transferred to the Federal Energy Regulatory Commission (FERC).

B. The Phillips Decision

1. In Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954) the Court held that a sale of gas from an independent producer to an interstate pipeline was a "sale in interstate commerce of natural gas for resale" and therefore subject to federal regulation.

2. FPC then tried to apply cost-of-service rate making concepts to a structurally competitive industry - they failed.

C. The Legacy of the NGA and Phillips

1. Divided the industry into three distinct functional segments:

a. Production - Oil and gas companies explore for and extract gas which they sell at or near the field where it is produced.

b. Transportation - Pipeline buys gas from producer at or near the field where produced and transports it to either:

(1) Another pipeline.

(2) A "local distribution company" (LDC).

(3) An "end user," such as the Acme Refinery.

c. Distribution - An LDC buys gas from the Pipeline for resale to LDC customers - such as a homeowner buying gas, from the local gas utility company, to heat their home.

2. Producers were seldom able to deal directly with end users and LDCs because they were dependent upon the pipeline to move their gas from the point of production to its point of ultimate consumption.

3. Pipelines are not "common carriers." They could refuse to transport gas even though the producer (or end user, LDC, or an upstream or downstream pipeline) was willing to pay the requested transportation rate and there was pipeline "capacity" (space) available to move the gas.

4. Pipelines were therefore able to maintain a regulated monopoly over the gas merchant function as well as the transportation function.

a. By controlling access to transportation, they could control, or eliminate, gas sales competition by producers. At the other end of the tube, it eliminated the ability of the end user and LDC to shop around for gas.

b. By controlling access to transportation, they could exert monopsony pressure on Producers to try and obtain gas on the most favorable terms possible.

c. The transportation monopoly could be protected by using the regulatory system to make it difficult, and expensive, for other interstate pipelines to obtain the right to service areas served by an existing pipeline.

d. The only major source of competition under the NGA was from intrastate pipelines which generally served only

states which had significant gas production. However, they competed against the interstate pipelines in two arenas:

(1) Gas purchases from producers; and

(2) Gas sales to end users and in-state distributors.

D. The Natural Gas Policy Act of 1978 (NGPA)

1. It was ultimately intrastate competition for gas supplies (purchases) that gave rise to the NGPA. In effect, the NGPA eliminated price-competition for wellhead purchases of gas by establishing the maximum price that could be paid for the gas by any entity (interstate or intrastate).

2. However, the maximum price approach would (from 1979 through 1987) be phased out (for most "new gas" supplies) and market forces would presumably determine the price paid for gas at the wellhead.

3. The amount paid for gas by the pipeline could be "passed through" to its gas customers (end users, LDCs, downstream pipelines), so long as the price paid for gas at the wellhead did not exceed the NGPA maximum lawful price -- UNLESS it could be demonstrated the gas purchase was "excessive due to fraud, abuse, or similar grounds." NGPA § 601(c)(2).

4. The NGPA (§ 311) also attempted to integrate the intrastate, interstate, and LDC gas transportation systems by permitting each segment (interstate pipeline, intrastate pipeline, local distribution pipeline) to haul gas for one another without pursuing burdensome regulatory procedures.

However, it remained purely optional with each segment whether it desired to deal with one or more of the other segments.

E. Restructuring the Gas Industry for Effective Competition: FERC Initiatives

1. FERC has acknowledged that only the transportation function requires regulation as a natural monopoly. The production and

sales function is structurally competitive; regulation suitable for a natural monopoly is unnecessary.

FERC is now proceeding to dismantle 35 years (and in some cases 50 years) of regulated gas marketing.

2. FERC is attempting to relieve each of the three main bottlenecks in the gas marketing system:

   a. Limitations on producer and LDC/end user access to transportation.

   b. Limitations on LDC/end user ability to shop around for gas.

   c. Limitations on producer ability to sell gas to anyone but the pipeline.

F. Eliminating the Transportation Bottleneck - Special Marketing Programs

1. Early attempts by FERC to provide access to pipeline transportation facilities: "Special Marketing Programs" (SMPs).

   a. Designed to permit producers and pipelines to compete for customers which could readily switch to competing fuels.

   b. Designed to permit producers to market increased gas volumes while providing pipeline benefits in the form of:

      (1) Reduced take-or-pay liability; and

      (2) Increased throughput.

   c. Permit the sale of gas at discounted prices, or provide transportation services, to permit gas transactions at unit prices below the pipeline's weighted average cost of gas (WACOG).

      (1) Often the pipeline's WACOG exceeded the cost of competing fuels - such as #2 or #6 fuel oil.

      (2) The pipeline's "captive customers," those that could not switch to alternative energy sources (most

LDCs and their residential customers), generally had to purchase gas at the pipeline's WACOG - they were prohibited from pruchasing SMP gas. Only customers currently using alternate fuels could buy SMP gas.

2. In Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985) (MPC I) and 761 F.2d 780 (D.C. Cir. 1985) (MPC II), the court held SMPs which gave one class of customers discounted gas prices (MPC I) or access to transportation to facilitate direct sales (producer to end user) (MPC II), while denying it to another class of customers, vioated the NGA's prohibition of "undue discrimination."

3. FERC responded with Order No. 436.

G. Eliminating the Transportation Bottleneck - FERC Order No. 436

1. Pipeline given the option to seek a "blanket certificate" to provide transportation services.

2. Under the non-Order 436 regime, FERC must approve all transportation transactions and specifically authorize the pipeline to provide the service.

3. Two types of transportation authorization:

a. Certificate of public convenience and necessity issued under NGA § 7(c).

NGA § 7(c) provides, in part:

"(c)(1)(A) No natural-gas company . . . shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor . . . unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations . . . ."

b. "Self-implementing" transactions "on

behalf of" intrastate pipelines or LDCs pursuant to NGPA § 311.

NGPA § 311 provides, in part:

"(a)(1)(A) . . . The Commission may, by rule or order, authorize any interstate pipeline to transport natural gas on behalf of -
(i) any intrastate pipeline; and
(ii) any local distribution company.

"(a)(2)(A) . . . The Commission may, by rule or order, authorize any intrastate pipeline to transport natural gas on behalf of -
(i) any interstate pipeline; and
(ii) any local distribution company served by any interstate pipeline."

4. Primary benefit of an Order 436 (Part 284) Blanket Certificate:

a. "Blanket" certificate of public convenience and necessity authorizing transportation by pipeline on behalf of others (e.g., interstate pipelines, end users, producers) without having to obtain a prior certificate for each transaction.

b. Generic authority to engage in NGA § 7(c) transactions and generic authority to abandon the service once the transaction is completed.

(1) Under NGA §7(b): "No natural-gas company shall abandon . . . any service
. . . without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the . . . present or future public convenience or necessity permit such abandonment."

(2) The Order 436 blanket certificate authorizes pre-granted abandonment upon the expiration of the underlying transportation agreement.

c. This reduction of regulatory review of transportation functions allows the pipeline to react quickly to transportation requests and compete for gas sales and transportation business.

d. Other major Order 436 incentives:

(1) Freedom to discount transportation rates within a minimum and maximum rate band approved by FERC.

(2) Availability of "optional expedited certificates" to construct facilities necessary to provide transportation services. Eliminates the traditional protracted §7(c) certificate process - but the pipeline's stockholders must assume the risk that the new facility will not generate enough income to recoup their construction investment.

e. FERC has fashioned its subsequent orders to provide pipelines with additional incentives to accept an Order 436 blanket certificate.

5. Public interests, previously protected by case-by-case review of § 7(c) transactions, are protected by the pipeline agreeing to specific blanket certificate conditions specified in Order 436.

6. The major condition is that pipelines must provide transportation on a non-discriminatory "open-access" basis.

7. Other Order 436 Conditions:

a. Pipeline must offer firm and interruptible service.

b. Pipeline capacity must be allocated on a "first-come, first-served" basis.

c. Employ generic rate conditions in developing their transportation rates. Rates must be:

(1) Cost-based (what does it cost the pipeline to provide the specified

service). Note that items (2) through (8) are merely refinements of the cost-based rate requirement.

(2) Volumetric-based (the quantitiy of gas being moved).

(3) Transportation component of the rate must be the same whether the service being requested is "sales" or "transportation."

(4) Must breakout (unbundle) the costs of pipeline services such as gathering, transportation, and storage.

(5) Based upon projected units of service.

(6) Based upon whether the service is firm or interruptible service.

(7) Based upon the time of service: peak or off-peak.

(8) Based upon the distance gas is moved.

H. Eliminating the Demand Bottleneck -

1. FERC has attempted to address the demand bottleneck by eliminating regulatory and contractual restrictions which, directly or indirectly, foreclose an end user or LDC from seeking alternative gas supplies.

2. FERC Order No. 380

a. FERC found that minimum charges imposed upon a pipeline's gas sales customers, regardless of their gas purchase levels, made it economically impossible for such customers to shop around for lower priced gas supplies.

b. Order 380 focused on the imposition of a "minimum commodity bill" for variable costs (those that vary with the level of service - the primary variable cost being purchased gas costs). The customer had to pay for a minimum amount of gas even though they didn't take any

gas.

The minimum bill was designed to compensate the pipeline for having the reserves available to provide the full contracted service. The pipeline would generally contract with producers for the reserves necessary to provide the level of service its customers demanded. The minimum bill mechanism was the primary means used by pipelines to recoup their take-or-pay payments to producers.

c. Order 380 was generally affirmed in Wisconsin Gas Co. v. FERC, 770 F.2d 1144 (D.C. Cir. 1985).

3. FERC Order No. 436

a. Provides the firm sales customers of a pipeline the option to convert firm sales service to firm transportation service.

b. Order 436 also allowed firm sales customers to reduce the amount of gas they had contracted to purchase from the pipeline (contract demand "CD" reduction vs. contract demand "CD" conversion). In Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987) the CD reduction part of Order 436 was remanded for FERC's reconsideration.

4. FERC Order No. 500

a. Recognizing the value of having pipelines provide backup gas supply service to its customers (sales and transportation), pipelines can impose a charge for maintaining gas supplies for backup service (identified by many different names: future gas supply charge, gas inventory charge, etc.).

b. This is essentially a minimum bill. FERC has described the difference between this minimum bill and the Order 380 situation as follows:

"The minimum commodity bill was an attempt to deal with this (take-or-pay)

problem, but its design did not work well as competition increased. One central problem was that the minimum bill was not the result of voluntary selection from a menu of services that enabled the customer to obtain exactly the level of supply security it desired at a charge known in advance. The principles underlying future gas supply charges, as adopted here, are intended to remedy this problem."

5. Congress has acted to reduce the demand bottleneck by:

   a. Eliminating restrictions on the use of gas for certain purposes. See Pub. L. No. 100-42, 101 Stat. 310 (1987). In 1978 Congress enacted the Powerplant and Industrial Fuel Use Act of 1978 (PIFUA), Pub. L. No. 95-620, 92 Stat. 3289 (1979), which restricted the use of gas to generate electricity and as a fuel for other major fuel burning facilities.

   b. Eliminating pricing mechanisms which discourage industrial use of gas as a fuel source. See Pub. L. No. 100-42, 101 Stat. 310 (1987). In 1978, as part of the Natural Gas Policy Act, Congress required the imposition of "incremental pricing" to raise the cost of gas to levels that approached the "appropriate alternative fuel costs."

I. Eliminating the Supply Bottleneck

1. Even though FERC was able to open up new markets for gas (Demand), and provide access to such new markets (Transportation), two impediments on the Supply end of the pipeline had to be addressed:
1. Gas reserves tied-up by long-term contracts; and 2. Gas reserves tied-up by the service abandonment requirement of NGA §7(b).

2. Abandonment

   a. Traditional Approach - gas subject to service obligation even though the gas sales contract terminated (or the underlying oil and gas lease

terminated). To obtain abandonment of the service obligation, must initiate proceeding under NGA §7(b) and demonstrate the need of the new (proposed) gas sale customers are greater than the needs of the existing customers.

b. FERC has attempted to reduce the regulatory burden of the abandonment requirement by:

(1) Using pre-granted abandonment when the service is certificated.

(2) Granting limited-term abandonments.

(3) Authorizing abandonment "legislatively" by rule when certain conditions exist.

c. The test for determining whether the public convenience and necessity will be served by abandonment has been changed by FERC to compare the needs of existing customers with the benefits freeing-up the gas would offer to the market as a whole.

(1) FERC takes the view that the market benefits will, in most every case, exceed the needs of the existing customers. This permits a generic (legislative vs. adjudicatory) approach to abandonment.

(2) FERC's new comparative needs test was generally approved in Consolidated Edison Co. of New York v. FERC, 823 F.2d 630 (D.C. Cir. 1987).

d. FERC Order No. 490 - permit party to an expired contract to abandon the service without a §7(b) proceeding - merely give 30 days notice to other party and "report" the abandonment to FERC within 30 days after it occurs.

(1) Applies to expired or terminated contracts where there is a NGA service obligation.

(2) Applies to contracts to the extent a pipeline has exercised its contractual authority to reduce takes below the specified level.

(3) Applies to contracts where the parties mutually agree to abandonment.

(4) Producers are granted blanket certificates to resell the abandoned gas.

e. FERC Order No. 451 - authorizes abandonment if the "good faith negotiation" procedure results in a termination of the gas contract. Also give producers blanket sales certificates.

f. FERC Order No. 436 - authorizes expeditious Commission action on abandonment requests to facilitate take-or-pay settlements between producers and pipelines.

3. Long-Term Contracts - FERC Order No. 451

a. Order 451 permits producers with old low-priced gas contracts (NGPA §§ 104 & 106) to force their pipeline purchaser into negotiations (either through voluntary action or through forced "good faith negotiations" (GFN)) to raise the price of the gas to an amount which more nearly represents the current market value of the gas.

Pipeline has a reciprocal right, against the producer triggering the GFN process, to bring to the table any high-priced gas which is sold with low-priced gas (sold under the same contract). Pipeline can force the producer to negotiate to reduce the high-priced gas to a price which more nearly represents the current market values.

If the parties agree on a new price - the contract continues. If they fail to agree - the contract can be terminated by either party and the gas abandoned from the service obligation.

b. Target Price Used - highest price authorized by NGPA for post-1974 vintage old gas ($2.57 per MMBtu as of June 6, 1986). Spot gas price on ANR's Custer County, Okla. receipt point/zone for August 1988 was $1.30/MMBtu.

c. Before producer can use the 451 process, must have a contract which authorizes higher prices - such as an area rate clause (clause which permits the contract price to rise to levels established by applicable regulation).

d. Effect of Order 451 will be to arrive at new contracts which reflect the current market environment or the termination of existing contracts to permit the parties to bargain with others.

e. Order 451 grants abandonment of old sales where the parties fail to agree and provides blanket certification of new sales.

J. New Business Opportunities

1. End users can now shop for gas in the field where it is produced and then purchase transportation services from the pipeline to ship it to their plants.

2. Many attorneys who represent clients that require large energy supplies may become involved in arranging direct sales transactions for their clients.

3. Work may focus on contracts with the gas producer, the transporting pipeline, the gas marketer or broker, and the exisitng supplier - usually a local distribution company (LDC) or a direct sale from a pipeline company.

4. Extremely large users may attempt to obtain their own storage reservoirs. See Anderson v. Beech Aircraft Corp., 237 Kan. 336, 699 P.2d 1023 (1985).

5. Representing the end user in these transactions will require an understanding of oil and gas law, public utility law, and the current regulatory programs administered by FERC.

Form 88 — (Producers)
Kan., Okla. & Colo. 1962 Rev. **B W**

OIL AND GAS LEASE

Reorder No. 09-119

KANSAS BLUE PRINT CO. INC.

THIS AGREEMENT made this _____ day of _____, 19____, between

_____

_____

_____ of _____
(Post Office Address)

herein called lessor (whether one or more), and _____ lessee:

1. Lessor, in consideration of _____ Dollars ($_____) in hand paid, receipt of which is here acknowledged and of the royalties herein provided and of the agreements of the lessee herein contained, hereby grants, leases and lets exclusively unto lessee for the purpose of investigating, exploring, prospecting drilling, mining and operating for and producing oil, liquid hydrocarbons, all gases, and their respective constituent products, injecting gas, water, other fluids, and air into subsurface strata, laying pipe lines, storing oil, building tanks, power stations, telephone lines, and other structures and things thereon to produce, save, take care of, treat, manufacture, process, store and transport said oil, liquid hydrocarbons, gases and their respective constituent products and other products manufactured therefrom, and housing and otherwise caring for its employees, the following described land, together with any reversionary rights and after-acquired interest, therein situated in _____ County, Kansas, to-wit:

A-1

In Section _____, Township _____, Range _____, and containing _____ acres, more or less, and all accretions thereto.

2. Subject to the provisions herein contained, this lease shall remain in force for a term of ten (10) years from this date (called "primary term"), and as long thereafter as oil, liquid hydrocarbons, gas or other respective constituent products, or any of them, is produced from said land or land with which said land is pooled.

3. The royalties to be paid by lessee are: (a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected; (b) on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale; and (c) at any time, either before or after the expiration of the primary term of this lease, if there is a gas well or wells on the above land (and for the purposes of this clause (c) the term "gas well" shall include wells capable of producing natural gas, condensate, distillate or any gaseous substance and wells classified as gas wells by any governmental authority) and such well or wells are shut in before or after production therefrom, lessee or any assignee hereunder may pay or tender annually 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 provided for in this lease for the acreage then held under this lease by the party making such payments or tenders, and if such payments or tenders are made it shall be considered under all provisions of this lease that gas is being produced from the leased premises in paying quantities. Such substitute gas royalty may be paid or tendered in the same manner as provided herein for the payment or tender of delay rentals.

4. If operations for drilling are not commenced on said land or on land pooled therewith on or before one (1) year from this date, this lease shall terminate as to both parties, unless on or before one (1) year from this date lessee shall pay or tender to the lessor a rental of _____ Dollars ($_____) which shall cover the privilege of deferring commencement of such operations for a period of twelve (12) months. In like manner and upon like payments or tenders, annually, the commencement of said operations may be further deferred for successive periods of the same number of months, each during the primary term. Payment or tender may be made to the lessor or to the _____ Bank of _____, which bank, or any successor thereof, shall continue to be the agent for the lessor and lessor's successors, heirs and assigns. If such bank (or any successor bank) shall fail, liquidate, or be succeeded by another bank, or for any reason fail or refuse to accept rental, lessee shall not be held in default until thirty (30) days after lessor shall deliver to lessee a recordable instrument making provision for another method of payment or tender, and any depository charge is a liability of the lessor. The payment or tender of rental may be made by check or draft of lessee, mailed or delivered to said bank or lessor, or either lessor if more than one, on or before the rental paying date. Notwithstanding the death of the lessor or his successors in interest, the payment or tender of rentals in the manner provided herein shall be binding on the heirs, devisees, executors and administrators of the lessor his successors in interest.

6. Lessee is hereby granted the right to pool or consolidate the leased premises, or any portion or portions thereof, as to all strata, or any stratum or strata, with other lands as to all strata, or any stratum or strata, but only as to the gas right hereunder (excluding casinghead gas produced from oil wells) to form one or more gas operating units of not more than 640 acres, plus a tolerance of ten per cent (10%) to conform to Governmental Survey quarter sections. Lessee shall file written unit designations in the county in which the premises are located. Such units may be designated either before or after the completion of wells. Drilling operations and production on any part of the pooled acreage shall be treated as if such drilling operations were upon or such production was from the land described in this lease whether the well or wells be located on the land covered by this lease or not. The entire acreage pooled into a gas unit shall be treated for all purposes, except the payment of royalties on production from the pooled unit, as if it were included in this lease. In lieu of the royalties herein provided, lessor shall receive on production from the unit so pooled only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit or his royalty interest therein on an acreage basis bears to the total acreage so pooled in the particular unit involved.

6. If, prior to the discovery of oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, on said land or land pooled therewith lessee should drill and abandon a dry hole or holes thereon, or if, after discovery of oil, liquid hyrocarbons, gas or their respective constituent products, or any of them, the production thereof should cease from any cause, this lease shall not terminate if lessee commences reworking or additional drilling operations within sixty (60) days thereafter, or (if it be within the primary term), (i) in the case of a dry hole, commences or resumes the payment or tender of rentals or commences operations for drilling or reworking on or before the rental paying date occurring twelve (12) months after the expiration of the rental period during which such dry hole was drilled, or (ii) in the case of cessation of production, commences or resumes the payment or tender of rentals or commences operation for drilling or reworking on or before the rental paying date next ensuing after the expiration of three (3) months from the cessation of production. If, at the expiration of the primary term, oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, is not being produced on said land or land pooled therewith but lessee is then engaged in operations for drilling or reworking of any well thereon, this lease shall remain in force so long as drilling or reworking operations are prosecuted (whether on the same or different wells) with no cessation of more than sixty (60) consecutive days, and if they result in production, so long thereafter as oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, is produced from said land or land pooled therewith.

7. Lessee shall have free use of oil, gas, and water from said land, except water from lessor's wells and tanks, for all operations hereunder, including repressuring, pressure maintenance, cycling, and secondary recovery operations, and the royalty shall be computed after deducting any so used. Lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by lessee on said land, including the right to draw and remove all casing. When required by lessor, lessee will bury all pipe lines below ordinary plow depth. Lessee shall pay for damages caused by its operations to growing crops on said land. No well shall be drilled within two hundred feet (200 ft.) of any residence or barn now on said land without lessor's consent. Lessor shall have the privilege, at his risk and expense, of using gas from any gas well on said land for stoves and inside lights in the principal dwelling thereon, out of any surplus gas not needed for operations hereunder.

8. The rights of either party hereunder may be assigned in whole or in part and the provisions hereof shall extend to the heirs, executors, administrators, successors, and assigns, but no change or division in ownership of the land, rentals or royalties, however accomplished, shall operate to enlarge the obligations or diminish the rights of lessee. No such change or division in the ownership of the land, rentals or royalties shall be binding upon lessee for any purpose until such person acquiring any interest has furnished lessee with the instrument or instruments, or certified copies thereof, constituting his claim of title from the original lessor. In the event of an assignment of this lease as to a segregated portion of said land, the rentals payable hereunder shall be apportioned as between the several leasehold owners ratably according to the surface area of each, and default in rental payment by one shall not affect the rights of other leasehold owners hereunder. An assignment of this lease, in whole or in part, shall, to the extent of such assignment, relieve and discharge lessee of any obligations hereunder, and, if lessee or assignee of part or parts hereof shall fail or make default in the payment of the proportionate part of the rentals due from such lessee or assignee or fail to comply with any other provision of the lease, such default shall not affect this lease in so far as it covers a part of said lands upon which lessee or any assignee thereof shall make payment of said rentals.

9. Lessee shall not be liable for delays or defaults in its performance of any agreement or covenant hereunder due to force majeure. The term "force majeure" as employed herein shall mean: any act of God including but not limited to storms, floods, washouts, landslides, and lightning; acts of the public enemy; wars, blockades, insurrections, or riots; strikes or lockouts; epidemics or quarantine regulations; laws, acts, order or requests of federal, state, municipal or other governments or governmental officers or agents under color of authority; freight embargoes or failures; exhaustion or unavailability or delays in delivery of any product, labor, service, or material. If lessee is required, or ordered or directed by any federal, state or municipal law, executive order, rule, regulation or request enacted or promulgated under color of authority to cease drilling operations, reworking operations or producing operations on the land covered by this lease or if lessee by force majeure is prevented from conducting drilling operations, reworking operations or producing operations, then until such time as law, order, rule, regulation, request or force majeure is terminated and for a period of ninety (90) days after such termination each and every provision of this lease that might operate to terminate it or the estate conveyed by it shall be suspended and inoperative and this lease shall continue in full force. If any period of supension occurs during the primary term, the time thereof shall be added to such term.

10. Lessor hereby warrants and agrees to defend the title to said land, and agrees that lessee, at its option, may discharge any tax, mortgage, or other lien upon said land, and in the event lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rentals and royalties accuring hereunder toward satisfying same. In case said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties, including substitute gas royalty, and rentals herein provided for shall be paid the said lessor only in the proportion that his interest bears to the whole and undivided fee; however, such rental shall be increased at the next succeeding rental anniversary after the acquisition of any reversionary interest or after-acquired title to cover the intcrest so acquired, and lessor agrees to notify lessee in writing upon acquisition of any additional interest in the above described property, whether it be by reversion or after-acquired title, or if such additional acquisition occurs after production be obtained, then the royalty shall be increased to cover the interest so acquired. Should any one or more of the parties named above as lessors fail to execute this lease, it shall nevertheless be binding upon the party or parties executing the same.

11. If the leased premises shall hereafter be owned in severalty or in separate tracts, the premises, nevertheless, shall be developed and operated as one lease, and all royalties accruing hereunder shall be treated as an entirety and shall be divided among and paid to such separate owners in the proportion that the acreage owned by each such separate owner bears to the entire leased acreage. There shall be no obligation on the part of the lessee to offset wells on separate tracts into which the land covered by this lease may be hereafter divided by sale, devise, or otherwise, or to furnish separate measuring or receiving tanks.

12. Lessee and lessee's successors and assigns shall have the right at any time to surrender this lease, in whole or in part, to lessor or his heirs and assigns by delivering or mailing a release thereof to the lessor, or by placing a release thereof of record in the county in which said land is situated; thereupon lessee shall be relieved from all obligations, expressed or implied, of this agreement as to the acreage so surrendered, and thereafter the rentals payable hereunder shall be reduced in the proportion that the acreage covered hereby is reduced by said release or releases.

IN WITNESS WHEREOF, we sign the day and year first above written.

WITNESSES:

_____ _____

_____ _____

_____ _____

_____ _____

_____ _____

A-3

STATE OF _____

COUNTY OF _____

ACKNOWLEDGMENT FOR INDIVIDUAL (KsOkCoNe)

The foregoing instrument was acknowledged before me this _____ day of _____, 19_____,

by _____ and _____

_____

My commission expires _____

Notary Public

STATE OF _____

COUNTY OF _____

ACKNOWLEDGMENT FOR INDIVIDUAL (KsOkCoNe)

The foregoing instrument was acknowledged before me this _____ day of _____, 19_____,

by _____ and _____

_____

My commission expires _____

Notary Public

AAPL FORM 690

THIS AGREEMENT, made and entered into this _____ _____ day of _____ 19 _____, by and between _____, hereinafter called Lessor, and _____, hereinafter called Lessee;

WITNESSETH:

1. That Lessor for and in consideration of the sum of _____ Dollars in hand paid, receipt of which is hereby acknowledged, and the covenants and agreements hereinafter contained to be performed by the Lessee, has granted, leased and let, and does by these presents hereby grant, lease and let exclusively unto said Lessee, the lands hereinafter described, with the right to unitize this Lease or any part thereof with other Oil and Gas Leases as to all or any part of the lands covered hereby as hereinafter provided, for the purpose of carrying on geological, geophysical, or other exploration work, including core drilling and the drilling, mining, and operating for, producing, and saving all of the oil, gas and other hydrocarbons, and for constructing roads, laying pipelines, building tanks, storing oil, building power stations, telephone lines, and other structures thereon necessary or convenient for the economical operation of said land alone, or conjointly with neighboring lands, to produce, save, take care of, and manufacture all of such substances, and for the housing and boarding of employees, said tract of land with any reversionary rights therein, being situated in the County of _____, State of Kansas, and more particularly described as follows:

in Section _____, Township _____, Range _____, containing _____ acres, more or less.

2. This Lease shall remain in force for a primary term of _____ years and as long thereafter as oil, gas or other hydrocarbons is or can be produced.

3. Lessee shall deliver to Lessor as royalty, free of cost, on the Lease, or into the pipeline to which the Lessee may connect its well, the equal one-eighth part of all oil produced and saved from the leased premises, or at the Lessee's option, may pay to the Lessor for such one-eighth royalty the market price for oil of like grade and gravity prevailing on the day such oil is run into the pipeline or into storage tanks.

4. Lessee shall pay to Lessor for gas produced from any oil well and used by the Lessee for the manufacture of gasoline or any other product, as royalty, one-eighth of the market value of such gas at the mouth of the well; if said gas is sold by the Lessee, then as royalty, one-eighth of the proceeds of the sale thereof at the mouth of the well. The Lessee shall pay Lessor as royalty one-eighth of the proceeds from the sale of gas as such at the mouth of the well where gas only is found. Where there is a gas well, or wells on the lands covered by this Lease or acreage pooled therewith, whether it be before or after the primary term hereof, and such well or wells are shut-in, and there is no other production, drilling operations or other operations being conducted capable of keeping this Lease in force under any of its provisions, Lessee shall pay as royalty to Lessor (and if it be within the primary term hereof such payment shall be in lieu of delay rentals) the sum of $1.00 per year per net royalty acre, such payment to be made to the depository bank hereinafter named on or before the anniversary date of this Lease next ensuing after the expiration of 90 days from the date such well or wells are shut-in, and thereafter on the anniversary date of this Lease during the period such wells are shut-in, and upon such payment it shall be considered that this Lease is maintained in full force and effect.

5. If operations for the drilling of a well for oil or gas are not commenced on said lands on or before the _____ day of _____, 19_____, this Lease shall terminate as to both parties unless the Lessee shall on or before said date pay or tender to the Lessor or to Lessor's credit in the _____ Bank, at _____, or its successors, which bank and its successors are the Lessor's agent, and shall continue as a depository of any and all sums payable under this Lease regardless of changes in ownership in said lands or in the oil and gas or in the rentals to accrue hereunder, the sum of _____ Dollars which shall operate as a rental and cover the privilege of deferring the commencement of operations for drilling for a period of one year. In like manner and upon like payments or tenders the commencement of operations for drilling may be further deferred for like periods successively. All payments or tenders may be made by check or draft of Lessee or any assigns thereof mailed or delivered on or before the rental paying date, either direct to Lessor or his assigns, or to said depository bank, and it is understood and agreed that the consideration first recited herein, the down payment, covers not only the privilege granted to the date when said first rental is payable as aforesaid, but also the Lessee's option of extending that period as aforesaid, and any and all other rights conferred herein. Notwithstanding the death of the Lessor or his successors in interest, the payment or tender of rentals in the manner above set out shall be binding on the heirs, devisees, executors and administrators of such persons.

6. If at any time prior to the discovery of oil or gas or other hydrocarbons on this land and during the term of this Lease the Lessee shall drill a dry hole or holes on said lands, this Lease shall not terminate, provided operations for the drilling of a well shall be commenced by the next ensuing rental paying date, or provided that the Lessee begins or resumes the payment of rentals in the manner and amount hereinabove provided for, and in this event the preceding paragraphs hereof governing the payment of rentals and the manner and effect thereof shall continue in force.

7. In case said Lessor owns a lesser interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided for shall be paid the said Lessor only in the proportion which his interest bears to the whole and undivided fee. Failure to proportionately reduce the rental hereinabove provided for shall have no effect on the right to reduce royalties to correspond with Lessor's actual interest in the above described lands. The rental above provided for shall be increased at the next succeeding rental paying date after any reversion occurs to cover the interest so acquired by the Lessor.

8. Lessee shall have the right to use, free of cost, gas, oil and water found on said land for its operation thereon, except water from the wells of the Lessor. When required by Lessor, the Lessee shall bury its pipelines below plow depth and shall pay for damages caused by its operations to growing crops on said land. No well shall be drilled nearer than 200 feet to any house or barn now on said premises without the written consent of the Lessor. Lessee shall have the right at any time during, or after the expiration of this Lease, to remove all machinery, fixtures, houses, buildings and other structures placed on said premises, including the right to draw and remove all casing, but Lessee shall be under no obligation to do so, nor shall Lessee be under any obligation to restore the surface to its original condition where any alterations or changes were due to operations reasonably necessary under this Lease.

9. If the estate of either party hereto is assigned, and the privilege of assigning in whole or in part is expressly allowed, the covenants hereof shall extend to the heirs, devisees, executors, administrators, successors and assigns, but no change of ownership in the lands or in the rentals or royalties, or any sum due under this Lease shall be binding on the Lessee until it has been furnished with either the original recorded instrument of the conveyance or a duly certified copy thereof, or a certified copy of the Will of any deceased owner and the probate thereof, or a certified copy of the proceedings showing the appointment of an administrator of the estate of any deceased owner, whichever is appropriate, together with all original recorded instruments of conveyance or duly certified copies thereof necessary to show a complete chain of title back to Lessor to the full interest claimed, and all advanced payment of rentals made hereunder before receipt of such documents shall be binding on any direct or indirect assignee, grantee, devisee, administrator, executor or heir of the Lessor.

10. No change or division in the ownership of the land, rentals or royalties, however accomplished, shall operate to enlarge the obligation, nor diminish the rights of the Lessee. In the event of assignment hereof in whole or in part, liability for breach of any obligation hereunder shall rest exclusively upon the owner of this Lease, or portion thereof who commits such breach. There shall be no obligation on the part of the Lessee to offset wells on separate tracts into which the lands covered by this Lease may be divided by sale, devise, descent or otherwise, or to furnish separate measuring or receiving tanks. It is further agreed that in the event this Lease shall be assigned as to a part or as to parts of the above described land and the holder or owner of any such part or parts shall make default in the payment of the proportionate part of the rental due from him, such default shall not operate to defeat or affect this Lease insofar as it covers a part of said land upon which the Lessee or any assignee hereof shall make due payment of said rentals. If six or more parties become entitled to royalty payments hereunder Lessee may withhold payment thereof unless and until furnished with a recordable instrument executed by all such parties designating an agent to receive payment for all.

11. Lessor hereby warrants and agrees to defend title to the lands herein described and agrees that the Lessee at its option may pay and discharge in whole or in part any taxes, mortgages or other liens existing, levied or assessed on or against the above described land and in the event it exercises such option it shall be subrogated to the rights of any holder or holders thereof and may reimburse itself by applying to the discharge of any such mortgage, tax or other lien, any royalty, shut-in royalty, or rentals accruing hereunder.

12. Notwithstanding anything in this Lease contained to the contrary, it is expressly agreed that if the Lessee shall commence operations for drilling at any time while this Lease is in force, this Lease shall remain in force and its terms shall continue so long as such operations are prosecuted and, if production results therefrom, then as long as production continues.

13. If within the primary term of this Lease, production on the leased premises shall cease from any cause, this Lease shall not terminate provided operations for the drilling of a well shall be commenced before or on the next ensuing rental paying date; or, provided lessee begins or resumes the payment of rentals in the manner and amount hereinbefore provided. If, after the expiration of the primary term of this Lease, production on the leased premises shall cease from any cause, this lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues.

14. Lessee may at any time surrender or cancel this Lease in whole or in part by delivering or mailing a release to the Lessor, or by placing same of record in the proper county. In case said Lease is surrendered and cancelled as to only a portion of the acreage covered thereby, then all payments and liabilities thereafter accruing under the terms of said Lease as to the portion cancelled shall cease and terminate and any rentals thereafter paid may be apportioned on an acreage basis, but as to the portion of the acreage not released the terms and provisions of this Lease shall continue and remain in full force and effect for all purposes.

11. All provisions hereof, express or implied, shall be subject to all federal and state laws and the orders, rules, or regulations (and interpretations thereof) of all governmental agencies administering the same, and this Lease shall not be in any way terminated wholly or partially nor shall the Lessee be liable in damages for failure to comply with any of the express or implied provisions hereof if such failure accords with any such laws, orders, rules or regulations (or interpretations thereof). If Lessee should be prevented during the last six months of the primary term hereof from drilling a well hereunder by the order of any constituted authority having jurisdiction thereover, or if Lessee should be unable during said period to drill a well hereunder due to equipment necessary in the drilling thereof not being available on account of any cause, the primary term of this Lease shall continue until six months after said order is suspended and/or said equipment is available, but the Lessee shall pay delay rentals herein provided during such extended time.

16. Lessee at its option, is hereby given the right and power to voluntarily pool or combine the lands covered by this Lease, or any portion thereof, as to oil and gas or either of them, with any other land, lease or leases adjacent thereto, when in Lessee's judgment it is necessary or advisable to do so in order to properly develop and operate said premises, such pooling to be into units not exceeding eighty (80) acres for an oil well plus a tolerance of 10%, and not exceeding six hundred forty (640) acres, for a gas well plus a tolerance of 10%, except that larger units may be created to conform to any spacing or well unit pattern that may be prescribed by governmental authorities having jurisdiction. Lessee shall execute in writing and record in the County Records an instrument identifying and describing the pooled acreage. The entire acreage so pooled into units shall be treated for all purposes, except the payment of royalties, as if it were included in this Lease, and drilling or reworking operations thereon, or production of oil or gas or other hydrocarbons therefrom, or the completion thereon of a well as a shut-in gas well, shall be considered for all purposes, except the payment of royalties, as if such operations were on or such production were from, or such completion were on the lands covered by this Lease, whether or not the well or wells be located on the premises actually covered by this Lease. In lieu of royalties elsewhere herein specified, including shut-in gas royalties, Lessor shall receive from a unit so formed only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit, or his royalty interest therein, bears to the total acreage so pooled.

This Lease and all its terms, covenants and conditions shall extend to and be binding on all successors of said Lessor and Lessee.

IN WITNESS WHEREOF this instrument is executed on the day and year first above written.

_____ _____

_____ _____

STATE OF

COUNTY OF } SS. ACKNOWLEDGMENT FOR INDIVIDUAL

Before me, the undersigned, a Notary Public, within and for said County and state, on this _____ day of _____,

19_____, personally appeared _____

and _____

_____,

to me personally known to be the identical person _____ who executed the within and foregoing instrument and acknowledged to me that _____

executed the same as _____ free and voluntary act and deed for the uses and purposes therein set forth.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal the day and year last above written

My commission expires _____ _____

Notary Public

TYPICAL OIL AND GAS DEVELOPMENT SEQUENCE

PARTIES	CONTRACTS
LANDOWNER [1/8th Royalty]	
	OIL & GAS LEASE
LEASE PROMOTER [8/8ths Working Interest]	
	ASSIGNMENT [1/16th ORR]
LEASE DEVELOPER [8/8ths Working Interest] [Subject to 1/8th R and 1/16th ORR]	
	ASSIGNMENT [24/32nds WI]
INVESTORS (24) [Each assigned undivided 1/32nd WI]	
	OPERATING AGREEMENT
OPERATOR (Lease Developer)	
	DRILLING CONTRACT
DRILLING CONTRACTOR	
OTHER CONTRACTORS	MISCELLANEOUS CONTRACTS
SUBCONTRACTORS SUPPLIERS (MATERIALMEN)	
PROCESSOR/TRANSPORTER	PROCESSING AGREEMENTS TRANSPORTATION AGREEMENTS
OIL PURCHASER	DIVISION ORDER(S)
GAS PURCHASER	DIVISION ORDER(S) GAS SALES CONTRACT
---	---
LEASE PROMOTER [Farmor]	
	FARMOUT AGREEMENT ASSIGNMENT OPERATING AGREEMENT
LEASE DEVELOPER [Farmee]	

OIL & GAS PROPERTY INTERESTS

Land - No Conveyances of Minerals

Surface Estate

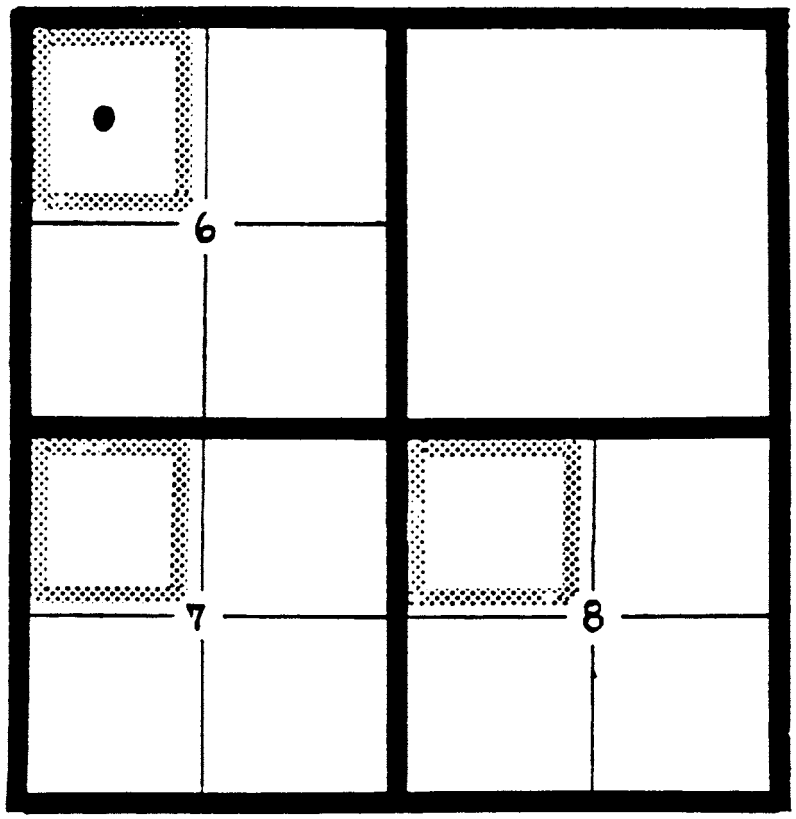
Mineral Estate

Mineral Estate:

- Divided Interest
- Undivided Interest (cotenancy)
- Term Interest
- Defeasible Interest
- Defeasible Term Interest
- Future Interest (successive interest)
- Depth Limitations
- Substance Limitations
- Limit to Specific Rights Associated with the Interest:
  - Right to Develop (Executive Right)
  - Right to Benefits of Development (Bonus, Delay Rental, Royalty)

Leasehold Estate:

- Operating Interest (Working Interest)
- Nonoperating Interests:
  - Overriding Royalty
  - Production Payment
  - Net Profits Interest
  - Convertible Interest



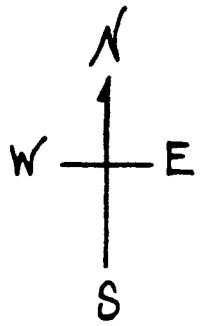


FIGURE 1

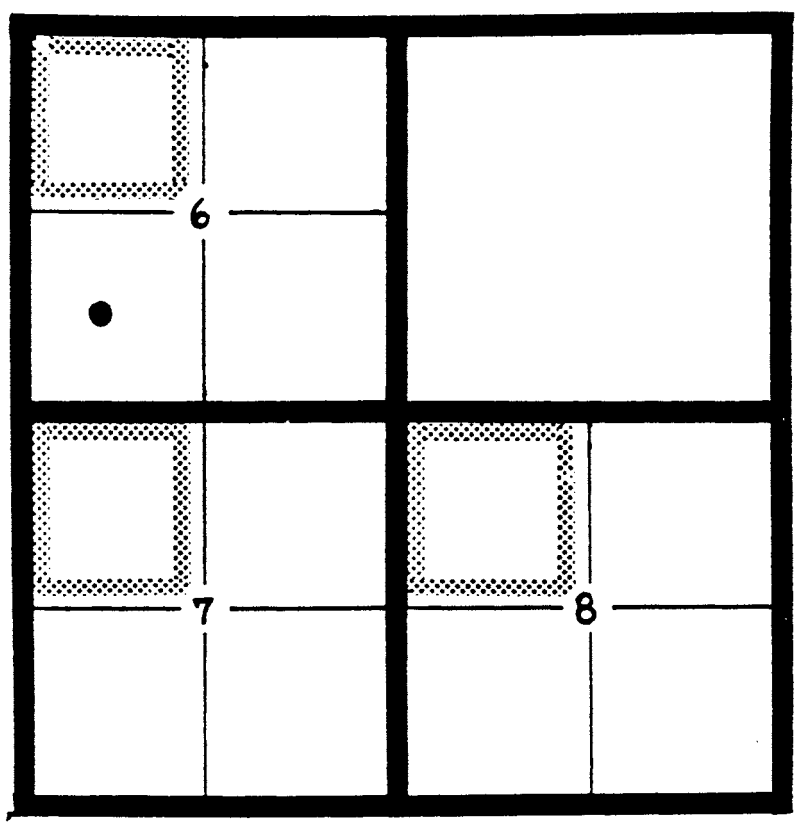
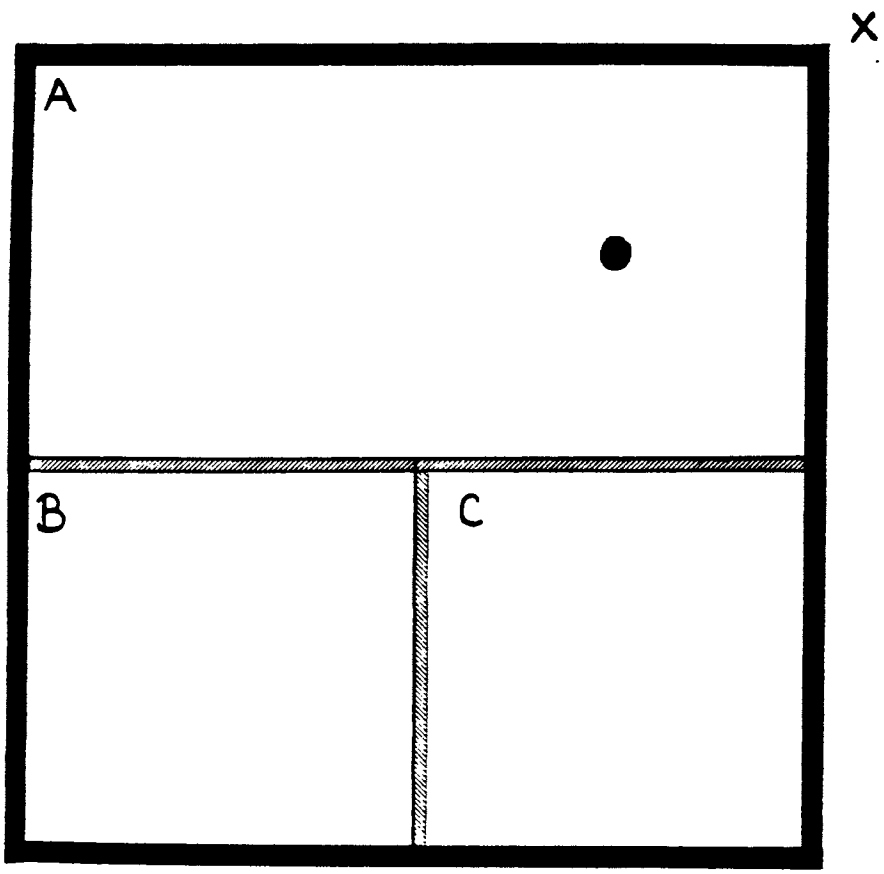


FIGURE 2



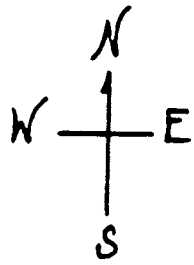


FIGURE 3

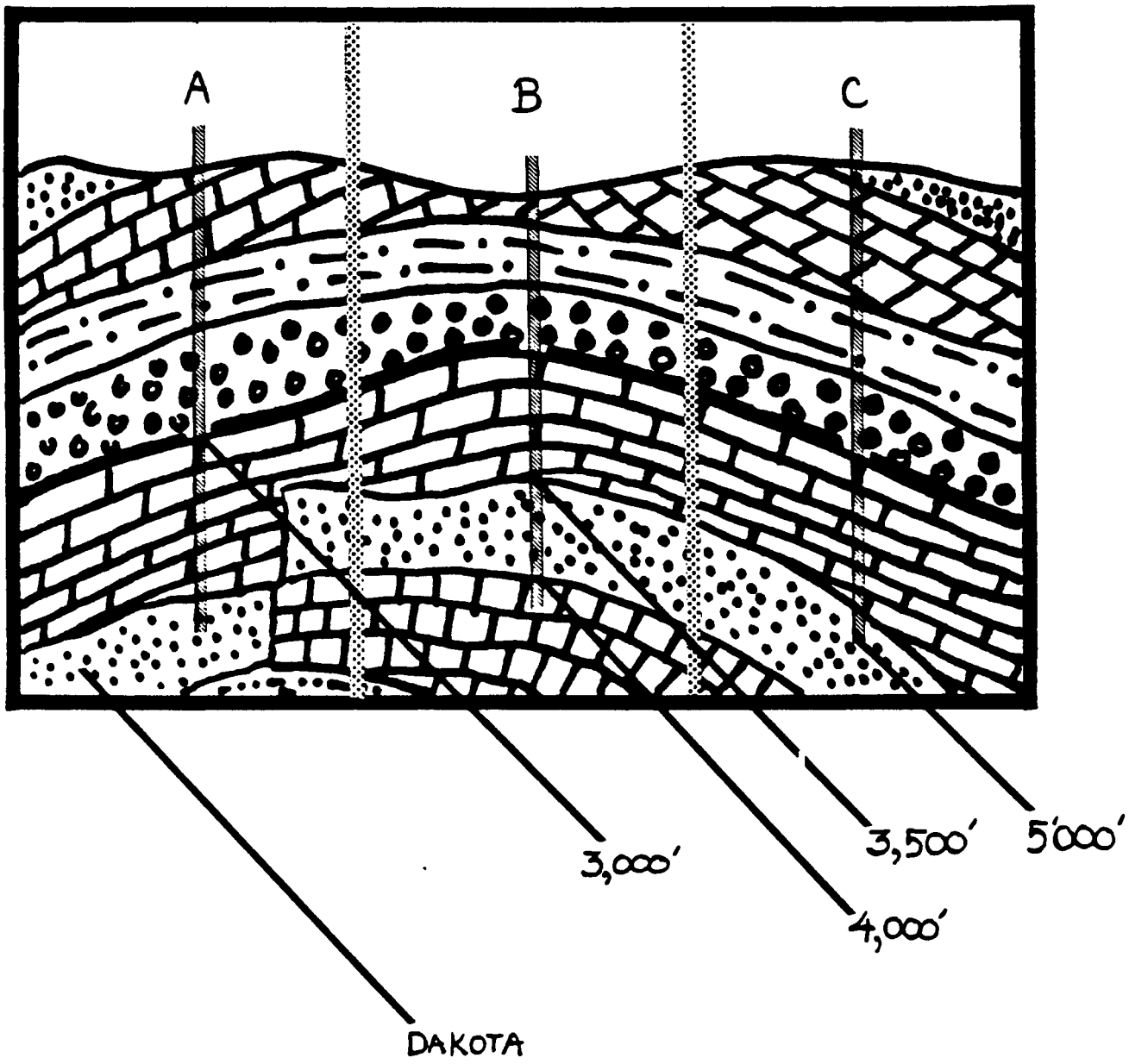
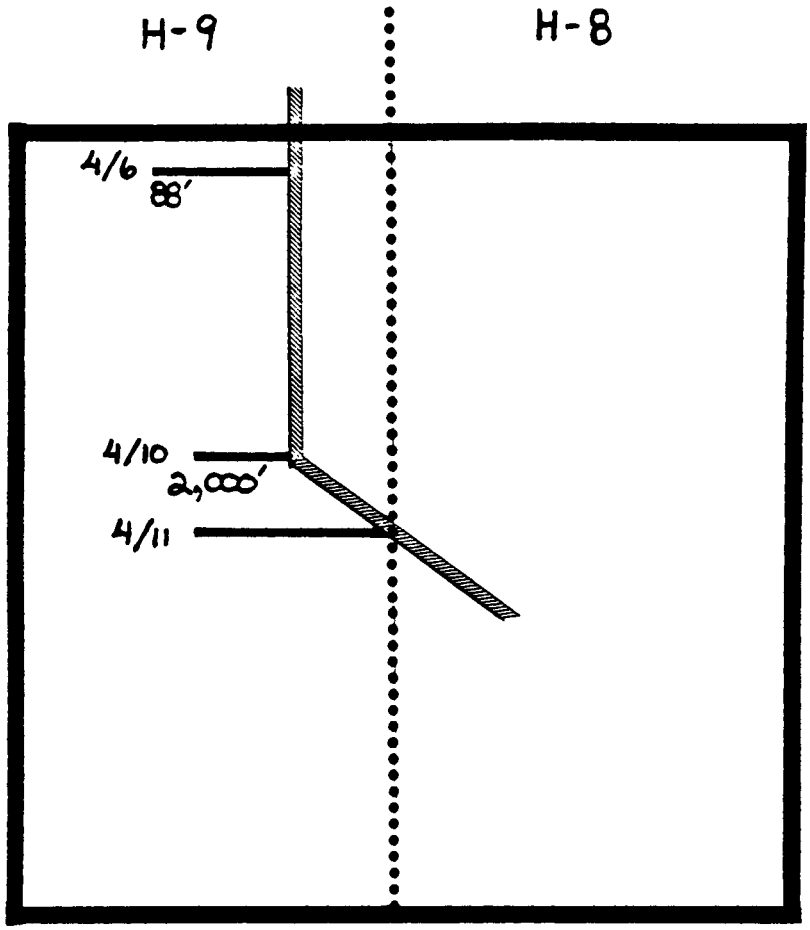


FIGURE 4



A & M Oil Inc. v. Miller
11 Kan. App. 2d 152 (1986)

FIGURE 5

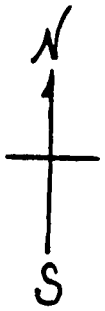
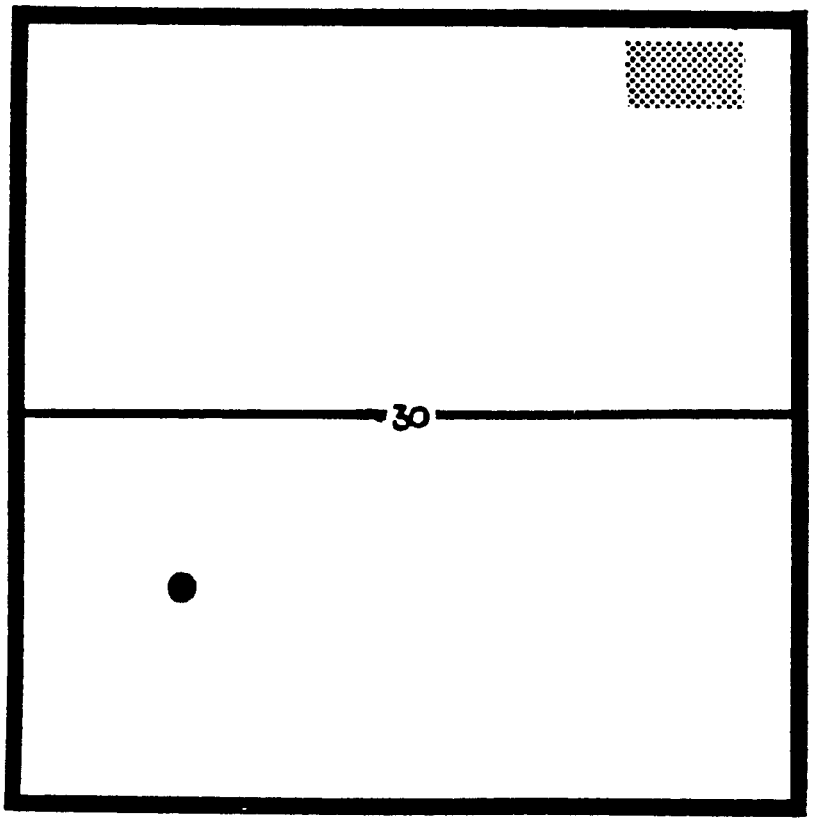


FIGURE 6



OIL & GAS LAW
Practical Exercise #1

MINERAL INTEREST SALES AGREEMENT

Nancy Farmer ("NANCY") agrees to sell, and Big Oil Company ("BIG") agrees to buy, for $50,000, the following property: All the oil, gas, and other minerals in the Southwest Quarter of Section 30, Township 36 South, Range 10 East, in Eureka County, Kansas (the "Property").

Under the following terms:

1. NANCY warrants title to the Property. However, BIG agrees to accept the Property subject to the following encumbrances: Oil and Gas Lease between NANCY and Major Petroleum Corporation recorded in Book 5, at Page 240, in the Eureka County Register of Deeds office ("Lease"). A copy of the Lease is attached as Exhibit A to this Agreement.

2. NANCY will have the deed prepared and available for inspection by BIG's legal counsel, David E. Pierce, by 3:00 p.m. 14 October 1987 at the University of Tulsa School of Law. Any objections to the form of conveyance will be raised by BIG at that time.

3. All rights and obligations under this Agreement, and the interests conveyed pursuant to this Agreement, shall bind and benefit the heirs, successors, and assigns of NANCY and BIG.

SIGNED 6 October 1987.

Nancy Farmer
NANCY FARMER
132 Autumn Lane
Claremore, Oklahoma 74017

Levi Zendt
LEVI ZENDT
Attorney-in-Fact
BIG OIL COMPANY
727 Katy Freeway
Houston, Texas 77001

ASSIGNED TASK

You represent Nancy Farmer, draft the deed required by Section 2 of the Agreement which will be effective to convey the property to Big Oil Company. Be prepared to discuss the form and terms of your conveyance document. What matters would you like to discuss with Nancy concerning this transaction? You can use <u>any</u> resource to complete this exercise.

AAPL FORM 690

THIS AGREEMENT, made and entered into this 3RD day of SEPTEMBER 19 87, by and between NANCY FARMER, hereinafter called Lessor, and MAJOR PETROLEUM CORPORATION, hereinafter called Lessee;

WITNESSETH:

1. That Lessor for and in consideration of the sum of $640.00 Dollars in hand paid, receipt of which is hereby acknowledged, and the covenants and agreements hereinafter contained to be performed by the Lessee, has granted, leased and let, and does by these presents hereby grant, lease and let exclusively unto said Lessee, the lands hereinafter described, with the right to unitize this Lease or any part thereof with other Oil and Gas Leases as to all or any part of the lands covered hereby as hereinafter provided, for the purpose of carrying on geological, geophysical, or other exploration work, including core drilling and the drilling, mining, and operating for, producing, and saving all of the oil, gas and other hydrocarbons, and for constructing roads, laying pipelines, building tanks, storing oil, building power stations, telephone lines, and other structures thereon necessary or convenient for the economical operation of said land alone, or conjointly with neighboring lands, to produce, save, take care of, and manufacture all of such substances, and for the housing and boarding of employees, said tract of land with any reversionary rights therein, being situated in the County of EUREKA, State of Kansas, and more particularly described as follows: ALL OF

In Section 30, Township 36 South, Range 10 East, containing 640 acres, more or less.

2. This Lease shall remain in force for a primary term of 3 years and as long thereafter as oil, gas or other hydrocarbons is or can be produced.

3. Lessee shall deliver to Lessor as royalty, free of cost, on the Lease, or into the pipeline to which the Lessee may connect its well, the equal one-eighth part of all oil produced and saved from the leased premises, or at the Lessee's option, may pay to the Lessor for such one-eighth royalty the market price for oil of like grade and gravity prevailing on the day such oil is run into the pipeline or into storage tanks.

4. Lessee shall pay to Lessor for gas produced from any oil well and used by the Lessee for the manufacture of gasoline or any other product, as royalty, one-eighth of the market value of such gas at the mouth of the well; if said gas is sold by the Lessee, then as royalty, one-eighth of the proceeds of the sale thereof at the mouth of the well. The Lessee shall pay Lessor as royalty one-eighth of the proceeds from the sale of gas as such at the mouth of the well where gas only is found. Where there is a gas well, or wells on the lands covered by this Lease or acreage pooled therewith, whether it be before or after the primary term hereof, and such well or wells are shut-in, and there is no other production, drilling operations or other operations being conducted capable of keeping this Lease in force under any of its provisions, Lessee shall pay as royalty to Lessor (and if it be within the primary term hereof such payment shall be in lieu of delay rentals) the sum of $1.00 per year per net royalty acre, such payment to be made to the depository bank hereinafter named on or before the anniversary date of this Lease next ensuing after the expiration of 90 days from the date such well or wells are shut-in, and thereafter on the anniversary date of this Lease during the period such wells are shut-in, and upon such payment it shall be considered that this Lease is maintained in full force and effect.

5. If operations for the drilling of a well for oil or gas are not commmenced on said lands on or before the 3RD day of SEPTEMBER, 19 88, this Lease shall terminate as to both parties unless the Lessee shall on or before said date pay or tender to the Lessor or to Lessor's credit in the ROGERS COUNTY BANK Bank, at CLAREMORE, OKLAHOMA, or its successors, which bank and its successors are the Lessor's agent, and shall continue as a depository of any and all sums payable under this Lease regardless of changes in ownership in said lands or in the oil and gas or in the rentals to accrue hereunder, the sum of $640.00 Dollars which shall operate as a rental and cover the privilege of deferring the commencement of operations for drilling for a period of one year. In like manner and upon like payments or tenders the commencement of operations for drilling may be further deferred for like periods successively. All payments or tenders may be made by check or draft of Lessee or any assigns thereof mailed or delivered on or before the rental paying date, either direct to Lessor or his assigns, or to said depository bank, and it is understood and agreed that the consideration first recited herein, the down payment, covers not only the privilege granted to the date when said first rental is payable as aforesaid, but also the Lessee's option of extending that period as aforesaid, and any and all other rights conferred herein. Notwithstanding the death of the Lessor or his successors in interest, the payment or tender of rentals in the manner above set out shall be binding on the heirs, devisees, executors and administrators of such persons.

-49-

EXHIBIT A

6. If at any time prior to the discovery of oil or gas or other hydrocarbons on this land and during the term of this Lease the Lessee shall drill a dry hole or holes on said lands, this Lease shall not terminate, provided operations for the drilling of a well shall be commenced by the next ensuing rental paying date, or provided that the Lessee begins or resumes the payment of rentals in the manner and amount hereinabove provided for, and in this event the preceding paragraphs hereof governing the payment of rentals and the manner and effect thereof shall continue in force.

7. In case said Lessor owns a lesser interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided for shall be paid the said Lessor only in the proportion which his interest bears to the whole and undivided fee. Failure to proportionately reduce the rental hereinabove provided for shall have no effect on the right to reduce royalties to correspond with Lessor's actual interest in the above described lands. The rental above provided for shall be increased at the next succeeding rental paying date after any reversion occurs to cover the interest so acquired by the Lessor.

8. Lessee shall have the right to use, free of cost, gas, oil and water found on said land for its operation thereon, except water from the wells of the Lessor. When required by Lessor, the Lessee shall bury its pipelines below plow depth and shall pay for damages caused by its operations to growing crops on said land. No well shall be drilled nearer than 200 feet to any house or barn now on said premises without the written consent of the Lessor. Lessee shall have the right at any time during, or after the expiration of this Lease, to remove all machinery, fixtures, houses, buildings and other structures placed on said premises, including the right to draw and remove all casing, but Lessee shall be under no obligation to do so, nor shall Lessee be under any obligation to restore the surface to its original condition where any alterations or changes were due to operations reasonably necessary under this Lease.

9. If the estate of either party hereto is assigned, and the privilege of assigning in whole or in part is expressly allowed, the covenants hereof shall extend to the heirs, devisees, executors, administrators, successors and assigns, but no change of ownership in the lands or in the rentals or royalties, or any sum due under this Lease shall be binding on the Lessee until it has been furnished with either the original recorded instrument of the conveyance or a duly certified copy thereof, or a certified copy of the Will of any deceased owner and the probate thereof, or a certified copy of the proceedings showing the appointment of an administrator of the estate of any deceased owner, whichever is appropriate, together with all original recorded instruments of conveyance or duly certified copies thereof necessary to show a complete chain of title back to Lessor to the full interest claimed, and all advanced payment of rentals made hereunder before receipt of such documents shall be binding on any direct or indirect assignee, grantee, devisee, administrator, executor or heir of the Lessor.

10. No change or division in the ownership of the land, rentals or royalties, however accomplished, shall operate to enlarge the obligation, nor diminish the rights of the Lessee. In the event of assignment hereof in whole or in part, liability for breach of any obligation hereunder shall rest exclusively upon the owner of this Lease, or portion thereof who commits such breach. There shall be no obligation on the part of the Lessee to offset wells on separate tracts into which the lands covered by this Lease may be divided by sale, devise, descent or otherwise, or to furnish separate measuring or receiving tanks. It is further agreed that in the event this Lease shall be assigned as to a part or as to parts of the above described land and the holder or owner of any such part or parts shall make default in the payment of the proportionate part of the rental due from him, such default shall not operate to defeat or affect this Lease insofar as it covers a part of said land upon which the Lessee or any assignee hereof shall make due payment of said rentals. If six or more parties become entitled to royalty payments hereunder Lessee may withhold payment thereof unless and until furnished with a recordable instrument executed by all such parties designating an agent to receive payment for all.

11. Lessor hereby warrants and agrees to defend title to the lands herein described and agrees that the Lessee at its option may pay and discharge in whole or in part any taxes, mortgages or other liens existing, levied or assessed on or against the above described land and in the event it exercises such option it shall be subrogated to the rights of any holder or holders thereof and may reimburse itself by applying to the discharge of any such mortgage, tax or other lien, any royalty, shut-in royalty, or rentals accruing hereunder.

12. Notwithstanding anything in this Lease contained to the contrary, it is expressly agreed that if the Lessee shall commence operations for drilling at any time while this Lease is in force, this Lease shall remain in force and its terms shall continue so long as such operations are prosecuted and, if production results therefrom, then as long as production continues.

13. If within the primary term of this Lease, production on the leased premises shall cease from any cause, this Lease shall not terminate provided operations for the drilling of a well shall be commenced before or on the next ensuing rental paying date; or, provided lessee begins or resumes the payment of rentals in the manner and amount hereinbefore provided. If, after the expiration of the primary term of this Lease, production on the leased premises shall cease from any cause, this lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues.

14. Lessee may at any time surrender or cancel this Lease in whole or in part by delivering or mailing a release to the Lessor, or by placing same of record in the proper county. In case said Lease is surrendered and cancelled as to only a portion of the acreage covered thereby, then all payments and liabilities thereafter accruing under the terms of said Lease as to the portion cancelled shall cease and terminate and any rentals thereafter paid may be apportioned on an acreage basis, but as to the portion of the acreage not released the terms and provisions of this Lease shall continue and remain in full force and effect for all purposes.

11. All provisions hereof, express or implied, shall be subject to all federal and state laws and the orders, rules, or regulations (and interpretations thereof) of all governmental agencies administering the same, and this Lease shall not be in any way terminated wholly or partially nor shall the Lessee be liable in damages for failure to comply with any of the express or implied provisions hereof if such failure accords with any such laws, orders, rules or regulations (or interpretations thereof). If Lessee should be prevented during the last six months of the primary term hereof from drilling a well hereunder by the order of any constituted authority having jurisdiction thereover, or if Lessee should be unable during said period to drill a well hereunder due to equipment necessary in the drilling thereof not being available on account of any cause, the primary term of this Lease shall continue until six months after said order is suspended and/or said equipment is available, but the Lessee shall pay delay rentals herein provided during such extended time.

16. Lessee at its option, is hereby given the right and power to voluntarily pool or combine the lands covered by this Lease, or any portion thereof, as to oil and gas or either of them, with any other land, lease or leases adjacent thereto, when in Lessee's judgment it is necessary or advisable to do so in order to properly develop and operate said premises, such pooling to be into units not exceeding eighty (80) acres for an oil well plus a tolerance of 10%, and not exceeding six hundred forty (640) acres, for a gas well plus a tolerance of 10%, except that larger units may be created to conform to any spacing or well unit pattern that may be prescribed by governmental authorities having jurisdiction. Lessee shall execute in writing and record in the County Records an instrument identifying and describing the pooled acreage. The entire acreage so pooled into units shall be treated for all purposes, except the payment of royalties, as if it were included in this Lease, and drilling or reworking operations thereon, or production of oil or gas or other hydrocarbons therefrom, or the completion thereon of a well as a shut-in gas well, shall be considered for all purposes, except the payment of royalties, as if such operations were on or such production were from, or such completion were on the lands covered by this Lease, whether or not the well or wells be located on the premises actually covered by this Lease. In lieu of royalties elsewhere herein specified, including shut-in gas royalties, Lessor shall receive from a unit so formed only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit, or his royalty interest therein, bears to the total acreage so pooled.

This Lease and all its terms, covenants and conditions shall extend to and be binding on all successors of said Lessor and Lessee.

IN WITNESS WHEREOF this instrument is executed on the day and year first above written.

Nancy Farmer

STATE OF OKLAHOMA }
COUNTY OF ROGERS } SS.

ACKNOWLEDGMENT FOR INDIVIDUAL

Before me, the undersigned, a Notary Public, within and for said County and state, on this 3RD day of SEPTEMBER, 19 87, personally appeared NANCY FARMER and _____

to me personally known to be the identical person _____ who executed the within and foregoing instrument and acknowledged to me that she executed the same as her free and voluntary act and deed for the uses and purposes therein set forth.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal the day and year last above written

My commission expires 1-19-91

John Doe
JOHN DOE Notary Public

-45-

Mid-Continent Royalty Owners Association Approved Form Revised

Recorder No. 09-195

AREAS BLUE PRINT CO. INC.

MINERAL DEED

KNOW ALL MEN BY THESE PRESENTS THAT NANCY FARMER

of 132 AUTUMN LANE CLAREMORE, OK (Give Exact Postoffice Address) hereinafter called Grantor, (whether one or more) for and in consideration of the sum of FIFTY THOUSAND Dollars ($ 50,000) cash in hand paid and other good and valuable considerations, the receipt of which is hereby acknowledged, do hereby grant, bargain, sell, convey, transfer, assign and deliver unto BIG OIL COMPANY of 727 Katy Freeway HOUSTON, TX (Give Exact Postoffice Address) hereinafter called Grantee (whether one or more) an undivided 100% interest in and to all of the oil, gas and other minerals in and under and that may be produced from the following described lands situated in EUREKA County, State of KANSAS, to-wit:

SOUTHWEST QUARTER of SECTION 30
TOWNSHIP 36 SOUTH, RANGE 10 EAST

containing 160 acres, more or less, together with the right of ingress and egress at all times for the purpose of mining, drilling, exploring, operating and developing said lands for oil, gas, and other minerals, and storing, handling, transporting and marketing the same therefrom with the right to remove from said land all of Grantee's property and improvements.

This sale is made subject to any rights now existing to any lessee or assigns under any valid and subsisting oil and gas lease of record heretofore executed; it being understood and agreed that said Grantee shall have, receive, and enjoy the herein granted undivided interest in and to all bonuses, rents, royalties and other benefits which may accrue under the terms of said lease insofar as it covers the above described land from and after the date hereof, precisely as if the Grantee herein had been at the date of the making of said lease the owner of a similar undivided interest in and to the lands described and Grantee one of the lessors therein.

Grantor agrees to execute such further assurances as may be requisite for the full and complete enjoyment of the rights herein granted and likewise agrees that Grantee herein shall have the right at any time to redeem for said Grantor by payment, any mortgage, taxes, or other liens on the above described land, upon default in payment by Grantor, and be subrogated to the rights of the holder thereof.

TO HAVE AND TO HOLD, The above described property and easement with all and singular the rights, privileges, and appurtenances thereunto or in any wise belonging to the said Grantee herein its heirs, successors, personal representatives, administrators, executors, and assigns forever, and Grantor do~~es~~ hereby warrant said title to Grantee its heirs, executors, administrators, personal representatives, successors and assigns forever and do~~es~~ hereby agree to defend all and singular the said property unto the said Grantee herein its heirs, successors, executors, personal representatives, and assigns against every person whomsoever claiming or to claim the same or any part thereof.

WITNESS my hand this 14th day of October 1987

Nancy Farmer

STATE OF KANSAS
COUNTY OF EUREKA } ss. ACKNOWLEDGMENT FOR INDIVIDUAL (Kans. Okla. and Colo.)

Before me, the undersigned, a Notary Public, within and for said County and State, on this 14th day of October 1987 personally appeared NANCY FARMER and

to me personally known to be the identical person who executed the within and foregoing instrument and acknowledged to me that she executed the same as her free and voluntary act and deed for the uses and purposes therein set forth.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal the day and year last above written.

My commission expires 11-5-89

Chuck Roast
CHUCK ROAST Notary Public

STATE OF _____
COUNTY OF _____ } ss. ACKNOWLEDGMENT FOR CORPORATION

Be it remembered that on this _____ day of _____ 19____, before me, the undersigned, a Notary Public, duly commissioned, in and for the county and state aforesaid, came _____ _____ president of _____ a corporation of the State of _____ personally known to me to be such officer, and to be the same person who executed as such officer the foregoing instrument of writing in behalf of said corporation, and he duly acknowledged the execution of the same for himself and for said corporation for the uses and purposes therein set forth.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal on the day and year last above written.

My commission expires _____

_____ Notary Public

Mid-Continent Royalty Owners Association Approved Form Revised "Approved" for malpractice? Number No 09-195 ARKLAHOMA BLUE PRINT CO. INC.

MINERAL DEED

KNOW ALL MEN BY THESE PRESENTS THAT — Does this serve any purpose? How about saying: "LOOKY HERE FOLKS"

of _____ hereinafter called Grantor, (whether one or more) for and in consideration of the sum of (Give Exact Postoffice Address) Probably don't want to disclose Dollars ($ _____) cash in hand paid and other good and valuable considerations, the receipt of which is hereby acknowledged, do hereby grant, bargain, sell, convey, transfer, assign and deliver unto _____ of _____ hereinafter called Grantee (whether one or more) an undivided (Give Exact Postoffice Address) Is this an undivided interest? interest in and to all of the oil gas and other minerals in and under and that may be produced from the following described lands situated in _____ County, State of _____ to-wit:

COAL? Such as? How about merely saying "for valuable consideration"? mineral/royalty problem - delete

mineral/royalty problem - do not include words of grant associated with personal property exception to grant or warranty?

containing _____ acres, more or less, together with the right of ingress and egress at all times for the purpose of mining, drilling, exploring, operating and developing said lands for oil, gas, and other minerals, and storing, handling, transporting and marketing the same therefrom with the right to remove from said land all of Grantee's property and improvements.

This sale is made subject to any rights now existing to any lessee or assigns under any valid and subsisting oil and gas lease of record heretofore executed; it being understood and agreed that said Grantee shall have, receive, and enjoy the herein granted undivided interest in and to all bonuses, rents, royalties and other benefits which may accrue under the terms of said lease insofar as it covers the above described land from and after the date hereof, precisely as if the Grantee herein had been at the date of the making of said lease the owner of a similar undivided interest in and to the lands described and Grantee one of the lessors therein.

Grantor agrees to execute such further assurances as may be requisite for the full and complete enjoyment of the rights herein granted and likewise agrees that Grantee herein shall have the right at any time to redeem for said Grantor by payment, any mortgage, taxes, or other liens on the above described land, upon default in payment by Grantor, and be subrogated to the rights of the holder thereof.

TO HAVE AND TO HOLD, The above described property and easement with all and singular the rights, privileges, and appurtenances thereunto or in any wise belonging to the said Grantee herein _____ heirs, successors, personal representatives, administrators, executors, and assigns forever, and Grantor do _____ hereby warrant said title to Grantee _____ heirs, executors, administrators, personal representatives, successors and assigns forever and do _____ hereby agree to defend all and singular the said property unto the said Grantee herein _____ heirs, successors, executors, personal representatives, and assigns against every person whomsoever claiming or to claim the same or any part thereof.

WITNESS _____ hand this _____ day of _____ 19____

need to except lease encumbrance?

is this acceptable? broader than contract requires?

surface use problems?

apportionment issue two grants problem?

STATE OF _____ } ss. ACKNOWLEDGMENT FOR INDIVIDUAL (Kans. Okla. and Colo.)
COUNTY OF _____ }

Before me, the undersigned, a Notary Public, within and for said County and State, on this _____ day of _____, 19____, personally appeared _____ and _____

Does this meet current law requirements?

to me personally known to be the identical person who executed the within and foregoing instrument and acknowledged to me that _____ executed the same as _____ free and voluntary act and deed for the uses and purposes therein set forth.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal the day and year last above written.

My commission expires _____ Notary Public

Is this habendum clause necessary?

STATE OF _____ } ss. ACKNOWLEDGMENT FOR CORPORATION
COUNTY OF _____ }

Be it remembered that on this _____ day of _____, 19____, before me, the undersigned, a Notary Public, duly commissioned, in and for the county and state aforesaid, came _____ _____ president of _____ a corporation of the State of _____, personally known to me to be such officer, and to be the same person who executed as such officer the foregoing instrument of writing in behalf of said corporation, and he duly acknowledged the execution of the same for himself and for said corporation for the uses and purposes therein set forth.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal on the day and year last above written.

My commission expires _____

Notary Public

MINERAL DEED

NANCY FARMER, a single person, ("NANCY") for valuable consideration, conveys and warrants to BIG OIL COMPANY, a Texas corporation with its principal offices at 727 Katy Freeway, Houston, Texas 77001 ("BIG"):

> All the oil, gas, and similar hydrocarbon substances in and under the Southwest Quarter of Section 30, Township 36 South, Range 10 East, in Eureka County, Kansas,

hereafter called the "Mineral Interest."

Subject to the following:

SECTION 1. Rights Granted as Part of the Mineral Interest. As part of the Mineral Interest, BIG has the exclusive right to develop, or authorize others to develop, the Mineral Interest. Subject to SECTION 2 of this Mineral Deed, BIG is entitled to any bonus, rental, royalty, or other payments which may accrue, after the date of this Mineral Deed, in existing leases or development contracts affecting the Mineral Interest. BIG is entitled to any reversionary interest NANCY may have in existing leases or development contracts affecting the Mineral Interest.

BIG is also given the right to enter and use the surface overlying the Mineral Interest to the extent necessary to explore, develop, produce, and operate the Mineral Interest, pursuant to the following terms:

[Enumerate rights of NANCY and BIG in the surface.]

Section 2. Apportionment of Royalties. The Mineral Interest is currently subject to the Oil and Gas Lease described in SECTION 3 of this Mineral Deed, which covers all of Section 30, Township 36 South, Range 10 East, in Eureka County, Kansas, hereafter called the "Leased Land." After the date of this Mineral Deed, when production is obtained anywhere on, or attributable to, the Leased Land, BIG and NANCY will share in all royalty, or shut-in royalty, in the following proportions:

NANCY - 3/4ths
BIG - 1/4th

If the Oil and Gas Lease on the Leased Land expires or otherwise ceases to burden the Leased Land, then each owner of mineral rights in the Leased Land will be released from any obligation, created by this SECTION, to apportion royalties.

SECTION 3. Exceptions to the Warranty. There is excepted from the warranty an encumbrance created by an Oil and Gas

Lease between NANCY and Major Petroleum Corporation dated 3 September 1987 and recorded in Book 5, at Page 240, of the Miscellaneous Records of Eureka County, Kansas.

SECTION 4. Binding Effect. This grant, and all related terms, are binding on the heirs, personal representatives, successors, and assigns of NANCY and BIG.

SIGNED and DELIVERED 14 October 1987.

Nancy Farmer
Nancy Farmer

ACKNOWLEDGMENT CERTIFICATE

Wilson County, Kansas

This Mineral Deed was acknowledged before me on 14 October 1987 by NANCY FARMER.

(SEAL)

Chuck Roast
CHUCK ROAST, Notary Public
My commission expires: 1-22-90

MINERAL DEED

[Title consistent with a mineral interest.]

NANCY FARMER, a single person, ("NANCY") for valuable consideration, conveys and warrants to BIG OIL COMPANY, a Texas corporation with its principal offices at 727 Katy Freeway, Houston, Texas 77001 ("BIG"):

[Identify parties, address of grantee for future tax statement mailings. Recital of consideration - optional.]

[Indicate marital status of grantor - homestead and inchoate statutory rights of spouse. Kan. Stat. Ann. § 59-401, § 60-2301, Kan. Const. art. 15, § 9. Kan. Stat. Ann. § 59-505.]

[Statutory short form for words of conveyance. Kan. Stat. Ann. § 58-2203.]

> All the oil, gas, and similar hydrocarbon substances [other mineral problem] in and under [mineral/royalty problem] the Southwest Quarter of Section 30, Township 36 South, Range 10 East, in Eureka County, Kansas,

[Description of property being conveyed. Kan. Stat. Ann. § 58-2203 and § 58-2204. Luthi v. Evans, 223 Kan. 622 (1978).]

hereafter called the "Mineral Interest."

Subject to the following:

SECTION 1. Rights Granted as Part of the Mineral Interest. As part of the Mineral Interest, BIG has the exclusive right to develop, or authorize others to develop, the Mineral Interest. Subject to SECTION 2 of this Mineral Deed, BIG is entitled to any bonus, rental, royalty, or other payments which may accrue, after the date of this Mineral Deed, in existing leases or development contracts affecting the Mineral Interest. BIG is entitled to any reversionary interest NANCY may have in existing leases or development contracts affecting the Mineral Interest.

[Applying Kansas precedent to ensure conveyance is interpreted as a mineral interest.]

BIG is also given the right to enter and use the surface overlying the Mineral Interest to the extent necessary to explore, develop, produce, and operate the Mineral Interest, pursuant to the following terms:

[Must coordinate respective rights to use surface.]

Section 2. Apportionment of Royalties. The Mineral Interest is currently subject to the Oil and Gas Lease described in SECTION 3 of this Mineral Deed, which covers all of Section 30, Township 36 South, Range 10 East, in Eureka County, Kansas, hereafter called the "Leased Land." After the date of this Mineral Deed, when production is obtained anywhere on, or attributable to, the Leased Land, BIG and NANCY will share in all royalty, or shut-in royalty, in the following proportions:

NANCY - 3/4ths
BIG - 1/4th

If the Oil and Gas Lease on the Leased Land expires or otherwise ceases to burden the Leased Land, then each owner of mineral rights in the Leased Land will be released from any obligation, created by this SECTION, to apportion royalties.

[Kansas applies the nonapportionment rule. Carlock v. Krug, 151 Kan. 407 (1940). Must address matter in deed because the oil and gas lease does not contain an entireties clause. Brubaker v. Branine, 237 Kan. 488 (1985).]

SECTION 3. Exceptions to the Warranty. There is excepted from the warranty an encumbrance created by an Oil and Gas Lease between NANCY and Major Petroleum Corporation dated 3 September 1987 and recorded in Book 5, at Page 240, of the Miscellaneous Records of Eureka County, Kansas.

[To avoid Duhig and Hoffman line of problems, simply indicate whether the exception is being made to the grant or to the warranty.]

SECTION 4. Binding Effect. This grant, and all related terms, are binding on the heirs, personal representatives, successors, and assigns of NANCY and BIG.

[Not required in Kansas. Kan. Stat. Ann. § 58-2202. However, I prefer to add this clause when the deed contains some reciprocal covenants - such as surface use agreements and apportionment of royalty. Want to ensure these are covenants which will "run with the land."]

SIGNED and DELIVERED 14 October 1987.

[Must be signed by grantor. Kan. Stat. Ann. § 58-2209. Delivery and acceptance is required to make the conveyance effective. Acceptance is presumed in most cases.]

_____
Nancy Farmer

[Acknowledgment required for recording. Kan. Stat. Ann. § 58-2212.]

[Acknowledgment certificate in this document uses a statutory short-form of acknowledgment. Kan. Stat. Ann. § 53-509.]

ACKNOWLEDGMENT CERTIFICATE

Wilson County, Kansas

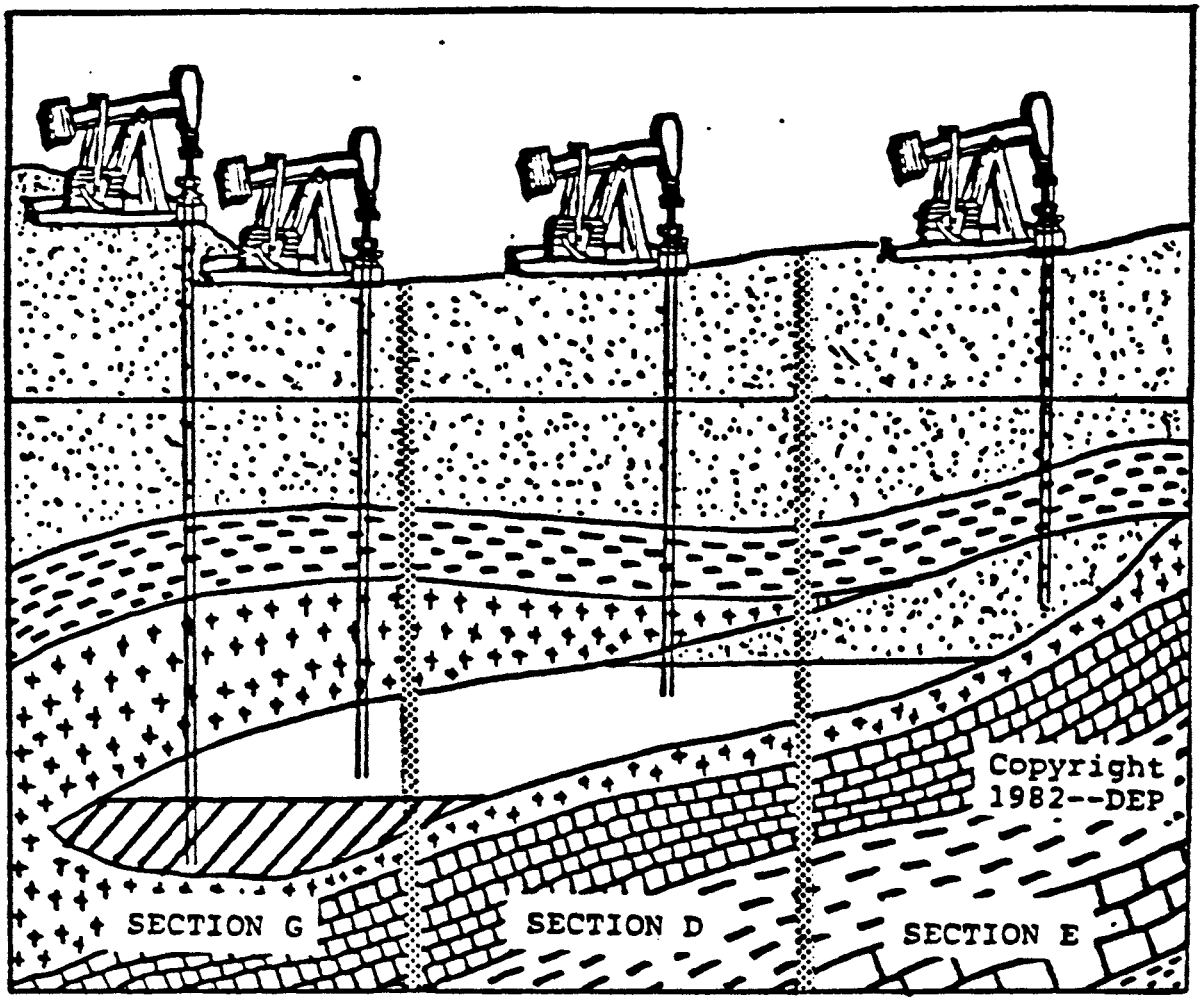
This Mineral Deed was acknowledged before me on 14 October 1987 by NANCY FARMER.

(SEAL)

CHUCK ROAST, Notary Public
My commission expires:_____

[Must record promptly or conveyance is void. Kan. Stat. Ann. § 79-420.]

See generally D. Pierce, Kansas Oil and Gas Handbook 5-2 to 5-14 (Kansas Bar Association 1986).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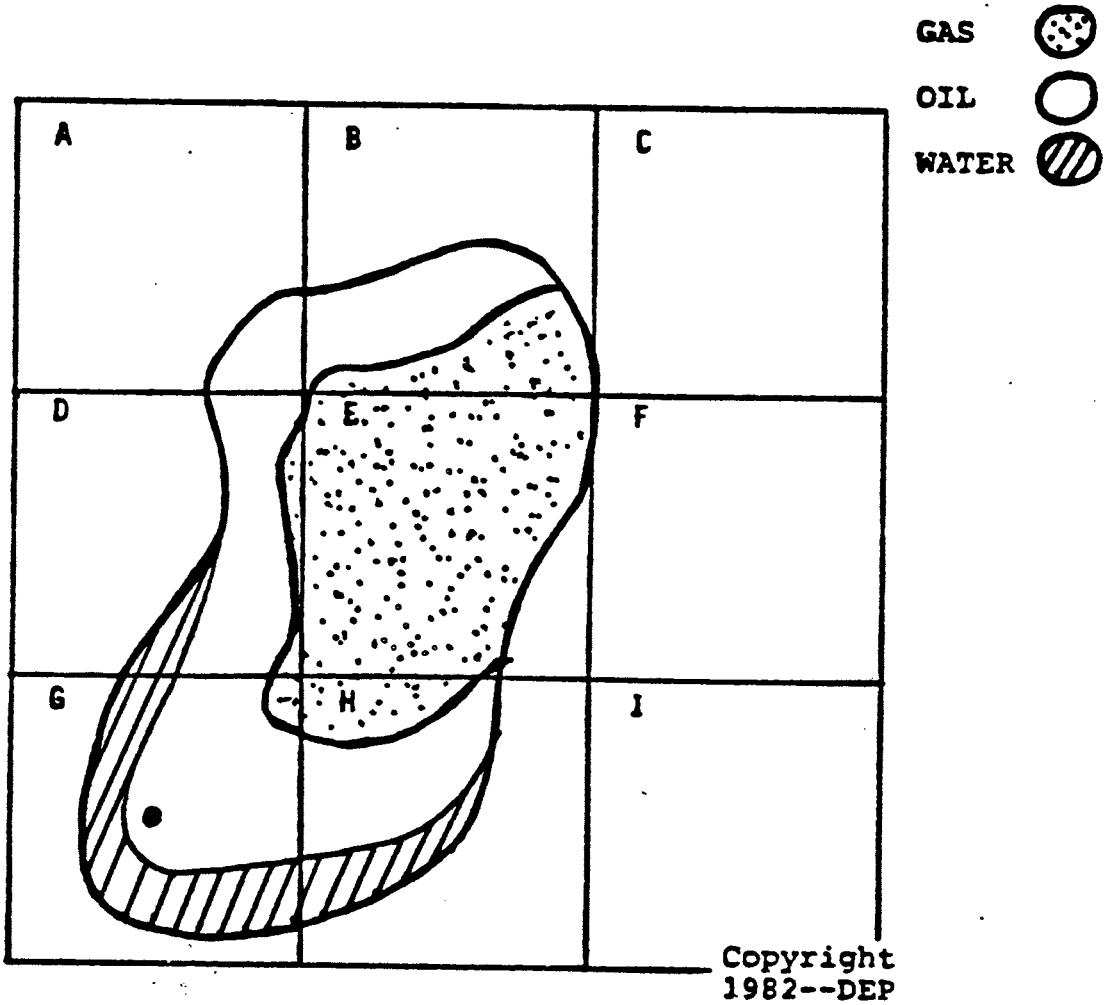
GAS
OIL
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A
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Copyright
1982--DEP

OIL AND GAS TRAPPING MECHANISMS

Figure 1. Stratigraphic Trap

Figure 2. Anticlinal Fold Trap

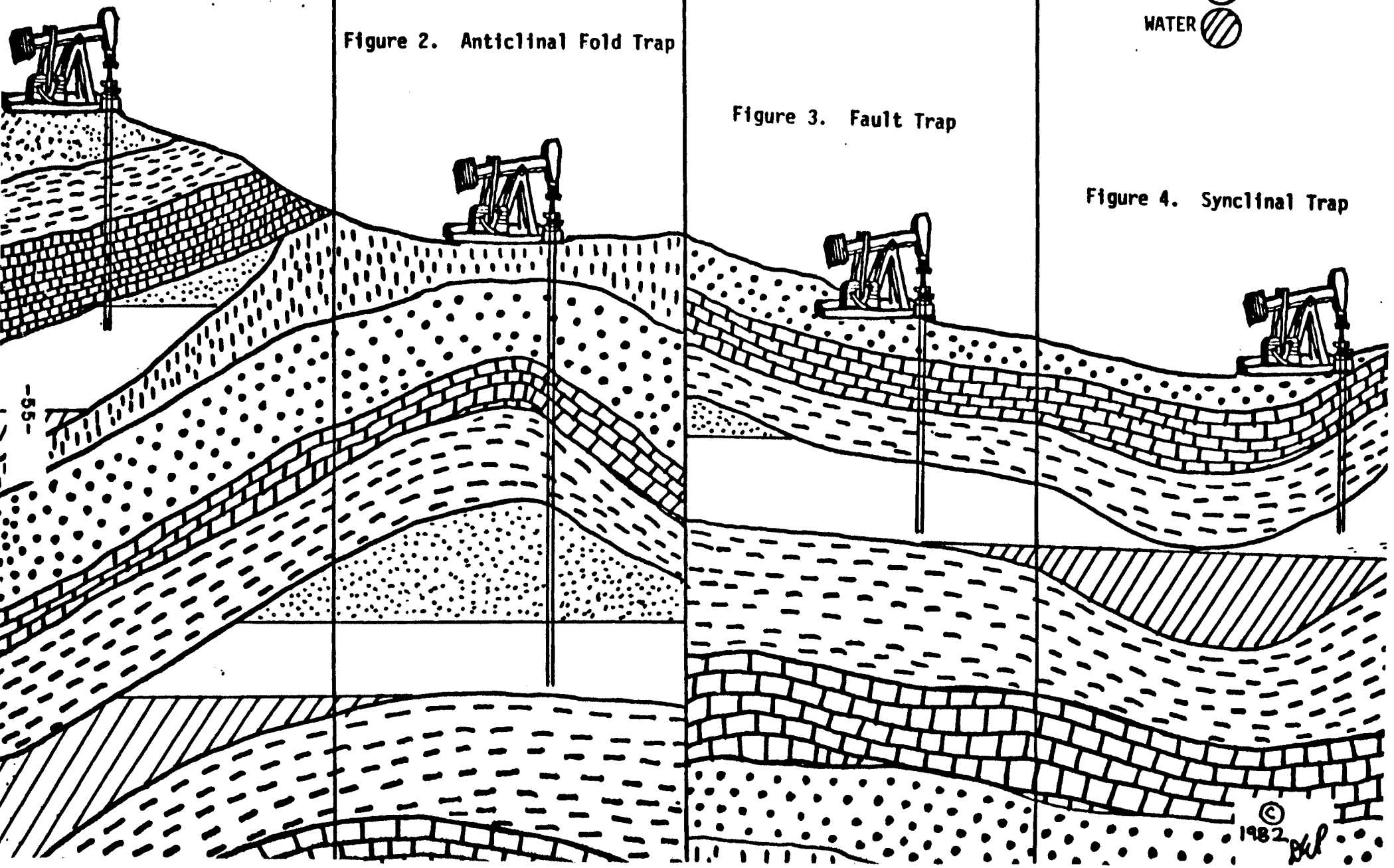
Figure 3. Fault Trap

Figure 4. Synclinal Trap

GAS

OIL

WATER



Title: **AN INTRODUCTION TO KANSAS OIL & GAS LAW**

Date: **November 11, 1988**

Location: **Overland Park, Kansas**

Program: **Washburn Law School Oil and Gas Law Series**

Sponsor: **Washburn University School of Law**

Duration: **Six Hours**