New Handbook Release

Kansas Oil & Gas Handbook Volume II

and accompanying seminar

Kansas Bar Association

Meet the Speakers

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7 Hours of CLE Credit

Seminar Schedule

8:00 a.m. Registration

8:30 a.m. *State & Local Regulation of Oil & Gas Development*
State Regulation of the Development Process Speaker: Phil M. Knighton. Conservation Regulation and Practice, Speaker: Walker A. Hendrix. Local Government Regulation Speaker: David E. Pierce

10:15 a.m. Break

10:30 a.m. *Petroleum Title Examination*
Speaker: Charles E. Hoke, II

11:20 a.m. *Common Oil and Gas Contracts* Speaker: David E. Pierce

12:10 p.m. Lunch (on your own)

1:30 p.m. *Financing Oil and Gas Development* Speaker: Dwight D. Keen

2:20 p.m. Break

2:35 p.m. *Creditor/Debtor Relations*
Speakers: A. J. Schwartz & Robert B. Morton

3:35 p.m. *Oil and Gas Taxation*
Speaker: Tim O'Sullivan

4:20 p.m. Adjournment

"KANSAS OIL & GAS
HANDBOOK VOLUME II RELEASE"

April 21, 1989
Century II - Room 209
Wichita, KS

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STATE REGULATION OF THE DEVELOPMENT PROCESS

OUTLINE OF PRESENTATION
PHILIP M. KNIGHTON
APRIL 21, 1989

HANDBOOK CHAPTER 13

I. Scope of the Chapter

A. Nuts and bolts of regulatory practice
   1. License to operate
   2. Applications
   3. Permits

B. Cradle to grave regulation by fits and starts and crisis
   1. Historical context
      a. Surpluses of the late '20's - State "conservation" jurisdiction
         (1) apportion "market share" - proration
         (2) prevent unnecessary drilling - spacing
      b. Policeman in the oil patch
         (1) complaints - operator v. operator
             (i) correlative rights
         (2) compliance - Commission v. operator
             (i) pollution - saltwater rules, 1930's
         (3) Waste - interest of the "public generally"
             (i) overproduction above M.E.R.(maximum efficient rate)
      c. Environmental Awareness of the 1960's - CWA implementation in 1981

C. "Practical" handbook organization
   1. Life cycle of operator - lease - well
      a. Operator gets license
      b. Operator gets well drilling permit
      c. Operator carefully reads rules and regulations, checks for spacing, thoughtfully choses Alternate I or Alternate II cementing, considers gas markets, special fresh water considerations in the area, artesian salt water zones in the area, etc.
      d. Operator drills well
      e-1. Operator plugs dry hole
      e-2. Operator completes well
         (1) dual or multiple completion - Application
         (2) comingling completion - Application
         (3) completes Alternate II cementing
      f. Operator gets NGPA Application filed to start higher pricing
      g. Well starts making some saltwater
         (1) Applications:
             (a) Enhanced Recovery - injection into producing zone
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h. Well ceases producing
   (1) Temporary Abandonment - Application - really a form
   (2) Plugging - permit

D. Path is littered with applications, forms and permits
   1. Noncompliance consequences
      a. Fines
      b. Lose license to operate

II. Tools of the Trade

A. Rules, Regulations, & Statutes
   1. K.C.C. rules books - substantive and procedural
      a. Free at K.C.C. Wichita Conservation Division Office
      b. Operator certifies he's read them on the chosen application

B. Ask
   1. K.C.C. staff very helpful
   2. K.C.C. "Bar" very friendly and helpful

C. Know the "lingo" & fundamentals
   1. The "rocks" in Kansas
      a. Sandstone - reservoir rock (has holes in it)
      b. Limestone (and dolomite) - reservoir rock
      c. Shale - clay, the sealer of most reservoirs
      d. Chert - reservior rock when fractured or weathered

D. The Kansas layer cake
   1. Basins
   2. Anticlines - El Dorado Field
   3. Buried erosional features
      (1) hill tops buried by shale - Arbuckle in Central Kansas
      (2) sand bars in river channels - Morrow sands in SW Kansas

E. Reservoir concepts
   1. Porosity - holes between "sand" grains
   2. Permeability - ability of fluids to move from pore to pore
   3. Pinchout - edge of reservoir, example: buried sand bar
   4. "Reservoir" - body of porosity and permeability that is pressure connected
   5. "Common source of supply" - one or more reservoirs in a distinct layer of rock (formation)
      a. Examples - Lansing/Kansas City zones
         - Morrow sands in SW Kansas

III. Examples of Problems

A. Compliance matters
   1. They can't do this to me
      a. I've been in this business for 25 yrs.
   2. We've always done it this way
      a. Reinterpretation of the rules

b. Change in rules
c. "New Staff"

3. Nobody told me we had to do that
   a. First question by staff counsel at hearing for <u>post facto</u> exception:

      "Now Mr. Operator, you did read the rules and regulations on this matter before you drilled the off location well.

      No? Well you certified you had on your Operator's License Applications on ...."

4. First steps with client
   a. Get copies of his factual records
   b. Read through rules and regulations with him - clarify misunderstandings and alternatives
      (1) avoid costly battles if compliance cheaper
      (2) avoid irritating the K.C.C. Staff
          (a) may need favors later
      (3) may see K.C.C. Staff is wrong and need
          (a) present more facts
          (b) educate new staff
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C. Examples
   1. Well too close to lease line

   2. Alternate II cementing didn't reach surface or converting old well for SW injection well that doesn't have portland cement behind casing

   3. New Pool Application denied (NGPA or Severance Tax Exemption)

   4. Neighbor overproducing his well
      a. Variation - think neighbor has other unreported zones open

   5. K.C.C. padlocked well for venting only a "little" gas

LOCAL GOVERNMENT REGULATION OF THE DEVELOPMENT PROCESS
HANDBOOK CHAPTER 15

by

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LOCAL GOVERNMENT REGULATION OF THE DEVELOPMENT PROCESS
HANDBOOK CHAPTER 15

I. CITY AUTHORITY TO REGULATE OIL & GAS DEVELOPMENT

A. Home Rule [Handbook § 15.03]

1. Cities in Kansas, since 1961, derive their municipal powers from Kan. Const. art. XII, § 5; the "home rule" amendment.

2. Cities in Kansas, subject to certain exceptions enumerated in the state constitution, can act on any matter so long as the city law does not conflict with the constitution or state enactments that apply uniformly to all cities. Kan. Const. art. XII, § 5(a) and (b).

3. Cities legislate by passing either an "ordinance" or a "charter ordinance."

   a. "Charter ordinance" used when a city desires to become exempt from conflicting state legislation that does not apply uniformly to all cities. Through the charter ordinance process, the city can adopt local legislation that conflicts with non-uniform state law. See Clark v. City of Overland Park, 226 Kan. 609, 616; 602 P.2d 1292, 1298 (1979).

   b. All other situations are addressed by an "ordinance." See K.S.A. §§ 12-3001 to 12-3007 (1982). The city can act in any area the state has failed to act; city can duplicate or supplement existing (uniform or non-uniform) state law so long as the ordinance does not "conflict" with the state's legislative purpose.

4. City ordinance "conflicts" with state law only when:

   a. The ordinance authorizes something state law prohibits;

   b. The ordinance prohibits something state law authorizes;

   c. The state statute expressly indicates that the matter is to be governed exclusively by state law. Kansas courts refuse to apply any sort of "implied preemption" analysis in this area.

See generally City of Junction City v. Lee, 216 Kan. 495, 532 P.2d 1292 (1975).

5. Defining "uniform" state law:

   a. The "enactment" must be uniformly applicable to all cities. Enactment refers to all sections of the law as published in the Kansas Session Laws.

      (1) A single "enactment" may include many separate sections once it is codified in the Kansas Statutes Annotated. See City of Junction City v. Griffin, 227 Kan. 332, 607 P.2d 459 (1980).

      (2) "[S]tatutory expression of intent to make a law uniform cannot supplant the constitutional requirement of uniformity. The constitution empowers a city by charter ordinance to opt out from any state enactment which is not uniformly applicable to all cities ...." Griffin, 227 Kan. at 338, 607 P.2d at 464.

   b. "Enactment" includes "[s]tatutes relating to the same subject, although enacted at different times . . . ." Claflin v. Walsh, 212 Kan. 1, 509 P.2d 1130 (1973).

   c. However, an enactment providing alternative laws, from which all cities can elect to operate under, does not render the enactment non-uniform. Moore v. City of Lawrence, 232 Kan. 353, 358, 654 P.2d 445, 449 (1982).

   d. Article XII, section 5(b) of the Kansas Constitution provides an exception to the uniformity requirement by permitting the state to place cities into from one to four classes for the "levying of any taxes, excises, fees, charges and other exactions." See Clark v. City of Overland Park, 226 Kan. 609, 602 P.2d 1292 (1979).

6. Analytical process for determining if a city has the authority to regulate:

   a. First, identify all state laws on the subject matter being regulated. If there is no state law on the subject, the city can freely legislate. Andersen Constr. Co. v. City of Topeka, 228 Kan. 73, 612 P.2d 595 (1980).

b. Second, if there are state laws on the subject, it must be determined whether the ordinance "conflicts" with state legislative goals.

c. Third, even though there is a conflict, if the city has acted by charter ordinance, and the state law does not apply uniformly to all cities, the city law is valid.

7. Note that where the city acts by charter ordinance, the state can always adopt uniform state law to displace local regulation. Where the city acts by ordinance, the state can displace local regulation by expressly indicating the area is reserved for exclusive state regulation (through uniform enactment).

B. Regulating Land Use [Handbook § 15.04]

1. Land use regulation in Kansas is accomplished through the zoning process. See K.S.A. §§ 12-701 to 12-735 (1982 & Supp. 1988).

2. City planning commission prepares a city plan that addresses city development and redevelopment.

a. The plan should address: "(f) Utilization and conservation of natural resources; and (g) Any other element deemed necessary to the proper development or redevelopment of the area."

b. See K.S.A. § 12-704 (1982).

3. Once adopted, the city plan serves as a "guide" for land use decisions. K.S.A. §§ 12-704 and 12-704a (1982).

4. Generally, the city will be divided ("zoned") into "districts" based upon broad classifications of land use - such as "residential" and "industrial." K.S.A. § 12-708 (1982).

5. Often, the city plan and zoning ordinance are silent regarding whether oil and gas exploration and development is a permissible land use within any of the designated districts.

6. Oil and gas development may be addressed in the "special use" permit portion of the zoning ordinance.

7. The "Special Use" Permit:

   a. Certain uses should not be limited to a single district. However, the city wants to control the use by determining, on a case-by-case basis, when and under what conditions, the use may be pursued.

   b. Must obtain a "special use permit" before the landowner can engage in the listed special use.

   c. Before a special use permit can be issued, must go through an involved notice and hearing process to ensure the public health, safety, and welfare will not be adversely affected by granting the permit. See <u>K-S Center Co.</u> <u>v.</u> <u>City of Kansas City</u>, 238 Kan. 482, 712 P.2d 1186 (1986) (affirming issuance of special use permit to locate sanitary land fill within four blocks of the Indian Springs Shopping Center).

8. In many cases, oil and gas development will be addressed in the special use permit portion of the city zoning ordinance. Often under the provision dealing with "mines or quarries."

9. If the zoning district provisions fail to address oil and gas development, and there is no special use provision covering oil and gas activities, the only alternative will be to seek a "rezoning" of the area to permit (and regulate) oil and gas development. This assumes the activity is not an existing nonconforming use. See <u>Goodwin</u> <u>v.</u> <u>City of Kansas City</u>, 244 Kan. 28 (1988).

   Must pursue the same notice, hearing, review, and approval process required for promulgation of the original zoning ordinance. K.S.A. § 12-708 (1982).

10. Must distinguish between a "special use permit," a zoning "variance," zoning "exceptions," and a "rezoning."

    a. Variances and exceptions - focus on the minor details of regulating an otherwise <u>authorized</u>

use of land. Not designed to change the zoning of an area or to permit a use which is not authorized in an area. K.S.A. § 12-715 (1982).

b. Special use permit - the "use" must be authorized in the zoning ordinance <u>and</u> the city governing body must determine, on a case-by-case basis, whether the conditionally authorized use is in fact compatible with the area.

c. Rezoning - change the zoning ordinance to permit uses which are not currently authorized.

11. Regulation of development <u>outside</u> the city limits:

a. Cities can adopt zoning regulations "affecting all or any designated portion of the land located outside the city but within three miles thereof . . . ." K.S.A. §12-715b (Supp. 1988).

b. Cannot affect land in excess of three acres under one ownership which is used <u>only</u> for agricultural purposes. K.S.A. § 12-715b (Supp. 1988).

c. Once it is leased for oil and gas development, is it still being used <u>only</u> for agricultural purposes? See generally <u>VanGrundy v. Lyon County Zoning Bd.</u>, 237 Kan. 177, 699 P.2d 442 (1985) (under county zoning law, if the activity is conducted to further an agricultural pursuit, such as mining stone to build a farm pond, the incidental mining operation, and rock sales, will not be subject to county zoning authority).

12. So long as the city follows statutory procedures, they can determine how to best control land uses within their jurisdiction. Only limitations:

a. Cannot violate state and federal constitutions. Most common assertion is that the local regulation constitutes a "taking" of private property requiring compensation. See <u>Kimberlin v. City of Topeka</u>, 238 Kan. 299, 710 P.2d 682 (1985).

b. City laws must be "reasonable." The regulation must be related to protecting the public health, safety, or welfare. K.S.A. §12-712 (1982) and Landau v. City Council of Overland Park, 244 Kan. 257 (1988) (discussing factors city must weigh in evaluating zoning actions and the type of evidence the reviewing court can consider).

C. Regulating Development Activities [Handbook § 15.05]

1. Concerned with regulating the details of development operations.

2. Three possible approaches:

a. Prohibit all development within the city. Appears to be feasible when it is reasonably related to protecting the public health, safety, and welfare.

(1) See generally Winkler v. Anderson, 104 Kan. 1, 177 P. 521 (1919) (upholding state statute prohibiting oil or gas wells within 100 feet or railroad right of way).

(2) Marrs v. City of Oxford, 32 F.2d 134, 140 (8th Cir. 1929), cert. denied, 280 U.S. 573 (1929) (in dicta the court notes: "Indeed, it would be hard to say that an ordinance prohibiting the drilling and operation of any well within the business or residential districts of a city would be an unreasonable and invalid exercise of the police power.").

(3) Op. Kan. Att'y Gen. No. 88-132 (Sept. 9, 1988) (finding that ordinances of the cities of Leavenworth and Lansing, which prohibit the drilling of wells within 1,000 feet of a residential building and prohibiting crude oil storage within the city, are valid exercises of the police power and home rule powers).

b. Permit the activity in some zoning districts but prohibit it in others.

(1) Note that regulating mineral development activities is fundamentally different from regulating other surface land uses.

(2) Although you cannot locate a mobile home on Lot A, you can still use Lot A for

some other authorized use and move the mobile home to the proper district. However, you cannot move a mineral deposit and such deposits do not respect surface boundaries created for regulatory control.

(3) Should courts take a harder look at the reasonableness of local laws when regulating mineral development? See Silva v. Township of Ada, 416 Mich. 153, 330 N.W.2d 663 (Mich. 1982).

c. Permit development throughout the city but directly regulate development by specifying the conditions under which the activity can be pursued. This approach can be used in addition to, or in lieu of, the zoning approach.

3. Three goals of city regulation:

a. Protect the public. [Handbook § 15.06] Regulate the potential impacts of mineral development. Ordinances can establish various performance standards, including requiring a permit, posting of a surety bond, and acquire insurance. Marrs v. City of Oxford, 32 F.2d 134, 135-38 (8th Cir. 1929).

b. Protect private interests. [Handbook §15.07] Regulate development to protect correlative rights.

(1) Limit drilling to one well per city block - need pooling system to protect owners of surrounding acreage that are prohibited from drillng offset wells to protect their correlative rights.

(2) Marrs v. City of Oxford, 32 F.2d 134 (8th Cir. 1929); Ramsey v. City of Oxford, 216 P. 572 (Kan. 1927); Helmerich & Payne v. Roxana Petroleum Corp., 136 Kan. 254, 14 P.2d 663 (1932); Boher v. Ramsey Petroleum Co., 141 Kan. 781, 44 P.2d 239 (1935).

(3) 1983 statutory provisions authorizing cities to establish drilling unit and force pool interests within drilling units. K.S.A. §§ 55-1610 to 55-1613 (1983).

c. Taxation [Handbook § 15.08] Prior to the home rule amendment, cities could tax only when expressly authorized by the legislature. After 1961, cities can tax in accordance with Kan. Const. art XII, § 5(b).

(1) The state can establish up to four categories of cities for imposing limitations on cities levying "taxes, excises, fees, charges and other exactions . . . ." Otherwise, the state law must apply uniformly to all cities.

(2) The state has acted by placing two types of restrictions on city taxing powers:

(a) Express prohibition or limitation on certain types of tax.

(b) General procedural guides for promulgating taxes. See K.S.A. §12-137.

(3) See Clark v. City of Overland Park, 226 Kan. 609, 602 P.2d 1292 (1979).

(4) If the proposed exaction can be legitimately classified as a "permit fee" or "license fee," for "regulatory purposes," K.S.A. § 12-137 does not apply. However, if subsequently determined to be a "tax," it will be invalid because the § 12-137 procedures were not followed. See generally Billy Oil Co. v. Leavenworth County Comm'rs, 240 Kan. 702, 732 P.2d 751 (1987).

(5) Could a city in Kansas promulgate a "city severance tax"?

II. COUNTY AUTHORITY TO REGULATE OIL & GAS DEVELOPMENT

A. Home Rule [Handbook § 15.09]

1. Counties have been granted home rule powers by statute; there is no constitutional basis for county home rule. K.S.A. § 19-101a (Supp. 1987).

2. Counties have "all powers of local legislation and administration . . . subject only to" twenty-two enumerated exceptions. K.S.A. § 19-101a.

3. Counties are subject to uniform state legislation but can exempt itself from non-uniform state legislation by "charter resolution." K.S.A. §19-101a(b) and 19-101b (Supp. 1988).

4. Exception twenty-two of K.S.A. § 19-101a provides:

   "Counties may not regulate the production or drilling of any oil or gas well in any manner which would result in the duplication of regulation by the state corporation commission and the Kansas Department of Health and Environment pursuant to chapter 55 and chapter 65 of the Kansas Statutes Annotated and any rules and regulations adopted pursuant thereto. Counties may not require any license or permit for the drilling or production of oil and gas wells. Counties may not impose any fee or charge for the drilling or production of any oil or gas well."

   K.S.A. § 19-101a(a)(22) (Supp. 1988). See Billy Oil Co. v. Leavenworth County Comm'rs, 240 Kan. 704, 732 P.2d 751 (1987).

5. Would a county regulation requiring an operator to post a plugging bond be "duplication of regulation"? What about a county regulation requiring force pooling?

6. To what extent does K.S.A. § 19-101a limit a county's zoning authority over basic land use decisions (such as whether oil and gas development should be allowed in an area)?

   K.S.A. § 19-2919 (Supp. 1988) authorizes counties to adopt and administer zoning regulations to control, among other things, "the location and use of buildings, structures and land for industry, business, trade, residence . . . and other uses."

B. Regulating Land Use [Handbook, § 15.09]

1. Counties genertally follow the same districting process employed under city zoning laws. K.S.A. §19-2920 (Supp. 1988).

2. K.S.A. § 19-101a(a)(22) (Supp. 1988) operates as a general limitation on county zoning authority when the matter concerns the regulation of oil and gas production or drilling activities already regulated by the KCC or KDH&E.

   a. However, since the KCC and KDHE have no jurisdiction over basic land use decisions, it would seem this is an area in which the county can act.

b. It appears a county can limit or prohibit oil and gas development in a district when there is a reasonable relationship between the restriction and the public health, safety, and welfare. K.S.A. § 19-2919 (Supp. 1988) and K.S.A. § 19-2926 (1981).

c. If the zoning has to be changed before drilling an oil and gas well, arguably a "fee" could be imposed for processing the change. K.S.A. § 19-2920 (Supp. 1988) and K.S.A. § 19-2907 (1981). However, the fee must have some reasonable relation to the cost of administering the zoning program. See generally Billy Oil Co. v. Board of Leavenworth County Comm'rs, 240 Kan. 702, 732 P.2d 751 (1987).

III. REPRESENTING THE DEVELOPER

A. Checklist [Handbook § 15.10]

1. [] Identify all state law requirements on the subject.

2. [] If outside city limits, obtain all county resolutions and charter resolutions on the subject.

3. [] Determine whether the county regulation is consistent with express limitations in the county home rule statute.

4. [] If outside city limits, but within three miles of an incorporated city, ascertain whether the city has exercised its authority to zone land within three miles of city boundaries.

5. [] If within city limits, or within an effective three-mile zone, obtain copies of all city ordinances and charter ordinances on the subject.

6. [] If the city has a zoning ordinance, which does not address oil and gas development, such activity is not authorized. Goodwin v. City of Kansas City, 244 Kan. 28, 31 (1988).

7. [] If oil and gas development is not expressly permitted in an established district, examine the special use permit provisions of the zoning ordinance.

8. [] If the zoning ordinance is completely silent regarding oil and gas development, consider applying for a general rezoning of the area (or the entire city) to permit, and regulate, oil and gas development.

9. [] If exisiting city or county law is not workable, discuss the matter with the appropriate government officials and propose workable provisions.

10. [] If you find it necessary to contest existing city or county law, consider the following:

    a. [] Determine whether the local governmental entity has the authority to legislate on the subject matter.

    b. [] Determine whether the proper procedures were followed in promulgating the local laws. E.g. was a "charter" resolution or ordinance required?

    c. [] Determne whether the local laws are "reasonable" in their promulgation and application to the facts.

    d. [] Determine whether there has been an improper "taking" of private property.

    e. [] Carefully review statutes and case law to ensure all special notice, venue, and pleading requirements are met. See, e.g., Davis v. City of Leavenworth, 243 Kan. 522, 759 P.2d 113 (1988).

B. Attitude

1. The affected city or county officials should be consulted --before development activities begin-- to ascertain whether they have acted to regulate development.

2. This can set the stage for a workable relationship

in the event the city or county has a problem with your proposed development - even though they don't currently regulate development. Often, some informal contact can avert reactionary local legislation.

3. If they decide to regulate the activity, you should actively participate to ensure the resulting law is workable.

IV. REPRESENTING THE CITY OR COUNTY

A. Primary Goal - Protect The Public [Handbook § 15.11]

1. Protect the public from the adverse effects and dangers associated with oil and gas development.

2. Consider areas where state law is inadequate or nonexistent.

3. Ensure existing regulations are workable. If you want to prohibit all development, do so -- don't try to achieve the same goal by enacting a convoluted regulatory scheme.

4. If you intend to tax, tax -- don't attempt to turn permits and permit fees into a taxing mechanism. Charge fees to the extent required to recoup the actual costs of administering the program.

5. City should adopt regulatory provisions which protect the public while providing whatever regulatory "assistance" is possible without jeopardizing public interests.

   a. Compulsory pooling?

   b. Compulsory unitization?

6. Follow the Kansas Supreme Court's direction in Golden v. City of Overland Park, 224 Kan. 591, 584 P.2d 130 (1978) and Landau v. City Council of Overland Park, 244 Kan. 257 (1988).

B. Maximizing Local Government Resources

1. Since the city is often the single largest landowner (and mineral interest owner) in the area, they have a pecuniary interest in promoting safe, orderly development.

2. The city may want to actively participate in the

development process to maximize its economic interests in the search for oil and gas.

3. For a detailed discussion on how cities might pursue an active development program, to include municipal lease sales, suggested documents, and ordinances, see Pierce, "Municipal Development of Oil and Gas," 19 Tulsa L. J. 337, 337-38, 342-72 (1984), reprinted at, 22 Public Land & Resources L. Digest 66 (1985).

OIL AND GAS TITLE EXAMINATION
HANDBOOK CHAPTER 16

By Charlie Hoke

I. INTRODUCTION

A. This Chapter covers oil and gas drilling title opinions and oil and gas division order title opinions. The Examiner should have a set of Kansas Title Standards and Volume I of the Handbook and further should be familiar with Chapter 55, (Oil and Gas) Chapter 59 (Probate) and Chapter 60 (Civil Procedure) of the Kansas Statutes Annotated.

II. PRELIMINARY STAGE: COLLECTION OF PROPER DOCUMENTS

A. Secure copies of both sides of all oil and gas leases along with riders, addenda, etc.

B. Secure an Affidavit of Possession. If the land is farmed by a tenant, it is recommended that the tenant execute the affidavit.

C. Secure copies of delay rental receipts.

D. Borrow all base and supplemental abstracts and update them past the recording date of the oil and gas lease or assignment to the client. It is important to examine all of the land covered by the lease or the leases in the unit, especially if the leases have entireties clauses.

E. Secure copies of farmout agreements, letter agreements, or side letter agreements with the landowner.

III. **EXAMINATION STAGE:**

A. Carefully note the legal description set out on the lease or leases and check the various certificate pages of the abstracts. They should be certified for all of the land being examined for the entire chain of title. Any gaps or exceptions need to be closed or shown in the title opinion.

B. The examiner should devise a system of notetaking that is consistent, orderly and allows him to discover that the minerals have been severed from the surface as well as noting all types of rights of way, mortgages and anything unusual which needs to be noted in the opinion.

IV. DRILLING OPINION

A. Before an operator can drill on the lease or unit, he must know whether he has a valid lease from all parties owning the minerals. He also needs to know about other matters which might effect title for drilling purposes, such as mortgages superior to the oil and gas lease, rights of way affecting the drilling location, certain restrictions against drilling, unpaid taxes or the existence of judgment liens which could endanger the priority of the oil and gas lease. The two most important matters in examination for drilling purposes are whether any superior oil and gas leases exist or whether any unleased mineral interests exist.

B. A well written drilling title opinion will list the necessary requirements and how they should be satisfied in order for the operator to have merchantable title for drilling purposes. If the operator satisfies the requirements listed in the opinion, he should be able to commence drilling operations safely.

IV. PROBLEMS TO ADDRESS

A. Rights of Way and easements need to be noted in case they might affect or interfere with drilling operations.

B. Mortgages, liens and unpaid taxes which might be superior to the oil and gas need to be listed and if necessary subordinated.

C. Railroad rights of way might not only create potential rights of way to avoid, but raise a question whether the railroad owns the minerals. K.S.A. 55-110 (1983) restricts the drilling of a well near a railroad right of way. Harvest Queen Mill and Elevator Co. v. Sanders, 189 K. 536, 370 P.2d 419 (1962), addresses whether a railroad has acquired minerals in a deed.

D. K.S.A. 55-211a (1986) covers leasing land from cities and drilling near cemetaries.

E. Restrictions on the face of the lease or an attached riders and addenda need to be reviewed and noted in the title opinion. Any particular troublesome provisions should be pointed out to the client.

F. Severed mineral or royalty interests need to be checked to determine whether any additional parties need to execute leases (or ratifications). It is not necessary in the drilling opinion to quantify the interest, merely to ascertain that all necessary signatory parties have signed the lease.

G. Ambiquities could arise regarding the quantity of overriding royalty interest, reserved or assigned, or with the fractional amount of a mineral or royalty interest reserved or conveyed (see Section 6.20). This does not typically affect drilling, but needs to be resolved before division orders can be issued.

H. A break in the chain of title might indicate an unfiled probate estate. If the probate case has been filed in another county or state, then the provisions of Chapter 59 of K.S.A. should be followed (see also Kansas Title Standard No. 19.4). If no estate has been filed, then a Determination of Descent should be filed under Chapter 59.

I. Unpaid real estate taxes could potentially extinguish the lease if it foreclosed. Generally the landowner should be required to pay them before drilling, otherwise the operator can pay them after production has been obtained and withhold the amount from the royalties, if the lease so provides.

J. Unreleased oil and gas leases still in the primary term, or leases for which an Affidavit of Production under K.S.A. 55-205 has been filed, need to be released by all parties of record who own an interest in them. If no Affidavit of Production is filed and the lease is past the primary term, then see Cities Service Oil Company v. Adair, 273 F. 2d 673 and Sec. 8.12 of Vol. I. See also Chapter 16 of the Kansas Title Standards Handbook.

K. Severed minerals or term mineral interests need carefully to be checked. If any unleased interests exist, the operator needs to be notified so that he can secure a lease or ratification before drilling. If a term mineral interest appears to have expired on its face and covers only the land under examination, see Title Standard 16.3. If the term mineral interest is past its primary term but covers lands other than those being examined, it will be necessary to examine all lands to ascertain whether any production has perpetuated the interest. If not, then secure an oil and gas lease or ratification. It might be necessary to order a copy of the full instrument if the abstract does not show all of the lands covered. For problems concerning the extension of term mineral interest involved in gas units, see Section 9.08 of Volume I.

L. District Court actions, such as partitions, mortgage foreclosures, tax foreclosure actions and normal actions for money damage, should be carefully reviewed to ascertain that all defendants were not only listed, but properly served with process. If publication service is used in the case, the provisions of K.S.A. 60-307 (1986) should be reviewed to ascertain whether they were followed. See for example Federal National Mortgage Association v. Beard, 8 Kan. App. 2d 371, 659 P.2d 32 (1983).

M. Severed mineral interests must be recorded within 90 days or otherwise timely "listed" in order to be put on the tax rolls. If not properly recorded or listed for taxation, K.S.A. 79-420 (1984) provides that the interest is void. See Section 5.10 of Volume I.

N. One of the biggest headaches in title examination is determining whether a particular interest is a mineral interest or a royalty interest or whether its owner must be a signatory party to the lease. Fortunately, the examiner for drilling purposes need not make a substantive legal determination whether the interest is a mineral or royalty, but only determine whether the owner of the interest needs to sign an oil and gas lease or a ratification.

O. Confusion concerning the nature of life estates can raise problems in oil and gas title examination. For a discussion of life estates, see Section 4.21 of Volume I. Generally, the life tenant, unless otherwise specifically stated in the creating instrument, is not entitled to receive the royalties without accounting to the remaindermen. It is necessary to have the life tenant and remaindermen and the spouses of the remaindermen sign an oil and gas lease or a ratification of the oil and gas lease. For division order purposes, a stipulation will have to be executed between the life tenant and the remaindermen, and spouses of remaindermen, setting out who is entitled to receive the royalty proceeds during the lifetime of the life tenant. If this is not possible, then a declaratory judgment can be filed under K.S.A. 60-1701 to 60-1703 (1983) and the parties can be paid under the provisions of K.S.A. 58-901 (1983), the Uniform and Principal Income Act.

V. DIVISION ORDER TITLE OPINIONS

A. A divison order title opinion is addressed to the oil or gas purchaser and its purpose is to show the purchaser who is entitled to payments and to list any further requirements. Some documents would be unique to the division order opinion which would not appear in the drilling opinion, such as an Affidavit of Production pursuant to K.S.A. 55-205, shut-in royalty payments and possibly a Declaration of Unitization or Declaration of Pooling. Typically, the requirements set out in the drilling opinion should have been satisfied by the time the division order opinion is being prepared. Requirements unique to the division order opinion should be listed in the opinion.

VI. STAND-UP TITLE OPINIONS

A. A stand-up title opinion is an opinion based on personal examination of the courthouse records by the attorney instead of examination of abstracts. The information to be ascertained is the same as an opinion based on abstracts. Some counties, such as Sedgwick County and Butler County before the early 1960's, do not have a legal description index and no stand-up opinion is possible. All instruments shown in the index book should be pulled and examined closely if such instruments might affect the chain of title. It is recommended that all deeds, easements, old oil and gas leases, and similar title instruments, be pulled and carefully read.

B. The system of notetaking should be similar to that for examination of abstracts, but the examiner should be cautioned to be especially accurate and careful in taking notes because of the difficulty in double checking his work after leaving the courthouse.

If any breaks in the chain of title are found from the Register of Deeds check, then the probate records need to be checked to see whether these gaps can be closed by probate cases. Furthermore, the plaintiff-defendant index needs to be checked along with the records of existing or past district court judgments or cases to ascertain whether any court actions could affect the chain of title. The mechanic's lien index is also in the Clerk of the District Court's office and should be checked. Taxes should also be checked in the Treasurer's office to see whether they are current.

COMMON OIL AND GAS CONTRACTS
HANDBOOK CHAPTER 17

by

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B. Kansas' Common Law of Contracts

1. The contract law of most states (Kansas included) is a product of the "common law." The common law of contract consists of the reported judicial decisions addressing contract principles in the context of a specific dispute.

   a. Typically these decisions are not arranged into any sort of formal code - although they could be if the legislature so desired.

   b. The committees and reporters of the American Law Institute have examined all cases on contract law and attempted to extract from them basic principles of contract law in the form of a "Restatement" of the law of contracts.

      (1) The Restatement (First) of Contracts was published in 1932.

      (2) The Restatement (Second) of Contracts was published in 1981.

(3) Although nothing contained in the Restatements is binding upon the courts, it is highly persuasive authority and an excellent research tool.

2 A few states have a substantial body of statutory contract law -- patterned after portions of the "Field Code."

a. David Dudley Field, in the nineteenth century, prepared a civil code which many states adopted. For example, California, Georgia, Montana, North Dakota, South Dakota, and Idaho adopted parts of the Field Code.

b. The presence of such statutes requires that they be consulted first when addressing a contract issue. See Sunco Mfg. Co. v. Hargrove, 581 P.2d 925, 928 (Okla. App. 1978) ("The basis of our contract law is statutory although it follows the contours of the common law and evolves like the common law through judicial construction.")

C. Statutory Contract Law - Article 2 of the Uniform Commercial Code ("UCC")

1. Article 2 of the UCC is a special body of contract law which governs certain types of commercial transactions: the sale of "goods."

2. Recognizing that transactions in goods are national in scope, the UCC is an attempt to adopt uniform state law to govern these transactions.

3. Article 2 modifies many of the traditional contract principles.

a. Generally, under Article 2 many agreements will be enforceable which would be unenforceable under non-UCC law.

b. Article 2 provides the contracting parties with many unique remedies for a party's nonperformance.

4. K.S.A. § 84-2-204 (1983) demonstrates the UCC's greater tolerance for creating enforceable agreements:

"(1) A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.

(2) An agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined.

(3) Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy."

D. Application of Article 2 to Oil and Gas Contracts

1. Definition of "Goods." K.S.A. § 84-2-105 (1) defines "goods" to mean: "[A]ll things . . . which are movable at the time of identification to the contract for sale . . . ."

   a. This simple definition also demonstrates the interrelationship of the UCC provisions and the need to define a number of terms to decipher its meaning.

   b. For example, what is a "contract," a "contract for sale," or a "sale?" What is "identification?"

   c. § 2-106 (1) defines a "contract" or "agreement" to mean "those relating to the present or future sale of goods. 'Contract for sale' includes both a present sale of goods and a contract to sell goods at a future time."

   d. § 2-106 (1) also provides: "A 'sale' consists in the passing of title from the seller to the buyer for a price . . . ."

   e. To decipher the definition we also need to know what are "future goods." Looking at the index of definitions in § 2-103 we are sent to § 2-105. § 2-105(2) informs us that:

      "Goods must be both existing and identified before any interest in them can pass. Goods which are not both existing and identified are 'future' goods. A purported present sale of future goods or of any interest therein operates as a contract to sell."

   f. What does "identification" mean? § 2-103 (2) tells us to look at § 2-501. § 2-501 states:

"[I]dentification can be made at any time and in any manner explicitly agreed to by the parties. In the absence of explicit agreement identification occurs

(a) When the contract is made if it is for the sale of goods already existing and identified;

(b) if the contract is for the sale of future goods . . . , when goods are shipped, marked or otherwise designated by the seller as goods to which the contract refers . . . ."

g. The importance of identification is noted in § 2-401 which provides, in part:

"Insofar as situations are not covered by the other provisions of this Article and matters concerning title become material the following rules apply:

(1) Title to goods cannot pass under a contract for sale prior to their identification to the contract (Section 2-501), and unless otherwise explicitly agreed the buyer acquires by their identification a special property as limited by this Act."

See <u>Kinetics Tech. Intern. Corp.</u> <u>v.</u> <u>Fourth Nat. Bank</u>, 705 F.2d 396, 401 (10th Cir. Okla. 1983) (dispute over title to specially manufactured "furnace economizers" that were seized by bank when the bank's debtor, the seller/manufacturer, became insolvent; court holds title to the incomplete goods passed to buyer because they had become identified to the purchase contract and a sale was completed when the first progress payment was made under the purchase contract).

h. Note that § 2-501 and § 2-401 contain another common characteristic: the parties can "explicitly agree" when an event will occur and then provides for the event if the parties fail to address the matter.

DRAFTING NOTE: Whenever a statute provides a standard, such as "explicitly agree," special care must be taken to ensure your selected language meets the standard.

E. Common Oil and Gas Transactions as a "Sale of Goods"

1. As noted in the previous section, "goods" means all things . . . which are movable at the time of identification to the contract for sale . . . ." § 2-105(1).

2. To determine whether an oil and gas transaction is a sale of goods, and governed by the contract law of UCC Article 2, § 2-107 must be consulted.

   § 2-107 provides:

   "(1) A contract for the sale of minerals or the like, including oil and gas . . . is a contract for the sale of goods within this article if they are to be severed by the seller, but until severance, a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell."

3. EXAMPLE: The typical gas sales agreement is a sale of "goods" governed by Article 2 of the UCC. The gas is "severed by the seller" (the producer) and delivered at a designated point to the purchaser. Although the gas contract may purport to cover all gas produced from specified wells or leases, the usual form of agreement is merely a contract to sell gas when it is actually severed from the ground by production.

   a. For example, in Manchester Pipeline Corp. v. Peoples Natural Gas, 862 F.2d 1439, 1444-45 (10th Cir. Okla. 1988), the court applies Article 2 of the Uniform Commercial Code to determine whether Manchester had entered into a gas sales contract whereby Peoples agreed to take or pay for gas. The court notes:

      "[S]ince the alleged contract related to the sale of natural gas reserves to be severed from the earth by the seller, Oklahoma's codification of the Uniform Commercial Code applies."

   b. See also Sunflower Elec. Co-op v. Tomlinson Oil Co., 7 Kan.App.2d 131, 638 P.2d 963, 969 (1981) (UCC applies to gas contract which included a dedication of reserves from specified acreage).

   c. Contrast a sale of natural gas with a sale of an oil and gas lease. In Casper v. Neubert, 489 F.2d 543 (10th Cir. Okla. 1973), the court, holding that a sale of oil and gas leases is not a sale of "goods," states:

"[S]ince the buyer-lessee has the right to sever, the seller's remedies of the [Uniform] Commercial Code are denied to vendors of oil and gas leases and the Code points to real property law for such protection."

4. Using the code terminology, the gas contract is a "contract for the sale of future goods." The goods (gas) become identified to the contract when they are produced and metered in accordance with the contract.

   a. Note that a processing agreement, to the extent there is no sale of the gas or liquids, is a <u>service</u> agreement governed by general contract law instead of the UCC.

   b. A sale of oil and gas leases, or similar rights to the oil and gas while in the ground, is not governed by the UCC.

   c. A transportation agreement is a service agreement and not governed by the UCC.

   d. How will a processing agreement be treated which provides for the processing of gas in return for a share of the liquids? Is it a sale of goods - the liquids? Or is it merely a service agreement where a share of the liquids are being used to pay for the service? Or, is the processor merely using the service as the consideration to purchase liquids?

      This type of issue is usually resolved by determining whether the contract is primarily for services or for the sale of goods. See E. Farnsworth, Contracts § 1.10, 33, n.15 (1981).

5. A sale of crude oil, to be severed by the seller, is also governed by Article 2 of the Uniform Commercial Code. <u>Amoco Pipeline Co.</u> <u>v.</u> <u>Admiral Crude Oil Corp.</u>, 490 F.2d 114, 116 (10th Cir. N.M. 1974).

F. Classification Of The Transaction

1. Must determine whether the transaction is covered by the UCC to ascertain what law applies to the transaction. If the transaction is a sale of goods, the UCC Article 2 provisions will govern to the extent the issue is addressed by the Code.

2. If the contract concerns a sale of goods, and a provision of Article 2 addresses the issue, you cannot rely upon the statutory or common law applied to non-goods contracts.

   For Example: In Bradford v. Plains Cotton Cooperative Ass'n, 539 F.2d 1249, 1253 (10th Cir. Okla. 1976), the court finds the trial judge erroneously relied upon Oklahoma statutes regulating non-sales transactions to resolve a dispute concerning a contract for the sale of cotton.

3. However, § 1-103 of the UCC provides:

   "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law of merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions."

   a. In Bradford v. Plains Cotton Cooperative Ass'n the court notes that for a sale of goods the general statutory provisions concerning mutual assent have been replaced by the UCC provisions.

   b. However, many basic contract doctrines are not addressed by the UCC. For Example: The law of third party beneficiary, detrimental reliance, and determining who has the authority to enter into a contract.

II. REQUIREMENTS FOR AN ENFORCEABLE AGREEMENT

A. Mutual Assent - The Parties Must "Agree"

1. Have the parties expressed an intent to be presently bound to an agreement?

2. To have an enforceable agreement the parties must <u>agree</u> on something. This agreement is referred to as "mutual assent."

   a. The presence of mutual assent is typically determined by examining the objective (outward) manifestations of each party.

   b. To evaluate whether mutual assent is present, the analytical process of offer and acceptance is employed. If there has been an "offer," followed by an "acceptance," there is mutual assent.

3. The Offer - Would a reasonable person conclude, from your actions, that you presently desire to enter into an agreement? If so, an "offer" has been made that creates a "power of acceptance" in the person to whom the offer is directed.

4. The Acceptance - Would a reasonable person, in the position of the party who made the offer, conclude, from your actions, that you have accepted the offer? If so, an enforceable agreement is formed - assuming the other requirements for a contract are satisfied.

5. Since the outward (objective) actions of each party govern whether an offer has been made, or accepted, an enforceable agreement may be created even though a party may not actually intend to make an offer, or exercise a power of acceptance. Their subjective intention is generally irrelevant.

B. The Basic Goal

1. During the pre-contract phase, the major goal is to control all outward manifestations so that a clear signal is sent to the other party regarding your intentions.

2. Ideally, you should be able to examine a transaction at any stage and clearly identify if you have made or accepted any offers or are merely engaged in preliminary negotiations.

3. The major obstacle to obtaining our goal is the informal process by which a contract can be created.

   a. Usually these "informal communications" are made by the non-laywers of an organization.

b. The UCC has made the process even more informal - increasing the instances in which a contract can be formed. See, e.g., Apex Oil Co. v. Vanguard Oil & Service Co. Inc., 760 F.2d 417 (2d Cir. N.Y. 1985) (million dollar fuel oil sale created by telephone call and subsequent confirmation by telex).

c. In Bradford v. Plains Cotton Cooperative Ass'n, 539 F.2d 1249, 1253 (10th Cir. Okla. 1976) the court notes: "The Code [Article 2 of the UCC] rejects the subjective test of intent to contract and replaces it with mutuality of assent as manifested by the conduct of the parties."

C. Analysis of the Offer

1. Restatement (Second) of Contracts, § 24 (1981) provides:

"An offer is the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it."

The Restatement defines the term "bargain" to mean "an agreement to exchange promises or to exchange a promise for a performance or to exchange performances." Restatement (Second) of Contracts § 3.

2. If you don't intend to make an offer, but rather are merely probing the contours of a possible deal with the other person, you are involved in "preliminary negotiations." The Restatement (Second) of Contracts § 26 provides:

"A manifestation of willingness to enter into a bargain is not an offer if the person to whom it is addressed knows or has reason to know that the person making it does not intend to conclude a bargain until he has made a further manifestation of assent."

a. If you do not intend to make at offer, you should ensure that all correspondence and contact with the other party is such that they "know" or have "reason to know" that you do not intend to currently create a contract.

b. Language and labels are not necessarily determinative.

c. If you don't intend to presently make an offer, in your correspondence consider using language similar to the following:

"These are only my preliminary thoughts on the matter; this letter is not intended to create any sort of present offer to contract."

3. A common technique to try and control the contract formation process is to solicit an offer from the other party and then control the process by which you accept the offer. One way to do this is with a "management approval" or "home office approval" clause.

a. For Example: In <u>Truscon Steel Co.</u> <u>v.</u> <u>Cooke</u>, 98 F.2d 905 (10th Cir. Okla. 1938), Truscon had submitted a bid to Cooke in which Truscon proposed to provide steel to Cooke. The bid contained the following statement:

"Prompt acceptance of this quotation by you and the written approval of our Home Office shall constitute a binding contract."

Cooke promptly "accepted" the quotation - however, a contract was not formed. Instead, Cooke had made an offer to Truscon.

b. Note that there is a danger for Truscon as well as Cooke in this situation - Cooke can change his mind anytime prior to Truscon's acceptance by the written approval of its' home office.

4. In some situations, you may need to engage in formal written <u>negotiations</u> prior to making an offer. Usually a document titled "Letter of Intent" is used for this purpose.

a. The letter of intent is typically used to work out the details of a proposal before either party agrees to be bound.

b. The letter may also be necessary to get third parties to take preliminary action necessary to the consumation of a contract. For example, a letter of intent may be used to prompt a bank to consider whether it will finance a particular transaction being negotiated.

c. The letter of intent should clearly indicate that the parties are not bound by the terms of the letter. Typically this is expressed by requiring some subsequent act to indicate assent - such as a "formal written agreement" signed by all parties.

5. It is common to encounter language which says that the agreement of the parties is "subject to a formal written agreement" or "our attorney preparing the necessary papers." The problem is determining whether the parties:

   a. Intend to be <u>presently</u> bound, but with the obligation to state their agreement in some formal manner; or

   b. Intend that no binding agreement will arise <u>unless and until</u> the required agreement is prepared and signed by the parties.

6. The Restatement (Second) of Contracts § 27 provides:

   "Manifestations of assent that are in themselves sufficient to conclude a contract will not be prevented from so operating by the fact that the parties also manifest an intention to prepare and adopt a written memorial thereof; but the circumstances may show that the agreements are preliminary negotiations."

   a. The parties may have come to agreement on many facets of a deal - either by oral agreement or an exchange of correspondence or letters of intent. Often the deal breaks down before the final documents are signed. The party feeling they had negotated a good deal may assert one or more contracts arose through such oral and written communications - and that a final written agreement was merely one of the covenants of the deal as opposed to a condition to the formation of a contract.

   b. To avoid this situation, the negotiating parties should expressly agree that they intend to be bound only upon the execution of a formal written agreement by the parties.

D. Analysis Of The Acceptance

1. Restatement (Second) of Contracts § 50 provides:

   "(1) Acceptance of an offer is a manifestation of assent to the terms thereof made by the offeree in a manner invited or required by the offer.

   (2) Acceptance by performance requires that at least part of what the offer requests be performed or tendered and includes acceptance by a performance which operates as a return promise.

   (3) Acceptance by a promise requires that the offeree complete every act essential to the making of the promise."

2. The requirement that the acceptance conform exactly to the terms of the offer is known as the "mirror image rule."

3. If the object of the transaction is a sale of goods, UCC § 2-207, alters the mirror image rule by providing:

   "(1) A definite and seasonable expression of acceptance . . . operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.

   (2) The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:

   (a) the offer expressly limits acceptance to the terms of the offer;

   (b) they materially alter it; or

   (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

   (3) Conduct of both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on

which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this act.

a. § 2-207 was designed to combat the "battle of the forms" where buyers and sellers send their form documents back and forth without ever reading them until a dispute arises.

b. The goal of § 2-207 is to provide fair contract terms when the parties act as though they have a contract but their writings do not agree.

E. Formalities

1. Although a contract can be created through the very informal process of offer and acceptance, the law may impose certain formalities in order to successfully enforce your contract.

2. The most common formality is that certain contracts, falling within the "statute of frauds," be in writing.

3. If the transaction is a sale of goods, the UCC statute of frauds applies. UCC § 2-201 provides, in part:

"(1) Except as otherwise provided in this section a contract for the sale of goods for the price of Five Hundred Dollars ($500.00) or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought or by his authorized agent or broker. A writing is not insufficient because it omits or incorrectly states a term agreed upon but the contract is not enforceable under this paragraph beyond the quantity of goods shown in such writing.

(2) Between merchants if within a reasonable time a writing in confirmation of the contract and sufficient against the sender is received and the party receiving it has reason to know its contents, it satisfies the requirements of subsection (1) against such party unless written notice of objection to its contents is given within ten (10) days after it is received."

F. Detrimental Reliance

1. In certain situations, although you do not have all the formal requisites for an enforceable agreement, equitable considerations will protect you from loss.

2. The Restatement (Second) of Contracts § 90 provides, in part:

   "(1) A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires."

III. CONTRACT FORMATION EXERCISE

<u>Assume The Following Facts:</u>

Acme Oil Company discovered and developed the Manchester Field in Grant County, Oklahoma. In 1983, Acme had completed four wells in the field and began contacting natural gas purchasers to discuss a possible sale.

In November 1983 Acme began negotiations with Oklahoma Pipeline Company ("OPC") concerning a gas purchase agreement. Acme and OPC representatives met on numerous occasions. OPC provided Acme with sample gas purchase contracts for Acme's review.

In April 1984, Acme's gas sales representative [Mary] met with OPC's gas purchase representative [Tom]. Sometimes Tom would tell prospective gas sellers that any offer he made was subject to OPC management approval. Tom's superiors knew about Tom's negotiations with Mary. Tom's superiors will testify that Tom had no actual authority to execute documents on behalf of OPC. Mary will testify that Tom told her he had authority to negotiate contracts - but he didn't imply that he had authority to sign contracts.

On May 14, 1984 Tom sent Mary a letter "offering" to purchase natural gas from the Manchester Field at $2.65 per MMBtu for 20 years.

The parties continued to negotiate during the following months. On three occasions, Tom sent Mary a single copy of a sample gas purchase contract. Each of these were stamped "DRAFT" in red ink.

On September 12, 1984 Tom sent Mary three copies of a document titled "Gas Purchase Contract" covering Acme's wells in the Manchester Field. This was not marked as a draft. The documents provided for a 10 year term and contained detailed price and take-or-pay provisions. These copies were forwarded with a letter from Tom stating:

> Enclosed for your review and approval, please find three copies of our Gas Purchase Contract covering acreage referenced above.
>
> If you find this Contract acceptable, please fully execute all three copies, (including notary pages) and return to this office. Following OPC's execution, one completed Contract will be forwarded to you.

The presidnet of OPC will testify that it would not be normal OPC procedure to send out a contract for a gas producer to sign unless OPC management found the terms of the contract acceptable.

On September 18, 1984 the vice president of Acme executed the contracts and returned them to Tom.

OPC never executed the contracts and denies that they have any sort of agreement with Acme. OPC's president will testify that it decided not to enter into the contract because it had lost one of its largest industrial customers and the gas market was becoming soft.

Acme sues OPC seeking $1,450,000 in damages arising from OPC's refusal to honor the gas purchase agreement.

IS THERE A CONTRACT?

IF YOU FIND THAT A CONTRACT WAS NEVER CREATED, WILL ACME STILL BE ENTITLED TO SOME SORT OF RELIEF?

HOW COULD OPC HAVE AVOIDED THIS DISPUTE?

See <u>Manchester Pipeline Corp.</u> <u>v.</u> <u>Peoples Natural Gas</u>, 862 F.2d 1439 (10th Cir. Okla. 1988) (court holds Acme and OPC had a contract; Acme recovered $1,450,000 in damages for OPC's breach).

IV. 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.

COMMON OIL AND GAS DEVELOPMENT SEQUENCE
(Figure 17-1)

Parties	Contract	Parties
1. Mineral Owner (Lessor)	**Oil & Gas Lease**	Developer (Lessee)
2. Lessee	**Investment Agreement**	Investors
3. Lessee	**Lease Purchase and Sale Agreements**	Other Developers
4. Lessee	**Assignments**	Investors & Developers
5. Lessee	**Exploration Agreements**	Other Developers
6. Lessee	**Farmout Agreements**	Other Lessees
7. Lessee	**Operating Agreement**	All Working Interest Owners
8. Mineral Owner Working Interest Owners Non-Working Interest Owners	**Pooling Agreement**	All Interest Owners
9. Operator	**Drilling Contract**	Drilling Company
10. Operator	**Well Service Contracts**	Service Companies
11. Mineral Owner Working Interest Owners Non-Working Interest Owners	**Oil Division Order**	Oil Purchaser
12. Mineral Owner Non-Working Interest Owners	**Gas Division Order**	Working Interest Owner
13. Working Interest Owner	**Gas Division Order**	Gas Purchaser
14. Working Interest Owner	**Gas Processing Agreement**	Gas Processor
15. Working Interest Owner	**Gas Sales Agreement (End User)**	End User
16. Working Interest Owner	**Transportation Agreements**	Pipelines
17. Working Interest Owner	**Marketing Agreements**	Gas Marketer/Broker
18. Working Interest Owner	**Gas Sales Agreement (Pipeline)**	Pipeline

c. New transportation role emerging for natural gas. See FERC Orders 436, 500, 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.

   An Operating Agreement is 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.

V. DIVISION AND TRANSFER ORDERS

A. The Division Order

1. Defined: A contract between the owner of production (or their agent) and a purchaser of production.

Terms authorize the purchaser to take custody of production and pay the parties in the proportions indicated in the division order.

2. Function: To protect the purchaser from adverse claims in the event of an improper distribution of production proceeds.

a. Relieves the purchaser from trying to interpret documents which may have varying meanings.

b. Purchaser's attorney will examine title to the production and identify all potential interest owners. If there are any defects in title, the attorney will identify these in the division order title opinion and state the requirements that must be satisfied before production proceeds can be distributed.

c. Once title requirements are satisfied, division order section will prepare the division orders and send them to each interest owner.

d. When the division orders are signed, production proceeds are disbursed in accordance with the division order.

Even though the division of interest may be inaccurate, the purchaser will be protected in relying on the division order until purchaser receives notice of the problem.

e. Division orders have obtained a "bad name" among royalty owners because lessees have often used them to, in effect, amend the oil and gas lease on significant payment issues such as: calculation of how production will be valued for royalty purposes, costs deductible from royalty, warranty of title, indemnity provisions, interest on suspended accounts. Often they purport to ratify the lease.

See the 1988 NARO Special Report: "Division Orders: Sign, Sue or Stall?" Also see the "Uniform Division of Interest Form" prepared for NARO members.

3. Common Provisions

a. Warranty - Provide purchaser with a remedy against the signing party (royalty owner, working interest owner, non-working interest owner) in the event purchaser pays the signing party and they do not own the represented interest.

b. Description of the Lease and Land - Establishes the premises from which production can be taken. Serves as the basis for other provisions in the division order; e.g. warranty, indemnity, etc.

c. Effective Date and Time - Must know, at all times, how payment is to be made.

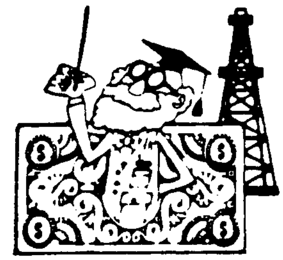
d. Term - Often revocable at will. Many gas division orders are tied to the term of a particular gas sales contract.

e. Direct How Payments Should be Made - Specify the fraction or decimal share of production purchaser has allocated to the interest.

f. Change of Ownership - Purchaser will follow payment directions in the division order

A 1988 NARO Special Report

DIVISION ORDERS: SIGN, SUE OR STALL?



The division order has evolved into one of the most important documents received by a royalty owner. But dealing with division orders has become one of the most confusing and frustrating issues in the entire royalty equation.

NARO has dedicated much of the past two years to helping its members through this maze. Following are some points to consider when faced with a new division order.

I. VERIFY YOUR INTEREST:

Verify that the decimal interest set out on the division order correctly states your interest. Following is a formula which should help.

Example: You own one half (50%) of an undivided interest in 160 mineral acres. Your tract is under a 640-acre spacing unit with a producing well. You retained a 3/16th royalty interest in your oil and gas lease. To calculate your decimal interest, divide your mineral acres (160) by the number of acres in the unit (640), then multiply that by your undivided interest (1/2) and your royalty interest (3/16th.)

> Your undivided fractional interest
> x
> Your gross acres under unit
> Total gross acres in unit*
> x
> Royalty rate retained in lease
> =
> Your decimal interest in the spaced unit
>
> Sample Calculation:
> 160/640 (.25) x 1/2 (.50) x 3/16 (.1875) = .0234375

*Note: Many sections do not contain exactly 640 acres, but have "fractional acreage set out as "lots" (especially Sections 1-7, 18-19, 30-31, and sections with rivers through them). This variance can affect your calculation.

If the tract is included in a waterflood or other secondary or tertiary recovery operation, several spaced units are often combined into one large unit. Each tract has a "tract participation factor" set out as decimal or percentage in the unitization agreement. To compute your interest in the entire unit:

> Your decimal interest (from above)
> x
> Tract participation factor
> =
> Your decimal interest in unit
>
> Sample Calculation:
> .0234375 x .0117825 = .000276152

Resolve any differences in your computation and the interest on the division order. You can request that the purchaser (or operator) send you their computation of your interest if you cannot figure out the interest set out in the division order.

II. READING THE FINE PRINT:

Be sure that you read all the fine print on the division order carefully! Don't just sign it and send it off -- it's as important as your lease.

Some D.O. Clauses to Watch Out For:

"The undersigned, and each of us, certify and guarantee that we are the legal owners of and hereby warrant the title to our respective interests...."

"Each of the undersigned...agrees to indemnify and save you or any carrier or purchaser...harmless against any and all liability for loss, cost, damage and expense including attorneys' fees, which you or said carrier... may suffer or incur on account of receiving, transporting or paying the undersigned for said oil and for gas proceeds."

"No waiver, change or modification of any of the provisions of this Division Order shall be binding on..(purchaser)..except when made expressly in writing and signed by an authorized representative of...(purchaser)..."

"Oil purchased hereunder shall be paid for...less any transporting, trucking, barging and/or pipeline gathering charges deemed necessary by you.. (purchaser).."

"If the provisions of this Division Order are in conflict with the provisions of any oil and gas lease covering the above-described land, the provisions of this Division Order shall prevail."

"This document is a binding contract between each undersigned and (purchaser) and is not intended to expand, modify or diminish any other agreement to which (purchaser) is not a party."

"...less applicable deductions including marketing and inactive account adjustments."

"...less administrative fees and....."

"It is provided that you are expressly authorized to deduct from the proceeds otherwise payable to such heirs, assigns, designees and successors in interest, dollar amounts equal to the actual time expended by you in reviewing documents supporting the transfer, preparing transfer orders and otherwise effecting such changes in your records at an overhead rate of $20 per hour, with a minimum charge of $10 per interest transferred or changed."

Note: The language may vary from company to company, but any such clauses that contain the above types of stipulation should be marked out and initialed by you.

Some Clauses to Consider Adding to the Purchaser's Division Order:

A. Lease terms prevail clause: "The execution of this Division Order shall not modify, change or vary the terms of the Oil and Gas Lease covering this tract."

B. Termination clause: "This Division Order may be terminated at any time by either party on 30 days written notice."

C. Accumulated amounts clause: "Notwithstanding anything to the contrary within this Division Order, payment for all accumulated amounts will be made at least once annually."

D. Interest on Suspensed Royalties: Many d.o.'s have a "no interest" clause. Add to that..."unless otherwise required by applicable statute."

III. EXECUTING THE DIVISION ORDER OR DIVISION OF INTEREST FORM

Once you have verified your interest, read the division order carefully and made any changes you feel necessary, the executed (signed) document or documents must be returned to the purchaser. If you prefer to bypass the purchaser's division order entirely, you may choose to send, instead, an executed Division of Interest Form, such as the one prepared by NARO (attached). Following are some of the options available to you, and possible responses from the purchasers:

A. Substitute a completed and signed "Division of Interest Form."

Results: 1. The purchaser will pay: or
2. The purchaser will object to or reject the D.O.I. form.

B. Submit the purchaser's d.o. marked up with deletions and additions, as necessary.

Results: 1. The purchaser will pay; or
2. The purchaser will object to or reject the alterations.

C. Negotiate the items that are objectionable to the purchaser and come up with a compromise version.

Result: The purchaser will pay royalty due, but on their terms.

D. Submit the purchaser's division order without alterations along with an "Economic Duress" letter. (see sample)

Result: The purchaser will pay royalty due, but on their terms. You have reserved the right to question the terms of payment but without further action on your part, these rights are not well protected.

Note: In items A and B above, if the Purchaser refuses to accept the Division of Interest Form or an altered Division Order, a letter to the Purchaser demanding payment under the terms of the rejected form or your oil and gas lease will many times result in payment. If applicable, you can also point out that under state laws they will owe interest on all unpaid royalties.

Some will pay, but will tell you that they do so "without the benefit of a division order." Since the division order primarily "benefits" the purchaser, and not the royalty owner, this is not a severe penalty. Just be sure that the decimal interest shown is correct, and that they have your correct tax identification number and mailing address.

IV. ROYALTY PAYMENTS:

Go ahead and deposit the check (in these perilous times, it might not clear if you wait too long), but...be sure to immediately take the time to run a quick re-calculation of the run check stub to be sure that all the figures jibe with the decimal interest as shown on the division order. Sometimes a simple error in calculation can cost you money. It's easier to get corrections made early on, than to try to recover underpayments a year or two later.

Some folks use a rubber stamp, or write on the back of the check..."payment on royalty account without prejudice to further claims."

Shut-in and delay rental checks are different, however. They must be paid timely in order to hold the lease, so you may want to check the anniversary date of your lease before cashing the check. If you deposit the check, you are "accepting" the rental check. In Texas, a lease can be canceled if the shut-in payment isn't made on time.

V. AN OUNCE OF PREVENTION:

Many of the above problems could be avoided by using language in your oil and gas lease to ensure that no costs will be deducted from your royalty interest for producing, transporting, marketing, etc. Also stipulate that an executed division order is not required for payment. Here are examples.

A. NO DEDUCTION CLAUSE:
"It is also agreed between the lessor and the lessee that all royalties accruing to the lessor under this lease shall be without deduction for the cost of producing, gathering, storing, separating, treating, dehydrating, compressing, processing, transporting and otherwise making the oil, gas and other products produced hereunder ready for sale or use."

B. NO DIVISION ORDER CLAUSE:
"Lessee agrees that all royalties accruing to lessor under this lease shall not be conditioned upon execution by lessor of a Division Order or any other document. Failure on the part of the lessee or its purchaser or assigns to pay royalties according to the terms of this lease is a material breach of the lease agreement and shall result in automatic forfeiture thirty (30) days after written notice of such a breach is received by lessee."

C. PAYMENTS CLAUSE:
(For possible split-stream connection wells in Oklahoma) "If any operator, purchaser or working interest owner in any unit well drilled on the land covered by this lease or any land unitized therewith refuses or neglects to pay any excess royalty (over 1/8th) to lessor as required by Oklahoma Statute, lessee covenants to pay all such excess royalty payments due lessor."

SAMPLE ECONOMIC DURESS LETTER

January 28, 1987

Mary O. Smith
Contract Analyst
Division Order Administration
Anoil Company
Houston, Texas 77252

Re: Wright No. 1
Property No. 36-20-6395
Section 1-22N-9W
Major County, OK

Dear Ms. Smith:

Your letter of January 20, 1987, states that the Uniform Royalty Division of Interest Form prepared by me covering the above-referenced property is not acceptable to Anoil Company. The Division of Interest form I submitted to you verified my ownership interest, provided my taxpayer identification number, was properly executed and witnessed. There is no legal requirement that I sign your form of Division Order as long as I provide you with the information outlined above. You have already purchased my oil and, although there is no title problem, you have refused to release to me royalties due and payable.

Therefore, I have executed your Division Order which is attached hereto. This Division Order has been executed under economic duress and by so executing, I have not agreed to any terms other than those contained in my lease agreement. Nor have I waived any of my rights to proper payment or to litigate under the lease and the laws of the State of Oklahoma.

Respectfully,

xc: (name of your attorney)

Attachment:
Anoil Company
Oil Division Order dated December 5, 1986

UNIFORM ROYALTY DIVISION OF INTEREST FORM

TO: Division Order Department

____

____

____

Date: ______________________

Effective: ______________________

____

REFERENCE: Lease/Division Order or Property # ______________________

The undersigned certify ________is/are the owner(s) of royalties payable on oil, gas and/or distillate, condensate and other gaseous or vaporous substances and liquid hydrocarbons in the proportions set out below which are produced from the ______________________ lease, insofar as said lease covers the following described property(ies) situated in the County of ______________________, State of ______________________, to wit, the:

____

____

The undersigned further certify such royalties are owned and payable according to the terms of the lease agreement or pooling order in force and are to be paid monthly in cash according to all applicable Federal and State Laws to the named royalty owners(s) for the interest(s) shown to the address(es) indicated until you are notified of any change by the undersigned or legal successors in interest. (Royalties less than $25.00 per month may be accrued, before payment, to $25.00 or December of each year whichever is first.)

This Royalty Division of Interest supercedes, cancels and revokes any previous Division Order or similar agreement which provided for payment of royalties on the property(ies) described that was issued to you or any of your affiliate companies or assignor(s) of either by the undersigned or any of their predecessors in interest in the property(ies).

______________________ Tax I. D. # ______________________

______________________ Your Owner # ______________________

______________________ Royalty Interest: ______________________

WITNESSES

By: ______________________ ______________________

By: ______________________ ______________________

By: ______________________ ______________________

If more than one interest is using this form for one property, the required interest owner information will be found on the reverse side. Check here if applicable: ________

DIVISION ORDER

TO:

______________________________ 19 ________

The undersigned, and each of us, certify and guarantee that we are the legal owners of and hereby warrant the title to our respective interests as set out below in all oil produced from all wells on the ____ **farm or lease**, located in ______________________________ **County, State of** ____________________ **more particularly described as follows:**

Effective 7 a.m., 1st day of ________________________ **19**________, **and until further written notice, you are hereby authorized to receive, purchase and give credit for all oil received from said property subject to the conditions, covenants and directions following:**

CREDIT TO	DIVISION OF INTEREST	ADDRESS

FIRST: The oil purchased in pursuance of this Division Order shall be merchantable and become your property upon delivery thereof to you or to any pipe line designated by you. Quantities of oil run and purchased hereunder shall be computed in terms of 42 U.S. gallons per barrel from regularly compiled tank tables showing the full capacity of the tanks. Corrections for temperature and deductions for dirt, sediment and other impurities are to be made in accordance with your rules, regulations and customs in effect at the time and place of delivery. The oil shall be steamed or treated when necessary to render it merchantable.

SECOND: The oil received in pursuance of the Division Order shall be paid for to the party or parties entitled thereto according to division of interests shown above at the price for each day's receipts posted and upon the basis therein indicated on that day by you for the same kind and quality of oil in the field in which it is received. If it is necessary to transport crude oil hereunder by truck, then, in that event, you are authorized to deduct from such price the trucking charges, together with Federal Transportation Tax thereon. Should the oil be sold by you to another purchaser accepting delivery thereof at the lease tanks, settlement thereof shall be based upon the price received by you for such oil and upon the volume computation made by such purchaser. Payments shall be made monthly for oil received and purchased during the preceding month by your checks delivered or mailed to the respective parties at the addresses stated. However, it is agreed, if the amount payable to any of the undersigned is less than Ten Dollars during any month, you may withhold payment thereof, without interest, and in lieu of monthly settlement, make payment at such time as a minimum sum of Ten Dollars has accumulated to the credit of the undersigned; provided, however, that settlement shall be made at least once during each calendar year, regardless of the amount which has accumulated to the credit of the undersigned. Pipe line grades and measurements are to govern and control in all settlements, subject to the provisions of price postings above referred to concerning computation of quantities. The undersigned authorize you to withhold from the proceeds of any and all runs made hereunder the amount of any tax placed thereon, or on the production thereof, by any governmental authority, and to pay the same in our behalf.

THIRD: In case of any question, controversy or adverse claim of title which in your opinion adversely affects title to any interest credited hereunder, or in case title shall not be satisfactory to you at any time during the term of this division order, each of the undersigned agrees to furnish complete abstract of title and other evidence of title satisfactory to you and authorizes you to retain the purchase price of the oil without obligation to pay interest on the amount so withheld, until satisfactory indemnity shall be furnished you against such question, controversy, adverse claim or any such defects in title, or until any question, controversy, adverse claim or defect to owners' title is settled to your satisfaction. In the event suit is filed in any court affecting title to oil purchased hereunder, either before or after severance, the undersigned agree to indemnify and save you harmless from any and all costs in connection with such action, including attorneys' fees, and further the undersigned agree to indemnify and save you harmless and any carrier transporting said oil for your account against any and all liability for loss, cost, damage and expense, including attorneys' fees, which you or the carrier may suffer or incur on account of receiving, transporting and paying us for said oil.

FOURTH: The undersigned severally agree to notify you of any change of ownership and no transfer of interest shall be binding upon you until transfer order and the recorded instrument evidencing such transfer, or a certified copy thereof, shall be furnished you. Transfers of interest shall be made effective on the first day of the calendar month in which notice is received by you. You are hereby relieved of any responsibility for determining if and when any of the interests hereinabove set forth shall or should revert to or be owned by other parties either as a result of the completion or discharge of money or other payments from said interests, or otherwise; and the signers hereof whose interests are affected by such money or other payments, if any, or by the reversion or change of an interest for any other reason, agree to give you notice in writing by registered letter addressed to you at Oklahoma City, Oklahoma, when any such money or other payments have been completed or discharged or when any other division of interest than that set forth above shall, for any reason, become effective and to furnish transfer orders accordingly, and that in the event such notice shall not be received, you shall be held harmless in the event of, and are hereby released from any and all damage or loss which might arise out of any overpayment. The undersigned hereby further agrees to reimburse you for all amounts incorrectly paid to the undersigned for the above-described property.

FIFTH: Working Interest owners and/or Operators who sign this Division Order, and each of them, guarantee and warrant for your benefit and that of any pipeline or other carrier designated by you to run or transport said oil, that all oil tendered hereunder has been and/or will be produced in accordance with applicable laws and/or official rules and regulations.

SIXTH: This Division Order shall become valid and binding on each and every owner above named as soon as signed by such owner, regardless of whether or not all of the above named owners have so signed and shall likewise be binding upon the heirs, personal representatives, successors and assigns of the parties hereto, and the undersigned hereby agree to all the terms and conditions of the Division Order now in effect and force.

SIGNATURE OF WITNESS	SIGNATURE OF OWNERS	SOCIAL SECURITY OR TAXPAYER NUMBER
________________	________________	__________
________________	________________	__________
________________	________________	__________
________________	________________	__________
________________	________________	__________
________________	________________	__________

IMPORTANT: To avoid delay in payment, please show your correct address and your social security number or tax identification number. Individual signatures must be witnessed by a disinterested person.

340-013 R11 84 OPCo.

Document # 2

DIVISION ORDER

Day 1-30 Well

TO: OIL INC. Date: May 15, 1970

The undersigned, and each of us, certify and guarantee that we are the legal owners of, and hereby warrant title to our respective interest as set out below in all gas or casinghead gas produced from the DAY 1-30 located within Section 30, T-21-N, R-32-W N.M.P.M., Tyler County, New Mexico, containing 640 acres, more of less, as to the Devonian formation.

Effective as of April 20, 1970, OIL INC. is hereby directed until further written notice, to disburse payment for gas proceeds to the payees shown below in accord with the designated division of interest of each payee. Said interests are subject to terms and provisions of New Mexico Gas Contract dated May 15, 1970 between Interstate Pipeline Company, as Buyer, and Oil Inc., as Seller, and as amended.

OWNER NO.	PAYEE	% OF GROSS	ADDRESS
001	Jan Day	6.25 RI	P. O. Box 102 Tulsa, Oklahoma 74102

The following are covenants and agreements and are part of the division order and shall be binding upon the undersigned and their respective heirs, devisees, administrators, executors, successors and assigns:

1. The undersigned severally agree that Oil Inc. is only required to disburse in the above set out proportions the amounts as reflected on the monthly gas settlement statements rendered by the purchaser. Oil Inc. is indemnified and held harmless for any inaccuracies that may be shown by purchaser's gas

settlements. Further, Oil Inc. is not required to disburse more funds than are received from purchaser, and if at any settlement date the amount payable to any party hereunder shall be less than $5.00, Oil Inc. may withhold payment without interest and in lieu of monthly settlement, make payment annually.

2. The undersigned shall be given credit for their respective interests as to gas as set forth above at the price paid under and pursuant to the terms and provisions of the above described contract, and in the event of cancellation or termination of the above Gas Contract, then at the price paid by any purchaser or purchasers for said gas so sold, less compression, treating, dehydration and transportation expenses, if any, necessary to render said gas marketable at the place being sold and for the price being paid by purchaser or purchasers. It is understood that all laws or conditions imposed by the State or Federal regulatory agencies or commissions concerning taxation, impounding of funds, refunds or such other matters that have to do with the sale or conditions of sale or payment for sale of gas under existing contracts shall have precedence.

3. The undersigned severally agree to notify Oil Inc. in writing of any change in their ownership; and, no transfer of interest shall be binding on Oil Inc. until Oil Inc. is furnished a recorded instrument evidencing such Transfer or certified copy thereof, and Oil Inc.'s regular form of Transfer Order is executed and returned to Oil Inc. Regardless of the effective date of the instrument of conveyance, all transfers of interest shall be made effective as of 7:00 A.M. on the first day of a calendar month; and transfers shall not be made effective earlier than the first day of the calendar month in which said written notice is received.

4. If a refund of a portion of the proceeds derived from the sale of gas may be required under any order, rule or regulation of the FPC, the provisions of the Natural Gas Act or any successor regulatory or governmental body or action, Oil Inc. may hold without interest the portion of the proceeds subject to refund

until indemnity satisfactory to Oil Inc. has been furnished, or until such refund obligation has been finally determined. If at any time a refund of a portion of the proceeds derived from the sale of gas which has been paid the undersigned is required under any order, rule or regulation of the FPC, the provisions of the Natural Gas Act or any successor regulatory or governmental body or action, Oil Inc. may recover said refund by deduction from future payments or, at Oil Inc.'s discretion, may invoice the undersigned for that portion applicable to the undersigned's interest, plus the legal rate of interest Oil Inc. is required to pay applicable to the undersigned's portion of the refund.

5. When this division order as submitted by Oil Inc. is signed and returned to Oil Inc. by one or more of the owners herein named, it shall be binding upon Oil Inc. and upon him or them; and shall be binding upon and inure to the benefit of the heirs, successors in interest, legal representatives and assigns of the parties hereto.

Jan Day

JAN DAY

until notified of a change.

Not required to keep track of terminable interests. Must receive notice of the changed circumstances.

g. Authority to Receive Production - Passing of title from interest owner to purchaser.

h. Price - Oil usually market or posted price. Gas, may refer to gas sales contract.

i. Payment Procedures - Time period for making settlement and sending payment.

Right to accumulate small amounts.

Authorization to pay by mail and check.

j. Measurement - Methods for determining quantity of production and deductions for quality problems.

k. Taxes - Authority of purchaser to deduct taxes. Effect on lease? May merely permit purchaser to pay; may not be a reallocation of the tax burden.

l. Evidence of Title - Obligation to provide purchaser with proof of title. Effect of a title dispute - power to suspend payment.

See, Maddox v. Gulf Oil Corporation, 222 Kan. 733, 567 P.2d 1326 (1977) cert. denied, 434 U.S. 1065 (1978) (court refuses to honor division order to relieve lessee from payment of interest on royalties held in suspense).

Kansas takes a dim view of lessees using division orders to try and adjust their obligations under the oil and gas lease. See Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983) (division order requiring payment of royalty based on proceeds ineffective when oil and gas lease required payment of the market value).

m. Miscellaneous Provisions - Compliance with applicable law.

B. Transfer Orders

1. Defined: An authorization to the purchaser to pay

another person for all or part of a share of production covered by purchaser's division order.

Often contains terms similar to those contained in a division order; or incorporates terms of the division order it amends.

2. Function: Usually the evidence required by the purchaser to effect a change of distribution under a division order.

   a. Unless the underlying division order is revocable, will need to effect a change of ownership through a transfer order - unless the parties agree to revoke the divsion order and execute a new division order with the transferee of the interest.

   b. A new division order may be used when the entire interest is being transferred.

C. "Letters In Lieu Of" Transfer Orders

1. Defined: A letter executed by the owner of the interest (shown in the division order) and their transferee, directing the purchaser to pay production proceeds to the transferee as of a specified date and time.

2. Function: When an owner sells all or a large part of their interest in a field, a letter may be used to authorize the purchaser to make payment to the new owner in lieu of executing individual transfer orders.

   a. Parties to the sale can use one letter, listing all the interests being sold, and then state terms similar to those contained in the production purchaser's standard division order.

   b. Designed to speed up the change of ownership process so the new owner gets paid as soon as possible.

   c. In many cases, if there has been a sale of all the owner's interests, the production purchaser will want the new owner to execute new division orders anyway.

D. Indemnity

1. Division orders, transfer orders, letters in lieu

of transfer orders, and just about every sort of contract you find in the oil and gas business, will contain some form of "indemnity" clause.

2. Defined: A contract provision which shifts the burden (risk) of liability for an event from one party to another.

   Does not exempt the party from potential liability. Party is still responsible to third parties for their acts. However, if they have to pay something to third parties, then the contract provides someone will reimburse the paying party.

3. Function: Participants in the oil and gas industry leverage risk in many ways. They often leverage risk by sharing it in joint operations. Also, within a joint operation, certain risks will be allocated among the parties. The indemnity clause is used to allocate such risks as: loss of title, lack of title, and accidents.

VI. . CONTRACTS TO COORDINATE LEASE DEVELOPMENT

A. Joint Operations

1. Can have a multiple working interest owner situation created in numerous ways:

   a. Various owners of undivided mineral interests lease to different developers. For Example: A owned the minerals in Section 30 at his death. Under A's will, the mineral interest passed to A's daughters, B and C, in equal shares. B leased to X; C leased to Y. X and Y each own the nonexclusive right to develop the minerals in Section 30.

   b. A leased the minerals in the North Half of Section 30; B leased the minerals in the South Half. By order, or agreement, the North and South Halves of Section 30 are combined to form a 640 acre drilling unit.

   c. A owns all the working interest in Sections 29 and 30. B proposes to drill a well on Section 29 if A will assign 100% of the working interest in Section 29, and 50% of the working interest in Section 30, conditioned upon B completing the well as a commercial producer. A retains an overriding royalty in Section 29, convertible at payout of B's well to a 50% working interest.

If B drills the required well, A and B will each have the nonexclusive right to develop Section 30. If the well on Section 29 "pays out," A and B may again each have the nonexclusive right to develop Section 29.

2. Anytime you have multiple ownership of the working interest, or the potential for multiple ownership, the parties owning the working interest will normally enter into a contract to coordinate development of the leased land.

   a. Called an "Operating Agreement" or "Joint Operating Agreement."

   b. NOTE: Sometimes the owners of the working interest will contract with a third party, who is not a working interest owner, merely to operate the well.

3. Operating Agreement designates one party as the "Operator," who will be responsible for daily lease operations.

   a. Operator is generally the person who contracts directly with the drilling contractor, other supply and service companies, gas processors, and production purchasers.

   b. Must ascertain operator's authority to dispose of production from the leased land.

B. Operator's Authority Under the Operating Agreement

1. For our purposes, primarily concerned with the operator's authority to market production attributable to the other working interest owners.

2. Typical form authorizes each working interest owner to separately market their proportionate share of gas production.

   A.A.P.L. Form 610 Model Form Operating Agreement: Each working interest owner has the right "to take in kind or separately dispose of its proportionate share" of gas produced from the contract area.

   Art. VI.C. (1982 & 1977 Model Forms); § 13 (1956 Model Form)

3. What happens if the nonoperators fail to make any arrangement to take gas in kind?

   a. OPERATOR BUYS THE GAS. Operator may purchase the nonoperators' gas after providing the nonoperators with advance notice. If they do not enter into a gas sales contract, operating agreement permits a sale for period of time not to exceed 1 year - but nonoperator can exercise right to take in kind "at any time." Price must be "at the best price obtainable in the area for such production." Art. VI.C., p. 7 ('77); Art. VI.C., p. 8 alternate ('82).

   b. OPERATOR ACTS AS AGENT. The operator can act as the nonoperator's agent in selling nonoperator's share of the gas. Must give notice of intent to sell as agent, must get best price, cannot contract to sell in excess of 1 year, and must account for all profits as a fiduciary.

   c. OPERATOR SELLS GAS FOR ITS OWN ACCOUNT. Operator might market all the gas for its own benefit with the obligation to account for the nonoperator's gas through some form of gas balancing arrangement.

      Cross-conveyance and co-tenancy problems - is each molecule of gas owned proportionately by each working interest owner?

      Operating agreement, with the right of each party to take in kind, dispells the co-tenancy argument and the express terms of the 77 and 82 forms disclaim any sort of cross-conveyance.

      Problem in absence of a Gas Balancing Agreement - what are the rights of the parties?

C. Effect Of Operating Agreement On Lessors And Non-Working Interest Owners

   1. The lessor is not a party to the operating agreement; nor are non-working interest owners.

   2. Lessee's obligations to lessor specified in the oil and gas lease and cannot be altered by other agreements to which the lessor is not a party.

3. Non-working interest owner's rights governed by the assignment between the non-working interest owner and the working interest owner. Non-working interest owner rights cannot be altered by post-assignment agreements to which they are not a party.

D. Gas Balancing Problems

1. Assume A and B each own an undivided 50% interest in an oil and gas lease covering Section 30. A has a market for his gas but B does not. Their operating agreement is silent regarding gas imbalances. Can A sell the full gas stream to its gas purchaser? Can A tender the full stream to its gas processor?

    a. What if B objects to the sale by A but makes no arrangments to take his share of the gas?

    b. Does B owe any royalty to his lessor?

2. In Oklahoma these matters have been somewhat mitigated by statute and judicial decisions interpreting certain statutes.

    a. Non-selling Working Interest Owners - See 52 Okla. Stat. §§ 541-547 (Supp. 1987): Non-selling working interest owner can elect to share in the proceeds of a gas sales contract negotiated by another working interest owner. Requires the operator to offer to market each working interest owner's share of the gas. See Seal v. Corp. Comm'n, 725 P.2d 278 (Okla. 1986) cert. denied 107 S.Ct. 1265 (1986).

    b. Royalty Owners - Whichever working interest owner sells gas must pay all royalty owners within the gas pooling unit. The "Blanchard" "weighted average" approach. See Shell Oil Co. v. Oklahoma Corp. Comm'n, 389 P.2d 951 (1964). 52 Okla. Stat. § 87.1 (Supp. 1987).

    52 Okla. Stat. § 87.1 provides, in part:

    "In the event a producing well or wells are completed upon a unit where there are, or may thereafter be, two or more separately owned tracts, the first purchaser or purchasers shall be liable to any royalty owner or group of royalty owners holding the royalty interest under a separately owned tract included in such drilling and spacing unit for the payment of proceeds from the sale of production from the drilling and spacing unit."

"Each royalty interest owner shall share in all production from the well or wells drilled within the unit . . . to the extent of such royalty interest owner's interest in the unit. Each royalty interest owner's interest in the unit shall be defined as the percentage of royalty, including the normal one-eighth (1/8) royalty, overriding royalties or other excess royalties owned in each separate tract by the royalty owner, multiplied by the porportion that the acreage in each separately owned tract or interest bears to the entire acreage of the unit."

"The first purchaser or purchasers shall also be jointly and severally liable for the payment to each royalty interest owner of any production payments or other obligations for the payment of monies contained within the leases covering any lands lying within the drilling and spacing unit."

c. Note, however, this statute does not address the situation posed above - these are not "separately owned tracts" in a unit. Instead we are dealing with co-tenants of undivided interests. Arguably each owns an undivided 1/2 interest in each molecule of gas.

d. The statute does not address non-working interest owners such as overriding royalty, production payment, and net profits owners, who are not "royalty owners."

3. Absent a statute, it would seem the rights of the producers would be determined through a co-tenancy analysis. Generally, the producer with a market could produce all the gas stream -- so long as they recognized the right of non-producing working interest owners to balance.

   a. Problems arise when one party asserts the reservoir is nearing exhaustion and the marketing producer is over-produced. Can they force the over-produced party to cease all production from the well(s)?

   b. More often the problem is whether the imbalance must be made up by cash balancing or balancing in kind. Depending upon the current value of gas, compared to the value when produced, one party will be arguing for balancing in kind while the other insists on cash balancing.

c. If cash balancing is ordered, the next dispute is the value that will be attributed to the gas and whether interest will be paid.

d. In the two cases directly addressing the in-kind/cash and value questions, the courts generally ruled in favor of the over-produced party requiring cash balancing but refusing to penalize the over-produced party in any way for the under-produced party's failure to produce. See United Petroleum Exploration v. Premier Resources, 511 F.Supp. 127 (W.D. Okla. 1980); Beren v. Harper Oil Co., 546 P.2d 1356 (Okla. App. 1975).

4. Gas Balancing Agreements -

a. May pose an even greater burden to the working interest owner.

b. Often provide for balancing in kind while producing and cash balancing upon exhaustion of the reservoir.

5. The opportunity for short-term gas imbalances will increase as producers are given more marketing options.

6. Most producers, when processing gas, will pay liquids on a current basis to all other working interest owners and royalty owners - even though they are not marketing the gas.

See 52 Okla. Stat. § 542 (Supp. 1987) A.: "This act [right to participate in working interest owner's gas sales contract proceeds] shall not apply to the natural gas liquids extracted as a result of mechanical processing of the natural gas stream for the removal of liquid components of the methane."

7. Gas balancing agreements can have a producer-take-all effect: See Chevron U.S.A., Inc. v. Belco Petroleum Corp., 755 F.2d 1151 (5th Cir. 1985)(agreement provided only for balancing in kind; Chevron never took any gas from the reservoir and Belco depleted the reservoir before

Chevron could produce any of its $600,000 imbalance).

VII. GAS SALES CONTRACTS

A. Purpose And General Format

1. Function: To pass title of gas (and other defined substances) from the producer to the gas purchaser. Specifies the terms of the sale and how the sale will be effected. E.g., construction of gathering lines, delivery point, custody transfer.

2. No standard form of gas contract. However, gas contracts do tend to uniformly address certain essential matters.

B. Basic Format

1. Identity of the Parties - Buyer and Seller.

2. Recitations - Consideration and purpose of the contract.

3. Representations - Title to the gas, authority to sell (or have it processed).

C. Basic Content

1. Commitment - What gas (leases, formations, etc.) is being committed to the contract?

2. Reservations - What rights to the gas are retained by the seller?

   a. Right to control operations, use gas for operations, prior commitments of gas (free gas clause in oil and gas lease).

   b. Ability to remove liquids prior to delivery of gas - or at some later time pursuant to a redelivery right for processing.

3. Price - How will the current and future sales prices be determined?

   a. Definite Price Escalators - precise schedule of periodic price increases.

   b. Indefinite Price Escalators - an event triggers a price increase; the price is calculated by reference to events outside the contract.

4. Indefinite Price Escalator Clauses - Traditional Forms:

   a. Area Rate Clause - price raised to the highest price permitted by applicable regulation.

   b. Favored Nations Clause - price raised to the level paid to another seller in the area.

5. Indefinite Price Escalator Clauses - Newer Forms:

   a. Index Pricing - price raised (or lowered) based upon reference to the price of a competing energy resource such as No. 2 Fuel Oil, No. 6 Fuel Oil, wholesale electric rates, coal, etc. The assumption is the indexed fuel will represent the current market value of the competing fuel (natural gas).

   b. Net-Back Pricing - price raised (or lowered) based upon reference to the price purchaser is able to resell the gas or gas and products. [This form of pricing has traditionally been used in Gas Processing Agreements and is now becoming more common in gas sales - especially where the gas is purchased by a marketer for resale.

   c. Another common form: Renegotiate (arbitrate).

6. Clauses Designed to Deescalate Prices - Market out, FERC out, Economic out provisions. Provide the purchaser with a mechanism to reduce the price paid when it is unable to resell the gas at the price being paid (market out), unable to recover the purchased cost of gas through its rates (FERC out), or it would be uneconomic for purchaser to continue purchasing under the current contract price (economic out).

7. Price-Related Matters - Tax reimbursement by purchaser to producer; Reimbursement for NGPA § 110 "production related costs" such as compression and gathering allowances.

8. Quantity - Although gas from a certain lease is "committed" to the contract, how much must the seller deliver and the buyer purchase?

9. Casinghead Gas - Purchaser's refusal to take casinghead gas may mean it will be flared in order to produce the associated oil. Many state conservation commissions prohibit or limit the quantity of gas that can be flared or vented; this means oil production will be shut in when the purchaser refuses to take casinghead gas.

   a. Take-<u>and</u>-Pay Clause - requires the purchaser to take the gas; no option to refuse to take the gas (by paying the producer money).

   b. Gas Processor has similar concerns when it sells residue gas at the tailgate of their processing plant. If the purchaser will not take the gas, processor may not be able to operate the plant.

10. Take-or-Pay Clause - requires the purchaser to take a stated percentage of the seller's gas deliverability or, instead of taking the gas, pay for it as though it was taken. Typically the purchaser has 5 years to make up the gas they paid for but did not take.

    a. A common form of take-or-pay clause provides:

       "Subject to the other provisions of this Contract, Seller agrees to sell and deliver and Pipeline agrees to purchase and receive, or pay for if made available hereunder but not taken, a daily quantitiy of gas, averaged over each accounting period (contract quantity) during the term hereof, equal to seventy-five percent (75%) of the maximum quantity of gas that Seller's well/s can deliver to Pipeline . . . ."

    b. Note that the take-or-pay clause begins: "Subject to the other provisions of this Contract . . . ." Other provisions of the contract may relieve the purchaser from its obligation to take or pay for gas, or substantially reduce the quantity of gas "made available" for the purchaser to take.

11. Other Take Formulas - Ratable take, best efforts, no express obligation to take.

12. Gas Processor Formulas - Limit take obligation to capacity of plant, right to allocate capacity, economic operation.

13. Connection Obligations - When must purchaser connect new wells onto the system?

14. Producer Delivery Obligations - Up to allowable assigned to wells; warrant to provide a specific quantity.

    a. Quality Standards - Limit impurities, heat content (Btu) limitations.

    b. Delivery Point - Point where custody and liability for the gas will pass.

        (1) NOTE: Today it is becoming more likely that gas produced in one state will have a delivery point far removed from the lease - such as a GM Plant in Michigan.

        (2) This may change basic rights under the oil and gas lease - with the gas being sold "off the leased premises" royalty may have to be calculated using a "market value" formula instead of a "proceeds" formula. Even if a "proceeds" formula is used, where does the sale to generate the proceeds take place? In Michigan? Can the transportation and other marketing costs (gas marketer fees) be deducted?

    c. Delivery Pressure - pressure requirements to deliver gas into the purchaser's pipeline.

    d. Compression - obligation or right of seller to compress gas to meet a delivery pressure.

15. Term - life of lease, life of reserves, stated duration. Right to terminate after notice.

    a. "Evergreen" provisions - continues in effect for a specified period of time unless party gives notice of termination within e.g. 30 days prior to the contract anniversary date. A type of "successor to an existing contract" under § 2 (14) of the Natural Gas Policy Act of 1978.

    b. "Rollover" Contract - term of art used in § 2 (12) of the Natural Gas Policy Act of 1978.

A contract entered into after an existing fixed term contract has expired.

c. Regardless of the stated term in many "old gas" contracts, a sale subject to federal jurisdiction under the Natural Gas Act of 1938 is commencement of a "service" that cannot be abandoned unless FERC finds abandonment is in the "public interest." FERC is making it much easier to abandon - See FERC Order 451 and Order 490.

16. Deliveries of Gas - how will the gas be delivered from seller to purchaser? Dispatching coordination.

17. Measurement - how will the gas, and other components be measured? Type of meters, maintenance and operation of meters.

18. Tests - how will tests required by the contract be conducted? Meter tests, deliverability tests, quality tests.

19. Title - Proof of ownership or right to sell (or process).

20. Payment Procedures - Reading meters, applying contract terms, calculating amount due, and sending the check.

    Will payment for all interests be made to the seller or will purchaser distribute payments to all persons having an interest in the gas?

21. Rights of Way - Purchaser usually given the right to use whatever easement rights lessee has under the oil and gas lease. See <u>Delhi Gas Pipeline Corp. v. Dixon</u>, 737 S.W.2d 96 (Tex. App. - Eastland 1987).

22. Force Majeure - Excuse for nonperformance due to specified events which relieve performance. God and government problems.

23. Notice - Contact person for each party to receive oral and written notices.

24. Disputes - Rights of parties, arbitration.

25. Choice of Law - What state's law will be used to interpret the contract?

26. Binding Effect - Contract binds the parties and their "successors and assigns."

27. Regulations - Contract subject to applicable state, federal, and local law.

28. Date - Date the agreement is executed. Typically not the date for calculating events under the contract.

29. Signatures - Signed by authorized individuals for each party.

D. Parties Bound by the Gas Sales Contract

1. Only the named producer, purchaser, and their successors and assigns are bound by the contract.

2. Typically the operator of the well will enter into the gas sales contract relying upon the terms of the operating agreement. However, the typical form of operating agreement does not grant the operator the right to bind the other working interest owners to a long term contract. Each has the right to take their gas in kind.

3. Gas contracts usually contain a representation by the gas seller that: "Seller owns or has the right to sell the gas."

4. To the extent seller does not actually have the right to sell the gas, the gas will not be subject to the gas sales contract. However, the seller may be liable to the purchaser under the contract warranty provision.

5. "Seller warrants the title to the Gas and that Seller has the right to sign this Contract on behalf of one hundred percent (100%) of the working interest owners in the well(s) under the lease(s) covered by this Contract."

6. Royalty owner's share of gas is probably subject to the contract unless royalty owner retains the right to take in kind.

    a. However, since the royalty owner is not a party to the contract, the provisions of the contract do not necessarily determine the lessor's rights against the lessee.

    b. For example, payment by the gas purchaser to the lessee may, in many situations, not be the basis for calculating lessee's royalty obligations under the oil and gas lease.

7. Although the royalty owner is not a party to the gas sales contract, they might be able to enforce the terms of the gas contract as a "third party beneficiary."

   a. If the lessee entered into the contract in part to discharge an obligation to its lessor (e.g. obligation to market production), the lessor may be able to assert rights under the contract as a third party beneficiary.

   b. Other working interest owners, and non-working interest owners, might also be able to assert third party rights.

VIII. OTHER AGREEMENTS ENCOUNTERED WITH GAS SALES

A. Gas Processing Agreements

1. Function: To acquire custody of gas suitable for removing liquid hydrocarbons, remove the liquids, and return the residue gas to the producer's gas purchaser.

2. Contain many of the same terms found in Gas Sales Contract.

3. Major difference is they require a number of additional calculations to allocate products and residue gas back to each producer delivering gas into the system.

   a. Agreement provides for the measurement of the inlet gas to determine its "theoretical" liquid content and then provides for the allocation of liquids and residue gas among each producer delivering gas into the plant.

   b. Requires additional testing and metering at each stage where the streams are comingled.

   c. Common to have a provision allowing the plant operator to allocate its capacity among various producers delivering gas into the plant.

   d. Assurance that residue gas and liquids are marketed to permit the plant to continue operating.

e. Requires coordination with ultimate gas purchaser when processor is not buiying the residue gas.

4. Gas Processing Basics

a. Natural gas consists of: methane, ethane, propane, iso-butane, normal butane, isopentane, normal pentane, hexane, heptane, octane, nonane, and decane.

b. Processing recovers hydrocarbon liquids (products) from natural gas.

Remove liquids as a bulk product called "propane-plus."

Can sell the propane-plus as a product or process it further to recover propane, butane, and natural gasoline through a process called "fractionation."

When there is a market, processor may also be able to fractionate ethane as a separate product.

c. Processing may also treat the gas to remove water (dehydration), carbon dioxide, hydrogen sulfide, and other impurities.

d. Shrinkage - Processing gas lowers the Btu content and volume of the gas entering the plant. This is called "shrinkage" and occurs when the liquid hydrocarbons are removed from the gas.

e. Plant Fuel - The processor will use some of the gas to run the processing operation.

f. Residue Gas - The gas remaining after processing is called the "residue gas."

g. Measurements - Gas is measured by volume (thousand cubic feet - "MCF") and heating value (million British thermal units - "MMBTU"). The liquid hydrocarbon concentration of the gas is expressed in "gallons per MCF" ("GPM").

5. Common Processing Arrangements

a. Processor purchases the gas.

b. Processor agrees to process gas and purchase liquids.

c. Processor performs the processing as a service for a fee. Liquids and residue gas redelivered to producer.

d. Where the processor does not own the gas being processed, it may be delivered by the producer or by the producer's purchaser (pursuant to redelivery and processing rights retained by the producer in the gas sales contract).

B. Transportation Agreements

1. Function: To move gas from delivery point to a redelivery point. No transfer of title. Pipeline merely functions as a bailee for a fee (typically regulated).

2. Common Concerns:

a. Measuring the gas entering the system; measuring the gas exiting the system. Quality of the gas, payment, etc. These are matters similar to those addressed in the Gas Sales Contract.

b. Transportation rates. Look at pipeline's applicable tariff.

c. Dispatching Problems. Controlling what goes in and what comes out at the other end. Pipelines often charge a fee (penalty) for failure to deliver and take the specified quantity of gas for which transportation has been contracted.

d. Firm or Interruptable Service. What if there isn't capacity on the line to transport all gas tendered? How will existing capacity be allocated?

C. End User Agreements

1. Same as a Gas Sales Contract except you are not dealing with a pipeline.

2. Unique problems - the end user typically needs to have the gas at certain volumes at varying times.

3. Need to carefully coordinate production

capabilities, existing contract restrictions, access to transportation, and customer's needs to determine whether the sale will be workable.

D. Other Marketing Agreements

1. Exchange Agreements. Trade gas in one location for gas at another location. Require quality adjustments so you are trading gas for gas. May be transportation obligations to meet the terms of the exchange.

2. Brokerage Agreements. What services are being provided? How will compensation to the broker be paid?

FINANCING OIL AND GAS LEASEHOLD DEVELOPMENT
HANDBOOK CHAPTER 18

by

Dwight D. Keen
Wichita, Kansas

except for a sale of the entire interest, the transaction will be "sale of a security"

integration - sale of interests in a series of oil & gas leases

giving a "put" to investors for period

SEC v. Murphy

Rule 506
unlim. $ amount

Ks. does not recognize Rule 504.

Part 1
Form 518

Rule 505 — $5,000,000 during 12 months
disclosure document
unlim. acc.
35 unaccredited

FINANCING OIL AND GAS LEASEHOLD DEVELOPMENT
HANDBOOK CHAPTER 18

I. Financing Options Available for Oil and Gas Development

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B. Activities to be Financed
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   (a) Limited Partnership Interests
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2. The Section 4(2) Private Placement Exemption
3. The Section 4(6) Exemption for Sales to "Accredited Investors"
4. Regulation D -- Limited Offering Exemption

D. Exemption for Oil and Gas Securities Under the Kansas Securities Act

most sig. / most widely used (private placement)

for oil & gas securities 32 purchasers w/o public advertising

1. The Transactional Exemption Under K.S.A. 17-1262a
2. The Isolated Transaction Exemption — aggregate # of sales not to more than 5 purchasers
3. The Kansas Version of Regulation D — 40 states adopted it

NOT UNIFORM IN THE STATES

E. Registration of Oil and Gas Securities

1. Federal Registration Requirements and Procedures
2. Kansas Registration Requirements and Procedures

Anti-fraud provisions always apply.
Fair dealing & full disclosure.
Ks. patterned after §17 & Rule 10b5
omission to state a material fact

private rights of action

SPEAKERS OUTLINE

Kansas Oil & Gas Handbook Volume II
Chapter 19
Creditor/Debtor Relations

A.J. Schwartz and Robert B. Morton

K.B.A. Seminar April 21, 1989
Wichita, Kansas

I. LIENS

A. Oil and gas mechanics liens

1. Statutory liens. Who may obtain the lien? K.S.A. § 55-207 confers a lien in favor of persons (partnership or corporations) who under an express or implied contract provide labor, material, machinery or supplies used for digging, drilling, perforating, completing, operating or repairing an oil or gas well. When the foregoing are provided in the construction of machinery used for drilling, perforating, operating, completing or repairing any gas well, a lien is also conferred. Any person who performs labor as a subcontractor of the § 55-207 contractor, or who furnishes machinery or supplies to a subcontractor under a § 55-207 contractor is also entitled to a lien. K.S.A. § 55-208.

a. Any person transporting oil field equipment as defined by K.S.A. § 55-212(b)(B) under an express contract with the owner or operator of an oil and gas lease or pipeline where the owner of oil field equipment or their agent is also entitled to a lien under K.S.A. § 55-213.

b. Suppliers of material to a materialman who sells the material to the owner of an oil and gas property is not entitled to a lien under K.S.A. § 55-207. See Interlake, Inc. v. Kansas Power & Light Company, 231 Kan. 251 (1982).

c. The contract described in the statute may be expressed or implied. The owners need not own or control all of the working interest in the lease. See Williams v. Otstot Oil Company, 129 Kan. 210 (1929). The contract terms are usually defined by statements for services rendered attached to the lien filing or by promissory note.

d. Some early Kansas cases suggested that a working interest owner could not obtain a lien against a leasehold in which he owned an interest. In Davis v. Sherman, 149 Kan. 104 (1939), however, the court suggested a different result if the claimant limited the lien to the interest of the other co-tenants of the leasehold.

2. Lienable items. In general, a K.S.A. § 55-207 mechanics lien attaches the whole leasehold, the building and appurtenances, the materials and supplies furnished the oil and gas well for which they were furnished and all the other oil wells, fixtures and appliances used in the operations on the leasehold for which the material and supplies were furnished and the labor performed.

   a. Production and production proceeds are not included in the statutory definition. Mechanics liens under this statute do not attach to severed oil or gas. Black v. Giarth, 88 Kan. 338 (1912) (interpreting the identical Oklahoma statute).

   b. Nonmanual labor, such as an attorney's title opinion, or an operator's monthly supervision charge probably are not within the scope of the term labor as contemplated by the statute. Insurance taxes and overhead probably also fall outside the scope of the term labor, machinery, materials and supplies. The machinery, materials or supplies also must be used in the operation before a lien attaches. Items stored on the lease, but not used in lease development operations, are not lienable.

3. Scope of the lien.

   a. A subcontractor or materialman to a subcontractor is entitled to a lien to the same extent as the original contractor. K.S.A. § 55-208. A lien attaches to all material, machinery, equipment and supplies furnished by the owner of the leasehold even if merely rented or borrowed. Fees v. Ritchey, 136 Kan. 221 (1932).

   b. An oil and gas lease lien properly filed and perfected pursuant to K.S.A. § 55-207 has priority from the earliest state of the furnishing of the labor or materials. Even though a working interest owner is current in his payments to the provider of labor or materials at the time a mortgage is properly recorded, the lien claimant has priority over the mortgagee upon default or bankruptcy. D Oil, Inc. v. Brungardt, 764 P.2d 851 (1988).

4. Perfecting the lien.

   a. Generally, in order for a lienholder to have a right in the attached equipment which is superior to that of a trustee in bankruptcy under Chapter 7 or a debtor in possession under Chapter 11, a mechanics lien under K.S.A. § 55-207 must be prepared, acknowledged and filed according to the statute.

      Filing. The lien must be filed within six months of the last date that labor, services or material was provided for the claimant. K.S.A. § 55-209.

   b. The lien should be filed in the Office of the Clerk of the District Court in the county in which the land and lease was situated and should include a statement of the following: (1) the amount claimed, (2) name of the owner of the land, (3) name of the owner of the lease, (4) name of the contractor if claimant is a subcontractor, (5) name of the claimant, (6) description of the property subject to the lien, (7) an itemization of the services rendered or labor and/or materials provided and (8) description of the items comprising the claim.

   c. The lien statement must be verified by affidavit. This provision is critical to perfection of the lien. A qualified verification, i.e., "to the best of my knowledge" will not suffice. Kansas Lumber Company v. Wang, 12 Kan. App. 2d 20 (1987). Improper verification invalidates the lien. DaMac Drilling, Inc. v. Shoemake, 11 Kan. App. 2d 38 (1986).

   d. If services were rendered prior to bankruptcy but the lien was not filed and after the debtor has filed his proceeding, lien claimants are still able to file their mechanics lien statement without violating the automatic stay. Section 546(b).

e. Services commenced and rendered after the bankruptcy proceedings are filed should be performed on a cash basis or the trustee or debtor in possession should obtain permission to incur credit for same under § 364. The debtor in possession cannot incur secured credit without a notice and hearing in bankruptcy court.

B. Operator's liens.

1. Many operating agreements make express provision for the attachment of a lien for unpaid operating expenses upon the nonoperator's share of oil and/or gas when extracted and all of the nonoperator's proportionate interest in the equipment on the lease. These agreements provide that in the event of a default of the nonoperator, the operator is entitled to collect from the crude oil purchaser all of the nonoperator's shares of the runs until the default is brought current.

2. At least one court has required that operating agreements be filed for record in order to grant the operator priority lien rights over third parties, like trustees in bankruptcy or debtors in possession. See In Re Wilson, 69 B.R. 550 (Bankr. N.D. Tex. 1986). Operators should file whatever agreements they have and should be sure that those agreements have been executed in recordable form, that is, acknowledged or verified before a notary public.

3. Kansas practitioners will note that mining partnerships are recognized in this state and this relationship can give rise to an operator's equitable lien against the working interest of a nonoperating mining partner. See Gilbert v. Fontaine, 22 F.2d 657 (8th Cir. 1927) (originating in the U.S. District Court for Kansas).

C. Tax liens.

1. K.S.A. § 79-329 provides that leases, casing, tubing, other materials and equipment, as well as royalties and working interests are taxable as personal property. K.S.A. § 79-2101 makes explicit provision for a collection of taxes due and owing under § 79-329. The sheriff of each county is

empowered to give notice to crude oil purchasers and the crude oil purchasers are then required to pay sufficient funds to service the delinquent taxes to the sheriff. While this activity is probably proscribed by the effects of an automatic stay in bankruptcy, debtors and trustees should bear in mind that county authorities, as a general rule, do not pay much attention to notices of bankruptcy nor do they let these notices hinder their attempts to collect taxes due. Defects of a sheriff's notification are obvious. The most serious being the likelihood that the crude purchaser will cause a suspension of the runs. The considerable crimp in the debtor's cash flow may be fatal to any attempt at reorganization.

2. The Internal Revenue Code provides for the attachment of a lien against property of a taxpayer at any time a tax assessment is rendered. 26 U.S.C. §§ 6321, et seq. This tax lien is not perfected until the lien is filed of record in the Register of Deeds Office. If a bankruptcy proceeding is filed prior to perfection of the tax lien, the trustee or debtor in possession utilizing its hypothetical lien creditor status under Bankruptcy Code § 544 could successfully attain priority over the tax lien.

3. Income tax debts are not dischargeable and are deemed priority claims under § 507 of the Bankruptcy Code. The Internal Revenue Code has extensive provisions for assessing unpaid corporate taxes to responsible officers who have been managing the corporation. Even where income tax liens are avoidable in bankruptcy under § 544, the consequences of income tax debt are many because the taxes must be paid either by the debtor in reorganization, by the debtor after the close of the case, or the surviving responsible individuals.

4. A filed notice of a federal Tax Lien Act tax lien should have priority over runs acquired by a debtor more than 45 days after the filing of a tax lien. Lenders should be advised to check the tax lien files every 45 days for the intervening federal tax liens.

5. K.S.A. § 79-4220 provides for the attachment of a lien on oil and gas production in the hands of an operator or producer or subsequent purchaser for unpaid severance tax. The lien created by the

statute does not appear to prime other liens nor does it appear to require recording. Arguably this lien is little more than a judgment lien under K.S.A. § 60-2202.

D. Judgment liens. K.S.A. § 60-2202 provides for a judgment lien to attach to the real estate interest of a judgment debtor in the county where the judgment is rendered. Such a judgment lien may be filed in other counties where the debtor owns real estate. Judgment liens do not attach to oil and gas leases which are not usually held to be real estate for the purpose of the judgment lien statute. See Utica National Bank & Trust Company v. Marney, 233 Kan. 432 (1983).

E. Equitable liens. Equitable liens pervade the oil patch. They present peculiar problems because they are often unrecorded and not well defined by the agreements which purport to create them.

1. Creation and attachment: Generally speaking, an equitable lien results where a debt arises and a res (a thing or object) to which that obligation to pay fastens is obtained or created as a result of the debt.

2. Operating agreements without specific lien clauses may contain sufficient language to cause an equitable lien to attach to the production from the lease. A lien is sometimes reasoned from the existence of language in an agreement providing for an order to pay operating expenses from crude proceeds. Because this lien is one which is reasoned from the conditions of the agreement rather than expressly set forth and consented to by the parties, the operator who relies upon it as security for his debt is less secure than an operator employing an AAPL agreement which is explicit.

3. Equitable liens may attach a debtor's property without being filed. However, as to third parties, courts will not enforce an equitable lien against mortgagees or purchasers who, in good faith, gave value without actual or constructive notice of the existence of the lien. In states where recording is required (like Kansas) even the open and notorious possession of a leasehold by a oil and gas operator will not suffice to give notice to third parties of the operator's interest. In order to protect an operator's interest against that of a trustee in bankruptcy or debtor in possession, the

operating agreement or other agreement out of which liens may spring should be filed for record.

II. MINING PARTNERSHIPS

A. Introduction

1. Illustration. A simple fact situation will illustrate the topic to be discussed in this section. Assume that John Smith leases real property for oil and gas development, and raises money for said development by selling interests in the lease to investors. Assume further that John Smith contracts with XYZ Drilling Company to drill a test well, that the test well is unsuccessful, and that John Smith files bankruptcy without paying the XYZ Drilling Company for its services. The lien rights of XYZ Drilling Company would be of little value because of the dry well; accordingly, XYZ Drilling Company might seek recovery from the investors. This section will discuss the principles of Kansas law to be applied in determining personal liability of the investors under a mining partnership theory. This section will also discuss ideas for the avoidance of a mining partnership.

2. Distinguish cases concerned with claims among interest holders. The discussion that follows is limited to mining partnerships in the context where third parties are seeking to establish liability against individual mining partners. Issues often arise, however, as to rights and obligations between and among working interest owners. Such issues may include the nature and amount of ownership rights, existence of fiduciary duties among the owners, and the availability of partnership remedies such as accountings and receiverships. For examples of said issues and application of mining partnership law thereto, see Huston v. Cox, 103 Kan. 73, 172 P. 992 (1918); Davidson v. Shaffer, 153 Kan. 661, 113 P.2d 90 (1941); and Shoemake v. Davis, 146 Kan. 909, 73 P.2d 1043 (1937).

3. Differences between mining partnerships and other entities. For purposes of considering liability to third parties, little distinction needs to be drawn between a mining partnership, a general partnership, and a joint venture. The essential elements for all three entities are basically the same. There are, however, certain distinctions

between a partnership and a general partnership that should be noted:

a. The change of partners in a mining partnership does not cause dissolution as in an ordinary partnership;

b. A mining partnership continues only during operation of an oil and gas lease; and

c. Authority of individual partners to bind the mining partnership is more limited than in a general partnership.

See Browne v. Loriaux, 189 Kan. 56, 366 P.2d 1016 (1961). The third distinction arises because of the limited scope of a mining partnership (i.e., to drill and operate an oil or gas well); presumably drilling and operating charges incurred by a partner should be within the authority implicit in a mining partnership. A fourth distinction, that a formal agreement is not needed to form a mining partnership, is not relevant in Kansas because the Uniform Partnership Act adopted by Kansas (K.S.A. § 56-301 et seq.) does not require a formal partnership agreement to form a general partnership. For a more thorough discussion of the differences between the foregoing entities see the following treatises: W. L. Summers, The Law of Oil and Gas, § 721-734 (1962); and Williams and Meyers, Oil and Gas Law, § 434-437.2 (1986).

B. Elements of a mining partnership

1. Mining partnerships require three elements: co-ownership, joint operation and an express or implied agreement to share in profits and losses. Yeager v. Graham, 150 Kan. 411 (1939). The co-ownership requirement can be met by an "equitable interest" in the venture. Id. Where a party exercises "rights of ownership" that make it appear to third parties that he is an owner, "[t]hird parties aware of the situation [have] a right to rely on such appearances." Id. The Yeager court held that the plaintiff had the burden to prove a mining partnership. Id.

2. In Yeager, an individual by the name of L. M. Graham purchased interests in various oil and gas leases for development. In developing one of those

leases, the Dawson lease, L. M. Graham received assistance from the Texokana Oil Company. Texokana supplied employees, equipment and funds. The plaintiff had contracted with certain named defendants, presumably including L. M. Graham, to drill a well on the Dawson lease. Texokana was not a party to the contract. The well was never fully completed and the plaintiff sued for recovery, inter alia, against Texokana on a mining partnership theory.

3. The evidence in Yeager was uncontroverted that Texokana had supplied the equipment, employees and funds above described. Texokana, however, argued that the reason said items were supplied was to verify production which would benefit other leases owned by Texokana in the vicinity. Finding this argument unpersuasive, the trial court found an implied agreement to co-own the Dawson lease, and an implied agreement to share profits and losses. The fact that Texokana did not own record title to the property did not prohibit this finding because equitable ownership, which was found, was deemed sufficient. The trial court further found joint operation on the property. The Kansas Supreme Court held that said findings were based upon competent evidence and should not be overturned.

C. Quantum of control required. As noted, the Yeager decision had facts clearly illustrating joint control of operations. In Mountain Iron & Supply Co. v. Branson, 134 Kan. 818, 8 P.2d 407 (1932), was asserted against working interests in an oil and gas lease. The opinion has very little discussion as to joint operations, and quoted testimony would imply that the defendants did not participate in operations, relying upon the developer/operator. Focusing on co-ownership and sharing of profits and losses, the Mountain Iron court held that a mining partnership had been established against the passive working interest owners. The value of Mountain Iron as a precedent is doubtful because the decision predates Yeager. However, given the small amount of authority in Kansas, a working interest owner must assume that even minimal control of operations could give rise to the establishment of a mining partnership.

D. Avoiding the mining partnership.

1. Elimination of co-ownership. A mining partnership is easily defeated by elimination of joint ownership. Therefore, ownership of the lease by a

limited partnership or a corporation is an alternative that allows for investors to participate with limited liability. Obviously, numerous factors determine whether an investor would prefer to be a working interest owner, a limited partner or a corporate shareholder.

2. Elimination of joint operations. In structuring the transaction between the oil and gas developer and the investors, care could be taken to clarify that the investors have absolutely no control over operations. The disadvantage to this approach are threefold. First, because only a small amount of control may be needed, the standard may be difficult to meet. Second, actual exercise of control would be determinative over documentation to the contrary. Thus, success of this approach would be dependent upon future performance. Finally, true elimination of this element means loss of control over an investment.

3. Express disclaimer of mining partnership. Many operating agreements executed by working interest owners expressly disclaim the existence of a mining partnership. While it is possible that such an agreement is effective as between the signing parties, it is doubtful that the provision would be enforceable against third parties. Thus, the provision may eliminate fiduciary duties owed by the operator to the investors in a mining partnership, while having no effect upon liability to third parties. See Williams and Meyers, Oil and Gas Law, § 435.2 (1986).

III. BANKRUPTCY OVERVIEW

A. Bankruptcy relief by way of Chapter 7 liquidation or Chapter 11 reorganization available to any business entity through a voluntary petition--irrespective of insolvency. The voluntary petition itself constitutes an order for such relief. Bankruptcy Code Sec. 301/302.

1. Although the filing incidence is low, a creditor's involuntary petition may impose bankruptcy on a debtor coupled with a showing of a general failure to pay debts. *Bankruptcy Code Sec. 303.

B. There are three important immediate and automatic legal effects of a voluntary bankruptcy petition filing--without any judicial action whatsoever.

* Title 11 United States Code

1. A new entity, the "debtor estate", is created constituting the full bundle of rights held by debtor at the moment the petition was filed. Bankruptcy Code Section 541.

    a. Included in such continued rights are, e.g., a debtor lessee/operator's physical possession of lease equipment and control over production.

2. In a Chapter 7 case, control of the debtors estate passes to a case trustee appointed by the U.S. Trustee. The latter's counterpart in a Chapter 11 reorganization is the debtor in a new statutory persona "Debtor-In-Possession". Both are accorded the same unique powers by statute. Bankruptcy Code Sec. 1107.

    a. As of the date a petition is filed, the DIP or the trustee assumes the status of a hypothetical lien creditor. Bankruptcy Code Sec. 544(a)(1) and (2) (1988). This "strong arm" clause permits the trustee to avoid unperfected security interests that are subordinate to a judgment lien creditor.

    b. Under Bankruptcy Code Sec. 544(a)(3) (1988) the trustee/DIP is a hypothetical good faith purchaser from the debtor of the estate's real property and holds that property free from unrecorded liens or conveyances.

    c. Under Bankruptcy Code Sec. 544(b) (1988) the trustee/DIP has (i) an unsecured creditor's power to set aside property transfers that are voidable under nonbankruptcy law and (ii) the further Bankruptcy Code Sec. 548 power to avoid any transfer made with one year before bankruptcy with fraudulent intent or for inadequate consideration while debtor was insolvent.

    d. Pursuant to Bankruptcy Code Sec. 547 (1988) the trustee or DIP can avoid a preferential transfer made by the debtor to a creditor and applied on a pre-existing debt. The debtor must be insolvent when the transfer is made, and the transfer must occur within 90 days of filing the petition unless the creditor is classified as an "insider". In that latter case the prepetition transfer period is one year. The transfer must enable the creditor to receive more than if the debtor's estate had been liquidated.

e. The trustee/DIP can assume or reject executory contracts or unexpired leases, Bankruptcy Code Sec. 365(a), (b) and (c), and in the instance of nonresidential real property leases, if the lease is not timely assumed, it is deemed rejected. Bankruptcy Code Sec. 365(d)(4) (1988).

3. A pervasive across-the-board injunction the--automatic stay--becomes effective by operation of law. Creditor activity judicial and non-judicial is thereby halted instantly--including, e.g., state Court judgment executions and repossessions. Bankruptcy Code Sec. 362.

   a. Modification of the stay requires a Court order.

   b. Creditor entitlement to such modification frequently turns on whether creditor has "adequate protection" for the creditor's collateral in the hands of the trustee/DIP. The statute sets out three non-exclusive methods of providing adequate protection.

      (1) cash payment;
      (2) replacement lien; or
      (3) granting the "indubitable equivalent".

IV. THE DEBTORS ESTATE

A. Initially all debtors property--exempt and non-exempt--is a part of the debtors estate under control of the trustee/DIP. Bankr. Code. Sec. 541. Individual debtors may remove exempt property from estate. There are no exemptions for corporations. Bankr. Code. Sec. 522.

1. Major exemption allowed Kansas individual is homestead not to exceed 160 acres of farmland or one acre within limits of a city. K.S.A. 60-2301. Kan. Const. Art. 15 Sec. 9. There is no limitation on value.

   a. A Kansas Bankruptcy case dealt with a debtor/landowner's conventional lessor-reserved royalty interest in producing wells located on his homestead tract. The Court held that unextracted minerals attributable to the royalty were a part of the homestead real property and hence exempt to the landowner debtor. In re Thexton, 39 B.R. 367 (Bankr. D. Kan. 1984) Kan. O & G Handbook Vol. II, p. 19-8. The opinion stressed that up to the time of bankruptcy filing all run proceeds attributable to the royalty were property of the bankruptcy estate.

4

V. REJECTION OF O/G LEASE UNDER BANKRUPTCY LAW

§365 B.C.

A. The statutory authority of a trustee/DIP to assume or reject an executory contract does not define the term "executory contract". The generally accepted abstract view is that the particular contract must be in existence--not terminated or expired before commencement of the bankruptcy case--and that some performance remains due on both sides. The companion power to assume or reject unexpired leases is similar but not identical in that some protection is provided for the vested estate of a lessee against a rejecting debtor real property lessor and the lease need not be in an "executory" posture. However, if the subject of the lease is personal property there is no "estate" and a lessee's interest may be terminated by rejection. The principles are easier said than applied to specific situations as is demonstrated by four cases.

1. In In re J.H. Land & Cattle Co., 8 B.R. 237 (Bankr. W.D. Okla. 1981)(applying Kansas law) state Court appointed receivers of the lessor had entered into 11 oil and gas leases with one John Masek. Approximately one month later, prior to commencement of drilling operations by Masek, the lessor filed a Chapter 11 petition and sought to reject the Masek leases so that it could enter into new leases which it deemed financially more advantageous. The Court addressed the following issues: (i) whether an oil and gas lease is an executory contract within the meaning of § 365; and (ii) whether a debtor/lessor may reject a valid oil and gas lease and deny the lessee the contracted right of remaining in possession and developing the leasehold estate.

   The Court held that a Kansas oil and gas lease is an unexpired lease of personal property for purposes of § 365 and the debtor/lessor is entitled to reject the lease and deny the lessee possession. The Court followed the "business judgment" test in approving debtor's rejection of the leases.

(a) Under the business judgment test, a debtor's rejection of an executory contract/unexpired lease will be approved as if the debtor made a reasonable business judgment that such rejection was in the best interest of the business.

(b) The rejected nondebtor lessee is left with a bankruptcy claim for damages resulting from the rejection.

(c) The J.H. Land & Cattle Co. opinion does not stress that the leases were undeveloped, but it seems clear that such was the fact.

2. In re Heston Oil Co., 69 B.R. 34 (N.D. Okla. 1986), was a subsequent decision by the District Court for the Northern District of Oklahoma sitting as an appellate Bankruptcy Court. The debtor was a lessee of an Oklahoma property. The nondebtor lessor sought to compel an assumption or rejection by the debtor/lessee. The Court noted that because of its singular characteristics an Oklahoma oil and gas lease was not a "lease" in the conventional sense; that the interests arising "are more akin to a profit a prendre." Moreover, that the only ongoing obligation of the lessor was to defend title to the leased property and not to "interfere with the lessees' drilling operation." The reasoning of J.H. Land & Cattle Co. was questioned and its conclusion flatly rejected. The district Court explicitly held that the oil and gas lease was neither an unexpired lease nor an executory contract under § 365 of the Bankruptcy Code.

3. Still later is the Oklahoma Bankruptcy Court decision, In re Clark Resources, Inc., 68 B.R. 358 (Bankr. N.D. Okla. 1986). Here again, the debtor was lessee and the nondebtor lessor moved for assumption or rejection. Bankruptcy Judge Mickey Wilson also declined to follow J.H. Land & Cattle Co. The Oklahoma oil and gas lease was defined merely as a license to explore, not an interest in real property within the scope of § 365 as an unexpired lease of real property. Equally specific was the determination that the lease was not a § 365 executory contract as to the debtor lessee. "Where a party's only remaining obligation is the payment of money, as in the case here for Clark Resources [debtor lessee] the contract is not executory."

4. A lease assignment pursuant to a "farmout" type of agreement was in issue in the unreported Kansas bankruptcy decision of Oursler and D&F Petroleum v. Cascade Oil Company, Inc., Adv. No. 83-0205 (Slip. op. Sept. 3, 1986) one of the three adversary proceedings in the Cascade Oil case noted at paragraph IIIA.3 infra. D&F was to install a gas gathering system in exchange for a ten percent working interest; Oursler was to drill eight wells in exchange for a five percent overriding royalty. The wells were completed and the gathering system was in place before Cascade's 1982 Chapter 11 bankruptcy filing. Farmout assignments had been executed but not recorded. Under those circumstances, the District Court, in its appellate capacity affirmed the Kansas Bankruptcy Court in holding that the agreements had been materially performed; hence were not "executory" requiring assumption or rejection. In isolation, this ruling was essentially factual in nature and seems to beg the question of whether the oil/gas lease was realty or personalty under Bankruptcy Code Sec. 365. But another holding in the same adversary discussed infra at IIIA.3, clearly classifies the oil/gas lease interest as real property for purposes of Bankruptcy Code Sec. 544(a)(3) [hypothetical good faith purchaser status of a trustee/DIP.]

VI. THE O/G LEASEHOLD AS A REAL PROPERTY INTEREST IN BANKRUPTCY LAW CONTEXT.

A. A holding that an oil and gas lease is real property carries important consequences. That premise brings into play the statutory fiction that the trustee/DIP is a good faith purchaser of that real property from debtor free from unrecorded assignments of the lease. Three Kansas bankruptcy cases adopt the real property view. All are in the framework of In re Cascade Oil Co., Inc. (No. 82-10635, Bankr. D. Kan. 1982).

1. The first decision is referred to as Mercier for convenience of reference. It is reported as In re Cascade Oil Co., Inc., 65 B.R. 35 (Bankr. D. Kan. 1986). Some two years before Cascade's Chapter 11 filing, a number of investors individually paid Cascade (primary lessee) at the rate of $24,000 for a five percent working interest in a 16 well drilling program in Chase County, Kansas (later a part of the program was transferred to a lease in Marion County). Cascade prepared assignments to

the investors, but the documents had not been delivered or filed of record when Cascade filed its Chapter 11 petition (the memorandum opinion states the court's assumption that until the bankruptcy petition was filed, the investors had a specifically enforceable right to the assignments; Id. at 38 n.9). After the Chapter 11 filing, Cascade, as debtor-in-possession, disavowed the unrecorded assignments. The Bankruptcy Court held that under Kansas law [citing Ingram v. Ingram, 214 Kan. 415, 521 P.2d 254 (1974)] Cascade's oil and gas lease and interest was real property for the purposes of Bankruptcy Code § 544(a)(3); and as a hypothetical good faith purchaser of that [real property] lease, Cascade owned the working interest free and clear of the unrecorded assignments to Cascade's own investors.

Section 544(a)(3) of the Bankruptcy Code provides that a trustee or DIP "shall have, as of the commencement of the case . . . the rights and powers of, or may avoid any transfer of property of the debtor . . . that is voidable by . . . a bona fide purchaser of real property, other than fixtures . . . from the debtor . . . ." 11 U.S.C. 544(a)(3) (1988). The Mercier opinion states that J.H. Land & Cattle Co., supra, determined a Kansas oil and gas lease personal property only in the context of 11 U.S.C. § 365 (rejection of executory contracts) and therefore possibly distinguishable from Mercier on that basis. The opinion also mentions, but declines to follow, a 1984 decision of the Oklahoma Bankruptcy Court. In re Mahan & Rowsey, Inc., 37 B.R. 530 (Bankr. W.D. Okla. 1984), held that a constructive trust for promised but unrecorded override assignments was not defeated by the Bankruptcy Code § 544(a)(3) [hypothetical good faith purchaser] rights of a debtor-in-possession/lessee. However, the Kansas Bankruptcy Court Mercier memorandum does not treat of a companion Oklahoma bankruptcy decision: In re Mahan & Rowsey, Inc., 35 B.R. 898 (Bankr. N.D. Okla. 1983). In that 1983 opinion, the bankruptcy Court imposed a constructive trust on a debtor/operator for overpayments induced by the operator's erroneous invoices. The Oklahoma District Court affirmed as did the Tenth Circuit in In re Mahan & Rowsey, Inc., 817 F.2d 682 (10th Cir. 1987). The Tenth Circuit opinion states:

> We noted in Reserve Oil [Reserve Oil, Inc. v. Dixon, 711 F.2d 951

> (10th Cir. 1983)] that an operating agreement of the type present in this case created a trustee type relationship imposing a duty of fair dealing between the operator and the nonoperator owners in the matter of distribution of the shares among the owners. What results from the fiduciary relationship thereby created is a constructive trust imposed on the operator. Because money was given to the operator for a particular purpose (for example, the payment of a debt), the operator received the money in trust to apply it to the intended purpose.

imposed by operation of equity

The Tenth Circuit went on to state that such a constructive trust was not overridden by the DIP's power under 11 U.S.C. § 365(a) to reject an executory contract. Id. at 64 n.3.

a. An appeal of Mercier to the Kansas District Court was dismissed February 1, 1988 in pursuance of an agreed settlement.

2. The second Kansas bankruptcy decision is unreported. Crooker and Scott v. Cascade Petroleum, Inc., Adversary No. 83-0066 (Slip op. July 14, 1987). Here again plaintiffs, apparently insiders, claimed working interests under assignments executed by Cascade, but not recorded. The Court upheld Cascade's avoidance of the assignments in its DIP capacity as a Sec. 544(a)(3) good faith purchaser in a memorandum incorporating its earlier opinion in Mercier, supra. The District Court affirmed on appeal. Cascade Oil Co., Inc., Civil Action No. 86-1649-K (Slip op. October 28, 1987). The appellate opinion expressly holds a Kansas oil and gas lease to be real property in the hands of a DIP as a good faith purchaser Bankruptcy Code Sec. 544(a)(3)] free from unrecorded assignments and also irrespective of claims of constructive trust by holders of the unrecorded assignments. The possible application of in re Mahan & Rowsey, Inc., 817 F.2d 682 (10th Cir. 1987), does not appear to have been raised by the parties. *

a. An appeal of Crooker and Scott to the Tenth Circuit Court of Appeals was dismissed on June 6, 1988 because the notice of appeal was not timely filed. In re Cascade Oil Co., 848 F.2d 1062 (10th Cir. 1988).

365(d)(4) debtor lessee on non-residential real prop. - must accept - or be deemed rejected

3. The third Kansas bankruptcy decision in Cascade also is unreported. Oursler and D & F Petroleum v. Cascade Oil Company, Inc., Adversary No. 83-0205 (Slip op. September 3, 1986). The case was discussed above in the treatment of executory contracts. It was a farmout where the court found the agreement had been substantially performed, pre-bankruptcy, and thus not "executory" within the meaning of Bankruptcy Code Section 365. Accordingly, it was held that assumption/rejection was not available to the trustee/DIP. That was largely a fact determination. There was a second more important ruling. The record was clear that the "farmees" did not obtain and record the previously executed assignments until after Cascade's Chapter 11 filing. On that factual premise, the Bankruptcy Court unvalidated the assignments on the Mercier rationale: Under Bankruptcy Code Sec. 544(a)(3), Cascade as DIP is considered as having in good faith purchased the [real property] lease without knowledge or notice of Cascade's own prebankruptcy outstanding but unrecorded assignments. The District Court concurred on appeal and in one of two memorandums In re Cascade, No. 86-1733 (Slip ops. April 11, 1987 and October 27, 1987), the District Court went on to observe:

> If the assignments had been recorded, the parties [Oursler and D & F] would now have been a secured claim [sic] but since their interests were not recorded, and the debtor had fully performed under the assignment, they hold unsecured claims against the estate.

365(h) (rental agt) to use real property

a. There was no appeal to the Tenth Circuit.

b. Caveat: Kansas investor/assignees and farmout assignees are at grave risk if their instruments of assignment are not recorded prior to a bankruptcy filing by the primary lessee.

B. In 1984, the Bankruptcy Code was amended to provide that in instance of a debtor lessee of non-residential real property, if the trustee/DIP does not assume the lease within 60 days (or a timely extension) the lease is deemed rejected and the property immediately surrendered to the lessor. Bankruptcy Code 365(d)(4). Should the Kansas Bankruptcy Court extend the real property concept to the compass of Section 365(d)(4), a lessee debtor could lose the lease automatically unless the debtor assumes within the 60 days following the bankruptcy filing.

1. The same surrender could occur through such postpetition inaction by the lessee should the court determine the o/g lease a "rental agreement to use real property" under Bankruptcy Code Section 365(m). That was the exact conclusion reached in In re Gasoil, 59 B.R. 804 (Bankr., N.D. Ohio 1986).

2. Bankruptcy filing by a primary lessee obviously presents a farmout assignee with an immediate and serious problem.

VII. KANSAS PERSONAL PROPERTY TAX LIENS AND THE O/G LEASEHOLD

A. A Kansas personal property tax lien is activated when the property is seized by legal process. K.S.A. 79-2111.

1. A Kansas Bankruptcy Court has held a voluntary bankruptcy with consequent reconstitution of debtor's property as the "debtor's estate" is not a "seizure" within the meaning of statute In re White Hat Feed Co., 67 B.R. 851 (Bankr. D. Kan. 1986).

B. Under a Kansas 1988 statute, the lien is also triggered when owner voluntarily "surrenders or transfers such property to another". K.S.A. 79-2020.

1. The U.S. District Court for Kansas recently held a voluntary bankruptcy petition is such a surrender and transfer to the bankruptcy estate; that consequently the unpaid tax was a paramount lien over a prebankruptcy SBA loan that was subordinated to state tax lien by 15 U.S.C. Sec. 646. Accordingly, the tax lien had first priority against proceeds of a sale by the bankruptcy trustee In re Knights Athletic Goods, Inc., Slip Op. Civ. Case No. 88-1537-K (March, 1988).

C. Under Knights Athletic Goods all of debtor's lease property constituting personalty is impressed with a K.S.A. 79-2020 lien as of the commencement of the bankruptcy case. If the leasehold itself should be characterized personal property for this purpose the entire lease interest of the debtor would be subject to the lien.

March 23 personal prop.

1. A Bankruptcy trustee/DIP could assert Bankruptcy Code Sec. 545 as a basis for avoiding the lien. That provision empowers the trustee/DIP to avoid the fixing of a statutory lien on debtor's property that first became effective when the bankruptcy case was commenced. The same section also invests the trustee/DIP with the rights of a fictional good faith purchaser for the purpose of such statutory lien avoidance.

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OIL AND GAS TAXATION HANDBOOK CHAPTER 20

by

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I. BACKGROUND

A. Primary Income Tax Benefits

1. Deduction for intangible drilling costs ("IDC").

2. A portion of production received tax-free through "cost" or "percentage" depletion.

B. "Pool of Capital" Doctrine

1. Allows contribution of property or services "tax-free" in exchange for interest in oil and gas property.

2. Accepted by Supreme Court in Palmer v. Bender, 287 U.S. 551C1933l.

3. Rev. Rul. 83-46 places a pall over doctrine.

C. Definition of Essential Terms

1. Property. Each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. I.R.C. § 614(a).

2. Economic Interest. Any interest in a mineral in place acquired by investment which secures, by any form of legal relationship, income derived from the extraction of such mineral, to which investor must look for a return of his capital. Reg. § 1.611-1(b). Must have an "economic interest" before claiming a depletion deduction.

3. Operator. Holder of a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of

contract granting working or operating rights. Reg. § 1.612-4. Must be an operator to deduct IDC.

II. ACQUISITION AND TRANSFER

A. Recovery of Cost of Acquisition of Oil and Gas Interest

1. Depletion and/or Depreciation

2. Reduction in amount realized upon sale

3. Abandonment loss

B. Specific Types of Transactions

1. Sale. Assignment of entire property interest; assignment of continuing, non-operating while retaining working interest; assignment of continuing property interest while retaining non-continuing interest in production; or assignment of an interest while retaining an identical interest.

a. Seller recognizes gain in year of sale. May qualify for installment sale treatment. Any gain is either long-term or short-term capital gain or ordinary income to a "dealer" or to the extent of "recapture".

b. Purchaser must capitalize cost to the extent of property interest and/or equipment based on fair market values. Equipment cost is recovered through depreciation and property interest through depletion.

2. Lease. Transfer of development rights with retention of continuing, non-operating interest in production, such as royalty interest.

a. Bonus. An amount paid to acquire an economic interest in minerals. Lessee-payor capitalizes bonus as cost basis in leasehold. Lessor-payee reports the bonus as ordinary income, subject to later depletion (I.R.C. § 613A(d)(5)) in the event there is in fact production from the land.

b. Delay Rental. Amount paid for privilege of deferring development operations. Ordinary income as rent to lessor; lessee may expense on non-productive properties or capitalize into basis of leasehold interest. Obligation of lessee ceases on abandoning the lease, developing the lease, or obtaining production.

c. Installment Bonus. Requires lessee to pay lessor annual payments for determinate number of years irrespective of production. Lessee capitalizes payments as leasehold acquisition costs; includible in income of lessor at face amount in year lease executed, unless lessor is a cash basis taxpayer and contract is either not freely transferable or lessee not solvent.

d. Advance Royalty. Owner of operating interest required to pay annual royalties irrespective of oil and/or gas extracted. Advance royalty payments later recoupable by lessee against actual production. Payment must be avoidable by lessee by termination of lease. Lessor must report income when received and cannot deduct depletion against advance royalty payments.

e. Advance Minimum Royalty. In contrast to advance royalty, requires a substantially uniform payment annually over life of lease or for a period of at least twenty years. See Reg. § 1.612-3(b)(3). Lessor must include payments into income when received with no deduction for percentage depletion; lessee may either deduct when paid or capitalize.

C. Avoiding Lease/Sublease Treatment

1. Lease payments treated as ordinary income; sale or exchange treated as capital gain or loss.

2. TRA '86 generally eliminates distinction between capital gain and ordinary income; however, sale or exchange treatment allows gain to be reduced by return of basis.

3. Tenth Circuit holds transaction is a lease, and not a sale, if oil and gas property is transferred and a continuing, non-operating interest (e.g., a royalty, overriding royalty or net profits interest) is retained by the transferor. McAfee v. U.S., 431 F.2d 1360 (10th Cir. 1970).

4. Many Structuring Possibilities.

D. Production Payments

1. <u>"Carved-Out" production payments</u>. Assignment of production payment by working interest owner in exchange for sum of money; payments split into principal and interest components. Creates no economic interest.

2. <u>Production payments assigned for payment of development costs</u>. Creates an economic interest. If owner of payment is independent producer or royalty owner, may be entitled to percentage depletion; in any event entitled to cost depletion. Operator has IDC commensurately reduced to extent of cost reimbursement.

3. <u>Production payment retained in sale of property interest</u>. Creates no economic interest. Treated as purchase money mortgage. Owner reports income in year of sale subject to installment sale rules.

4. <u>Production payment retained in leases transaction</u>. Creates an economic interest. Payments to owner constitute ordinary income subject to cost or percentage depletion.

E. "Take or Pay" Contracts

1. Rev. Rul. 80-48 treats payments as ordinary income.

2. Rev. Rul. 80-48 may be invalid as such payments appear to qualify as "carved out" production payments under I.R.C. § 636(a).

3. May wish to use Rev. Rule. 80-48 to accelerate income.

F. Abandonment

1. I.R.C. § 165 loss equal to basis.

2. Rev. Rul. 54-581 specifies when interest becomes worthless so as to be deductible.

G. Tax-Free Exchanges

1. I.R.C. § 1031: "like kind". Carry-over basis; gain recognized to extent of "boot".

2. I.R.C. § 721: partnership capitalizations.

3. I.R.C. § 351: corporate capitalization.

H. Recapture on Disposition

1. I.R.C. § 1254

2. Requires gain realized be recaptured as ordinary income to the extent of IDC and depletion deductions which reduced adjusted basis of property.

3. I.R.C. § 1245 requires recapture of depreciation deductions (to the extent of gain) upon sale of tangible equipment.

III. DEVELOPMENT OPERATIONS

A. Geological and Geophysical ("G and G") costs

1. Must be capitalized. I.R.C. § 263.

2. Rev. Rule 77-188 governs tax treatment and allocation procedure.

B. Support Agreements

1. Include "bottom hole" and "dry hole" contributions.

2. Rev. Rul. 80-153 requires payee to include payment in gross income; payor must capitalize the contribution.

C. IDC

1. Reg. § 1.623-4 defines IDC as costs having no salvage value (i.e., not equipment) and which are necessary and incident to the drilling of wells or production of income (i.e., not lease payments).

2. Under general tax law would have to be capitalized; however, I.R.C. § 263(c) allows immediate deductibility. Taxpayer owning operating rights may elect to expense.

3. IDC classification normally ends at installation of "Christmas Tree".

4. Prepayment deductibility governed by Rev. Rul. 71-252.

5. I.R.C. § 461(i) limits the use of "tax shelters" to deduct items earlier than when economic performance occurs; permissible for economic performance to occur with ninety days after the close of the taxable year.

D. Depreciation of Equipment Costs

1. Most equipment placed under I.R.C. § 168 on a 5-year or 7-year depreciation schedule based upon 200% declining balance method.

2. Taxpayer can elect to utilize straight-line method over designated life of property. I.R.C. § 168(b)(3)(C).

3. Also can elect expense method (up to $10,000) or unit of production method. I.R.C. §§ 179 and 168(f)(1).

IV. OPERATION AND PRODUCTION

A. Operating costs

1. Deductible if ordinary and necessary trade or business expenses under I.R.C. § 162.

2. Deductible when incurred.

B. Depletion

1. Represent an apportionment of costs of property against its income.

2. Taxpayer <u>must</u> compute cost and percentage methods and claim the greater amount.

a. <u>Cost Depletion</u>. Deduction of adjusted basis ratably against current production as a portion of all reserves prior to current production. Reg. § 1.611-2.

b. <u>Percentage Depletion</u>. I.R.C. § 613 and 613A. A fixed percentage of 15% of each dollar received from production (irrespective of tax basis) up to 1,000 barrels of oil (or 6 million cubic feet of gas) per day. Subject to limitations of 50% of taxable income from the property and generally, 65% of the taxpayer's taxable income for the year. Can only be utilized by "independent producers and royalty owners," or for natural gas under fixed contracts.

C. Possible Loss Limitations

1. I.R.C. § 469(h)(1) generally disallows losses in which taxpayer does not "materially participate," i.e., provide significant services.
2. However, does not include working interest which taxpayer holds directly or in an entity which does not limit liability. I.R.C. § 469(c)(3).
3. "Material participation" still necessary to determine if interests included in net investment income for purposes of net investment interest limitation under I.R.C. § 163(d)(5)(A)(ii).

D. Alternative Minimum Tax ("AMT")

1. Oil and gas tax preference items (percentage of depletion in excess of adjusted basis and IDC deductions in excess of 65% of the property's net income) added to taxpayer's adjusted gross income.
2. After reduction for applicable exemptions, AMT is imposed (21% rate or 20% for corporations) if AMT exceeds taxpayer's regular tax liability.

E. At Risk Limitation

1. I.R.C. § 465 applies to individuals, partnerships, S corporations and corporations having less than six individual stockholders.

2. Requires taxpayer be "at risk" in an investment before deducting investment losses.

3. "At risk" to the extent of cash investment, tax basis of property contributed and fair market value of property not used in the activity securing nonrecourse debt.

F. Interest Expense Limitation

1. I.R.C. § 163 determines deductibility of interest (trade or business, tax deficiencies, investment interest, passive activity, qualified residential and personal) under a tracing method. Reg. § 1.263A-1T.

2. Passive activity interest (e.g., interest on debt incurred to purchase LP interest) may only be deductible against passive income.

3. Interest on money borrowed to purchase a working interest in which borrower does not materially participate may only be deducted against net investment income.

G. Capitalization Rules

1. I.R.C. §§ 263A and 460 provide for uniform capitalization rules for real and personal property production and resale.

2. Appears capitalization of direct and indirect overhead costs and interest required except to extent deductible as IDC.

V. FORMS OF OWNERSHIP

A. Corporations

1. Limited liability
2. "C" corporations generally have reduced IDC and percentage depletion.
3. Tax at corporate and shareholder level (as dividend when distributed) if "C" corporation.
4. Repeal of General Utilities doctrine by TRA '86 causes double tax on liquidation.
5. "S" corporation election mitigates negative tax impact with certain restrictions.

B. Partnerships

1. Avoids double taxation.
2. Special allocations of tax items such as IDC or depreciation must have "substantial economic effect" under I.R.C. § 704.
3. Limited partnership predominant form of investment in oil and gas properties; if ULPA used, will avoid IRS position that limited partnership should be taxed as association, i.e., as a C corporation. Reg. § 301.7701-2.

C. Joint Ownership

1. Tax benefits flow through in same manner as partnership (i.e., under Subchapter K); must elect out of taxation as partnership. I.R.C. § 761(a).
2. May stay within Subchapter K if desire special allocations.

VI. JOINT OPERATIONS

1. Generally. IDC and depreciation deductions limited to fractional interest of operating rights of "carrying party"; balance of "carried party" interest must be capitalized subject to depletion. Reg. § 1.612-4. Limited exception if payor of the well costs holds the entire working interest during "complete payout period".

2. "Manhattan" carried interest variation. Grantee entitled to deduct all IDC and depreciation on equipment until costs recovered; upon reversion to grantor of specified fractional portion, co-owners will be responsible for respective shares of subsequent costs.

3. "Obligation well" farm out arrangements. Negative impact of Reg. Rul. 77-176; contrast with prior rulings of service. Creation of tax partnership may avoid its impact.

VII. NON-CONVENTIONAL SOURCE FUEL CREDIT

1. I.D.C. § 29(a) provides for a nonrefundable $3/barrel income tax credit to producers of certain types of oil and gas sold to unrelated persons.

2. Must be produced >1979 and <1990 and sold >1979 and <2001.

VIII. WINDFALL PROFITS TAX

1. Repealed effective August 23, 1988.

2. Basic structure for prior transactions.

a. Computation

b. Net income limitation of 90%

c. Three-tier tax system

d. Exemptions: qualified charitable interest; exempt royalty oil and exempt stripper well oil

e. Withholding

IX. KANSAS SEVERANCE TAX

1. K.S.A. § 79-4216 et seq: 8% tax minus ad valorem tax credit (3.67% on severed oil and 1% on severed gas).

2. Imposed on producer

3. Reported on Form MT/01 (crude oil) or Form MT/03 (natural gas); due on last day of month following removal.

4. Tax submitted with Form MT/05a (crude oil) or Form MT/05 (natural gas); due 20th of second month following production.

5. Exemptions

   a. K.S.A. § 79-4217(b)(1) for gas.

   b. K.S.A. § 79-4217(b)(2) for oil.

X. KANSAS AD VALOREM TAXATION

1. Taxed at 30% of fair market value under Article 11, § 1; f.m.v. based on past year's production and decline rate (8% built in) to establish present work factor according to Kansas Property Valuation Department guidelines.

2. Add back equipment cost facts according to P.V.D. manual.
3. Operating cost allowance
4. Due to reappraisal, may see a reduction in property tax to extent of mill levy decrease resulting from increase in total assessed value in all taxing districts where oil and gas property located (county, school district, township and possibly, city).

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