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SPECIAL TOPICS

SELECTED OIL & GAS TOPICS: ILLINOIS, KANSAS, AND KENTUCKY

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CONTENTS

I. INTRODUCTION

This article provides an update of oil and gas law developments in the States of Illinois, Kansas, and Kentucky. In addition to addressing recent developments, the following four areas, for each state, are examined:

1. Common problems associated with mineral interests under trust administration;

2. Common problems associated with mineral interests subject to estate administration;

3. Common problems associated with mineral interests under forced pooling statutes;

4. Common problems associated with the calculation of royalty: statutory obligations and gas balancing.

II. TRUST ADMINISTRATION PROBLEMS

A. Trust Law Basics

Although the concept of property held in "trust" sounds somewhat mysterious and complex, it is really quite simple. For example, Lucy Farmer wants to convey her farm to her two children (Tracy and Levi); but she does not want to give it to them outright. Lucy wants to share in some of the income from the farm during her life, but let her daughter, Tracy, operate the farm. Lucy conveys the farm to Tracy, in trust for the benefit of Lucy, Tracy, and Levi.

LUCY (Settlor) ------>TRACY (Trustee)

for the benefit of:

LUCY (Beneficiary)
LEVI (Beneficiary)
TRACY (Beneficiary)

After the conveyance, Tracy has "legal" title to the farm which she holds subject to her trust obligations. Lucy is referred to as the "settlor" of the trust;[1] she also happens to be one of the "beneficiaries" of the trust. Tracy is the "trustee" and one of the beneficiaries. Levi is also a trust beneficiary.[2]

To have a valid trust there must be: (1) A declared intention to create a trust, (2) a description of the property subject to the trust, and (3) a trustee to accept the trust duties.[3] The trust can be created during the settlor's life (a "living" or "inter vivos" trust) or at the settlor's death (a

"testamentary" trust).[4] The living trust is typically created in one of two ways: (1) By a conveyance of property, in trust, for the benefit of others; or (2) By the property owner declaring that they hold the property in trust for the benefit of others. The testamentary trust is created by the settlor's will and takes effect upon the settlor's death. The living trust takes effect upon transfer of the property to the trustee.[5]

The trustee is in a "fiduciary" relationship to the trust beneficiaries. The Restatement (Second) of Trusts defines the nature of the trustee's fiduciary duties as follows:

> A person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation. . . . As to matters within the scope of the relation he is under a duty not to profit at the expense of the other and not to enter into competition with him . . . . If the fiduciary enters into a transaction with the other and fails to make a full disclosure of all circumstances known to him affecting the transaction or if the transaction is unfair to the other, the transaction can be set aside by the other.[6]

The trustee, as a fiduciary, is charged with the task of carrying out the terms of the trust and acting to protect and maximize the interests of the trust beneficiaries.

B. Trustee Powers

Returning to our hypothetical trust, Tracy, as the trustee, has the power, and the obligation, to manage the trust property for the benefit of the trust beneficiaries. The most common problem associated with oil and gas interests held in trust is whether the trustee has the authority to perform a certain act--such as signing a division order. The inquiry involves two issues: (1) Does the trustee have the power to act and bind the trust? and (2) What documentation can we rely upon to ensure the trustee has the requisite power, or that it is being properly exercised?

To determine the scope of a trustee's authority, we must look to one or more of the four basic sources of trustee power:

1. The conveyance document which transferred the trust property from the settlor to the trustee.

2. The trust agreement which the settlor prepared prior to or contemporaneous with the conveyance.[7]

3. Statutory powers conferred on the trustee.

4. Common law powers conferred on the trustee.

If the settlor of the trust expressly addresses the trustee's powers, in either the conveyance document or the trust agreement, the settlor's expressed directions will control over generally authorized statutory or common law powers.[8] For example, if the trust agreement states the trustee cannot enter into oil and gas leases covering the property held in trust, this express direction of the settlor will control over a statutory authorization to lease the property.[9] Therefore, we must always

begin our analysis of the trustee's powers by examining the documents by which the property was conveyed into trust plus any trust agreement prepared by the settlor prior to or contemporaneous with the conveyance.

Step 1: Obtain And Examine Trust Conveyance And Trust Agreement.

If the trust conveyance and trust agreement fail to address the matter, step two of our analysis is to determine whether there are any applicable statutes which confer authority on the trustee to act.

Step 2: Examine Applicable State Trustee Powers Statutes.

Before we can examine the state statutes, we must determine which state's law applies. For example, if the settlor, while living in Kentucky, creates a trust covering oil and gas properties in Kansas, which state's law will apply to determine the scope of the trustee's powers? What if the trustee is a resident of Illinois? These are called "conflict of laws" issues.

If the trust conveyance or trust agreement specify what state's law will apply to determine the trustee's powers, the settlor's desires will control.[10] If the settlor fails to address the issue, various conflict of laws rules will be applied to determine which state's law will be used to define the trustee's powers. To the extent oil and gas is classified as an "interest in land," administration issues will be determined by the law of the "situs"[11] of the affected land.[12] The law of the situs will also govern issues relating to whether a trust covering the interest in land has been properly created.[13] However, in each of these cases it is assumed the oil and gas interest is properly classified as an "interest in land." After determining which state's law to apply, the appropriate statutes can be identified.

1. **Statutory Powers: Illinois**

A potentially useful statute concerning trustee powers is Ill. Ann. Stat. ch. 17, 1678 (Smith-Hurd 1981), which states:

> Anyone dealing with the trustee is not obligated to inquire as to the trustee's powers or to see to the application of any money or property delivered to the trustee and may assume that the trust is in full force and effect, that the trustee is authorized to act and that his act is in accordance with the provisions of the trust instrument.

Note this protection only applies if you are in fact dealing with "the trustee." Therefore, the first task is to obtain evidence that a trust has been created and that the person purporting to act is the trustee. A copy of the conveyance creating the trust, and the trust agreement, will at least identify the original trustee. If you are dealing with a successor trustee, you will need to ensure the successor trustee has been properly appointed.[14] If there are co-trustees, unless the trust conveyance or agreement indicate otherwise, the co-trustees must agree on any action taken on behalf of the trust.[15] When there are three or more trustees, a majority can take action on behalf of the trust after giving written notice of the proposed action to all trustees.[16]

Once satisfied you are dealing with "the trustee," Ill. Ann. Stat. ch. 17, 1678 will permit you to assume the trustee has the power to act. For example, under a similar provision in Kansas- -Kan. Stat. Ann. 58-1207,[17] the Kansas Title Standards would permit you to rely on the trustee's representations of authority to convey trust property.[18] However, a "note" to the Kansas Title Standard on this subject provides:

> The trust may contain powers which diminish the powers given under K.S.A. 58-1207 and the deed should refer to the powers of the trustee to convey by reference to the date and terms of the instrument . . . .[19]

The Title Standard is circular, to determine if the trust contains limitations on the effect of 58-2207, you must examine (and interpret) all relevant trust instruments--the very task statutes like Kan. Stat. Ann. 58-2207 and Ill. Ann. Stat. ch. 17, 1678 were arguably designed to avoid. It is doubtful such statutes were intended to eliminate diligence and prudent business practices. Therefore, it will be necessary to examine all relevant trust documents and, if they fail to address the issue, examine the pertinent statutes.

Illinois has an unusually detailed statute concerning a trustee's authority to engage in the routine administration of oil and gas interests. Ill. Ann. Stat. ch. 17, 1674.2 provides:

[The trustee has the powers specified in 1674.2][20]

> To drill, mine and otherwise operate for the development of oil, gas and other minerals; to enter into contracts relating to the installation and operation of absorption and repressuring plants; to enter into unitization or pooling agreements for any purpose including primary, secondary or tertiary recovery; to place and maintain pipe lines; **to execute oil, gas and mineral leases, division and transfer orders, grants, deeds, releases and assignments and other instruments;** to participate in a cooperative coal marketing association or similar entity; **and to perform such other acts as the trustee deems appropriate, using such methods as are commonly employed by owners of such interests in the community in which the interests are located.**[21]

In addition to specifically authorizing routine acts, such as executing division and transfer orders, the statute contains a catch-all phrase permitting the trustee to do whatever is commonly done by "owners of such interests in the community in which the interests are located."[22] Once you have determined you are dealing with a trustee, and that the trust conveyance and trust agreement fail to address the issue, you can safely rely upon Ill. Ann. Stat. ch. 17, 1674.2 as authority for the trustee to properly bind the trust to routine oil and gas production and marketing activities.

2. Statutory Powers: Kansas and Kentucky

Kansas and Kentucky each have statutory powers patterned off the Uniform Trustees' Powers Act.[23] Each state expressly protects third persons who deal with trustees through

provisions similar to Ill. Ann. Stat. ch. 17, 1678.[24] The Kansas version, found at Kan. Stat. Ann. 58-1207, states:

> With respect to third persons other than attorneys, auditors, investment advisors or agents employed by the trustee, dealing with a trustee or assisting a trustee in the conduct of a transaction, the existence of trust powers and their exercise by the trustee may be assumed without inquiry. Third persons are not bound to inquire whether the trustee has power to act or is properly exercising the power; and third persons, without actual knowledge that the trustee is exceeding his or her powers or improperly exercising them, are fully protected in dealing with the trustee as if the trustee possessed and properly exercised the powers he or she purports to exercise. Third persons are not bound to assure the proper application of trust assets paid or delivered to the trustee.[25]

The Kentucky version is found at Ky. Rev. Stat. Ann. 386.830 and provides:

> With respect to a third person dealing with a trustee or assisting a trustee in the conduct of a transaction, the existence of trust powers and their proper exercise by the trustee may be assumed without inquiry. The third person is not bound to inquire whether the trustee has power to act or is properly exercising the power; and a third person, without actual knowledge that the trustee is exceeding his powers or improperly exercising them, is fully protected in dealing with the trustee as if the trustee possessed and properly exercised the powers he purports to exercise. A third person is not bound to assure the proper application of trust assets paid or delivered to the trustee.[26]

Each statute appears to place a premium on ignorance of the trustee's actual authority to act on behalf of the trust. If the third party lacks "**actual knowledge** that the trustee is exceeding his powers or improperly exercising them," they will be "**fully protected** in dealing with the trustee." The trustee's authority to act "may be assumed **without inquiry**." This creates a dilemma for the diligent: the more you inquire, the more you know, resulting in increased "knowledge" and decreased protection under statutes such as Kan. Stat. Ann. sect. 58-1207 and Ky. Rev. Stat. Ann. sect. 386.830. However, it would appear imprudent not to make some inquiry into the trustee's power to act. The main concern, in the division order context, should be ensuring the money is properly paid, not whether you will be ultimately held liable if it is improperly paid. There is no case law in Illinois, Kansas, or Kentucky addressing the scope of this type of statute. Under these circumstances, the only prudent course of action would be to inquire into the trustee's authority to act on behalf of the trust.

MY VIEW

The Kansas and Kentucky statutes follow sect. 7 of the Uniform Trustees' Powers Act.[27] The purpose of sect. 7 must be considered in conjunction with sect. 3 of the Uniform Act. Section 3(a), which is identical to Kan. Stat. Ann. sect. 58-1203(a) (1983) and Ky. Rev. Stat. Ann. sect. 386.810(1) (Michie/Bobbs-Merrill 1984), gives the trustee the authority "to perform . . . every act which a prudent man would perform for the purposes of the trust . . . ."[28] Absent a statute similar to sect. 7, persons dealing with a trustee would have the impossible burden of determining whether the trustee was, in fact, acting in a prudent

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manner to perform the purposes of the trust.[29] At common law a person dealing with a trustee assumes the risk that the trustee may not be acting within the scope of its authority.[30] Section 7 was intended to relieve the third party from making inquiry into the trustee's authority. If the third party deals with the trustee, without having actual notice of a limitation on the trustee's authority, the trustee's actions will bind the trust. Although the trustee will be liable to the trust beneficiaries for a breach of trust, the beneficiaries will not be able to rescind the transaction.[31]

However, sect. 2 of the Uniform Act,[32] like Kan. Stat. Ann. sect. 58- 1202(a) (1983) and Ky. Rev. Stat. Ann. sect. 386.805(1) (Michie/Bobbs- Merrill 1984), provides:

> The trustee has all powers conferred upon him by the provisions of this Act **unless limited in the trust instrument** . . . .

Can the settlor of the trust effectively limit the scope of statutes like sect. 7 of the Uniform Act by express provisions in the trust conveyance or trust agreement? Such a provision would require third parties to make inquiry[33] into the trustee's authority to act. Charles Horowitz, the Chairman of the Special Committee which drafted the Uniform Trustees' Powers Act, offers the following comment concerning the interplay of sect. 2 and sect. 7:

> A more difficult question is whether a trustor purporting to act under section 2 may exclude the operation of section 7 and thereby restore a third party's duty of inquiry. Such an exclusion, if permitted, would mean that a third person dealing with a trustee would always have to inquire or examine the trust instrument to see if section 7 had been excluded. Such an obligation would impose the duty of inquiry even in cases where no limitation or prohibition had been imposed upon the exercise of trust powers. To impose such a duty of inquiry would prevent the operation of section 7 as intended and provided. Because the consequence of permitting a trustor to exclude the operation of section 7 would be to restore the duty of inquiry even in cases where clearly not intended, it is believed that an express exclusion should be ineffective. The remedy for breach is limited to the trustee and a third person with actual knowledge that the trustee is exceeding his powers or improperly exercising them.[34]

Without any case law addressing the issue in Kansas or Kentucky, the only safe practice is to make inquiry concerning the trustee's authority by examining the trust conveyance and trust agreement. If these documents do not address the issue, the statutes should be consulted to determine what authority the state has conferred on the trustee.

The Kansas and Kentucky statutes authorize the trustee:

(a) . . . [T]o perform, without court authorization, every act which a prudent man would perform for the purposes of the trust including but not limited to the powers specified in subsection (c) [subsection "(3)" in the Kentucky version].

(b) In the exercise of powers including powers granted by this act, a trustee has a duty to act with due regard to the obligation as a fiduciary.

(c) A trustee has the power, subject to subsections (a) and (b):
. . . .

(2) to receive additions to the assets of the trust;
. . . .

(11) to enter into a lease or arrangement for exploration and removal of minerals or other natural resources or enter into a pooling or unitization agreement;
. . . .

(20) to allocate items of income or expense to either trust income or principal, as provided by law, including creation of reserves out of income for depreciation, obsolescence or amortization, or for depletion in mineral or timber properties;
. . . .

(26) to execute and deliver all instruments which will accomplish or facilitate the exercise of the powers vested in the trustee;
. . . .[35]

Although none of these express statements mention, like the Illinois statute,[36] the execution of division or transfer orders, the trustee's actions would be actions "which a prudent man would perform for the purposes of the trust." This is also the situation where the courts would be most inclined to apply the protections of sect. 7 of the Uniform Act.[37]

3. Common Law Powers

Common law powers are those powers, or restrictions on authority, created by courts. Common law powers must be considered in two contexts:

1. When the matter is not addressed in the trust conveyance, the trust agreement, or state statutes, the next place to turn for guidance are court opinions which discuss and define a trustee's authority to act.

2. When there is a statute addressing the issue, such as the Uniform Trustees' Powers Act, but the trust was created prior to the effective date of the statute. For example, Illinois, Kansas, and Kentucky each limit the effect of their trustee powers statutes to a specified time frame. In Illinois, the Trusts and Trustees Act "applies to every trust created by will, deed, agreement, declaration or other instrument, **except that the provisions of Section 4 dealing with powers of trustees applies only to trusts executed on or after October 1, 1973** . . . ."[38] In Kentucky, the act applies to trusts established after June 19, 1976.[39] In Kansas the critical date is July 1, 1968.[40]

Since the enactment in Illinois, Kansas, and Kentucky of broad trustee power acts, most trust administration issues will be resolved either by interpreting the trust documents or the

trust statutes. The common law principles will be applied most often when dealing with a trust established before the effective date of the trust act. In the few situations where the trust documents, statutes, or cases fail to adequately define the trustee's authority, the trustee can always seek special authority from the courts.[41]

III. Estate Administration

A. Function of Estate Administration

Estate administration is typically viewed, by the non-legal world, as something to be avoided. However, in many cases it will be absolutely necessary to render title to mineral interests marketable, and to permit the continuing purchase of production from a well. When someone dies owning property, an orderly process must be available to accomplish the following tasks:

1. **Place someone in charge to identify, collect, and preserve the decedent's property.** This person or entity is called the "administrator" if the decedent died without a will, and an "executor" if the decedent died with a will. While the estate is being administered, the executor or administrator will have control over the decedent's property and will often be collecting production proceeds for the estate.[42] The process for determining the authority of the executor is very similar to the trust situation. First you look to the will to see what powers were conferred on the executor by the decedent. If the matter is not addressed in the will, you need to determine whether a state statute addresses the issue.[43] If there is no contractual or statutory grant of authority, it will be necessary to obtain court authority to act. The administrator's authority must be found in the state statutes or be established by order of the court.

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2. **Provide the decedent's creditors with an opportunity to file claims against the decedent's estate and permit the administrator to either pay or contest the claims.** This process also clears the decedent's property of any debts which a creditor could have filed a claim for during the statutory claim period.[44]

3. **Determine all federal and state tax liability associated with the decedent's death and the transfer of their property.** To pass marketable title, it is necessary to determine whether any taxes are due because of the decedent's death. Taxes could include the decedent's final income tax, taxation of income earned by the estate during administration, state inheritance tax (in most states), state estate tax (in some states), and federal estate tax.

4. **Determine who is entitled to the decedent's real and personal property.** This is the function that is focused upon most often. Included in this ownership function is the application of any rights a spouse may have to elect against a will,[45] and homestead and similar statutory allowances for surviving spouses and the decedent's children.[46]

1. Determining Ownership of a Decedent's Property

Consider the following hypothetical. Mary owns the following property:

1. All the minerals in Section 30, Township 36 South, Range 10 East of the 6th Principal Meridian in Eureka County, Kansas.

   The oil and gas rights in this property are currently leased to Acme Oil Company. The lease provides for a 1/8th royalty. A producing well is located on the leased land; it produces oil and gas. The oil is sold to Crude Purchasing, Inc.; the gas is sold to Interstate Gas Company.

2. An undivided 50% working interest in an Oil and Gas Lease between Levi and Major Oil Company covering the oil and gas in Section 21, Township 30 South, Range 10 East of the 6th Principal Meridian in Eureka County, Kansas.

   The lease provides the working interest owners with a 7/8ths net revenue interest. A producing well is located on the leased land; it produces oil which is sold to Ace Crude Company.

   Assume Mary dies. **On the date of her death**, there are the following production proceeds from Mary's oil and gas interests in the possession of the purchasers:

(1)	Crude Purchasing, Inc.	$15,000
(2)	Interstate Gas Company	5,000
(3)	Ace Crude Company	30,000

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Each purchaser continues to take production from Mary's mineral interests following her death. Who is entitled to the unpaid proceeds for production purchased **prior** to Mary's death? Who is entitled to unpaid proceeds for production taken **after** Mary's death? If any of the interests were held in joint tenancy, the surviving joint tenants would own the oil and gas interests, and production proceeds accruing **after** Mary's death, in equal shares; it would be a fairly simple matter of filing for record adequate proof of Mary's death and proof that all taxes associated with Mary's death have been paid.[47] However, the facts indicate the property was owned by Mary in her sole name. Therefore, ownership of the production proceeds, past and future, will be determined by Mary's will, if she has one--and if it is timely offered for probate.[48] If Mary does not have a will, or it is not timely offered for probate, Mary's property will pass as specified by the appropriate state's "intestacy" laws.[49]

Ownership of the proceeds from production prior to Mary's death may be different from ownership of proceeds after Mary's death. The proceeds **prior to** Mary's death

are personal property and will pass to the successor to Mary's personal property. However, **future** proceeds belong to the owner of the underlying interest generating the proceeds; in our case, the successor to Mary's ownership of the mineral interest in Section 30 and the oil and gas leasehold interest in Section 21. In Kansas, the mineral interest will be classified as an interest in real property; the leasehold interest is considered personal property.[50] The administration process will identify the successors to Mary's personal and real property.

2. Determining Ownership Without Administration

Suppose Mary's will is not offered for probate. Or if Mary does not have a will, suppose proceedings are never instituted to administer her estate. Under these circumstances, administration may be avoided in some situations, under a state procedure to "determine descent." For example, in Kansas the heirs of Mary could rely upon Kan. Stat. Ann. 59-2250, which provides, in part:

> Whenever any person has been dead for more than six months[51] and has left property or any interest in property, any person interested in the estate or claiming an interest in such property may petition the district court of the county of the decedent's residence, or of any county where property or any interest in property of the decedent is situated, to determine its descent under the laws of intestate succession or under the terms of a valid settlement agreement . . . .[52]

However, if it has been less than ten years since Mary's death, the court will not issue a decree of descent until inheritance taxes are determined and paid.[53] Once the taxes are taken care of, and the decree of descent issued, the heirs of Mary can obtain marketable title to Mary's property by filing a complete transcript of the proceedings with the district court of each county where Mary owned interests in land.[54]

In many situations the determination of descent alternative will not be workable for the parties. For example, suppose Mary had a will in which she leaves all her estate to her husband. If the husband wants to avoid sharing Mary's estate with their minor children, he must offer the will for probate to avoid having the property pass by intestate succession. Although many states have enacted procedures to avoid full-blown administration,[55] some form of administration will usually be required when dealing with oil and gas interests. Since the purchaser will usually be concerned with paying out proceeds for production after the decedent's death, the purchaser must ensure they are dealing with the correct owners of the property from which the production is being taken.

Currently, the only safe way to ensure you are dealing with the proper party is to require some sort of proceeding by which a court finds that title to the property has vested in named parties. To the extent something less is relied upon, it should be identified as a conscious business risk and treated as such.

B. Administering The Nonresident Decedent's Estate

Suppose full-blown administration of the decedent's estate has been completed in the state where the decedent lived at the time of their death. What impact will this proceeding have on property located outside the administering state? Using our hypothetical, suppose Mary was domiciled in Kentucky at the time she died and her estate has been fully administered in Kentucky. Will the Kentucky proceeding clear title to her property in Kansas? In Illinois? If the property concerns an interest in land, such as oil and gas interests, the proceedings in Kentucky will not clear title to Mary's interests in Kansas and Illinois. The extent to which Mary's estate will require administration in another state will depend upon the law of her domicile and the law of the state where the property is located.

For example, if Mary was residing in Kentucky at the time of her death, and her estate has been administered in Kentucky, it will be necessary for her executor or administrator to take action in Kansas to clear title to her Kansas mineral property. Generally, as to the decedent's Kansas property, the nonresident's property is administered, with some exceptions,[56] the same as if the person died a resident of Kansas.[57] If Mary dies without a will, and the parties are able to wait six months following her death, administration in Kansas could be avoided by conducting a determination of descent.[58] If Mary had a will, but there is no administration in Kentucky, her will can be probated in Kansas. However, if the will is probated in Kentucky, and it is possible to wait six months before dealing with the property in Kansas,[59] Kan. Stat. Ann. 59-806(a)(1) permits the filing of an authenticated copy of the Kentucky probate transcript with the Kansas district court in the county where the property at issue is located.[60] The district court judge can then determine whether administration is necessary.[61]

Procedures for dealing with the property of a nonresident vary widely from state to state. For example, if Mary owned personal property in Illinois, her executor or administrator in Kentucky may be able to collect the personal property using an affidavit procedure.[62] Such a procedure can protect a production purchaser in distributing accrued production proceeds to an **executor or administrator**, but does not protect them if they distribute to persons they believe are the heirs, devisees, or legatees of a decedent. **Although there are various abbreviated procedures that can sometimes be employed to determine who is entitled to a nonresident decedent's estate, some form of judicial action to clear title to the decedent's oil and gas interests will be required.**

IV. Forced Pooling

A. Basic Concepts

All producing states limit, to some extent, the spacing of wells.[63] The spacing statute, or regulation promulgated pursuant to statutory authority, may limit drilling to a minimum distance from property boundary lines and establish a minimum distance between wells. The boundary line restriction is designed to protect adjacent properties from drainage. The minimum distance

between wells, even though on a single lease and distant from adjacent properties, is designed to control the density of development. For example, the Kentucky spacing statute provides, in part:

> [N]o permits shall be issued for the drilling . . . of any shallow well[64] for the production of oil, unless the proposed location of the well shall be at least three hundred thirty (330) feet from the nearest boundary of the premises upon which the well is to be drilled . . . and, the proposed location must be at least six hundred sixty (660) feet from the nearest oil producing well.[65]

In addition to these "state-wide" rules, the administrative agency that regulates oil and gas conservation matters can establish special "field" rules that may require a different spacing pattern.[66] The conservation agency can also grant exceptions to the state-wide and field rules when necessary to protect correlative rights or prevent waste of the oil and gas resource.[67]

If a developer owns a lease covering a tract of land that is not large enough to satisfy the minimum spacing requirements, they will need to "pool" their lease with other properties.[68] Additional lands will be pooled with the developer's lease to assemble a tract that will satisfy the spacing requirements. Pooling can be either voluntary or "forced" by an order of the state conservation agency. The developer can sometimes achieve voluntary pooling relying upon the pooling clauses in its oil and gas leases. For example, if the developer owns separate leases covering tracts **A** and **B**, and each lease contains a pooling clause which is broad enough to accomplish the necessary pooling, the lessee has, in effect, obtained the prior approval of its lessors to the pooling. If each pooling clause is not broad enough to cover the proposed pooling, or one or both of the leases lack a pooling clause, or the leases are owned by separate developers, the parties will need to enter into a separate agreement which expressly pools their interests.

If the pooling has been accomplished by voluntary agreement, either under the pooling clause or a separate agreement, the terms of the clause or agreement will control in determining each party's share of production.[69] Most lease forms which contain a pooling clause either require or contemplate that the lessee will file a document for record which evidences that they have exercised their right to pool.[70] This document is commonly titled a "Declaration of Pooling." Since this document, like a separate pooling agreement, designates how production will be divided between the parties, it should be shown of record. If the parties cannot agree, the well will either not be drilled, or the developer will seek assistance from the state either in the form of forced pooling or an exception to the spacing requirements.

All major producing states, except Kansas, provide for some form of forced pooling. "Forced pooling" simply means the state, through statute and regulatory action by the conservation agency, forces a combination of acreage, and rights in such acreage, so the oil and gas in the pooled unit can be developed in accordance with spacing requirements. Although developers in Kansas lack direct statutory assistance from the state in pooling interests, it does not appear that orderly development has been impaired.[71] In Illinois and Kentucky, the developer is aided by comprehensive pooling statutes which can be used to force other interest owners into a pooled unit.[72] For example, the Kentucky statute provides, in part:

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> (1) Whenever any separate tract of land is so situated because of size or other condition that it does not contain a location at which a well for oil or gas may be drilled . . . , the department shall order, after notice and hearing, the pooling of all oil and gas interests in the separate tract or in a portion thereof with all like interests in a contiguous tract or tracts, or portions thereof, as are necessary to afford the pooled tracts one (1) location for the drilling . . . of a well for the production of oil or gas in compliance with the spacing requirements . . .[73]

Once the oil and gas conservation agency hears the pooling application, it will issue a pooling "order" that establishes each party's right to participate in developing the pooled unit. The order will also state each party's share of production proceeds in the event production is obtained from the pooled unit. In Kentucky the statute governing the pooling order provides, in part:

> (2) A pooling order shall authorize the drilling . . . and the operation of a well for the production of oil or gas on the tracts . . . pooled; shall designate the operator . . . ; shall prescribe the time and manner in which all owners in the pooled tracts . . . may elect to participate therein; shall provide that all reasonable costs and expenses of drilling, . . . completing, operating, plugging and abandoning the wells shall be borne, and all production from the well shall be shared by all owners of operating interests in proportion to the net mineral acres in the pooled tracts owned or under lease to each owner; and shall make provision for the payment of the reasonable actual costs thereof, including a reasonable charge for supervision, by all those who elect to participate therein.[74]

A major function of the pooling hearing, and the resulting pooling order, is to define how unleased mineral interest owners and other operating interest owners will be treated. Must they pay a proportionate share of the drilling costs? Can they set back and have costs deducted from any production credited to their account in the event a producing well is obtained? Can they be forced to sell their interest or accept a nonparticipating interest such as an overridng royalty or royalty? These issues are addressed in the following section.

B. Options for the Nonconsenting Interest Owner

In dealing with nonconsenting interest owners,[75] the conservation agency is guided by what is "just and reasonable" and what will give each party in the pooled unit "the opportunity to recover and receive their just and equitable share of oil or gas from the drilling unit without unreasonable expense . . . ."[76] The pooling order gives each owner of development rights "the opportunity" to participate in development of the pooled unit. However, participation in development requires some agreement concerning the cost and risk of development. These matters must be addressed by the pooling order.[77] In Illinois the order must specifically:

> [P]rescribe the time and manner in which all the owners[78] in the drilling unit may elect to participate therein; and make provision for the payment by all those who elect to participate therein of the reasonable actual cost thereof, plus a reasonable charge for supervision and interest. **If requested, each such integration order shall further provide for one or more just and equitable alternatives whereby an owner who does not elect to participate in the risk and cost of the drilling and operation, or operation, of a well may elect to surrender his leasehold interest to the participating owners on some reasonable basis and for a reasonable consideration which, if not agreed upon, shall be**

determined by the Department [of Mines and Minerals], or may elect to participate in the drilling and operation, or operation, of the well on a limited of carried basis upon terms and conditions determined by the Department to be just and reasonable.[79]

The Illinois statute also provides for recovery of a "risk factor" on the costs of drilling, completing, equipping, and operating the well. If some of the owners decide to participate in development, but other owners elect to be "carried," the owners who assume the risk of development are entitled to collect, out of production credited to the carried owners, each carried owner's proportionate share of the following amounts:

1. 150% of the cost of drilling, testing, and completing the well; and

2. 100% of the cost of surface equipment and operating expenses.[80]

When recouping costs from a carried owner, 1/8th of the production will be exempt to account for royalty obligations.[81]

Kentucky has two separate statutes which deal with the pooling order. The first, Ky. Rev. Stat. Ann. 353.640,[82] deals will all wells except "deep" wells.[83] Deep well pooling is addressed by Ky. Rev. Stat. Ann. 353.651.[84] The major difference between the two statutes is that for deep wells, a risk factor equal to 125% of the drilling and operating costs can be recovered from carried owners.[85] Under both statutes, an owner of an "operating interest" that elects not to participate in the drilling of the unit well must be given one or more of the following alternatives:

1. Surrender all or part of their interest to the participating owners for "reasonable consideration;" or

2. Participate on a "carried basis" on just and reasonable terms established by the director of oil and gas conservation.[86]

An unleased mineral interest owner is treated as an "operator" as to 7/8ths of their interest and as a "royalty owner" as to 1/8th.[87]

When dealing with production from a force pooled unit, it will be necessary to obtain a copy of the pooling order.[88] The order should be carefully reviewed to determine if there are any elections which were offered to nonparticipating owners of operating interests. In many cases it will be necessary to supplement the order with proof of the election that was made. For example, if the nonparticipating operating interest owner agreed to accept a cash payment and a 1/16th of 8/8ths overriding royalty in exchange for their operating interest, this should be shown either in the final order or a certified copy of the supplemental proceedings in which the election was approved. Since the Illinois and Kentucky statutes provide for alternatives to be settled either by agreement or agency action, the terms of the agreement, or the agency action, must be established.

Another problem for production purchasers is administering the "carried interest" and the shift of each party's status upon "payout." Division orders usually shift any risk associated with the

determination of payout onto the respective owners of the carrying operating interest and the carried interest. The burden is placed upon the parties to the carrying arrangement to inform the purchaser when payment to the carrying interest owner should be altered. If a lessee elects to be carried, it will not affect the payment of production proceeds to their royalty owner--to the extent the royalty does not exceed 1/8th. In Illinois, if the leased mineral interest owner's royalty exceeds 1/8th, the excess will need to be contributed by the carried lessee until the lessee's share of costs are recouped by the participating owners.[89] Presumably, any nonparticipating royalty and overriding royalty interests covering the leased land would have to be paid by the carried lessee. In Kentucky, as to deep wells, such excess royalty, nonparticipating royalty, and overriding royalty, will be paid from the carried interest owner's share of production before the carrying parties can recoup their costs.[90] The provisions as to shallow wells do not expressly mention overriding royalty or assignments. Instead, only "royalty reserved in any lease or leases" can be paid from the carried interest owner's share of production.[91] Apparently, any nonparticipating royalty interests and overriding royalty interests would have to be paid by the carried lessee--even though the carried lessee will not receive any production proceeds from the well until payout.

V. Royalty Payment

A. Statutory Obligations

In 1985, Illinois enacted a statute governing the timely distribution of production proceeds.[92] The statute provides that the "payor"[93] will distribute production proceeds within 150 days after the end of the month they commence purchasing from the well.[94] Following the initial payment, payments on oil production must be made within 60 days after the end of the month in which production was sold. Gas production payments must be made within 90 days after the end of the month in which production was sold.[95] However, the 60- and 90-day dates can be altered by written agreement between the payor and payee.[96] For small interests, the payor is permitted to accumulate proceeds for up to 12 months so long as the total amount owed is $25 or less.[97]

If payments are not made within the specified time periods, interest will accrue on the unpaid sums **"beginning at the expiration of those time limits."**[98] The rate of interest will be the rate **"charged on loans to depository institutions by the New York Federal Reserve Bank,"** unless the parties agree to a different rate of interest.[99] Arguably, a division order provision which states that no interest will be paid is superceded by the statutory provision for interest.

The statute provides for a number of situations where failure to pay in a timely manner will be excused. The statute provides for the following exception to prompt payment:

1. [A] dispute concerning title that would affect distribution of payments;

2. a reasonable doubt that the payee does not have clear title to the interest in the proceeds of production; or

3. a requirement in a title opinion that places in issue the title, identity, or whereabouts of the payee and that has not been satisfied by the payee after a reasonable request for curative information has been made by the payor.[100]

The statute excuses timely payment and the accrual of interest on the money held in suspense because of the listed title problems.[101] Before any action can be brought under the statute to collect interest, and enforce the prompt payment provisions, the payee must give the payor "written notice by mail" of their claim. The payor then has 30 days in which to make payment or state in writing the reason for nonpayment.[102] The Illinois statute imposes only minor burdens on the production purchaser. The legislatures of Kansas and Kentucky have not yet passed statutes addressing the timely distribution of production proceeds.

B. Gas Balancing Problems

Suppose lessee **A** and lessee **B** each own a 50% working interest in the Smith 1-30 Well. **A** has been involved in a take-or-pay dispute with Acme Interstate Pipeline Company and therefore **A** has not been marketing any gas from the well for over a year. However, **B** has been producing 100% of the gas and marketing it as though it was **B**'s gas. **B** has been paying royalty to its lessor based upon 100% of the gas it produces. Since **A** has not been marketing any gas, **A** has not been paying any royalty to its lessor. The well is producing 1,000,000 cubic feet of gas each day. **A** and **B** contemplate that at some later date **A** will be able to catch-up by taking part of **B**'s 50% share of the gas stream until their takes from the well are in balance. Is **A**'s royalty owner entitled to a royalty on 50% of all gas produced from the well? To what extent is **A**'s royalty owner bound by the terms of an operating agreement or gas balancing agreement between **A** and **B**?

There are no cases or statutes in Illinois, Kansas, or Kentucky which address this issue. The cases from other states, most notably Oklahoma, turn on the application of a pooling statute which specifically addresses the issue.[103] However, it would seem most of these cases could be resolved by the express terms of the lease royalty clause. Most oil and gas leases provide for the payment of a royalty on gas "**produced from said land and sold or used off the premises.**" Since gas has been produced from the land, and sold or used off the premises, royalty would appear to be due under the express terms of the lease contract. It would appear that the royalty owner should be paid currently for their proportionate share of the amount of gas that is being credited to **A**'s balancing account--even though **A** is not marketing any of the gas.

VI. Oil and Gas Law Update: Recent Cases

A. The New Math of Oil and Gas Law: 1/16 = 1/2

In Powell v. Prosser,[104] the court interprets the effect of a document titled "Oil and Gas Royalty Conveyance." The granting clause conveys "an undivided one sixteenth (1/16) interest in and to all of the oil, gas and other minerals in and under and that may be produced from . . . described land . . . ."[105] After describing the property, the conveyance document provides:

> [T]his conveyance is made subject to . . . [a described] oil and gas lease and covers and includes one half (1/2) of the oil royalty and gas rental or royalty that may become due and be paid or delivered under the terms of said lease.
>
> It is agreed . . . that should said oil and gas lease be terminated for any reason, that the grantor . . . may at any time lease the above described premises for oil and gas and other mineral privileges without the permission or consent of the said grantee . . . provided, however, that such lease shall provide that the said grantee . . . shall receive a one sixteenth (1/16) of the oil and gas that may be produced under such lease . . . .
>
> It is further agreed . . . that the grantee . . . shall be entitled to one half (1/2) of all bonus or consideration paid for any oil and gas lease that may be made covering said premises and one half (1/2) of all rentals that may be paid thereunder . . . the grantor . . . shall have the full power to determine the bonus and consideration to be received from any such oil and gas or other mineral lease and the rentals to be paid thereunder without the consent, permission or approval of the grantee . . . .[106]

The court initially had to determine whether a "mineral interest" or a "royalty interest" had been conveyed. The court concludes that a nonexecutive mineral interest had been conveyed with the grantee entitled to receive one half of the bonus and delay rental provided for in any subsequent lease.[107]

However, a more difficult question is the size of the fractional mineral interest: is it a 1/16th mineral interest or a 1/2 mineral interest? The granting clause clearly conveys a 1/16th mineral interest. However, the subsequent provisions in the deed suggest that the grantee will share in 1/2 of all present and future lease benefits. The court relies upon a judicial observation about oil and gas conveyancing that has become a rule of judicial construction in Kansas: When conveying mineral interests subject to an oil and gas lease, mineral interest owners incorrectly believe they only own a 1/8th royalty instead of 100% of the minerals-- subject to the terms of the oil and gas lease. Therefore, if I believe I only own a 1/8th royalty, and I want to convey to someone 1/2 of my leased mineral interest, I may incorrectly convey to them a 1/16th royalty.[108] Applying this rule of construction, the court concludes, as a matter of interpretation, 1/16th in the granting clause actually means 1/2.[109]

Although the court's holding in Powell v. Prosser is consistent with the Kansas Supreme Court's holding in a very similar case, Heyen v. Hartnett,[110] the court in Powell was able to avoid determining whether the conveyance is **ambiguous**.[111] However, the Supreme Court, in Heyen v. Hartnett, addressing a similar conveyancing problem, finds the deed to be ambiguous and considers evidence extrinsic to the deed to aid its interpretation.[112] This creates a real dilemma for persons having to determine ownership of the mineral interest. To resolve the ambiguity, it will usually require litigation.

B. Gutting the Proportionate Reduction Clause

The Kentucky Court of Appeals, in E.H. Lester Leasing Co. v. Griffith,[113] considers the operation of a proportionate reduction clause when leasing a mineral interest that is subject to preexisting nonparticipating royalty interests. In 1919, the lessor's predecessors in title conveyed perpetual

1919 A → B 1/8th of all production from 330
1950's A → Griffith (minerals) → E.H. Lester Leasing (1982 leases)

nonparticipating royalty interests which entitled the grantees to 1/8th of production from the land. In 1982, Griffith, the current owner of the mineral interest, entered into an oil and gas lease which contained the following proportionate reduction clause:

> If said lessor owns a less interest in the above described land than the entire undivided fee simple estate therein, then the royalties and rentals herein provided shall be paid to the lessor only in the proportion which his interest bears to the whole and undivided fee.[114]

The lessee argued that the 1/8th nonparticipating royalty interest must be satisfied out of the lessor's 1/8th share of production.[115] This would leave the lessor with no production from the leased land. To avoid this result, the trial court treats the 1/8th nonparticipating royalty interest, for purposes of the proportionate reduction clause, as though it is a 1/8th mineral interest. The effect was to reduce the lessor's royalty to 1/8th of what the court characterizes as a 7/8ths mineral interest. Therefore, the lessor becomes entitled to 1/8th x 7/8ths or 7/64ths of total production.[116] In affirming the trial judge's ruling, the Court of Appeals holds:

> Here we find a situation in which the lessor's right to lease the mineral estate is encumbered by a 1/8 perpetual royalty interest. The bargain he struck pursuant to the lesser interest clause requires that his interest be reduced to 1/8 x 7/8 or 7/64th's because that is the extent of his interest. Were it otherwise, we believe the lease should be cancelled due to failure of consideration--it would be an absurd inequity to require the lessor to give up his interest in the minerals below his land, put up with the inconvenience attendant to production and receive nothing in return.[117]

Therefore, the lessor contributes only 1/64th towards satisfying the 1/8th nonparticipating royalty interest; the remaining 7/64ths must be paid from the lessee's share of production. **Lessee devised the proportionate reduction clause to avoid just this sort of problem.** The function of the proportionate reduction clause, where the lease provides for a 1/8th royalty, is to ensure the lessee has a net revenue interest of not less than 56/64ths of production. As applied by the court in the E.H. Lester Leasing Co. v. Griffith case, the lessee's net revenue interest will only be 49/64ths. Although not articulated by the court, the message the court is conveying is clear: if the lessee wants to have the entire nonparticipating interest deducted from the lessor's share of production, the lease should expressly provide for such a result. Arguably, the clause, as drafted, covers the situation. Consider the following scenario:

1. Does the lessor own a fee simple estate in the oil and gas? Answer: NO.
2. What does the lessor lack in the way of having a fee simple interest? Answer: He lacks a 1/8th cost-free share of production.
3. How should this deficiency be apportioned? Answer: The lessor shall be paid "only in the proportion which his interest bears to the whole and undivided fee."

The proportionate reduction clause in the E.H. Lester Leasing Co. case probably contemplates that only **mineral** interests will be held by others. It does not complete the verbal equation to determine the "proportion his interest bears to the whole and undivided fee" when the unowned

if there is one

interest is a **royalty** interest. However, other clauses of the lease would seem to resolve this ambiguity in favor of the **lessee**. Through the warranty clause, the lessor warrants that he owns 100% of the mineral rights in the property. Since he actually owns only 100% less a 1/8th royalty, a breach of warranty has occurred to the extent of the preexisting 1/8th royalty. The breach can be satisfied by reducing the lessor's rights to royalty under the lease to zero. The court avoids this analysis and instead adopts a rule which it deems "fair" to the lessor--the lessee, despite the proportionate reduction clause, must bear 7/8ths of the burden created by the preexisitng royalty interest. After the E.H. Lester Leasing Co. case, the lessee, leasing land in Kentucky, cannot safely rely upon the standard proportionate reduction clause to deal with preexisting royalty interests burdening the leased land.

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1 The Restatement (Second) of Trusts sect. 3 (1959) provides: sect. 3. Settlor, Trust Property, Trustee and Beneficiary

(1) The person who creates a trust is the settlor.
(2) The property held in trust is the trust property.
(3) The person holding property in trust is the trustee.
(4) The person for whose benefit property is held in trust is the beneficiary.

2 The Restatement (Second) of Trusts sect. 2 (1959) defines the trust as follows:

A trust . . . is a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.

3 See Shumway v. Shumway, 141 Kan. 835, 842, 44 P.2d 247 (1935).

4 Restatement (Second) of Trusts sect. 17 (1959).

5 See generally P. Haskell, Preface to the Law of Trusts 6-7 (1975).

6 Restatement (Second) of Trusts sect. 2 comment b (1959).

7 If the settlor retains the power to revoke the trust, we would need to examine any amendments to the trust agreement.

8 Kan. Stat. Ann. sect. 58-1202 (1983) provides, in part:

(a) The trustee has all powers conferred upon him or her by the provisions of this act unless limited in the trust instrument.
(b) ....
(c) Unless the instrument expressly states otherwise, the prudent man rule, as expressed in K.S.A. 17-5004, shall apply as the standard for the exercise of the powers conferred upon a trustee by the uniform trustees' powers act.

In Illinois, the Trust and Trustees Act provides, in part:

(1) A person establishing a trust may specify in the instrument the rights, powers, duties, limitations and immunities applicable to the trustee, beneficiary and others and those provisions where not otherwise contrary to law shall control, notwithstanding this Act. The provisions of this Act apply to the trust to the extent that they are not inconsistent with the provisions of the instrument.

Ill. Rev. Stat. ch. 17, para. 1653(1) (Smith-Hurd Supp. 1990). Kentucky has a provision similar to Kan. Stat. Ann. sect. 58-1202(a) (1983). See Ky. Rev. Stat. Ann. 386.805 (Michie/Bobbs-Merrill 1984).

9 Kan. Stat. Ann. 58-1203(11) (1983) expressly permits the trustee "to enter into a lease or arrangement for exploration and removal of minerals or other natural resources . . . ." Similar authorization is found in Illinois at Ill. Ann. Stat. ch. 17, para. 1674.2 (Smith-Hurd Supp. 1990) and Kentucky at Ky. Rev. Stat. Ann. sect. 386.810(k) (Michie/Bobbs-Merrill 1984).

10 Restatement (Second) of Conflict of Laws sect. 279 comment b (1971). Comment b provides, in part:

The courts of the situs [place where the oil and gas well is located] would usually apply their own local law to determine issues of administration. But if the testator or settlor provides that the local law of some other state shall be applied to govern the administration of the trust, or certain issues of administration, the courts of the situs would apply the designated law as to issues which can be controlled by the terms of the trust.

11 "Situs" refers to the location of the real property interest. For example, if the issue concerns whether the trustee can enter into an oil and gas lease covering a mineral interest situated in Kansas, the "situs" of the affected interest in land is in Kansas.

12 Restatement (Second) of Conflict of Laws sect. 279 (1971) provides:

The administration of a trust of an interest in land is determined by the law that would be applied by the courts of the situs as long as the land remains subject to the trust.

13 Restatement (Second) of Conflict of Laws, sect. 278 (1971) provides:

The validity of a trust of an interest in land is determined by the law that would be applied by the courts of the situs.
See generally R. Leflar, L. McDougal,III, R. Felix, American Conflicts Law subsect. 187, 191, 192 (4th ed. 1986).

14 See Ill. Ann. Stat. ch. 17, para. 1683 (Smith-Hurd 1981).

15 G. Bogert, Trusts sect. 91 (6th ed. 1987).

16 Ill. Ann. Stat. ch. 17, para. 1680 (Smith-Hurd 1981) ("If there are 3 or more trustees of a trust, a majority of the trustees are competent to act in all cases after prior written notice to, or written waiver of notice by, each other trustee, but a dissenting trustee has no liability for the acts of the majority."). Again, this assumes neither the trust conveyance nor the trust agreement provide otherwise.

17 Kan. Stat. Ann. 58-1207 (1983).

18 See Title Standards Handbook, Examination Standard 6.2 Trustee's Deed (Kan. Bar. Assoc. 1985).

19 Id.

20 See Ill. Ann. Stat. ch. 17, para. 1654 (Smith-Hurd Supp. 1990).

21 Ill. Ann. Stat. ch. 17, para. 1674.2 (Smith-Hurd Supp. 1990).

22 Id.

23 Uniform Trustees' Powers Act subsect. 1-13, 7B U.L.A. 743 (1985).

24 Ill. Ann. Stat. ch. 17, para. 1678 (Smith-Hurd 1981).

25 Kan. Stat. Ann. sect. 58-1207 (1983).

26 Ky. Rev. Stat. Ann. sect. 386.830 (Michie/Bobbs-Merrill 1984).

27 Uniform Trustees' Powers Act sect. 7, 7B U.L.A. 758 (1985).

28 Uniform Trustees' Powers Act sect. 3(a), 7B U.L.A. 746 (1985).

29 Horowitz, Uniform Trustees' Powers Act, 41 Washington L. Rev. 1, 28-29 (1966).

30 G. Bogert, The Law of Trusts and Trustees sect. 565 (1980). Bogert summarizes the rule stating:

At common law, a person who deals with another whom he knows to be a trustee is put upon inquiry as to the extent of the trustee's powers and charged with knowledge of the facts which a reasonable investigation would disclose. He is not entitled to assume that a power exists because the trustee asserts that he has such a power. There is no presumption that any power exists. The third party must examine the trust instrument and look to other sources of information in order to satisfy himself that the trustee has authority to enter into the transaction which he is seeking to consummate. He is charged with such knowledge of the trustee's powers as a reasonable inquiry would have disclosed to him.

G. Bogert, The Law of Trusts and Trustees 565, 273-74 (1980).

31 See generally Jarrett v. U.S. National Bank, 81 Or.App. 242, 725 P.2d 384 (1986), rev. denied, 302 Or. 476, 731 P.2d 442 (1987) (although trustee breached fiduciary duty in extending lease term, trust beneficiaries could not rescind lease since third party lacked knowledge the trustee was committing a breach of trust in making the lease).

32 Uniform Trustees' Powers Act sect. 2(a), 7B U.L.A. (1985).

33 This would impose upon third parties dealing with the trustee an inquiry obligation similar to that imposed by the common law. See supra note 30.

34 Horowitz, Uniform Trustees' Powers Act, 41 Washington L. Rev. 1, 29 (1966).

35 Kan. Stat. Ann. sect. 58-1203 (1983). The Kentucky statute is very similar to the Kansas statute. See Ky. Rev. Stat. Ann. 386.810 (1), (2), (3)(b), (k), (u), and (z) (Michie/Bobbs-Merrill 1984).

36 Ill. Ann. Stat. ch. 17, para. 1674.2 (Smith-Hurd Supp. 1990).

37 Horowitz, Uniform Trustees' Powers Act, 41 Washington L. Rev. 1, 12, 28-29 (1966).

38 Ill. Ann. Stat. ch. 17, para. 1653(2) (Smith-Hurd Supp. 1990).

39 Ky. Rev. Stat. Ann. sect. 386.835 (Michie/Bobbs-Merrill 1984).

40 Kan. Stat. Ann. sect. 58-1208 (1983).

41 G. Bogert, Trusts sect. 89, at 318 (6th ed. 1987) (court can grant trustee authority to act in a manner necessary to perform the trust purpose; court can, in limited situations, permit the trustee to "deviate" from the settlor's instructions when necessary to perform the trust purpose).

42 Kan. Stat. Ann. sect. 59-1401 (Supp. 1989) authorizes the executor or administrator to "(d) pay the taxes and collect the rents and earnings on the property until the estate is settled or until delivered by order of the court to the heirs, devisees and legatees . . . ."

43 Statutes addressing executor and administrator powers are much more restrictive than statutes concerning trustee powers. See, e.g., Kan. Stat. Ann. sect. 59-1401 (Supp. 1989) (limited authority to collect and protect the decedent's property); Kan. Stat. Ann. sect. 59-1409

(1983) (executor or administrator may execute oil and gas lease only with the joinder of "the heirs and devisees having an interest therein . . . ."). In Illinois, the court must issue an order approving the oil and gas lease. Ill. Ann. Stat. ch. 101 1/2, para. 20-20 (Smith-Hurd Supp. 1990) (the statute establishes minimum requirements for the lease, such as a primary term not to exceed 10 years).

44 E.g., Kan. Stat. Ann. sect. 59-2239 (Supp. 1989) bars creditor claims unless administration of the decedent's estate is commenced within six months after the death of the decedent.

45 E.g., Kan. Stat. Ann. sect. 59-2233 (1983) (unless spouse has previously "consented" to be bound by the decedent's will, spouse has six months after the probate of the will to take an intestate share in lieu of the share granted them by the will).

46 E.g., Kan. Stat. Ann. sect. 59-401 (1983) (homestead rights in real property); Kan. Stat. Ann. 59-403 (Supp. 1989) (allowance for spouse and minor children in personal property); Kan. Stat. Ann. sect. 59-2235 (1983) (procedure for selecting homestead and allowances).

47 Kan. Stat. Ann. sect. 58-501 (1983) provides, in part:

> When a joint tenant dies, a certified copy of letters testamentary or of administration, or where the estate is not probated or administered, a certificate establishing such death issued by the proper federal, state or local official authorized to issue such certificate, or an affidavit of death from some responsible person who knows the facts, shall constitute prima facie evidence of such death and in cases where real property is involved, such certificate or affidavit shall be recorded in the office of the register of deeds in the county where the land is situated.

See also Title Standards Handbook, Examination Standard 12.4 Proof of Title in the Survivor (Kan. Bar Assoc. 1985).

Joint tenancy property will not be subject to the terms of the decedent's will. When a joint tenant dies, their share of the property is divided equally among the surviving joint tenants. Therefore, the major issue is proof of the joint tenant's death. Although the property will not be subject to administration, it will be subject to state and federal taxes as part of the decedent's total estate.

48 In Kansas, for example, Kan. Stat. Ann. sect. 59-617 (Supp. 1989) provides:

No will of a testator who died while a resident of this state shall be effectual to pass property unless a petition is filed for the probate of such will within six months after the death of the testator, except as hereinafter provided.

Kan. Stat. Ann. sect. 59-618 and sect. 59-618a (Supp. 1989) provide certain exceptions to the six month time frame in sect. 59-617.

49 All states specify who will receive a person's property when they die without making other arrangements, such as through a will, joint tenancy, or inter vivos trust. When a person dies without a will, they die "intestate" and the state's "intestacy," also called "intestate succession," laws will be applied. The intestacy laws can vary substantially from state to state. For example, when Mary dies without a will in Kansas, survived by a spouse and two children, her Kansas property will be disposed of under Kan. Stat. Ann. sects. 59-504 and 59-506 (1983) one-half to Mary's spouse and one-fourth to each of her children. In Kentucky, the intestate succession of Mary's property would depend upon whether it was classified as real or personal property, and whether, if real property, it had been a gift from the decedent's surviving parent. See Ky. Rev. Stat. Ann. sects. 391.101, 391.020 (Michie/Bobbs-Merrill 1984) and sect. 391.030 (Michie/Bobbs-Merrill Supp. 1988). If we assume the property is real property, and it was not a gift from the decedent's parent, all of the property would descend to Mary's children in equal shares. Ky. Rev. Stat. Ann. sect. 391.101 (Michie/Bobbs-Merrill 1984).

50 See generally 1 D. Pierce, Kansas Oil and Gas Handbook sect. 4.10 and sect. 4.11 (Kan. Bar Assoc. 1986).

51 This time frame coincides with the six-month limitation on offering a will for probate. Kan. Stat. Ann. sect. 59-617 (Supp. 1988). It also coincides with the six-month limitation on a creditor's ability to commence administration of the estate. Kan. Stat. Ann. sect. 59-2239 (Supp. 1989).

52 Kan. Stat. Ann. sect. 59-2250 (Supp. 1988).

53 Kan. Stat. Ann. sect. 59-2251 (Supp. 1988).

54 Kan. Stat. Ann. sect. 59-213 (1983); Title Standards Handbook, Examination Standard 19.4 Decree of Descent--Transcript to Another County (Kan. Bar Assoc. 1985). See also J. Logan and N. Roush, Kansas Estate Administration sect. 12.01 (Kan. Bar Assoc. 1986).

55 For example, Kansas has a "Simplified Estates Act" which reduces the degree of court supervision of the administration process. Kan. Stat. Ann. sections 59-3201 to 59-3206 (1983 and Supp. 1989). Kansas also has an "Informal Administration Act" which is designed for estates with small amounts of personal property. Kan. Stat. Ann. sections 59-3301 to 59-3306 (Supp. 1988).

56 Kan. Stat. Ann. sect. 59-806 (1983) will look to the nonresident's domicile to determine such matters as the validity of their will, the rights of a surviving spouse to elect against the will, the effect of divorce or the birth of a child, and the determination of the ultimate burden of inheritance taxes. Kan. Stat. Ann. sect. 59-806(a) (1983). However, if the decedent dies without a will, or the will is not eligible for probate, sect. 59- 806(b) provides, in part:

> **Real estate** situated in this state [Kansas], owned by an intestate decedent [no will, or the will is not eligible for probate] who is a nonresident of this state at the time of death, **shall pass by intestate succession in the same manner as though said decedent were a resident of this state** at the time of said decedent's death. The **personal property** of such a decedent **shall pass by intestate succession under the laws of the place of the decedent's residence** at the time of death.

This statute makes it imperative to properly classify the property being administered. For example, under our hypothetical production proceeds held for Mary's benefit **prior** to her death are personal property which would pass to her heirs under **Kentucky** law. Production proceeds accruing to Mary **after** her death, and attributed to Mary's Kansas mineral interest, would pass to her heirs under **Kansas** law. However, production proceeds accruing to Mary **after** her death, and attributed to her 50% working interest under an oil and gas lease, would be classified as **personal property** under Kansas law and would pass to her heirs under **Kentucky** law--even though Kentucky law may treat the oil and gas lease as an interest in real property for determining who gets it under Kentucky law.

57 Kan. Stat. Ann. sect. 59-804 (1983).

58 See Kan. Stat. Ann. sect. 59-2250 (Supp. 1988); J. Logan and N. Roush, Kansas Estate Administration 14.3 (Kan. Bar Assoc. 5th ed. 1986).

59 There is some risk in waiting six months. Under Kan. Stat. Ann. sect. 59-617 (Supp. 1989) the will of a resident of Kansas must be offered for probate within six months after the testator's death. However, this statute does not apply to a nonresident testator. In order to protect persons who deal with the heirs of a nonresident decedent, Kan. Stat. Ann. sect. 59-803 (Supp. 1989) provides:

> The title of any purchaser in good faith, without knowledge of a will, to any real estate situated in this state, derived from the heirs of any person not domiciled in this state at the time of the person's death, shall not be defeated by the production of the will of the decedent unless a petition for the probate of such will in this state is filed within six months from the death of the testator.

Kan. Stat. Ann. sect. 59-2229 (Supp. 1989) similarly provides, in part:

> When a copy of a will executed outside this state and the probate of it, duly authenticated, is presented to the executor or any other person interested in the will, with a petition for its probate, the court shall fix the time and place for the hearing of the petition .... The title of any purchaser in good faith, without knowledge of the will, to any property derived from the fiduciary, heirs, devisees or legatees of the decedent shall not be defeated by the production of the will of the decedent and the petition for its probate after six months from the death of the decedent.

60 Kan. Stat. Ann. sect. 59-806(a)(1) (1983).

61 Id. J. Logan and N. Roush, Kansas Estate Administration sect. 14.4 (Kan. Bar Assoc. 5th ed. 1986).

62 Ill. Ann. Stat. ch. 101 1/2, para. 22-1 (Smith-Hurd 1978) provides:

A representative to whom letters are issued on the estate of a nonresident decedent or ward by a court of competent jurisdiction of any other state ... may collect and receive personal estate in this State of the decedent or ward and remove it to the jurisdiction in which his letters are issued upon delivering to the person or corporation indebted to or holding the personal estate of the decedent or ward, the following: (a) an affidavit by the representative that to his knowledge no letters have been issued ... [or] is pending on the estate in this State, and there are no creditors of the estate in this State, and (b) a copy of his letters certified within 60 days before the date of presentation. **Upon payment or delivery of the assets, after receipt of the affidavit and certified copy, the person or corporation is released to the same extent as if the payment or delivery had been made to a legally qualified resident representative and is not required to see to the application or disposition of the property;** but no payment or delivery may be made sooner that 30 days after decedent's estate.

63 E.g., Ill. Ann. Stat. ch. 96 1/2, para. 5433 (Smith-Hurd Supp. 1990); Kan. Stat. Ann. sect. 55-703a (1983) (gas); Ky. Rev. Stat. Ann. sect. 353.610 (1983).

64 Kentucky generally defines a "shallow well" as "any well drilled and completed at a depth less than four thousand (4000) feet ...." An exception is made for certain wells drilled east of longitude line 84 degrees 34 minutes; these wells will be considered a shallow well if it is completed, at any depth, "above the base of the lowest member of the Devonian Brown Shale ...." Ky. Rev. Stat. Ann. sect. 353.510(15) (Michie/Bobbs-Merrill Supp. 1988).

65 Ky. Rev. Stat. Ann. sect. 353.610 (Michie/Bobbs-Merrill 1983).

66 See, e.g., Ill. Rev Stat. ch. 96 1/2, para. 5433(a) (Smith-Hurd Supp. 1990).

67 See, e.g., Ky. Rev. Stat. Ann. sect. 353.620 (Michie/Bobbs- Merrill 1983).

68 For what will certainly become the first and last word on pooling, unitization, and oil and gas conservation matters, see: B. Kramer & P. Martin, The Law of Pooling and Unitization (3d ed. Matthew Bender 1990).

69 See generally Smith v. Rogers, 702 S.W.2d 425 (Ky. 1986) (interpreting effect of pooling clause in oil and gas lease).

70 A common form of pooling clause provides:

> 5. Lessee is hereby granted the right to pool or consolidate the leased premises, or any portions thereof, ... but only as to the gas right hereunder ... to form one or more gas operating units of not more than 640 acres, plus a tolerance of ten per cent (10%) to conform to Governmental Survey quarter sections. **Lessee shall file written unit designations in the county in which the premises are located.** Such units may be designated either before or after the completion of wells. Drilling operations and production on any part of the pooled acreage shall be treated as if such drilling operations were upon or such production was from the land described in this lease whether the well or

wells be located on the land covered by this lease or not. The entire acreage pooled into a gas unit shall be treated for all purposes, **except the payment or royalties on production from the pooled unit,** as if it were included in this lease. **In lieu of the royalties herein provided, lessor shall receive on production from the unit so pooled only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit or his royalty interest therein on an acreage basis bears to the total acreage so pooled in the particular unit involved.**

Note the limited scope of the pooling clause. If the lessee needed to pool to drill an oil well, it would need to go back to the lessor for special permission, evidenced by a separate pooling agreement. Also note that the clause contemplates the filing of a "written unit designation." This is typically captioned a "Declaration of Pooling." The final portion of the clause allocates the lessor's royalty, under the royalty clause, in proportion to the lease acreage included in the pooled unit.

71 I used to think the Kansas approach was inferior to the pooling approaches of other states, such as Oklahoma and Texas. After practicing several years in Kansas, Oklahoma, and Texas, it is my opinion the Kansas system works best--for Kansas. It gives the individual property owner much greater bargaining power. However, the Kansas Corporation Commission, and the Kansas Supreme Court, have indirectly created some "carrots and sticks" to assist "voluntary agreement." Another important factor in Kansas is the fairly simple ownership pattern of land and minerals. Unlike Oklahoma, where you may need to combine over fifty ownership interests to create the pooled unit, in Kansas you may only need the agreement of one or two additional parties. "Agreement" is usually obtained the old fashioned way--with a checkbook.

72 Ill. Ann. Stat. ch. 96 1/2, para. 5436 (Smith-Hurd Supp. 1990); Ky. Rev. Stat. Ann. sect. 535.630 (Michie/Bobbs-Merrill Supp. 1988).

73 Ky. Rev. Stat. Ann. sect. 353.630(1) (Michie/Bobbs-Merrill Supp. 1988).

74 Ky. Rev. Stat. Ann. sect. 353.640(2) (Michie/Bobbs-Merrill Supp. 1988).

75 See generally 1 B. Kramer & P. Martin, The Law of Pooling and Unitization sect. 12.01 (3d ed. Matthew Bender 1990) (Options Afforded Owners of Interests).

76 Ill. Ann. Stat. ch. 96 1/2, para. 5436(b) (Smith-Hurd Supp. 1990).

77 See generally Newkirk v. Bigard, 109 Ill.2d 28, 485 N.E.2d 321 (1985), cert. denied, 475 U.S. 1140 (1986).

78 "Owner" is defined by Ill. Ann. Stat. ch. 96 1/2, para. 5401 (Smith-Hurd Supp. 1990) as "the person who has the right to drill into and produce from any pool, and to appropriate the production either for himself or for himself and another, or others." This would include lessees and unleased mineral interest owners. It would not include a leased mineral interest owner, nonparticipating royalty owner, or an owner of a nonoperating interest, such as an overriding royalty, production payment, or net profits interest.

79 Ill. Ann. Stat. ch. 96 1/2, para. 5436(d) (Smith-Hurd Supp. 1990). See also Newkirk v. Bigard, 109 Ill.2d 28, 485 N.E.2d 321 (1985), cert. denied, 475 U.S. 1140 (1986).

80 Id.

81 Id.

82 Ky. Rev. Stat. Ann. sect. 353.640 (Michie/Bobbs-Merrill Supp. 1988).

83 Ky. Rev. Stat. Ann. sect. 353.510(16) (Michie/Bobbs-Merrill Supp. 1988) defines "deep" well as any well completed below the depth established for a "shallow" well. Ky. Rev. Stat. Ann. sect. 353.510(15) (Michie/Bobbs-Merrill Supp. 1988) generall defines "shallow" well as any well completed at a depth less than 4000 feet.

84 Ky. Rev. Stat. Ann. sect. 353.651 (Michie/Bobbs-Merrill 1986).

85 Id. at sect. 353.651(2)(e).

86 Ky. Rev. Stat. Ann. sect. 353.640(3) (Michie/Bobbs-Merrill Supp. 1988); Ky. Rev. Stat. Ann. 353.651(2)(d) (Michie/Bobbs-Merrill 1983).

87 Ky. Rev. Stat. Ann. sect. 353.510(17) (Michie/Bobbs-Merrill Supp. 1988).

88 Ky. Rev. Stat. Ann. sect. 353.640(4) (Michie/Bobbs-Merrill Supp. 1988) provides:

A certified copy of any pooling order entered under KRS 353.500 to 353.720 shall be entitled to be recorded in the office of the county clerk of the county or counties in which all or any portion of the pooled tract is located, and the record of the order, from the time of lodging the order for record, shall be notice of the order to all persons.

89 Ill. Ann. Stat. ch. 96 1/2, para. 5436(d) (Smith-Hurd Supp. 1990).

90 Ky. Rev. Stat. Ann. sect. 353.651(2)(e) (Michie/Bobbs-Merrill 1983) (the amount the carrying parties can recoup is "exclusive of any royalty or overriding royalty reserved in any leases, assignments thereof or agreements relating thereto . . . .").

91 Ky. Rev. Stat. Ann. sect. 353.650 (Michie/Bobbs-Merrill 1983).

92 Ill. Ann. Stat. ch. 96 1/2, para. 4910 (Smith-Hurd Supp. 1990).

93 Ill. Ann. Stat. ch. 96 1/2, para. 4910(1)(b) (Smith-Hurd Supp. 1990) states:

'Payor' means the first purchaser of production of oil or gas from an oil or gas well, but the owner of the right to produce under an oil and gas lease or pooling order is deemed to be the payor if the owner of the right to produce and the first purchaser have entered into arrangements providing that the proceeds derived from the sale of oil or gas have been paid by the first purchaser to the owner who assumes the responsibility of paying those proceeds to the payee. 100% division order

94 Id. at sect. (2)(a).

95 Id. at sect. (2)(a)(1) and (2).

96 Ill. Ann. Stat. ch. 96 1/2, para. 4910(2)(a) (Smith-Hurd Supp. 1990).

97 Id. at sect. (2)(b).

98 Id. at sect. (3)(a).

99 Id.

100 Ill. Ann. Stat. ch. 96 1/2, para. 4910 (Smith-Hurd Supp. 1990).

101 Id. at sect. (3)(b).

102 Id. at sect. (4)(a) and (c).

103 See Okla. Stat. tit. 52, sect. 87.1 (Supp. 1989); Shell Oil Co. v. Oklahoma Corporation Commission, 389 P.2d 951 (Okla. 1963) (the "Blanchard" case adopting the "weighted average" approach to the royalty payment problem. See also TXO Production Corp. v. Prickette, 653 S.W.2d 642 (Tex. Ct. App. 1983) (weighted average approach); Puckett v. First City Nat'l Bank of Midland, 702 S.W.2d 232 (Tex. Ct. App. 1985) (adopting tract allocation approach), writ ref'd n.r.e.

104 12 Kan. App.2d 626, 753 P.2d 310 (1988).

105 Powell v. Prosser, 12 Kan. App.2d 626, 627, 753 P.2d 310, 312 (1988).

106 Id. at 627-28, 753 P.2d at 313.

107 Id. at 631, 753 P.2d at 315.

108 The court in Powell v. Prosser observes:

> This difficulty is occasioned where it is not understood that owners of mineral interests still own all of the minerals even if they are subject to a lease reserving to the mineral interest owners one-eighth or some other fractional royalty. As a consequence, the conveyance wishing to convey a one-half mineral interst expresses it by conveying one-sixteenth of the minerals, erroneously believing, since the land is under lease, one-half of his interest is one-half of the one-eighth royalty or one-sixteenth. Such appears clearly to be the case here.
>
> 12 Kan. App.2d at 632, 753 P.2d at 316.

109 Id. at 633, 753 P.2d at 313.

110 235 Kan. 117, 679 P.2d 1152 (1984).

111 Powell v. Prosser, 12 Kan. App.2d 626, 629, 753 P.2d 310, 316 (1988).

112 Heyen v. Hartnett, 235 Kan. 117, 123, 679 P.2d 1152, 1157 (1984).

113 770 S.W.2d 226 (Ky. App. 1989).

114 E.H. Lester Leasing Co. v. Griffith, 770 S.W.2d 226, 227 (Ky. App. 1989).

115 Id. at 228.

116 Id.

117 Id. The Kentucky Supreme Court denied review of this case.