Title: OIL AND GAS ISSUES OF INTEREST TO THE AGRICULTURAL LAWYER
Date: October 28, 2011
Location: Manhattan, Kansas
Program: 8th Annual Agricultural Law Update
Sponsor: Kansas Bar Association
Duration: One Hour
Section 4

Oil and Gas Issues of Interest to the Agricultural Lawyer

Prof. David E. Pierce
Washburn University School of Law
Topeka
I. TRANSACTING IN MINERALS IS DIFFERENT

A. Title to Minerals

1. Marketable Record Title Act, K.S.A. §§ 58-3401 to 58-3412. Not of much use in the mineral context because of the interests expressly excluded from operation of the Act. Interests not subject to the Act’s provisions:

   a. § 58-3408(b): “rights . . . to any lease of any lessee or any lessee’s successor.”

   b. § 58-3408(d): “any mineral interest which has been severed from the fee simple title of the land.”

   c. § 58-3408(e): “any easement or interest in the nature of an easement, or any rights granted, reserved or excepted by any instrument creating such an easement or interest.”

   d. § 58-3408(f): “use restrictions.”

   e. § 58-3408(g) & (h): rights in a future interest (reversionary interests and remainders). What about executory interests?

2. K.S.A. § 79-420. A vicious statute designed to ensure severed mineral interests are listed for taxation by deeming the conveyance void if not timely recorded.

   a. “Whenever the fee to the surface . . . is in any person . . . and the right or title to any minerals therein is in another . . . such mineral shall be listed . . . separately from the fee . . . When such reserves or leases are not recorded within 90 days after execution, they shall become void if not listed for taxation.”

   ...
b. There is an extensive, and sometimes surprising, body of common law interpreting this statute. See 1 DAVID E. PIERCE, KANSAS OIL AND GAS HANDBOOK 5-10 to 5-13 (1986).

3. **Mineral vs. Royalty.** Kansas law, as a practical matter, requires the owner of a severed interest in oil and gas to determine whether they own a "mineral" or a "royalty" interest.

   a. **Mineral Interest:** right to oil and gas "in place." Classic language is conveyance of oil and gas "in and under" the land.

   b. **Royalty Interest:** right to oil and gas as it is extracted. Classic language is conveyance of oil and gas "produced" from the land.

   c. Reasons why it matters:

      (1) Mineral interest deemed to vest immediately and does not violate the Rule Against Perpetuities.

      (2) Royalty interest not subject to K.S.A. § 79-420.

      (3) Mineral interest includes development rights and corresponding right to lease.

      (4) Royalty interest is a passive income interest.

      (5) Fractional "royalty" interest typically yields 8 times the production revenue as compared to a fractional "mineral" interest.

   d. Mineral interests can be "nonparticipating" in one or more of the mineral attributes or benefits under an oil and gas lease.

      (1) The right to lease or develop oil and gas that is part of a mineral interest can be severed from the mineral interest.

      (2) Benefits under an oil and gas lease can be severed from the mineral interest.

      (3) For example, O conveys to A an undivided 50% of the oil and gas in and under § 30 [legal description]
but excepting and retaining in O the right to lease and develop the oil and gas conveyed to A together with the right of O to retain for himself all bonus and delay rental associated with any oil and gas lease covering A’s nonparticipating mineral interest.

(a) A in the above example has a nonparticipating mineral interest that participates only in royalty attributable to A’s 50% mineral interest.

(b) Assume O enters into an oil and gas lease covering O’s 50%, plus A’s 50%; the lease provides for a $10,000 bonus, $640/year delay rental, and a 1/8th royalty (and assume the 1/8th royalty is the maximum O could have negotiated for). O is entitled to all the bonus, all the delay rental, and 50% of the royalty; A is entitled to 50% of the royalty.

4. Rule Against Perpetuities.

a. The Kansas Supreme Court has held that creation of a perpetual royalty interest violates the Rule Against Perpetuities (the “Rule”).

b. For example: O conveys to A 1/16th of all the oil and gas produced from § 30.

(1) This is treated as a non-vested interest because the court has defined the vesting event as “production.”

(2) At the date of the grant it cannot be said with certainty that there will be production from § 30 within a life or lives in being plus 21 years.

(3) Violates the Rule so A’s interest is void. A owns nothing.

c. A mineral interest is deemed by the court to vest upon delivery of the deed.

(1) Note, just like a royalty interest, we don’t know if there will ever be production from § 30. But the royalty interest is void and the mineral interest is valid.
(2) Note also that a nonparticipating mineral interest, that participates in nothing by royalty, is nevertheless deemed to vest immediately and not subject to the Rule.


e. Uniform Statutory Rule Against Perpetuities

(1) The “new” rules apply to transactions entered into on or after July 1, 1992 – primarily the exemption of “nondonative transfers” (K.S.A. § 59-3404(1)), the 90-year wait-and-see provision (K.S.A. § 59-3401(a)(2)), and the reformation provision (K.S.A. § 59-3403).

(2) Important section that has retroactive effect (to help with all pre-July 1, 1992 transactions): K.S.A. § 59-3405(b).

(3) But, are these statutes part of a bill containing multiple subjects that violates article 2, § 16 of the Kansas Constitution – and is void? See David E. Pierce, *Void Enactments of the Kansas Legislature*, 80 J. KAN. B. ASS’N 28 (July/Aug. 2011).

5. Adverse Possession.

a. Many title problems are resolved by adverse possession. But problems associated with a previously-severed mineral interest will not be impacted by surface use.

b. Once a mineral interest is severed from the surface, entry by an adverse possessor of the surface will not impact the severed mineral interest.

c. Use of the previously severed surface interest does not create a cause of action that can be asserted by the mineral interest owner.
(1) Occupancy by an adverse possessor of a house, farming the land, etc. are not acts adverse to a severed mineral interest owner.

(2) Must be some direct activity that invades the mineral interest so as to give rise to a cause of action and at the same time provides notice to the world that an interest other than the surface is being claimed.


**B. Easements by Necessity**

1. **Severed Mineral Interest.** *O* conveys to *A* the oil and gas in § 30. If the deed contains no further language addressing the scope of *A*'s mineral rights, *A*'s rights include the right to make reasonable use of the surface to extract the oil and gas.

2. **Oil and Gas Lessee.** Although oil and gas leases typically contain express provisions — easements — to use the surface to support oil and gas operations, if the lease were silent on the matter the lessee would nevertheless enjoy an implied right to make reasonable use of the surface.

3. **Obligation to Pay Damages Associated with Reasonable Use?**

   a. **Severed mineral interest: no case on point.** General easement by necessity law does not require payment for use of the land within the confines of the recognized easement.

   b. **Oil and gas lease: crop damage cases.** Obligated to pay only when the damage comes within the definition of “crop damages.”

C. Conflicts Among Competing Land Users

1. Farm Tenants.
   a. What is the intended scope of a farm lease? Does it anticipate that during the term of the lease the owner of the land cannot develop its mineral potential?
   b. Minerals severed, or oil and gas lease granted, prior to the farm lease: farm tenant subject to the terms of the severed mineral owner’s right to make reasonable use of the surface (assuming no limitations expressed in the deed creating the mineral interest).

2. Wind Tenants.
   a. Who was first? Severed mineral interest, oil and gas lessee, wind lessee?
   b. Ability to co-exist using the same tract of land?


D. What is a “Mineral”?

1. \(O\) conveys to \(A\) “all minerals” in § 30.
   a. We know one thing for sure: \(A\) does not own “all minerals” in § 30; \(A\) owns “some” minerals.
   b. \(O\) owns minerals that do no pass to \(A\) under various interpretive tests.

2. Interpretive tests:
   a. K.S.A. § 58-2202. “[E]very conveyance of real estate shall pass all the estate of the grantor therein, unless the intent to pass a less estate shall expressly appear or be necessarily implied in the terms of the grant.” Still useful? Central Natural Resources, Inc. v. Davis Operating Co., 288 Kan. 234, 247, 201 P.3d 680, 689 (2009) (“Given that the deeds expressly tell us that not all of the grantors’ estates passed to the grantees, we need not resort to the statutory presumption.”).
b. Surface destruction test. Minerals that require significant destruction to mine are not included in a generic grant of “all minerals.”

c. Community knowledge test. Could the specific mineral have been reasonably contemplated at the time the conveyance was made?

d. Special varieties test. Is the sand, stone, etc. “special” or “ordinary”? Special sand is a “mineral” while ordinary sand is not.

e. Conveyance of “oil, gas, and other minerals” limits the scope of “other minerals” to minerals that are similar to oil and gas.

(1) *Ejusdem generis* solves the problem at the “oil” and “gas” level.

(2) Does not address what is encompassed by the term “gas.”


4. O owns all rights in the property but conveys “all coal” to A. Who owns the methane gas that was created by and found within the coal? *Central Natural Resources, Inc. v. Davis Operating Co.*, 288 Kan. 234, 201 P.3d 680 (2009) (A owns the coal but O owns all the gas within the coal).

II. SPECIAL ISSUES WHEN TRANSACTING IN LEASED LAND

A. What Does the Landowner Own?

1. Traditionally landowners often misconceive what they “own” when their mineral interest is subject to an oil and gas lease.

2. Often mix-up not only the nature of the interest (“royalty” as opposed to “mineral”), but also the fraction of ownership (“1/8th” as opposed to “8/8ths”).

3. Can have unique situation where a conveyance of a “1/8th royalty interest” is intended to convey an “8/8ths mineral interest.”

B. Nonapportionment Doctrine

1. 2005: O enters into oil and gas lease with X covering all of § 30 with a primary term of 3 years and a 1/8th royalty.

2. 2006: O conveys to A the NW1/4 of the NW1/4 of § 30.
   a. X drills a well on the NW1/4 of the NW1/4.
   b. How will royalty under the lease be divided?
   c. Nonapportionment doctrine: A receives all the royalty; O gets nothing.
   d. Does the lease have an "entireties clause"? If so, the effect will be to give A 40/640 x 1/8th and O 600/640 x 1/8th.
   e. Does the deed creating the divided interest in A address the issue? Rarely.

3. See 1 DAVID E. PIERCE, KANSAS OIL AND GAS HANDBOOK 6-30 to 6-31 (1986).

III. THE OIL & GAS LEASE

For analysis, the oil and gas lease can be viewed as having three categories of operative provisions: (1) the grant, (2) the duration of the grant, and (3) royalty.

A. Rights Granted

1. The first paragraph of the lease lists the basic rights being granted.

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

[Granting Clause]

2. Other portions of the lease also grant various rights.

a. “Lessee shall have free use of oil, gas, and water from said land, except water from lessor’s wells and tanks, for all operations hereunder, including repressuring, pressure maintenance, cycling, and secondary recovery operations . . . .” [Free Use Clause]

b. “Lessee shall have the right . . . to remove all property and fixtures place by lessee on said land, including the right to draw and remove all casing.”

c. “There shall be no obligation on the part of the lessee to offset wells on separate tracts into which the land covered by this lease may be hereafter divided by sale, devise, or otherwise, or to furnish separate measuring or receiving tanks.”

3. Other portions of the lease also restrict certain granted rights.

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

b. “Lessee shall pay for damages caused by its operations to growing crops on said lands.” [Crop Damage Clause]

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

d. “Lessor shall have the privilege, at his risk and expense, of using gas from any gas well on said land for stoves and inside lights in the principal dwelling thereon, out of any surplus gas not needed for operations hereunder.” [Free Gas Clause]

4. The lease also contains title provisions impacting the granted interests.

a. “together with any reversionary rights and after-acquired interest, therein . . . .”
b. "containing ____ acres, more or less, and all accretion thereto."

c. "The rights of either party hereunder may be assigned in whole or in part and the provisions hereof shall extend to the heirs, executors, administrators, successors, and assigns . . . ." [Assignment Clause]

d. "An assignment of this lease, in whole or in part, shall, to the extent of such assignment, relieve and discharge lessee of any obligations hereunder." [Advance Novation Clause]

e. "Lessee and lessee's successors and assigns shall have the right at any time to surrender this lease, in whole or in part, to lessor . . . ; thereupon lessee shall be relieved from all obligations, expressed or implied, of this agreement as to the acreage so surrendered . . . ." [Surrender Clause]

f. "Lessor hereby warrants and agrees to defend the title to said land, and agrees that lessee, at its option, may discharge any tax, mortgage, or other lien upon said land, and in the event lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rentals and royalties accruing hereunder toward satisfying same." [Warranty Clause; Subrogation Clause]

g. "In case said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties, including substitute gas royalty, and rentals herein provided for shall be paid the said lessor only in the proportion that his interest bears to the whole and undivided fee . . . ." [Proportionate Reduction Clause/Lesser Interest Clause]

h. "If the leased premises shall hereafter be owned in severalty or in separate tracts, the premises, nevertheless, shall be developed and operated as one lease, and all royalties accruing hereunder shall be treated as an entirety and shall be divided among and paid to such separate owners in the proportion that the acreage owned by each such separate power bears to the entire leased acreage." [Entireties Clause]
B. Duration of the Rights Granted

1. "Subject to the provisions herein contained, this lease shall remain in force for a term of ten (10) years from this date (called 'primary term'), and as long thereafter as oil, liquid hydrocarbons, gas or other respective constituent products, or any of them, is produced from said land or land with which said land is pooled." [Habendum Clause]

2. "[I]f there is a gas well or wells on the above land (and for the purposes of this clause the term 'gas well' shall include wells capable of producing natural gas, condensate, distillate or any gaseous substance and wells classified as gas wells by any governmental authority) and such well or wells are shut in before or after production therefrom, lessee or any assignee hereunder may pay or tender annually at the end of each yearly period during which such gas well or gas wells are shut in, as substitute gas royalty, a sum equal to the amount of delay rentals provided for in this lease . . . and if such payments or tenders are made it shall be considered under all provisions of this lease that gas is being produced from the leased premises in paying quantities." [Shut-In Royalty Clause]

3. "If operations for drilling are not commenced on said land or on land pooled therewith on or before one (1) year from this date, this lease shall terminate as to both parties, unless on or before one (1) year from this date lessee shall pay or tender to the lessor a rental of ____ Dollars which shall cover the privilege of deferring commencement of such operations for a period of twelve (12) months . . . ." [Drilling, Delay Rental Clause]

4. "If prior to the discovery of oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, on said land or land pooled therewith lessee should drill and abandon a dry hole or holes thereon, or if, after discovery of oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, the production thereof should cease from any cause, this lease shall not terminate if lessee commences reworking or additional drilling operations within sixty (60) days thereafter, or (if it be within the primary term), (i) in the case of a dry hole, commences or resumes the payment or tender of rentals or commences operations for drilling or reworking on or before the rental paying date occurring twelve (12) months after the expiration of the rental period during which such dry hole was drilled, or (ii) in the case of cessation of production, commences or resumes the payment or tender of rentals or commences
operations for drilling or reworking on or before the rental paying date next ensuing after the expiration of three (3) months from the cessation of production.  [Dry Hole Clause; Cessation of Production Clause]

5. "If, at the expiration of the primary term, oil, liquid hydrocarbons, gas or their constituent products, or any of them, is not being produced on said land or land pooled therewith but lessee is then engaged in operations for the drilling or reworking or any well thereon, this lease shall remain in force so long as drilling or reworking operations are prosecuted (whether on the same or different wells) with no cessation of more than sixty (60) consecutive days, and if they result in production, so long thereafter as oil, liquid hydrocarbons, gas or their respective constituent products, or any of them, is produced from land or land pooled therewith."  [Operations/Completion Clause]

6. "Lessee shall not be liable for delays or defaults in its performance of any agreement or covenant hereunder due to force majeure . . . ."  [Force Majeure Clause]

C. Landowner Compensation

1. In addition to compensation through the up front payment of cash to induce the mineral owner to enter into a lease – the “bonus” – lessors will receive delay rental (unless they are entering into a “paid up” lease), and, if there is production, royalty.

2. "The royalties to be paid by lessee are: (a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected; [Oil Royalty Clause]

3. "(b) on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the leased premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale . . . ."  [Gas Royalty Clause]
D. **Lessor Considerations**

1. **Is it time to lease?**
   a. Risks associated with waiting to lease.
   b. Risks associated with leasing too soon.
   c. Most favored nations clause?

2. **When the landowner decides to lease.**
   a. Granting Clause: whatever is granted should contract to the smallest unit necessary to operate the parts of the lease that are actually developed by the end of the primary term.
   b. Two dimensions: vertical and horizontal.
   c. Problems with floating easements. Ensure the lessor is not limited in prospective use of the land – at least until the lessee actually occupies an area not already occupied by the lessor.
   d. Surface disruption compensation.
   e. Surface use limitations.

3. **Habendum clause.** Once you decide to lease, you want development as soon as possible – as much as possible. Use it or lose it.

4. **Royalty clause.** Objective and easy to police.

E. **Lessee Considerations**

1. **Granting Clause:** minimum area necessary to conduct the anticipated development. Pooling to assemble the minimum block of acreage.

2. **Habendum Clause:** reasonable period to conduct development and maintain the lease even when production is disrupted. Well-defined guidance as to when a well is “commenced,” “completed,” when “operations” are in progress, the scope of “work over” and similar duration defining terms such as “shut-in” and “dry hole.”
3. Scope of authority to prudently pursue operational activities required to maximize production from the leased land.

4. Royalty clause. Objective and easy to understand what must be done to comply with the royalty obligation.