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by

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I. TECHNICAL CONSIDERATIONS

A. Petroleum Geology

1. Porosity

2. Permeability

B. Reservoir Mechanics

1. Pressure Changes

2. Displacement Process

II. OWNERSHIP

A. Surface Boundaries

1. Ownership of oil and gas initially determined by surface boundaries.

2. Ownership of the land includes ownership of all the oil and gas found within the surface boundaries of the land.

B. Rule of Capture

1. Person drilling a well bottomed within the surface boundaries of their land obtains title to all oil and gas produced by their well--even though some of it is drained from adjacent lands.

2. To perfect ownership of oil and gas it must be brought to the surface and "captured."

3. Person causing the drainage is protected so long as

the well is within the surface boundaries of their property.

C. Correlative Rights

1. Limitation on the Rule of Capture.

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

D. Conservation Regulation

1. General Goal: protect correlative rights and prevent waste of the oil and gas resource.

   a. Kansas - Regulated by the Kansas Corporation Commission. Kan. Stat. Ann. § 55-602 (1983) (oil); § 55-702 (1983) (gas).

   b. Missouri - Regulated by the State Oil and Gas Council established by Mo. Ann. Stat. § 259.010 (Vernon 1990). Administered and enforced by the state geologist.

2. Spacing - Require a minimum distance between producing wells and require wells to be drilled a minimum distance from lease or property lines.

3. Prorationing - Control the rate of production to achieve orderly removal of the resource.

4. Pooling - Permit separate properties to be operated as a production unit to comply with spacing and prorationing restrictions.

   a. Kansas - Pooling must be voluntary.

   b. Missouri - If parties cannot agree to pool their interests, the council can order the separate interests in the spacing unit pooled for development. Mo. Ann. Stat. § 259.110 (Vernon 1990).

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

   a. Can be voluntary. In Missouri even voluntary agreements must be approved by the council.

Mo. Ann. Stat. § 259.120(1) (Vernon 1990).

b. Can be compulsory.

(1) Kansas - Kan. Stat. Ann. § 55-1305 (1983) (requires at least 75% of all interest owners to agree before the remaining 25% can be forced into the program).

(2) Missouri - Mo. Ann. Stat. § 259.120 (1990) (requires at least 75% of all interest owners to agree).

III. PROBLEMS ASSOCIATED WITH CONVEYANCE OF MINERAL INTERESTS

A. The Surface and Mineral Estates

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

2. Two basic issues:

a. What minerals have been conveyed?

b. What are the relative rights of the surface owner and the owner of the mineral estate?

B. Surface Use

1. To determine what right a mineral interest owner has to use the surface to support mining of the mineral, consider the following:

a. Does the deed creating the interest address the issue? If it does, the express terms of the deed will govern.

b. If the deed does not address the issue, the mineral interest owner will be given the implied right to make reasonable use of the surface to develop the granted minerals--the "reasonable use" doctrine.

2. Reasonable use doctrine still undefined in most states, including Kansas and Missouri.

a. However, if mining operations cannot accommodate a competing surface use, the surface use must give way.

b. **When representing real estate developers, must determine whether any minerals have been severed from the surface estate. The existence of the mineral estate will often impair any safe use of the surface for development.**

3. Although the mineral owner may have the right to use the surface, a separate issue is whether the mineral owner must pay for such use.

   a. Most oil and gas producing states hold that reasonable use can be made of the surface without payment for disruption of the surface.

   b. This has been changed by statute in some states.

   c. Issue undecided in Kansas and Missouri.

4. See generally D. Pierce, "Toward a Functional Mineral Jurisprudence for Kansas," 27 **Washburn L. J.** 223 (1987).

C. Defining What "Minerals" Are Conveyed

1. **A** conveys to **B** "all the minerals in Section 30." Who owns the minerals? Answer: **A** owns some, **B** owns some.

2. Since the owner of the minerals also obtains the right to use (often without further payment) the surface to mine the minerals, courts have tended to limit the scope of conveyances of "all minerals" or "oil, gas, and other minerals."

3. Common interpretive limits (designed to keep certain minerals with the surface owner--unless the conveyance **expressly** conveys them):

   a. Surface Destruction Test - Include substance in the grant only if it can be extracted without significant destruction to the surface.

   b. Community Knowledge Test - Include substance in the grant only if it was generally known to exist at the time of the conveyance.

   c. Construe Against Grantor - Construe deed against the grantor so as to pass the greatest estate possible to the grantee.

d. Ejusdem Generis - If the grant or reservation is of "oil, gas, or **other minerals**" limit the reference to "other minerals" to substances similar to oil and gas.

e. Tests used vary considerably from state-to-state.

4. **If you have property which is subject to a "mineral" or "other mineral" conveyance, must evaluate the case law of the state to determine, in light of the express language used, whether a mineral resides with a particular party.**

IV. COMMONLY CREATED OIL AND GAS PROPERTY INTERESTS

A. The Mineral Estate

1. Divided Interests.

2. Undivided Interests.

3. Term Interests.

4. Defeasible Interests.

5. Defeasible Term Interests.

6. Life Estate.

7. Depth Severances.

8. Substance Severances.

9. Nonparticipating Interests.

10. Combinations of the listed interests.

B. The Leasehold Estate

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

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

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

2. Lessor still owns the mineral interest; subject to the contractual terms of the oil and gas lease.

3. Three forms of landowner compensation under the lease:

   a. Bonus - upfront money paid to induce landowner to enter into the lease.

   b. Delay Rental - money paid to landowner to delay development of the lease for a specified period of time.

   c. Royalty - landowner paid a share of production when oil or gas are produced from the land. Traditional royalty is 1/8th of the oil produced and 1/8th of the value of gas produced and sold.

4. Can divide up lease much like the mineral interest.

5. Leasehold interest is called the "working interest." Lessee has the right to enter the property and "work" the lease.

6. Lessee often assigns non-operating rights out of the lease to third parties.

   a. Overriding Royalty - a right to a share of oil and gas from the leased land.

   b. Production Payment - like and overriding royalty but limited to payment of a specified amount of money or production.

   c. Net Profits Interest - share of **net** profits instead of a share of the gross production.

C. Basic Structure of the Oil and Gas Lease

1. Granting Clause.

2. Habendum (Term) Clause.

3. Drilling/Delay Rental Clause.

4. Royalty Clause.

5. Miscellaneous Express Covenants.

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

   a. The "Prudent Operator Standard."

   b. Implied covenants to explore and develop.

   c. Implied covenant to market.

   d. Implied covenant to protect against drainage.

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

V. DEVELOPMENT SEQUENCE

A. Exploration

1. Landowner enters into oil and gas lease with developer.

2. Developer may also obtain leasehold rights to develop from other lessees through a "Farmout Agreement."

   a. Farmout Agreement is a contract where a lessee agrees to assign its working interest in a lease to a developer in return for the developer's agreement to drill a well on the lease.

   b. Farmor usually retains an overriding royalty which can be "converted" to a working interest once the farmee recovers all its development costs from the well ("Payout").

3. Developer may decide to leverage its risk in drilling a well by sharing it with others.

   a. Assign fractional working interests to investors.

   b. Assign non-operating interests to investors.

   c. "Promoter" will sell interests in the venture and often the promoter will make money even though the well is dry.

(1) May get a free ride. Quarter-for-a-third deal: three investors each put up 1/3 the cost of drilling and completing a well in return for a 1/4th working interest in the lease and well equipment.

(2) May get a free ride **plus** profit on the sale of working interests. For example, enter into a turnkey drilling arrangement that costs $100,000. Sell a 1/4th working interest to three investors at $50,000 each. Not only does the promoter get a free ride in the well, also makes $50,000 even if the well never produces.

4. Often many trade creditors involved. Drilling contractor, well logging company, etc.

5. Developer often contracts with independent contractor (drilling company) to have the well drilled.

   a. Daywork drilling contract.

   b. Footage drilling contract.

   c. Turnkey drilling contract.

B. Production

1. If more than one working interest owner, they will most often enter into an Operating Agreement (also called a Joint Operating Agreement or "JOA") which designates one working interest owner as the "operator" and addresses how operations will be conducted.

2. Operating agreement specifies each parties ownership in production from the property.

3. If lease not large enough to meet spacing or prorationing requirements, may need to enter into pooling agreements with other leasehold owners in the drill site area.

C. Marketing

1. Transporters.

   a. Sales at the lease.

   b. Sales off the lease.

2. Production purchasers.

a. Division Orders; Transfer Orders.

b. Gas Sales Contract.

VI. REPRESENTING THE OIL & GAS INVESTOR

A. What Type of Deal?

1. Exploration?

2. Development?

3. Producing Properties?

4. Mixed?

B. The Major Risk Factor - The Promoter

1. Track record?

2. How much of their money is actually in the deal?

3. Will they make money even if the venture results in a dry hole?

4. References from other developers, investors, banks.

C. Obtain copy of proposed investment contract <u>and</u> the proposed operating agreement.

D. Second Major Risk - Personal Liability

1. Beware of the "Mining Partnership."

2. Environmental liability.

VII. INVENTORY YOUR CLIENTS WHO USE LARGE AMOUNTS OF ENERGY

A. New Gas Marketing Opportunities

1. Don't have to buy gas from the local public utility.

2. May be able to obtain gas at more competitive prices by direct gas purchases.

3. May also be able to avoid curtailment limitations imposed by local public utility sales.

4. Savings can be significant.

B. Open Access

1. The Federal Energy Regulatory Commission (FERC) has restructured the gas industry to permit end users and producers to buy and sell gas to one another and then transport it on interstate pipelines for a regulated transportation fee.

2. Often enables the end user to bypass the local gas utility and purchase and transport its gas needs at rates far below those charged by its traditional supplier.

VIII. OIL AND GAS AND THE BANKER

A. Unique Classification of Oil and Gas Interests

1. The law that must be followed to create an effective security interest depends upon the classification of the property interest being used as collateral.

2. The two major divisions are:

a. Real Property Interests. Governed by K.S.A. §§ 58-2301 through 58-2342 (1983 & Supp. 1990).

b. Personal Property Interests and Fixtures. Governed by Article 9 of the Uniform Commercial Code. K.S.A. §§ 84-9-101 through 84-9-508 (1983 & Supp. 1990).

3. When dealing with personal property interests and fixtures, must further classify the interests to determine which UCC Article 9 procedures apply.

B. Special Problems with Oil and Gas Interests

1. Three Sources of Classification

a. General case law classifications.

(1) **Mineral Estate.** When the surface and mineral estates are in separate ownership, the mineral estate, like the surface estate, is classified as **real property.** Froelich v. United Royalty Co., 178 Kan. 502, 507, 290 P.2d 93, 96 (1955), modified, 179 Kan. 652, 297 P.2d 1106

(1956).

(2) **Oil and Gas Lease.** "[A]n oil and gas lease conveys no interest in the land . . . but merely a license to explore, and is **personal property**--an incorporeal hereditament--a profit a prendre." Connell v. Kanwa Oil Co., 161 Kan. 649, 653, 170 P.2d 631, 634 (1946).

(3) **Royalty.** Classified as **personal property**, representing merely a right to share in oil and gas when it is actually produced. Magnusson v. Colorado Oil and Gas Corp., 183 Kan. 568, 571, 331 P.2d 577, 580 (1958).

(4) **Overriding Royalty; Production Payment; Net Profits Interest; Convertible Interest.** Since they are all carved from the oil and gas lease (an interest in personal property), they must be **personal property.**

b. Statutory classifications. Classification is often altered to treat the personal property interest like real property for specified purposes.

(1) E.g. K.S.A. § 58-2221 (1983) (record interests in oil and gas lease same as real estate interest).

(2) There are situations where statutes reaffirm the personal property classification: E.g., K.S.A. § 79-329 (1989) (oil and gas lease personal property for ad valorem taxation).

(3) There are situations where statutes **do not** expressly change the personal property classification:

(a) E.g., K.S.A. 60-2202 (Supp. 1990) (judgment lien statute applies only to "real estate" of the debtor).

(b) Utica Nat'l Bank & Trust Co. v. Marney, 233 Kan. 432, 661 P.2d 1246 (1983), court holds:

"[J]udgment . . . become liens upon the real estate of the debtor but do not become liens upon oil and gas leasehold interests. Such interests constitute personal property **except in those specific instances when that classification is changed by statute for a specific purpose.** Such is not the case here."

Marney, 233 Kan. at 435, 661 P.2d at 1248.

c. Context classifications. Although the interest would, under the general rule, be classified as **personal property**, the court finds that the context requires that the interest be dealt with as **real property**.

(1) Contract to convey oil and gas leases subject to statute of frauds. Robinson v. Smalley, 102 Kan. 842, 171 Pac. 1155 (1918).

(2) Oil and gas lease subject to recording statute. Derby Oil Co. v. Bell, 134 Kan. 489, 7 P.2d 39 (1932) (decided before statute was amended to specifically reference oil and gas leases).

(3) "[F]uture royalty (**unaccrued royalty**) is a part of the **real estate of the lessor** . . . . Present royalty (**accrued royalty**) on the other hand, is captured and severed from the realty; it is **personal property.**"

In re Estate of Sellens, 7 Kan. App.2d 48, 51, 637 P.2d 483, 486 (1981), rev. denied, 230 Kan. 818 (1982); see also In re Thexton, 39 B.R. 367 (Bankr., D. Kan. 1984) (unaccrued royalty interest is part of the exempt homestead).

(4) "[A] mortgage or assignment of an oil and gas leasehold for security purposes is to be treated as a real estate mortgage and . . . such instruments are not controlled by the provisions of the Uniform Commercial Code."

Ingram v. Ingram, 214 Kan. 415, 423, 521

P.2d 254 (1974) (court arrived at this conclusion noting that oil and gas leases were subject to the real estate recording statute K.S.A. § 58-2221).

C. Routine Changes in Collateral Classification

1. Routine development of oil and gas properties cause the collateral to shift from real property (oil or gas in the ground) to tangible personal property (severed oil or gas) to intangible personal property (account owed by production purchaser) and back to tangible personal property (cash proceeds).

2. As noted by Chief Justice Prager in Ingram v. Ingram, 214 Kan. 415, 423, 521 P.2d 254 (1974):

"The oil and gas situation presents an unusual problem. Oil and gas are considered to be part of the real estate until they are extracted; then they immediately change from realty to personalty. It is upon extraction that the law pertaining to security interests in personal property comes into play."

D. Types of Collateral

1. Intangible property interests such as contract rights:

a. The oil and gas lease is an asset of the developer which may be used to secure an obligation.

b. The right to receive a share of production from land is an asset. (Royalty, Overriding Royalty, Production Payment, Net Profits Interest, Convertible Interest)

c. A drilling company's right to payment under a drilling contract.

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

2. Tangible property interests, real and personal property, associated with oil and gas development:

Unextracted oil and gas, pumping unit, tubing, casing, flow lines, gathering lines, pipelines,

separator, heater-treater, stock tanks, dehydrator, compressor, saltwater disposal tanks, saltwater injection well, equipment and supplies on the lease, extracted oil and gas.

E. Tracing Collateral Through the Development Process

Oil & Gas as Collateral

In the Ground
UCC does not apply.[1]

When Produced from the Well
"Goods"[2] **"Inventory"**[3]

When Sold to a Production Purchaser
"Accounts"[4]

When Purchaser Pays for the Production
"Proceeds"[5]

IX. **FUTURE BUSINESS OPPORTUNITIES**

A. Environmental Law Comes to the Oil Patch

1. Hazardous waste liability (RCRA not a defense against CERCLA claims).

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[1]Article 9 applies to any transaction intended to create a security interest in personal property or fixtures. K.S.A. § 84-9-102(1)(a) (1983). Excluded from Article 9 is "the creation or transfer of an interest in or lien on real estate . . . ." K.S.A. § 84-9-104(j) (1983).

[2]Goods includes oil and gas after extraction. K.S.A. § 84-9-105(1)(h) (Supp. 1990).

[3]"Goods are . . . 'inventory' if they are held by a person who holds them for sale . . . ." K.S.A. § 84-9-109(4) (1983).

[4]"'Account' means any right to payment for goods sold . . . ." K.S.A. § 84-9-106 (1983).

[5]"'Proceeds' includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds . . . . Money, checks, deposit accounts, and the like are 'cash proceeds' . . . ." K.S.A. § 84-9-306(1) (1983) (amended by Senate Bill 12 effective July 1, 1991).

2. Oil Pollution Act of 1990.

3. Tort liability for land use problems. Marshall v. El Paso Natural Gas Co., 874 F.2d 1373 (10th Cir. Okla. 1989).

4. Criminal enforcement.

B. The New Gas Industry.

C. Litigation.

1. Revisiting the Basics.

2. Relational Contracts.

3. Tortious Interference.

4. Deregulation and Antitrust Law.

D. Oil and Gas Lending.

1. Banks doing things by the numbers.

2. Banks demanding a new degree of certainty.

E. Cyclic Business.

1. Litigation at each economic cycle.

2. Business opportunities at each regulatory cycle.

X. **FEES**

A. Situs of the Property At Issue.

B. Title Examination - many still do it on a flat-fee basis.

C. Other Services - hourly rate. May have negotiated rates for certain services where there is an on-going relationship.

D. Kansas: Don't forget K.S.A. §§ 55-201, 55-202, and 55-206 (1983).