

# **RECENT DEVELOPMENTS AND CRITICAL LEASE LANGUAGE**

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# Property Law Basics: Easements

- ***City of Arkansas City v. Bruton***, 166 P.3d 992 (Kan. Sept. 7, 2007).
- Not an “oil and gas” case.
- Oil and gas lease consists of a number of express and implied easements.
- Easement to enter property to search for and remove oil and gas: *profit à prendre*.

# Property Law Basics: Easements

- **Restatement (Third) of Property: Servitudes § 1.2(2):** defines a *profit à prendre* as “an easement that confers the right to enter and remove timber, minerals, oil, gas, game, or other substances from land in the possession of another.”
- Restatement refers to it simply as a “profit.”

# Property Law Basics: Easements

- It is “an established rule of property” that “an oil and gas lease conveys no interest in the land therein described but merely a license to explore, and is personal property – an incorporeal hereditament – a profit a prendre.” ***Connell v. Kanwa Oil, Inc.***, 161 Kan. 649, 653, 170 P.2d 631, 634 (1946).

# Property Law Basics: Easements

- The Restatement defines an “easement” as “a nonpossessory right to enter and use land in the possession of another and obligates the possessor not to interfere with the uses authorized by the easement.” § 1.2(1).

# Property Law Basics: Easements

- The dispute in *Bruton*:
- **1935:** City was conveyed an express easement to construct and maintain dike on land adjacent to the Arkansas River.
- **2000:** City and Corps sought to make improvements to the dike.
- Was this activity within the scope of the easement?

# Property Law Basics: Easements

- 4/3 Supreme Court holds:
- Improvements within the **geographic scope** of the easement.
- Improvements within **express authority to conduct “maintenance”** of the dike.
- Improvements **“in accordance with plans and specifications”** referenced in the easement grant.

# Property Law Basics: Easements

- Grant “easement . . . to **construct and maintain a dike for the purpose of** protecting . . . City . . . from damage by flood waters coming from the Arkansas River . . . .”
- “[S]aid dike is to be constructed and maintained **in accordance with plans and specifications prepared by the U.S. Army Engineers**, which plans and specifications have been examined and approved by first parties.”

# Property Law Basics: Easements

- The 4/3 split:
- The majority felt the expert testimony provided by the City answered the three issues in favor of the City.
- The dissent felt an issue of material fact remained concerning whether the activities were “in accordance with plans and specifications” referenced by the easement.

# Property Law Basics: Easements

- The “plans and specifications” referenced in the easement were never found.
- City’s expert examined drawings made when the dike was originally constructed and opined which drawing most likely reflected the missing “plans and specifications.”

# Property Law Basics: Easements

- **What's so important about this case?**
- The court's approach to the issue and its reliance on the **Restatement (Third) of Property: Servitudes.**
- Lets look at the Court's analysis in the context of the oil and gas lease.

# Property Law Basics: Easements

- ***Something for lessees:***
- When addressing the maintenance issue, the court quotes **Restatement § 4.10:**
- “[t]he manner, frequency, and intensity of the use [of an easement] may change over time **to take advantage of developments in technology and to accommodate normal development of the dominant estate or enterprise benefited by the servitude.**”

# Property Law Basics: Easements

- ***Something for lessors:***
- Court also quotes § 4.13 which provides:
- “Unless the terms of a servitude determined under § 4.1 provide otherwise, **duties to repair and maintain the servient estate and the improvements used in the enjoyment of a servitude** are as follows:

# Property Law Basics: Easements

- (1) The beneficiary of an easement or profit **has a duty to the holder of the servient estate to repair and maintain the portions of the servient estate and the improvements used in the enjoyment of the servitude that are under the beneficiary's control, to the extent necessary to**

# Property Law Basics: Easements

- (a) **prevent unreasonable interference with the enjoyment of *the servient estate***, or
- (b) **avoid liability of *the servient-estate owner* to third parties.**

# Property Law Basics: Easements

- Court quotes **Comment b. to § 4.13:**
- “[u]nder the rule stated in § 4.10, the holder of an easement or profit is entitled to **make any use of the servient estate that is reasonable for enjoyment of the servitude, including the right to construct, improve, repair, and maintain improvements that are reasonably necessary.**” (Emphasis by the Court).

# Property Law Basics: Easements

- Court also applies § 4.1:
- “(1) A servitude should be interpreted to give effect to the **intention of the parties** ascertained from the language used in the instrument, **or** the circumstances surrounding creation of the servitude, **and** to carry out the purpose for which it was created.”

# Property Law Basics: Easements

- Court quotes Official Comment a. to § 4.1:
- “[t]he circumstances of the mode of creation of the servitude affect the manner in which it is interpreted. *If the servitude is expressly created, the expressed intentions of the parties are of primary importance.*” (Emphasis by the Court).

# Property Law Basics: Easements

- ***Southern Star Central Gas Pipeline, Inc. v. Cunning***, 37 Kan. App.2d 807, 157 P.3d 1120 (May 18, 2007).
- Another “easement” case.
- The “blanket easement” analysis.
- The classic blanket easement: the oil and gas lease.

# Property Law Basics: Easements

- **1959**: landowner grants easement to Southern Star's predecessor-in-interest.
- **1959 or 1960**: 8" natural gas pipeline installed.
- **Easement authorizes Southern Star to**:  
“construct, reconstruct, renew, operate, maintain, inspect, alter, replace, repair, and remove **a pipeline** and . . .

# Property Law Basics: Easements

- “**for the transportation** of gas, oil, petroleum, or any of its products, water and other substances, **and such** drips, valves, fittings, meters and **other equipment and appurtenances** *as may be necessary or convenient for such operations* . . . together with the right of ingress and egress at convenient points for such purposes; *together with all rights necessary for the convenient enjoyment of the privileges herein granted.*”

# Property Law Basics: Easements

- **2003:** Ronnebaum, the owner of the land burdened by the easement, constructed a two-car garage that has a 27-foot wall 41 inches from the pipeline.
- **2004:** Cunning purchased the property from Ronnebaum and in the process of seeking to install electrical service to the garage the Kansas One-Call process revealed to Southern Star the location of the garage.

# Property Law Basics: Easements

- Southern Star brought suit in 2005 to have the garage removed to provide a 33-foot set back from the pipeline.
- No specified set back distance in the easement document.
- General language authorizing Southern Star right to use the burdened property to maintain its pipeline.

# Property Law Basics: Easements

- Court quotes *Aladdin Petroleum Corporation v. Gold Crown Properties, Inc.*, 221 Kan. 579, 561 P.2d 818 (1977):
- “The law appears to be settled that where the width, length and location of an easement for ingress and egress **have been expressly set forth in the instrument the easement is specific and definite**. The expressed terms of the grant or reservation are controlling in such case and considerations of what may be necessary or reasonable to a present use of the dominant estate are not controlling.”

# Property Law Basics: Easements

- In *Aladdin* the servient estate owner constructed carports on the easement.
- Remedy: mandatory injunction requiring removal of the carports.
- Cause of Action: “**Obstruction**” of the easement.

# Property Law Basics: Easements

- The *Aladdin* court defined “obstruction” as follows:
- “An obstruction or disturbance of an easement is **anything which wrongfully interferes with the privilege** to which the owner of the easement is entitled **by making its use less convenient and beneficial than before.**”

# Property Law Basics: Easements

- **Different rules for the “blanket easement.”**
- “The facts of *Aladdin* are distinguishable from the facts of this case because the easement in *Aladdin* covered a specific width, length, and location. **The easement in this case is a blanket easement that does not have specified dimensions** as it crosses the Cunning’s property.”

# Property Law Basics: Easements

- “The easement only provides that Southern Star is granted a right-of-way on the property sufficient to operate and maintain its pipeline, together with all rights necessary for the convenient enjoyment of this privilege. **Thus, Southern Star’s rights under its blanket easement are less precise and not as readily enforceable as the plaintiff’s easement rights in *Aladdin*.**”

# Property Law Basics: Easements

- “To prevail in this case Southern Star must establish *the encroachment on its easement was of a ‘material character’ as to interfere with Southern Star’s ‘reasonable enjoyment’ of its easement.*”

# Property Law Basics: Easements

- “In summary, **Southern Star’s blanket easement did not expressly define the amount of space Southern Star needed to adequately maintain its pipeline.** There was evidence that Southern Star could use means other than its standard practices in order to access and work on the pipeline. **The district court weighed the evidence and found no material interference with the easement. . . .** This does not mean that a 41-inch clearance from a natural gas pipeline would be considered adequate in every case. Under the facts of this case, however, we conclude the district court did not err in denying Southern Star’s request for injunctive relief.”

# Property Law Basics: Easements

- The *Southern Star* case indicates that until the **lessee (or severed mineral interest owner)** acts to use its “blanket” surface rights, any act of “obstruction” by the lessor/surface owner will most likely be evaluated determining whether the lessee has carried its burden of proof that: ***“the encroachment on its easement was of a ‘material character’ as to interfere with . . . [Lessee’s] ‘reasonable enjoyment’ of its easement.”***

# Property Law Basics: Covenants

- ***Jeremiah 29:11, Inc. v. Seifert***, 161 P.3d 750 (Kan., July 13, 2007).
- Lately have any of you pondered the difference between an “indenture” and a “deed poll”?
- **Indenture:** conveyance signed by the grantor and the grantee.
- **Deed Poll:** conveyance signed only by the grantor.

# Property Law Basics: Covenants

- What happens when the document is in indenture form, with a signature line for the grantee, but the grantee fails to sign?
- Nevertheless, the deed is delivered, accepted by the grantee, and recorded.
- Is the conveyance invalid? If so, does the grantor still own the land?
- Are covenants contained in the deed invalid? If so, is the conveyance valid?

# Property Law Basics: Covenants

- **1978:** Jordans convey land to the Dallingas using an indenture form of deed; the Dallingas do not sign.
- The deed contained restrictive covenants limiting use of the land to residential purposes.
- **1978:** Dallingas accept delivery of the deed, record it, enter into possession, and abide by the covenant limitations.

# Property Law Basics: Covenants

- **1999:** Jeremiah obtains the Dallingas land.
- Seifert now owns Jordan land.
- Seifert seeks to enforce covenant against Jeremiah.
- **Trial Court:** covenants not effective because deed not signed by grantee.
- **Court of Appeals:** deed was effective to convey land and covenant ran with the land.

# Property Law Basics: Covenants

- **Supreme Court** (unanimous): failure of grantee to sign deed meant register of deeds should not have accepted it for recording but, even though placed of record, it did not give constructive notice of the covenant to Jeremiah.
- **Question:** would mutual covenants be binding on the grantor in such a case?

# Property Law Basics: Covenants

- Note that oil and gas leases are a collection of mutual covenants in addition to the transfer of an interest in land.
- Also note, there are frequently a number of blank signature lines at the bottom of an oil and gas lease.

# Property Law Basics: Covenants

- Didn't somebody look at the deed in this case?
- It was the grantee's source of title.
- Was it constructive notice for conveyancing purposes but not for the covenant contained in, and a part of, the conveyance?

# Property Law Basics: Covenants

- Court notes Jeremiah was unaware of the restrictive covenants when it purchased the property.
- This is the normal state of affairs for all property buyers.
- Real estate agents don't point them out.
- Attorneys representing a prospective buyer should ensure the buyer is aware of any covenants before they enter into a purchase contract.

# Property Law Basics: Covenants

- Is it possible, without limiting, explanatory language, for a grantee to limit the effect of their acceptance of a deed to the conveyance component and not the covenant component?
- Apparently so if there is a signature line on the deed for the grantee to sign, and they fail to sign – even though they accept the conveyance without objection or condition.

# Property Law Basics: Covenants

- Why does this case bother me?
- The answer, I think, is bound up in the **ghost of horizontal privity!**
- The court applies a **contract analysis** to this case as though there was no concurrent conveyance of land involved; as though there was no horizontal privity.

# Property Law Basics: Covenants

- A owns Tract A, B owns Tract B. A and B desire to enter into an agreement regarding their mutual maintenance of the fence between Tract A and Tract B. They enter into an agreement whereby A and B each covenant to do, or not do, certain things regarding maintenance of the fence. They state that the agreement is binding on their “heirs and assigns” and is intended to be a covenant running with the land.

# Property Law Basics: Covenants

- **As a matter of contract law**, B's failure to sign the agreement may indicate a lack of agreement (mutual assent) or it may create enforcement problems under the statute of frauds.
- **As a matter of “real covenant law,”** even if the document were signed by both parties, it would not “run with the land” because it lacks the requisite “horizontal privity.” There is no privity ***of estate***.

# Property Law Basics: Covenants

- **As a matter of “real covenant law,”** to have the requisite property-based privity (as opposed to privity *of contract*), **the covenant must be made in conjunction with a transfer of the affected property.**
- However, applying an **“equitable servitude”** analysis, courts will generally enforce this form of purely contractual covenant relying upon **“notice” as opposed to privity of estate.**

# Property Law Basics: Covenants

- **A property analysis:** Assume A owns Tract A/B and conveys a portion, Tract B, to B. If the fence covenant is made as part of the conveyancing transaction, the requisite horizontal privity would exist.
- The covenant would “run with the land, *i.e.*, bind a subsequent owner,” so long as (quoting the Supreme Court in *Jeremiah*):

# Property Law Basics: Covenants

- “[T]he grantor and grantee must **intend that the covenant run with the land**; the covenant **must touch and concern the land**; and there must be privity of estate [**horizontal privity**] between the original parties to the covenant, the original parties and the present litigants [**vertical privity**], or between the party claiming the benefit of the covenant and the party burdened. In addition, the covenant **must be in writing**, and the successor to the burden must have had **notice** of it.”

# Property Law Basics: Covenants

- Only element apparently at issue: notice.
- Constructive notice is sufficient.
- The very deed which is the source of the grantee's only property interest in the land at issue is also the document which contains the limitation on the use of the property the document conveys.
- The deed containing the covenant was recorded.

# Property Law Basics: Covenants

- **Statute of Frauds: Which One?**
- The statute applicable to this situation is not K.S.A. § 33-106 but rather K.S.A. § 33-105 which states: “No leases, estates or interests of, in or out of lands . . . shall at any time hereafter be assigned or granted, unless it be by deed or note, in writing, **signed by the party so assigning or granting the same . . . .**”
- Section 33-105 employs a “property” analysis while § 33-106 employs a “contract” analysis.

# Property/Contract Analysis

- **1995:** A and B enter into a joint operating agreement.
- **2000:** B assigns its interest to C.
- **2005:** C assigns its interest to D.
- **2006:** D consents to drilling another well on the contract area. A, the operator, drills the well and bills D for D's share of the costs. D is unable to pay.
- **Can A sue C, who no longer owns any working interest in the contract area, to pay the costs that D agreed to but cannot pay?**

# Property/Contract Analysis

- Something to think about, particularly when the price of oil returns to \$20/barrel.

# Property/Contract Analysis

- ***Seagull Energy E & P, Inc. v. Eland Energy, Inc.***, 207 S.W.3d 342 (Tex. 2006).
- Can ***you*** be held liable for ***your assignee*** who elects to participate in a well (ten years after you assigned all your interest in the contract area) and then fails to pay their share of the development costs?

# Property/Contract Analysis

- The “***advance novation***” clause of the Oil and Gas Lease:
- “In the event of an assignment hereof in whole or in part, liability for breach of any obligation issued hereunder shall rest **exclusively upon the owner of this Lease**, or portion thereof, **who commits such breach.**”

# Property/Contract Analysis

- The advance novation clause in the Oil and Gas Lease uses a privity of estate basis for liability.
- Each party liable only for acts occurring during their ownership of the leasehold and to the extent of their leasehold interest.

# Property/Contract Analysis

- Court's holding in ***Seagull***:
- Working interest owner's obligations under operating agreement continue even after assigning its working interest to a new owner.
- No novation, or "advance novation."

# Property/Contract Analysis

- Assignee of working interest failed to reimburse operator for its share of operating costs.
- Assignee *and assignor* each held liable for the \$268,418.90 in unreimbursed costs.
- “[A] party cannot escape its obligations under a contract merely by assigning the contract to a third party.”

# Property/Contract Analysis

- This assumes the contract does not provide for a release from continuing liability (the advance novation clause).
- “[A] party who assigns its contractual rights and duties to a third party remains liable unless expressly or impliedly released by the other party to the contract.”

# Property/Contract Analysis

- The court reviews the operating agreement and concludes it: “simply does not explain the consequences of an assignment of a working interest to a third party.”
- Court also considers whether there is an *implied* release from continuing liability.
- Court discusses the *Restatement of Property* and the *Restatement of Contracts*.

# Property/Contract Analysis

- Although not addressed by the court, a “property” analysis that could exempt the assignor from continuing liability following conveyance of its working interest is a “***covenant running with the land***” analysis.
- Argue the parties intended the burden to run with ownership of the working interest.

# Property/Contract Analysis

- The ***Seagull*** case will prompt a careful review of existing operating agreements to determine whether they have express language addressing the issue or imply that the obligations should “run with the land” as opposed to having a lingering contractual presence.

# Property/Contract Analysis

- For example, the A.A.P.L. Form 610-1989 Model Form Operating Agreement states, under the heading “Successors and Assigns:”
- “This agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, devisees, legal representative, successors and assigns, ***and the terms hereof shall be deemed to run with the Leases or Interests included within the Contract Area.***”

# Property/Contract Analysis

- Employing a property analysis it could be argued this standard language expresses the intent that liability should “run with the Leases or Interests included within the Contract Area.”
- The problem is easily addressed in future agreements with appropriate language (either imposing continuing liability or providing for an advance novation).

# Property/Contract Analysis

- What about all those other routine oil and gas contracts that do not explicitly address the assignor's continuing liability?

# The Wellbore Assignment

- ***Petro Pro. LTD v. Upland Resources, Inc.***, 2007 WL 1717178 (Text. Ct. App., June 14, 2007).
- “All of Seller’s right, title and interest in and to the oil and gas leases described in Exhibit “A” attached hereto and made a part hereof . . . insofar and ***only insofar as said leases cover rights in the wellbore of the King ‘F’ No. 2 Well.***”

# The Wellbore Assignment

- When assigned the well was on a 704-acre pooled gas unit completed in the Cleveland formation.
- **Issue:** Can the owner of the wellbore rights recomplete the well in the shallower Brown Dolomite formation?
- **Issue:** Can the owner of the retained rights drain the Brown Dolomite by completing a well near the well?

# The Wellbore Assignment

- Wellbore owner argued they had the exclusive right to produce gas from the 704-acre pooled gas unit in all formations penetrated by the King “F” No. 2 Well.

# The Wellbore Assignment

- **Analysis:**
- Petro received a determinable fee interest in the oil and gas in place.
- **Vertical Rights:** defined by the existing wellbore to include any formation penetrated.
- **Horizontal Rights:** limited by the confines of the wellbore.

# The Wellbore Assignment

- Rights Appurtenant:
- Right to explore and develop the lease.
- Includes the right to rework the King “F” No. 2 Well to produce from any formation.
- “Subject to governmental regulations . . . .”

# The Wellbore Assignment

- Right “does not extend beyond the present confines of the wellbore.”
- “Petro does not have the right to extend the present well beyond its current depth, nor does it have the right to drill horizontally beyond the confines of the existing wellbore.”
- No ownership interest in gas beyond the wellbore.

# The Wellbore Assignment

- “To the extent that the leases embodied other rights not exclusive to the possession and use of the wellbore in question (*e.g.*, the right to extend the lease by the payment of shut-in royalties), the assignment created a co-tenancy with the other lessees, with each party sharing those incorporeal appurtenant rights.”
- Cotenants?

# The Wellbore Assignment

- “[A] wellbore assignment is the narrowest form of oil and gas assignment.”
- **Judge Campbell, concurring and dissenting:** Petro’s rights should be limited to the formation in which it was completed at the time of the assignment with no right to open up a new formation penetrated by the wellbore.

# The Wellbore Assignment

- I wonder what the original parties to the assignment intended?
- “Here, none of the parties allege that the assignments are ambiguous, and we agree that they are not.”

# Destroying Survivorship

- ***In re Estate of Quick***, 905 A.2d 471 (Penn. 2006).
- **A & B** own land in joint tenancy with the right of survivorship.
- **A** leases to **X**.
- **B** subsequently leases to **X**, with some terms that differ from the **A/X** lease.

# Destroying Survivorship

- **A** dies.
- Does **B** own all the land?
- What about the impact on the **A/X** lease?
- If the joint tenancy was severed when **A** leased to **X**, **A** and **B** became cotenants.
- If so when **A** dies, **A**'s interest will pass through **A**'s estate as opposed to going to **B** as the survivor.

# Destroying Survivorship

- At common law if the any of the four unities cease to exist, the joint tenancy becomes a tenancy in common.
- **Unities of: (1) interest; (2) title; (3) time; and (4) possession.**
- Arguably when **A** granted the oil and gas lease it changed the interest, title, and possession that **A** had compared to **B**.

# Destroying Survivorship

- Since you must have a clear intent to **create** a joint tenancy, there should be an equally clear intent to **destroy** a joint tenancy.
- Although the court does not expressly abandon the unities analysis, that was its obvious goal in re-characterizing the facts and then focusing on intent.

# Destroying Survivorship

- What is motivating the court to avoid a unities analysis in favor of an intent analysis?
- An intent analysis avoids the *surprise* that **A** and **B** may have when they discover that by entering into an oil and gas lease they have changed their underlying legal relationship regarding the property.

# Destroying Survivorship

- Why is this observation useful?
- The “**intent**” analysis might be overcome by a “**surprise**” analysis—follow the unities requirement when the resulting severance would not be an unfair surprise to the parties.
- Trying to prevent an inadvertent change in ownership, and the right to survivorship.

# Destroying Survivorship

- Manipulating the law vs. ignoring the law.
- In *In re Estate of Quick* the court manipulates the facts to avoid an undesirable legal outcome.
- In *In re Estate of Lasater* the court simply ignores the law and holds that the unity of interest is not violated when **A** owns a 1% interest and **B** owns a 99% interest.

# Destroying Survivorship

- What does the applicable statute suggest?
- **K.S.A. § 58-501 (2005).**
- “unless the language used in such grant or devise makes it clear that a joint tenancy was intended to be created . . . .”
- Eliminates some of the traditional situations where the unities would be violated: one owner transfers to the himself and others as joint tenants.

# Transactional Law Issues

- ***Bergman v. Commerce Trust Company***, 35 Kan. App.2d 301, 129 P.3d 624 (2006).
- Rights of first refusal.
- What acts are required to trigger the right of first refusal?
- Must first have a desire to sell.
- Then must receive an acceptable bona fide offer.
- Settlement with heir not a trigger.

# Transactional Law Issues

- Rights of first refusal and the rule against perpetuities.
- Is it still an issue in Kansas?
- Uniform Statutory Rule Against Perpetuities, K.S.A. §§ 59-3401 *et seq.*
- Article 2, § 16 of the Kansas Constitution.
- “No bill shall contain more than one subject . . . .”

# Preferential Right to Purchase

- ***Fordoche, Inc. v. Texaco, Inc.***, 463 F.3d 388 (5<sup>th</sup> Cir. 2006).
- Issues encountered when a working interest owner seeks to sell burdened properties in a “package sale” with other properties.

# Preferential Right to Purchase

“Before the sale to third party by any Operating Party of its interest, in whole or in part, in the properties affected by this agreement, the other Operating Parties shall be given the refusal thereof at the best price offered in good faith by a third party, and such other Operating Parties shall have the preferred right to purchase at the price stated, which shall be exercised within thirty (30) days after receipt of written notice of the offer made by a third party.”

# Preferential Right to Purchase

“Before the sale . . .by any party of all or any part of its interest in Unitized Substances, the other party or parties shall be given the preferential right of the refusal of the purchase of such interest at the minimum sale price placed thereon by the party offering such interest for sale, and any one or more of the parties desiring to purchase such interest shall have the preferential right to purchase at said price.”

# Preferential Right to Purchase

- Seller offers properties in a \$78.7 million package; prospective purchaser values the ROFR properties at \$2 million.
- Seller notifies ROFR holder that the ROFR only applies to the working interest owner's fractional share of production and not any of the physical or intangible assets.

# Preferential Right to Purchase

- Preferential rights recognized by the Louisiana Civil Code.
- **Article 2625:** “A party may agree that he will not sell a certain thing without first offering it to a certain person. The right given to the latter in such a case is a right of first refusal that may be enforced by specific performance.”

# Preferential Right to Purchase

- **Article 2626:** “The grantor of a right of first refusal may not sell to another person unless he has offered to sell the thing to the holder of a right on the same terms, or on those specified when the right was granted if the parties have so agreed.”

# Preferential Right to Purchase

- The court found the Seller's offer letter failed to:
- (1) recognize all the property interests that were subject to the ROFR;
- (2) specify the property being offered by Seller; and
- (3) offer the property subject to the ROFR on the same terms the property was sold to the third party purchaser.

# Preferential Right to Purchase

- The court also considers whether the Seller breached the obligation of “good faith” recognized by the Civil Code as being part of all contracts.
- The analytical tool the court uses to define “good faith” in this situation is “cooperation.”

# Preferential Right to Purchase

- The court notes:
- “Within the record, there are several implications of [Seller’s] bad faith, i.e., evidence that leads to the inference that [Seller] did not cooperate with the [holder of the ROFR] to attain the mutual end for which they entered into the ROFRs.”

# Preferential Right to Purchase

- The court's cooperation analysis comes from Professor Saul Litvinoff's scholarship where he notes: "good faith binds the parties to a contract to cooperate with each other in order to attain the mutual end for which they entered into the agreement."

# Transactional Law Issues

- ***Newman Memorial Hospital v. Walton Construction Company***
- Useful contract clauses.
- Limiting the applicable statute of limitations.
- Specifying the accrual date.
- Avoids a \$1 million jury verdict.
- Discussing settlement not an estoppel.

# Transactional Law Issues

- Contracting to avoid misrepresentation claims.
- Focus on the “reliance” requirement for a misrepresentation claim.
- “A party cannot avoid a contract on the ground of misrepresentation unless the party relied on it in manifesting assent.”
- ***Alires v. McGehee*** (Kan. Sup. Ct. 2003)

# Transactional Law Issues

- “Under the facts of this case, the buyer of real estate ***could not reasonably rely upon representations of the seller*** when the truth or falsity of the representation would have been revealed by an inspection of the subject property and the misrepresentations were made prior to or as part of the contract in which the buyer contracted for the right to inspect, agreed that the statements of the seller were not warranties and should not replace the right of inspection, declined inspection, and waived any claims arising from defects which would have been revealed by an inspection.”

# Transactional Law Issues

- ***Brennan v. Kunzle*** (sellers' failure to disclose report, fraud by silence, material issue of fact regarding inspection).
- ***Phillips v. Tyler*** (contract language caused reversal of \$1 million jury verdict).
- ***McLellan v. Raines*** (contract language and information from inspection negates any reliance on inadequate disclosure).

# Transactional Law Issues

- ***Crandall v. Grbic*** (contract language protects real estate agent too; also has statutory protection).
- Buyers and sellers should never mix. Closing day walk-through together.
- Failure to comply with mediation clause warranted summary judgment.
- Breach? Condition? Both?

# Ad Valorem Taxation

- ***In re Director of Property Valuation***, 161 P.3d 755 (Kan., July 13, 2007).
- Does the current definition of “public utility” found at K.S.A. 2006 Supp. § 79-5a01 include non-Kansas entities that purchase gas storage services from interstate pipelines when the gas is stored by the pipelines in facilities located in Kansas?

# Ad Valorem Taxation

- No.
- The non-Kansas entities must “own, control *and* hold for resale stored natural gas in an underground formation in the state.”
- To determine the status of the gas in Kansas storage facilities, the Court looks to the pipeline tariffs.

# Ad Valorem Taxation

- Southern Star tariff:
- “Southern Star shall be in control and possession of the natural gas it receives hereunder and responsible, as between Southern Star and Shipper, for any damage or injury caused thereby until the same have been delivered to Shipper at the point of delivery.”

# Ad Valorem Taxation

- ***Cimarex Energy Co. v. Seward County Board of County Commissioners***, 164 P.3d 833 (Kan. Ct. App., Aug. 10, 2007).
- Seward County valued Cimarex gas using the Oil and Gas Appraisal Guide.
- Cimarex objected to the County's valuation and commenced an equalization proceeding.

# Ad Valorem Taxation

- County sought access to Cimarex's confidential reserves information to support the County's appraisal.
- BOTA held County was entitled to the information to support its challenged appraisal numbers.
- Cimarex objected stating the County had established no "just cause" because it too was applying the Appraisal Guide.

# Ad Valorem Taxation

- K.S.A. § 79-1456:
- “The county appraiser is obligated to follow the Oil and Gas Appraisal Guide (Guide) prescribed by the Director of Property Valuation but may deviate from the Guide on an individual piece of property ‘for just cause shown and in a manner consistent with achieving fair market value.’”

# Ad Valorem Taxation

- Here there was no deviation from the Guide; it was used to appraise the property.
- The only issue is whether the Guide was properly applied by the County.
- What Cimarex may believe its reserves are is not relevant to whether the Guide was used properly by the County.

# Gas Storage Issues

- ***Northern Natural Gas Company v. Nash Oil & Gas, Inc.***, 2007 WL 926137 (D. Kan., March 27, 2007).
- Nash operates gas wells 4.5 miles from the boundary of Northern's gas storage facility.
- Prior rulings: not "adjacent" so cannot test using K.S.A. § 55-1210.

# Gas Storage Issues

- Can Northern assert ownership to gas that allegedly migrated from its storage facility and into land leased to Nash?
- Court relies upon procedural defenses: statute of limitations and defensive collateral estoppel.
- No “continuing tort” because Northern’s injury was aware of the injury.

# Gas Storage Issues

- ***Northern Natural Gas Company v. Trans Pacific Oil Corporation***, 2007 WL 2461620 (D. Kan., Aug. 23, 2007).
- Northern commenced administrative proceedings at the FERC to expand its storage facility to encompass the Trans Pacific lands.
- Court abstains from interfering with the administrative process.

# Third Party Beneficiary

- Something to think about, particularly when the price of oil returns to \$20/barrel.

# Third Party Beneficiaries

- ***In re Moose Oil & Gas Company*, 347 B.R. 868 (Bankr. S.D. Tex. 2006).**
- **A** leased land to **X**.
- **X** enters operating agreement with **Y**.
- **X** goes nonconsent, **Y** gets production revenue during payout period.
- Royalty is not paid to **A**.
- **A** sues **Y** under operating agreement.

# Third Party Beneficiaries

- **A** is not a party to the **X/Y** operating agreement.
- **A** has no privity of contract with **Y**.
- Basis for holding **Y** liable for **X**'s non-payment of royalty: **A** is a third party beneficiary of the **X/Y** operating agreement.

# Third Party Beneficiaries

- The operating agreement states:
- “During the period of time Consenting Parties are entitled to receive Non-Consenting Party’s share of production, or the proceeds therefrom, **Consenting Parties shall be responsible for the payment of . . . all royalty . . . and other burdens applicable to Non-Consenting Party’s share of production . . . .**”

# Third Party Beneficiaries

- “To be a third party beneficiary of a contract under Texas law, a party must establish both that (1) **the contracting party intended to confer some benefit to the third party**; and (2) **the contracting party entered into the contract directly for the third party’s benefit.** . . . . The intent to benefit a third party must be clear from the language of the agreement. . . . Persons who benefit only incidentally by the performance of the contract are not third party beneficiaries.”

# Third Party Beneficiaries

- The court holds **A** was a third party beneficiary of the clause obligating **Y** and other Consenting Parties to pay “all royalty . . . applicable to Non-Consenting Party’s [**X**’s] share of production.”
- The court also holds that **Y**’s contractual liability to **A** is not limited to **Y**’s proportional working interest in the contract area encompassed by the operating agreement.

# Royalty Game Jurisprudence

- The “*Tana and Tawney*” of Royalty Game Jurisprudence.
- If the oil and gas lease provides for a “1/8<sup>th</sup> Royalty”
  - Can the Lessee pay a “1/16<sup>th</sup> Royalty”?
  - Can the Lessor demand a “3/16<sup>th</sup> Royalty”?

# Royalty Game Jurisprudence

- The major element of the royalty equation that is subject to manipulation by lessors and lessees alike is the **location** where the royalty fraction will be applied.
- *E.g.*, applying the fraction at the wellhead will net a different royalty than if the same fraction is applied at the tailgate of a processing plant or at a refinery.

# Royalty Game Jurisprudence

- One of the few facts on which lessors and lessees can agree is:
- **Following extraction, oil and gas tend to increase in value as they move downstream away from the wellhead.**

# Royalty Game Jurisprudence

- The “royalty game” describes the actions of litigants to maximize their positions under a contract clause which bases compensation on the value of oil and gas; a value which increases as the oil and gas moves from the point of production to the point of consumption.

# Royalty Game Jurisprudence

- Lessors will seek to receive a fraction of a downstream value while lessees will seek to pay a fraction of an upstream value.
- The cases discussed demonstrate the latest theories being employed by lessors and lessees to ensure royalty is calculated at the location which maximizes their position.

# Royalty Game Jurisprudence

- Although frequently discussed as a “deduction-of-costs” issue, these cases are really about the “location” where production must be valued for royalty purposes.
- The deduction of costs is merely a necessary step that is often required to apply the proper location for royalty valuation.

# The Texas Analysis

- ***Tana Oil and Gas Corp. v. Cernosek***, 188 S.W.3d 354 (Tex. Ct. App.—Austin 2006), *review denied* (July 28, 2006).
- The “percentage of proceeds” or “POP” contract has prompted attorneys for lessors to argue that payment of royalty on anything less than 100% of the gas purchaser’s resale proceeds is a breach of contract.

# The Texas Analysis

- The POP contract merely provides that the risks and rewards of changes in the purchaser's resale market will be *shared* by buyer and seller.

# The Texas Analysis

- The POP contract terms:
- Clajon agreed to pay Tana: “(1) **84%** of the combined monthly sales prices of the component-plant products extracted from the raw gas; and (2) **84%** of the alternate market resale price for all residue gas remaining after treatment.”

# The Texas Analysis

- Trial court entered summary judgment against Tana for \$1,267,470.33 in unpaid royalties, \$937,846.72 in prejudgment interest, and \$780,860 in attorney fees.
- On appeal: reversed, payment of 84% of the proceeds complied with the royalty clause.

# The Texas Analysis

- Court of appeals focuses on the value of the gas at the place of production not the place of sale.
- Focus on the location language of the royalty clauses at issue.

# The Texas Analysis

- “Tana did not sell the residue gas or the liquids; Tana sold raw gas at the well, before value was added by preparing the gas for market. . . . In exchange for its sale of 100% of the total volume of raw gas at the well, Tana received a price equivalent to 84% of the proceeds for the processed gas.”

# The Texas Analysis

- The court recognizes that **gas can have different values at different locations as it moves away from the wellhead** through a processing plant and ultimately to a pipeline distribution system.
- The court acknowledges that once you determine the appropriate location for calculating royalty, a failure to deduct value-enhancing costs beyond that point **results in the payment of royalty on “costs” as opposed to “gas.”**

# The Texas Analysis

- The “at the well” language guides the court regarding the proper location for valuing the gas and at the same time answers the deduction-of-costs issue by recognizing the necessity of adjusting downstream values to calculate “at the well” values.

# The Texas Analysis

- Some of the gas produced from the leased land was used to support production operations on the leased land, in this case “gas-lift” operations.
- Royalty owners asserted they were entitled to royalty on gas used in gas-lift operations.
- Court holds the express terms of the various oil and gas leases authorize Tana to use the gas in all operations, without any obligation to pay royalty on the gas.

# Royalty Game Jurisprudence

- What prompts courts to ignore specific location references, such as “at the wellhead”?
- What prompts courts to search for a way to negate location language?

# The West Virginia Approach

- ***Tawney v. Columbia Natural Resources, L.L.C.***, 633 S.E.2d 22 (W. Va. 2006).
- Lessee marketed gas at downstream delivery points on a pipeline system.
- Lessee deducted from the downstream sales price the cost of moving the gas from the wellhead to the pipeline delivery point.

# The West Virginia Approach

- The oil and gas leases provided for a royalty “at the well,” “at the wellhead,” “one-eighth of the price, net of all costs beyond the wellhead,” or “less all taxes, assessments, and adjustments.”
- Court concludes this language is ambiguous regarding the deduction of costs from downstream sales proceeds.

# The West Virginia Approach

- Instead of seeking to try and ascertain the intent of the parties to resolve the ambiguity, the court relies upon the rule of construction “construe the language against the lessee.”
- Royalty based upon the downstream sales price without any location adjustment.

# The West Virginia Approach

- **Premise #1:** “traditionally . . . the landowner has received a royalty ***based on the sale price*** of the gas received by the lessee.”
- **Premise #2:** it is “the general duty of a lessee to ***market*** the oil and gas produced.”
- **Premise #3:** royalty owner “is not chargeable with any of the ***costs of discovery and production.***”

# The West Virginia Approach

- Regarding premise #3 the court uses the terms “discovery and production” to include “the expense of *transporting oil and gas to a point of sale . . . .*”

# The West Virginia Approach

- The total effect of the court's premises is to create a presumption that **wherever the gas is sold to generate proceeds, that is the number to be used to calculate royalty; regardless of how far downstream the sale may occur.**
- This is accomplished by negating the “at the well” language as having anything to do with the deduction of costs.

# The West Virginia Approach

- Doesn't "at the well" tell us a lot about "location" for calculating royalty?
- The future issue will be whether courts will allow the lessee to offer evidence to try and resolve the location "ambiguity" as opposed to being held to a single rule of construction against the lessee.

# The West Virginia Approach

- The effect of negating the wellhead language is to shift the critical “location” analysis away from “the wellhead” to “the point of sale.”
- This is where the court’s use of the premise that lessor royalty is “based on the sale price of the gas received by the lessee” becomes so important.

# The West Virginia Approach

- If the assumption (royalty is NOT “based on the sale price of the gas received by the lessee”) is not accurate for the specific transaction at issue, this would be an important fact in resolving any ambiguity regarding royalty calculation.
- Court relied on a 1951 treatise for this assumption.

# The West Virginia Approach

- What motivated the court to ignore the “at the well” location language?
- Is there some sort of unstated problem it is seeking to “solve” for lessors in general?

# The West Virginia Approach

- Court observes there has been “**an attempt** on the part of oil and gas producers in recent years to charge the landowner with a pro rata share of various expenses connected with the operation of an oil and gas lease such as the expense of transporting oil and gas to a point of sale, and the expense of treating or altering the oil and gas so as to put it in a marketable condition.”

# The West Virginia Approach

- There is a legitimate explanation for why transportation charges, post-1951, are being deducted to calculate royalty.
- Federal regulatory changes beginning in 1985, and continuing into 1992, have made it possible for producers to market gas at many locations downstream from the wellhead.
- Producers now have access to pipeline services that allow them to market downstream from the wellhead.

# The West Virginia Approach

- Nevertheless, the court attributes a sinister element to the situation stating:
- **“To escape the rule that the lessee must pay the costs of discovery and production, these expenses have been referred to as ‘post-production expenses.’”**

# Royalty Game Jurisprudence

- Not a deduction-of-costs issue.
- As noted, it is a “location” issue.
- How do we define the location?
- If the express terms of the lease do not provide the answer, then the issue is **where** must the lessee market the gas to fulfill their royalty obligations?

# Royalty Game Jurisprudence

- Saying the lessee must “market” the production does not answer the question because the lessee often has many marketing options at many locations.
- Once it is established **where** the lessee **must market** the production, that should (absent express language addressing the matter), define the critical location for royalty calculations.

# For Further Discussion

- David E. Pierce, “Developments in Nonregulatory Oil and Gas Law: Beyond Theories and Rules to the Motivating Jurisprudence, 58 Institute on Oil and Gas Law 1-1 (2007).