KANSAS OIL AND GAS LAW INSTITUTE

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by

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Outline Table of Contents

SESSION 1 - INTRODUCTION TO OIL AND GAS LAW
PART A - BASIC OIL AND GAS CONCEPTS

PART B - COMMONLY CREATED OIL AND GAS PROPERTY INTERESTS

SESSION 2 - CONVEYANCES OUT OF THE MINERAL INTEREST

SESSION 3 - ASSIGNMENTS OUT OF THE LEASEHOLD INTEREST

SESSION 4 - THE OIL AND GAS LEASE

SESSION 5 - PART A
REPRESENTING THE LESSEE

SESSION 5 - PART B
REPRESENTING THE LESSOR AND SURFACE OWNER

SESSION 6 - PITFALLS UNIQUE TO KANSAS

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SESSION 1 - INTRODUCTION TO OIL AND GAS LAW
PART A - BASIC OIL AND GAS CONCEPTS

I. The Oil and Gas Development Process
[Reference: Chapter 1, Kansas Oil and Gas Handbook]

A. Five Phases

1. Exploration - application of various techniques to identify areas likely to contain oil and gas deposits. Handbook §1.02.

   a. Seismic surveys - most common technique and the one which often gives rise to disputes.

   b. Generally, must obtain right to conduct exploratory activities from owner(s) of the mineral rights.

2. Land Acquisition - acquire the right to enter property and conduct operations. Handbook §1.03.

   a. Right to enter and use the surface of land to conduct operations.

   b. Right to produce minerals found beneath the surface of the land.

   c. Usually accomplished by all interested parties entering into an oil and gas "lease".

3. Drilling - identify a prospect, obtain the necessary permits, acquire a drilling rig, and commence drilling operations. Handbook §1.04.

   a. After reaching projected depth, conduct tests, such as logging and taking core samples, to see if well should be completed.

   b. Decide not to complete, or complete without finding oil or gas in commercial quantities, plug and abandon as a dry hole.

   c. Complete and find oil or gas in commercial quantities, enter the production phase.

4. Production - construct facilities to produce, treat, store, and deliver oil or gas to a

purchaser. Handbook §1.05.

a. Enter into agreements with purchaser to sell production.

b. Establish accounting procedures to pay royalty, working interest, and taxes in accordance with development contracts and state and federal law.

c. Manage wells to obtain the most production and the best price possible for the oil and gas produced.

5. Post-Production - when the economic limit of the operation is reached, properly plug and abandon the well and reclaim the well site. Handbook §1.06.

a. Comply with state law and terms of contract in abandoning the well site.

b. Record the necessary documents to release the lease as an encumbrance against the landonwer's title.

B. Special Industry Attributes - certain industry facts and practices must be acknowledged to fully appreciate common problems encountered in oil and gas law. Handbook §§1.07 - 1.15.

1. Complex ownership of the resource is common.

2. Capital-intensive undertaking.

3. High risk undertaking.

a. Unsuccessful operations - all you have is a lengthy hole in the ground which, in most cases, has no economic value and, in most cases, is a liability.

b. Odds are your operations will be unsuccessful.

c. Opportunity for substantial personal injury and property damage.

4. Common industry practices.

a. Time restrictions - rule of capture and special limitations on the leasehold grant.

b. Dominated by non-lawyers negotiating, writing, and interpreting contracts and conveyances.

c. Use of forms.

C. Terminology - unique terminology dominated by the technical disciplines it seeks to regulate. Handbook §1.16 and Table A.

II. The Geology and Mechanics of Oil and Gas
[Reference: Chapter 2, Kansas Oil and Gas Handbook]

A. Petroleum Geology. Handbook §2.02.

1. Oil and gas are normally found in sedimentary rock which possesses the physical properties of porosity and permeability.

a. Porosity - the rock has spaces in which oil, gas, and water can accumulate.

b. Permeability - the rock spaces are connected so the material within the spaces can be transmitted from pore to pore.

2. Must have rock with a high porosity to permit oil or gas to accumulate in commercial quantities. The porous rock must also be permeable to permit the oil and gas to flow toward a hole drilled in the rock.

3. A connected bed of porous and permeable rock which contains oil and gas is called a "reservoir."

a. The reservoir must be contained within natural barriers to trap the oil and gas.

b. Two general types of reservoir traps:

(1) Stratigraphic

(2) Structural

B. Reservoir Mechanics. Handbook §2.03.

1. Oil, gas, and water are usually found together in a reservoir.

a. If there is water and free gas in a reservoir, water will be found near the bottom of the reservoir, oil in the middle and gas at the top.

b. Rock pores are usually lined with a certain quantity of water.

c. Gas will dissolve into the oil when the reservoir is under presssure.

2. The reservoir, in its natural state, is under pressure.

   a. Once the reservoir is breached, the oil and gas under pressure will move toward the low pressure zone created by the well.

   b. Energy needed to push the oil and gas through the permeable rock is provided by the force of gravity, expansion of gas in the reservoir, and water encroaching into the oil zone as oil and gas are removed.

3. Dissolved Gas Expansion (Solution-Gas-Drive) Reservoir Drive Mechanism. Handbook §2.05.

   a. As reservoir pressure is reduced by the well, gas dissolved in the oil will be liberated from the oil, fill the pores which the oil previously occupied, and begin to displace the oil.

   b. As reservoir pressure declines further, larger quantities of gas will be released and increasing amounts of gas will be produced by the well as oil production declines.

   c. Least efficient reservoir drive mechanism; average recoveries of less than 20% of the oil in the reservoir.

4. Gas-Cap Expansion Reservoir Drive Mechanism. Handbook §2.06.

   a. Oil in the reservoir is saturated with dissolved gas and excess gas is compressed and found free in a cap lying over the oil zone.

   b. Energy to move the oil to the well bore is supplied by the compressed gas cap which tends to flush the oil downward out of the upper part of the reservoir.

   c. Average recoveries of less than 50% of the oil in the reservoir.

5. Water Encroachment Reservoir Drive Mechanism. Handbook §2.07.

a. Water at the bottom and edges of the reservoir creates pressure against the upper zones of oil and gas.

b. When oil and gas are produced, water will encroach from the bottom of the reservoir flushing the oil and gas upward.

c. Average recoveries exceed 50% of the oil in the reservoir.

6. Reservoir development must be planned to make maximum use of the natural reservoir energy. Handbook §2.08.

a. Improper location or completion of wells can reduce the efficiency of the reservoir drive mechanism.

b. Improper rates of production can reduce the efficiency of the reservoir drive mechanism.

III. Ownership and the Rule of Capture
[Reference: Chapter 3, Kansas Oil and Gas Handbook]

A. Ownership of oil and gas is initially determined according to surface boundaries. Handbook §3.02.

1. The owner of land owns the surface and any minerals beneath the surface.

2. Two theories of oil and gas ownership:

a. "Ownership" or "ownership in place" theory - oil and gas are part of the real estate in which they are found; owner of the surface has a present right to them even while they remain unproduced in the reservoir.

b. "Non-ownership" theory - owner of the surface does not presently own oil and gas beneath the land; surface owner has the right to extract oil and gas. Ownership is obtained only when, and to the extent, oil and gas are actually produced.

3. Kansas, in Zinc Co. v. Freeman, 68 Kan. 691, 696, 75 P. 995, 997 (1904), adopted the "ownership" theory.

a. In Kansas, the person vested with title to land is deemed to presently own, in addition to surface rights, any oil, gas, or other minerals which may be located

beneath the surface boundaries of the land. Magnusson v. Colorado Oil and Gas Corp., 183 Kan. 568, 574, 331 P.2d 577, 582 (1958); Gas Co. v. Neosho County, 75 Kan. 335, 337-38, 89 P. 750, 751-52 (1907) (ownership in place rule applied to oil and, in a companion case, to natural gas).

b. In Kansas, upon receiving title to a parcel of land, the landowner obtains a present right to all oil, gas, and other minerals within the land.

4. Oil and gas can migrate, within the reservoir, in response to pressure changes created by wells drilled into the reservoir. See Northwest Cent. Pipeline Corp. v. Kansas Corp. Comm'n, 237 Kan. 248, 251, 699 P.2d 1002, 1007 (1985) (U.S. Sup. Ct. appeal pending) (court discusses migration of gas in the Hugoton Field).

a. Although, under the ownership theory, the landowner technically "owns" oil and gas beneath his land, if they migrate to another person's land, ownership is lost. Zinc Co., 68 Kan. at 696, 75 P. at 997.

b. To perfect ownership of oil and gas, it must be reduced to possession through the process of "capture."

B. Rule of Capture. Handbook §3.03.

1. Although the landowner has a present ownership interest in oil and gas beneath his land, rights in the resource are lost once it moves outside surface boundaries. Zinc Co. v. Freeman, 68 Kan. 691, 696, 75 P. 995, 997 (1904).

2. The rule of capture qualifies the landowner's oil and gas ownership when these substances remain unproduced in the reservoir. To perfect his ownership interest, the landowner must "capture" the oil and gas. See Republic Natural Gas Co. v. Baker, 197 F.2d 647, 648 (10th Cir. 1952) and State Corporation Commission of Kansas v. Wall, 113 F.2d 877, 881 (10th Cir. 1940) (title to oil and gas absolute only when "captured").

3. The rule of capture protects the adjacent landowner who properly completes a well in the common reservoir and causes oil and gas to migrate across surface boundaries toward

his land.

a. Adjacent landowners must protect their land from drainage by development of their own land. Carlock v. Krug, 151 Kan. 407, 411, 99 P.2d 858, 861 (1940).

b. Rule of capture gives landowners the right to drill wells, bottomed anywhere within the surface boundaries of their property, and to obtain legal title to all the oil and gas they could produce from such wells, even though some or most of it was drained from under land owned by others.

4. Kansas Supreme Court recently applied the rule of capture to the production of natural gas injected into a gas storage reservoir. The party injecting the gas was not a public utility authorized to condemn the reservoir for storage, nor had it obtained the right to use the reservoir from the adjacent landowner. Anderson v. Beech Aircraft Corp., 237 Kan. 336, 699 P.2d 1023 (1985).

5. Although Kansas recognizes the rule of capture, the landowner has certain rights which can be enforced to protect oil and gas while still in the reservoir - correlative rights and conservation regulation.

IV. Correlative Rights Doctrine and Conservation Regulation

A. The correlative rights doctrine recognizes that a person operating a well properly located on his land can significantly affect the rights of other property owners in the same reservoir. Handbook §3.04.

B. Unrestrained, an absolute right to drill and produce as one pleases from a reservoir could destroy the ability of others to try and capture oil and gas beneath their property.

1. Although a landowner can, through operations on his land, drain oil and gas from adjacent lands, the right to capture is not absolute.

2. In an effort to protect the common rights of all owners overlying the reservoir, the Kansas Corporation Commission restricts each owner's right to produce from a reservoir so they will not:

"(A) injure the reservoir to the detriment of

others;
(B) take an undue proportion of the obtainable oil or gas; or
(C) cause undue drainage between developed leases." K.A.R. §82-3-101(15) (May 1986) [5 Kansas Register 346 (March 6, 1986)].

a. K.S.A. §55-603 (1983). Kansas Corporation Commission directed "to prevent the inequitable or unfair taking of crude oil" which is "injurious to the respective correlative rights of the producers" in a reservoir.

b. K.S.A. §55-703 (Supp. 1985). Similar mandate with regard to natural gas.

c. See Northwest Cent. Pipeline Corp. v. Kansas Corp. Comm'n, 237 Kan. 248, 254-55, 699 P.2d 1002, 1009 (1985) (court discusses Kansas statutes and regulations which protect correlative rights).

d. Correlative rights doctrine designed to protect private interests in the reservoir; public interests protected by "conservation regulation."

C. Conservation Regulation. Handbook §3.05.

1. Rule of capture causes much of the oil and gas in the reservoir to be wasted through inefficient production practices. However, such practices are necessary to maximize a producer's individual gain under the rule of capture.

2. Conservation regulation required to protect the public, and producers, from the wasteful effects of an unrestrained rule of capture.

a. Public interest - obtain maximum recovery of the oil and gas resource at as low a cost as possible. Ensure the resource is not used for inferior purposes.

b. Private interest - protect the reservoir against damage from improper development practices, control the amount of investment required to capture the resource, avoid excessive production.

3. Primary goal of conservation regulation - prevent "waste." Handbook §3.06.

a. Waste includes development and operation practices which result in a physical loss of oil or gas, or which reduce the quantity of oil or gas ultimately recoverable from a reservoir.

b. Waste may include using the resource for inferior purposes which fail to efficiently use its energy content.

c. Unnecessary capital investment to recover the resource is "economic waste."

d. Kansas - waste defined by statute to include economic waste, underground waste, surface waste, waste of reservoir energy, and the production of oil or gas in excess of transportation or marketing facilities or resonable market demand. K.S.A. §55-602 (1983) (oil); K.S.A. §55-702 (1983) (gas).

4. Conservation techniques used to prevent or control waste include: location restrictions (spacing of wells), production restrictions (prorating production to coincide with "market demand"), and unitization (operating reservoir as a single property).

5. Location Restrictions - require a minimum distance between producing wells and require wells to be drilled a minimum distance from lease or property lines. Handbook §3.07.

a. K.S.A. §55-604(C)(c) (1983) establishes, for proration purposes, a statewide spacing unit for oil wells of one well per ten acres, unless otherwise provided by the KCC.

b. K.A.R. §82-3-207 (May 1986) further defines the ten acre requirement by requiring a standard spacing unit with the well located at least 330 feet from any lease or unit boundary line.

c. By special order, the KCC can enlarge or reduce the standard spacing unit to protect correlative rights and prevent waste.

d. K.S.A. §55-703a (1983) grants the KCC authority to regulate the spacing of gas wells.

e. If a proposed well does not meet the established spacing unit distance or acreage

requirements, the KCC can require the well to produce at a reduced rate to protect the correlative rights of adjacent property owners. K.S.A. §55-604(C)(c) (1983); K.S.A. §55-703a (1983); K.A.R. §82-3-108 (May 1986); §82-3-207 (May 1986).

6. Pooling - once a spacing unit is designated, the developer may have to include adjoining acreage to meet the minimum acreage requirement. Handbook §3.08.

   a. Example - assume the spacing order calls for development on the basis of one well per governmental quarter quarter section (40 acres). You have a lease on the South Half of a quarter quarter section (20 acres). The North Half is unleased. Neither tract is entitled to a well, or full allowable. However, the North and South halves can be "pooled" to form the required quarter quarter section spacing unit.

      (1) Assuming participation on an acreage basis, the owners of each half will receive 50% of production from the spacing unit well.

      (2) In Kansas, pooling can be achieved only through voluntary agreement. Kansas does not have a compulsory pooling statute. However, some cities have ordinances which force pool diverse interests to meet city spacing unit requirements. Bohrer v. Ramsey Petroleum Co., 141 Kan. 781, 44 P.2d 239 (1935). K.S.A. §§55-1610 to 55-1613 (1983). See Handbook §§3.08 and 11.47.

   b. This process of combining interests to meet the acreage requirements for a spacing unit is called "pooling."

7. Production Restrictions - primary mechanism used in Kansas to maintain orderly development and achieve conservation goals. Handbook §3.09. Two phases to the Kansas production restriction regime:

   a. Establish "Market Demand" for oil and gas. K.S.A. §55-604(B) (1983) (oil); K.S.A. §55-703 (Supp. 1985) (gas). Handbook §3.10.

b. Divide the forecasted market demand among the various reservoirs in the state. Handbook §3.11.

(1) Determine amount each reservoir in the state will be permitted to produce.

(2) Allocate the reservoir's share of production among the wells producing from the reservoir.

(3) Each well is assigned an "allowable" - the amount it can produce from the reservoir.

(4) To calculate a well's allowable its ability to produce oil or gas under specified conditions must first be determined. See K.A.R. §82-3-101(17) (May 1986) (gas well); K.A.R. §82-3-101(50) (May 1986) (oil well). To determine how much a well in a prorated pool can produce, the well's ability to produce is considered in relation to the acreage attributable to the well. See K.S.A. §55-603 (1983) (oil); K.S.A. §55-703 (Supp. 1985) (gas). See Aylward Production Corp. v. Corporation Commission, 162 Kan. 428, 176 P.2d 861 (1947).

c. Subject to tolerances established by the KCC, production in excess of an assigned allowable is unlawful. K.S.A. §55-607 (1983) (oil); K.S.A. §55-708 (1983) (gas).

7. Unitization - operate reservoir as a single unit. Surface boundaries used only to calculate each party's share in total production from the reservoir. Handbook §3.12.

a. Rule of capture effectively nullified.

b. Most efficient technique for developing reservoir.

c. Permits operator to develop the reservoir without regard to artificial surface boundaries. Reservoir's natural pressure can be maximized and development costs can be reduced by eliminating unnecessary wells.

d. Essential for enhanced recovery operations.

e. Unitization can be accomplished by voluntary agreement or by compulsory unitization pursuant to statute. K.S.A. §§55-1301 et seq. (1983).

f. See Veverka v. Davies & Co., Inc., 10 Kan. App.2d 578, 705 P.2d 558 (1985).

PART B - COMMONLY CREATED OIL AND GAS PROPERTY INTERESTS
[Reference: Chapter 4, Kansas Oil and Gas Handbook]

I. The Surface and Mineral Estates. Handbook §4.03.

A. Ownership of minerals underlying a tract of land can be conveyed separately from the overlying surface interest.

B. Two separate property interests are created: a surface estate and a mineral estate. Zaskey v. Farrow, 159 Kan. 347, 351, 154 P.2d 1013, 1015-16 (1945). Two separate fee simple estates are created. Each is potentially infinite in duration and can be disposed of by gift, sale, or inheritance. Crowe Coal & Mining Co. v. Atkinson, 85 Kan. 357, 360, 116 P. 499, 500 (1911).

C. Severance of the mineral estate from the surface estate can occur by granting the mineral estate or by granting the surface estate and excepting the mineral estate. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 89, 69 P.2d 4, 7 (1937). Conveyance of the mineral estate is accomplished by a document called a "mineral deed." Hickey v. Dirks, 156 Kan. 326, 327, 133 P.2d 107, 109 (1943).

II. Divided and Undivided Interests. Handbook §4.17.

A. Owner may convey all their interest in the mineral and surface estates or they may convey something less than all their interest.

1. Divided Interest

a. For example, assume A owns a section of land, Section 30. A can divide Section 30 into two tracts by conveying the East Half of Section 30 to B. A owns what can be called a "divided" interest, the West Half, and B owns a divided interest, the East Half.

b. A and B each have the exclusive right to develop their individual half section.

2. Undivided Interest

a. A can convey an interest in Section 30 by conveying to B a one-half "undivided" interest in Section 30.

b. A and B would then own all of Section 30 as cotenants with each owning an undivided one-half interest in Section 30.

c. A and B each have the nonexclusive right to possession of Section 30. Mulsow v. Gerber Energy Corp., 237 Kan. 58, 62, 697 P.2d 1269, 1273 (1985).

d. In Kansas, each owner of an undivided interest in the mineral estate has the right to enter the property to explore for, develop, and produce oil and gas. Each owner can contract with a third party to develop the property. Compton v. People's Gas Co., 75 Kan. 572, 89 P. 1039 (1907).

(1) If one cotenant enters the property and produces oil and gas, a portion of the production belongs to the other cotenant.

(2) When oil and gas are produced by a cotenant, the producing cotenant must account to nonconsenting cotenants for their share of production. Prewett v. Van Pelt, 118 Kan. 571, 235 P.1059 (1925).

(3) The producing cotenant is permitted to deduct the nonconsenting cotenants' proportionate share of the reasonable costs of development, production, and marketing. Krug v. Krug, 5 Kan.App.2d 426, 428, 618 P.2d 323, 325 (1980).

(4) The burden of proving deductible costs is on the producing cotenant. Johnson v. Gas Co., 90 Kan. 565, 135 P. 589 (1913).

(5) The developing cotenant is entitled to reimbursement from nonconsenting cotenants only to the extent there is production from the specific well from which they receive a share of production. Davis v. Sherman, 149 Kan. 104, 86 P.2d 490 (1939).

(6) Rationale for allowing the developing

cotenants to recover their costs out of the nonconsenting cotenants' share of production: unjust enrichment (quasi-contract). Krug, 5 Kan.App.2d at 429, 618 P.2d at 325.

B. Cotenant development problems - assume A and B each own an undivided one-half interest in Section 30. Even though A has the right to develop the property without B's consent, as a practical matter A will not develop because A must assume all the risk and, if successful, will only receive one-half the production following payment of development costs. Handbook §4.19.

1. Problems in determining what are reasonable costs in the event a producing well is drilled. See, e.g., Brown v. Loriaux, 189 Kan. 56, 366 P.2d 1016 (1961).

2. Nonconsenting cotenant may be able to ratify a favorable lease negotiated by consenting cotenant when the lease purports to lease the entire interest in the property. Depending upon the terms of the lease, this may require payment of a portion of the bonus to the nonconsenting cotenant in addition to his proportionate share of the delay rental and royalty. Brooks v. Mull, 147 Kan. 740, 78 P.2d 8.9 (1938).

III. Concurrent and Successive Interests. Handbook §4.20.

A. Concurrent Interests - in Paragraph II we considered concurrent interests; an interest where two or more owners share the nonexclusive present right to possess the property. Property held in joint tenancy or as tenants in common creates concurrent interests. Each owner has an undivided interest in the property. Handbook §4.17.

B. Successive Interests - the right to possession and enjoyment of the property is held, at different times, by different owners. The right to possession precedes or follows another person's right to possession.

1. Example - A is given a life estate in Section 30 with a remainder in B. A, as the life tenant, has the right to immediate possession of Section 30. B has a vested remainder in Section 30. B's interest is a future interest which becomes possessory upon A's death.

2. Major problem is determining who has the right

to develop the property when there are successive interests. Handbook §4.21.

3. Unlike cotenants, successive interest owners, in absence of express authorization or conduct by the grantor, do not have the authority to independently develop the mineral potential of the property subject to their interest.

   a. The life tenant and all remaindermen must join in the conveyance or development contract. Neither the life tenant, nor the remaindermen, have the power to independently convey or develop the property.

   b. The remaindermen lack a possessory interest to permit access to the property and the life tenant lacks the authority to do anything with the property which would be adverse to the future estate of the remaindermen. Cannot commit waste.

4. Exceptions to the rule:

   a. The instrument creating the life estate can confer upon the life tenant the power to lease or convey the property without being liable to remaindermen. Handbook §4.22.

   b. If the property was leased or being operated for oil and gas prior to commencement of the life estate, the life tenant can continue such operations. Open Mine Doctrine. Handbook §4.24.

   c. The remaindermen can agree to permit the life tenant to convey or lease the property. Handbook §4.23.

5. Once you determine who can authorize development, must determine how the proceeds from development should be divided. Handbook §4.26.

   a. Instrument creating the interest will govern; if it addresses the matter.

   b. Instrument silent, but open mine doctrine applies, life tenant gets all the development proceeds accruing during his life. Kimbark Exploration Company v. Von Lintel, 192 Kan. 791, 793, 391 P.2d 55, 58 (1964).

c. Instrument silent, open mine doctrine does not apply, oil and gas considered part of the corpus of the estate which must be held for the benefit of the remaindermen. See Burden v. Gypsy Oil Co., 141 Kan. 147, 40 P.2d 463 (1935).

(1) Royalty is principal to be held for the benefit of the remaindermen.

(2) Delay rental and interest on royalty is income payable to the life tenant.

(3) Bonus - undecided how it will be treated.

d. Arguable whether the allocation rules established in Burden and Kimbark cases have been changed with the enactment of the Revised Uniform Principal and Income Act ("UPIA"), K.S.A. §§58-901 et seq. (1983).

(1) UPIA provides "rules for the guidance of fiduciaries to determine what is principal and what is income, to determine who is entitled to income, and to determine the allocation of expenses to each." Pederson v. Russell State Bank, 206 Kan. 718, 721, 481 P.2d 986, 988 (1971).

(2) UPIA expressly applies only to trustees. Other provisions of the UPIA suggest it applies to administrators and executors during estate administration. Issue is whether it applies to non-trust interests. Apparently, the UPIA will be applied when the person in possession of the non-trust interest has fiduciary obligations to manage an asset similar to those imposed on a trustee. See Kumberg v. Kumberg, 5 Kan.App.2d 640, 623 P.2d 510 (1980) and Kumberg v. Kumberg, 232 Kan. 692, 702, 659 P.2d 823, 832 (1983) (approve, without discussion, court of appeals use of UPIA).

(3) If UPIA applies, K.S.A. §58-909 (1983) specifies how lease and development proceeds will be allocated.

(4) UPIA will not apply when the instrument creating the interest provides for

allocation of principal and income. K.S.A. §58-902(1) (1983).

C. Contingent Successive Interests - typical successive interest does not present much of a problem for the developer, you just obtain a lease from the life tenant and all the remaindermen. However, problems arise when the interest of the remaindermen is not "vested" but instead is "contingent," "subject to divestment," or shared with members of a class who you cannot presently identify. Handbook §4.25.

1. Preference for early vesting of testamentary gifts. "Where a life tenancy and remainders are carved out of an estate by will, and the remaindermen are in esse, definitely ascertained, and nothing but their death before the termination of the life tenancy can defeat their title, the remainders thus created and bestowed by the will are vested absolutely in the remaindermen." Anderson v. Wise, 144 Kan. 612, 618, 62 P.2d 805, 809 (1936).

2. However, if the interest is vested, but subject to divestment, the remaindermen cannot convey a marketable interest. See Ghormley v. Kleeden, 155 Kan. 319, 124 P.2d 467 (1942).

3. Similar problem with contingent remainders. See Robinson v. Barrett, 142 Kan. 68, 45 P.2d 587 (1935) and Pedroja v. Pedroja, 152 Kan. 82, 102 P.2d 1012 (1940).

4. Procedure for leasing or developing land subject to contingent interests:

   a. Kansas has a common law procedure which has developed under traditional equity jurisdiction.

   b. District court can appoint a trustee for unknown contingent executory devisees and contingent interest holders with the authority to enter into an oil and gas lease and hold the proceeds from the lease until the contingencies are determined. Robinson, 142 Kan. at 71, 45 P.2d at 589.

      (1) Proceeding "to preserve the property from immediate loss and diminution to be divided or distributed by order of the court when the contingency shall have concluded." Robinson, 142 Kan. at 73, 45 P.2d at 590.

(2) Proceeding contemplates a need for immediate action, such as development occuring in the general area. Pedroja v. Pedroja, 152 Kan. 82, 102 P.2d 1012 (1940).

IV. Interests Limited by Duration or Event. Handbook §4.04.

A. Defeasible Term Mineral Interests - the mineral estate, as with other interests in land, can be limited for a specified time or until a specified event occurs. The most common limitation is created by a limitation on the grant which requires production of oil or gas in paying quantities after a specified period of time.

1. Example - A grants B all the oil, gas, and other minerals in Section 30 "for a period of twenty (20) years from and after April 25, 1941 . . . and so long thereafter as oil, gas and/or other minerals or any of them are produced therefrom." Classen v. Federal Land Bank of Wichita, 228 Kan. 426, 427, 617 P.2d 1244, 1257 (1980).

2. Creates a fee simple determinable, generically referred to as a "defeasible fee" or "base fee."

a. Title vests immediately in grantee subject to grantor's possibility of reverter in the event production of the stated substance fails to occur or continue. See Wilson v. Holm, 164 Kan. 229, 234-35, 188 P.2d 899, 904 (1948).

b. The grant is for a fixed "term" of years, followed by a contingency which extends the stated term.

c. The grant is "defeasible" because it will terminate twenty years after April 25, 1941 unless the required production is obtained.

d. Since the subject matter of the grant is a mineral interest, A has conveyed to B a "defeasible term mineral interest."

B. Extending Defeasible Term Mineral Interests. Handbook §§4.05 and 4.06. To extend the defeasible interest beyond the stated term, there must be production, from the conveyed land, in paying quantities.

1. Production from the Conveyed Land. Handbook §4.05. Assume: A owns the Northwest Quarter in each of Sections 6, 7, and 8. A grants to B, in a single mineral deed, all the oil and gas in the Northwest Quarter of Sections 6, 7, and 8, for three years from 26 June 1986 and for so long as oil or gas is produced from "said land." In July 1989 there is a producing well on the Northwest Quarter of Section 6. There are no wells on Sections 7 or 8.

   a. Will production from the Northwest Quarter of Section 6 satisfy the production contingency as to the Northwest Quarter of Sections 7 and 8? Yes. No interest will revert to A. "Said land" refers to the entire tract (all three quarter sections) described in the granting clause. Production from any part of the described land will extend the defeasible term mineral interest. Baker v. Hugoton Production Company, 182 Kan. 210, 212, 320 P.2d 772, 774 (1958). See also Palmer v. Brandenburg, 8 Kan.App.2d 154, 157-58, 651 P.2d 961, 965 (1982).

   b. So long as there is actual production from a portion of the conveyed land, the production contingency will be satisfied for all the land included in the grant.

2. Assume: Instead of having a well on the Northwest Quarter of Section 6, the Northwest Quarter is pooled with other Section 6 lands to form a 640 acre spacing unit. A producing well is completed on the Southwest Quarter of Section 6. Pursuant to the pooling agreement, the owners of interests in the Northwest Quarter of Section 6 receive a one-fourth share of all production from the well.

   a. If no other wells are located on the Northwest Quarter of Sections 6, 7, and 8, will the production contingency be met? Only the Northwest Quarter of Section 6 is extended by production from the Southwest Quarter of Section 6. The mineral interest in the Northwest Quarter of Sections 7 and 8 revert to the grantor. Classen v. Federal Land Bank of Wichita, 228 Kan. 426, 617 P.2d 1255 (1980).

   b. Acreage included in the grant, but not participating in production from the spacing

unit, will not be held by pooled or unitized operations. Classen.

c. Different rule applies when construing the habendum clause of an oil and gas lease. Somers v. Harris Trust & Savings Bank, 1 Kan.App.2d 397, 566 P.2d 775 (1977). If the foregoing example concerned an oil and gas lease instead of a defeasible term mineral interest, production from the Southwest Quarter of Section 6 would satisfy the production requirement for all the land included in the grant. [Assuming effective pooling of the interest and no Pugh clauses]. Handbook §9.21.

3. Practitioner must be vigilant to distinguish the defeasible term mineral interest from an oil and gas lease.

a. Defeasible term mineral interest conveyances normally lack most of the contractual protections granted the lessee in an oil and gas lease.

b. Example: Payment of shut-in royalties under a lease covering the mineral interest does not satisfy the "production" required to perpetuate the defeasible term mineral interest. Dewell v. Federal Land Bank, 191 Kan. 258, 263, 380 P.2d 379, 383 (1963).

c. Even though the reversionary interest owner and the defeasible term mineral interest owner grant leases to a third party, this will not alter the legal relationship between the parties granting the leases. Smith v. Home Royalty Association, 209 Kan. 609, 498 P.2d 98 (1972) (lease containing unitization clause executed by grantor and grantee of defeasible term mineral interest did not change rights between grantor and grantee) overruled in part by Classen (agreement between grantor and grantee not necessary as to portion of granted acreage committed to the unit).

d. Defeasible term mineral interest owner could try and obtain protections in the grant similar to those found in oil and gas lease. For example, pooling clause, shut-in clause, operations clause. However, in absence of an effective agreement between the defeasible term mineral interest grantor and

grantee, acreage outside a producing unit will not be held by unit production.

4. Other production requirements are discussed in Session 4. Handbook §§9.21 - 9.25.

V. Depth Limitations.

A. The grantor can limit the mineral interest to a specified depth or interval beneath the surface.

1. A can convey to B all minerals located from the surface of Section 30 to a depth of 3,000 feet, or from the surface to the base of an identifiable formation. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 89, 69 P.2d 4, 7 (1937) (owner of land can divide it vertically and horizontally).

2. The grantor can also limit the grant to the minerals within a specified formation. Gas Co. v. Oil Co., 83 Kan. 136, 140, 109 P. 1002, 1004 (1910) (stratum in which oil and gas are found can be separated from remainder of the mineral estate).

B. The techniques for describing depth and formation limitations are discussed in Session 3. Handbook §§7.06 and 9.18.

VI. Substance Limitations. The grantor can limit the mineral interest to specified substances. For example, A could grant to B only the rights to natural gas and retain the other minerals, including oil. Skelly Oil Company v. Savage, 202 Kan. 239, 447 P.2d 395 (1968) (pooling clause applied only to "gas rights"); Arnold v. Garnett Light & Fuel Co., 103 Kan. 477, 174 P. 1027 (1918) (lessees separated oil from gas rights by contract).

VII. Incidents of Mineral Ownership

A. Courts generally recognize certain incidents of mineral ownership: property rights associated with a mineral interest and necessary to permit enjoyment of the mineral interest. Handbook §4.07.

B. Unless the conveyance instrument contains an express limitation, each owner of a mineral interest has the right to:

1. Enter the land encompassed by the mineral interest to explore for and develop the minerals. Corbin v. Moser, 195 Kan. 252, 257, 403 P.2d 800, 804 (1965).

2. Grant the right to explore and develop to a third party. Shepard, Executrix v. John Hancock Mutual Life Ins. Co., 189 Kan. 125, 133, 368 P.2d 19, 25 (1962).

3. Receive any rights or benefits created pursuant to the grant in item 2. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 89, 69 P.2d 4, 7-8 (1937). Typically, these rights include:

   a. Bonus - money paid by developer (lessee) to induce mineral interest owner (lessor) to enter into an oil and gas lease. Wright v. Brush, 115 F.2d 265, 267 (10th Cir. 1940).

   b. Delay Rental - money paid to lessor by lessee, pursuant to an oil and gas lease, as rent for the privilege of delaying drilling operations on the leased land. State v. Board of Regents, 176 Kan. 179, 190, 269 P.2d 425, 433 (1954).

   c. Leasing ("Executive") Right - mineral interest owner's right to contract for development of the mineral interest. Drach v. Ely, 237 Kan. 654, 658, 703 P.2d 746, 750 (1985).

   d. Royalty - a share of oil and gas produced from the mineral interest free of any costs of production. Shaffer, 146 Kan. at 89, 69 P.2d at 7.

VIII. Participating and Nonparticipating Interests. Handbook §§4.07 and 4.16.

A. The mineral interest owner's executive rights, and related rights to bonus, delay rental, and royalty, are often collectively referred to as the mineral interest owner's right to "participate." Shepard, Executrix v. John Hancock Mutual Life Ins. Co., 189 Kan. 125, 133, 368 P.2d 19, 25 (1962).

B. If one or more of these rights is separated from the mineral interest, in Kansas it is called a "nonparticipating mineral interest" as to the incidents of mineral ownership which are not granted. Drach v. Ely, 237 Kan. 654, 659, 703 P.2d 746, 751 (1985) (mineral interest nonparticipating as to executive rights and the rights to receive bonus and delay rental). Common usage - nonparticipating refers to severance of the executive right from the mineral interest.

IX. Operating and Nonoperating Interests. Handbook §§4.09 and 7.14.

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

1. The instrument used to transfer development rights is the oil and gas "lease."

2. The lessee obtains the mineral interest owner's right to enter the premises and conduct exploration and development operations.

3. The lessor will normally have rights under the lease to bonus, delay rental, and royalty. In addition, the lessor has reversionary rights in the mineral interest when the lease terminates.

B. Leasehold Interest or Working Interest - refers to the rights which the lessee has under the oil and gas lease. The lessee often conveys part of the working interest to other parties in return for development funds and services, or to secure financing. Unless restricted by the terms of the lease, the working interest, like the mineral interest, can be divided in many ways.

1. Example: A has a lease on Section 30. A can assign all of A's working interest in the East Half of Section 30 to B. B has a divided interest in the East Half of Section 30. A can

also assign B an undivided interest in the Section 30 lease; A and B will then become cotenants of the working interest in Section 30.

2. A can also limit the working interest by depth, substance, and duration.

3. Cotenants of the working interest typically coordinate development through a joint operating agreement ("JOA").

C. Granting B an undivided interest in the Section 30 lease gives B an "operating" interest in the lease. B has a concurrent right, with A, to enter Section 30 and conduct development operations.

D. A can also create "nonoperating" interests in the Section 30 leasehold. Nonoperating means the holder of the interest does not have the power to enter the leased premises to conduct development operations. It is merely an economic interest in oil and gas when, and if, it is produced. Common nonoperating interests include:

1. Overriding Royalty - a right to a share of oil and gas from the leased land free of the cost of production. Payable out of the working interest from which it is carved; will terminate when the lease terminates. Campbell v. Nako Corporation, 195 Kan. 66, 402 P.2d 771 (1965).

2. Production Payment - a right to a share of oil and gas from the leased land free of the cost of production but limited to a specified quantity or value of production.

   a. Limitation can be stated as a certain quantity of production from the lease - such as an agreement to deliver the first 20,000 barrels of oil produced from the lease to the holder of the production payment. McCrae v. Bradley Oil Co., 148 Kan. 911, 84 P.2d 866 (1938).

   b. Limitation can be stated as certain value of production - such as a production payment of $30,000 to be paid out of 1/2 of 7/8ths of the first oil produced from the lease. Matthews v. Ramsey-Lloyd Oil Co., 121 Kan. 75, 245 P. 1064 (1926).

3. Net Profits Interest - a right to a share of oil

and gas from the leased land free of the cost of production but payable only if and when the lessee earns a net profit from his operations. Difficulty is defining what costs will be deducted from revenues to determine whether a net profit has been realized. See generally Kumberg v. Kumberg, 232 Kan. 692, 659 P.2d 823 (1983).

4. Carried Interest - a working interest owner who, pursuant to an operating agreement, or as a non-consenting cotenant, refuses to join in development operations and the other working interest owners proceed with development. In such a case the developing working interest owners may agree to "carry" the other working interest owners by paying the full cost of development. The developing owners will have the right to receive all of the "carried interest" owner's share of production until the carried interest owner's share of costs are recovered.

5. Convertible Interest - a nonoperating interest, such as an overriding royalty, may be convertible to an operating interest after the occurrence of a specified event, such as recovery of costs from a well. Commonly used in farmout transactions.

6. Royalty - the lessor's interest under the typical oil and gas lease is a nonoperating interest.

SESSION 2 - CONVEYANCES OUT OF THE MINERAL INTEREST

I. An Approach to Drafting. Handbook §5.13.

A. Forms.

1. Too often the thought process begins and ends with selection of a form conveyance, lease, or similar document.

2. Reference to an existing form is often helpful - but not at the initial stage of the drafting process.

B. Drafting Goals:

1. Meet the requirements of local law necessary to accomplish the transaction.

2. Address any special requirements of the transaction.

3. Use only the terms and provisions necessary to accomplish the transaction.

4. Express the transaction as briefly and simply as the subject matter and circumstances will permit.

C. The Drafting Process.

1. Outline what you need to express, factually, in the document. Primary source of this information will be your client.

2. Outline the legal issues which the facts implicate.

a. First "legal" problem - what is required to validate the document? Research appropriate statutes, regulations, and cases. May be necessary to research the general topic in a treatise before conducting more specific statutory or case law research.

b. Second problem - address legal issues raised by your factual outline. Client may want to be indemnified against certain matters. Apply research process again.

3. Using outlines of the facts and law, state the transaction as briefly and simply as possible.

4. Edit. Ensure document accomplishes client's goals. [Good time to refer to other forms on

the subject].

5. Ensure the legal requirements identified at the pre-drafting stage are fully executed. Example: K.S.A. §79-420 (1984) (file for record within 90 days after execution of mineral conveyance). Obtain necessary powers of attorney, corporate resolutions, etc. to support execution of document.

D. Once the drafting process has been conducted regarding a particular subject, such as a mineral deed, it is not necessary to go back and "reinvent the wheel" each time. Instead, it will be a matter of updating your research and consciously applying it to new facts. The major drafting problem, however, seems to be that many attorneys have never really "invented the wheel;" they continue the process of using forms without independent analysis of why certain language is included in their documents. This is particularly true with the oil and gas lease where the transaction is invariably stated using a "standard form."

II. Requirements for a Valid Conveyance. Handbook §5.02.

A. Parties to the Conveyance. Handbook §5.03.

1. The conveying instrument must accurately identify the grantors and grantees involved in the transaction.

2. If the grantors are individuals, the spouse of each grantor must join in the conveyance to release their homestead and inchoate statutory rights to real property.

a. Homestead property cannot be conveyed "without the joint consent of husband and wife, when that relation exists." Kan. Const. art. 15, §9; K.S.A. §59-401 (1983); K.S.A. §60-2301 (1983).

b. Lease of homestead property, since it may interfere with the use and occupancy of the homestead, deemed to be a "conveyance" requiring joint consent of husband and wife. Palmer v. Parish, 61 Kan. 311, 315, 59 P. 640, 641 (1900); Franklin Land Co. v. Wea Gas, Coal & Oil Co., 43 Kan. 518, 23 P. 630 (1890).

c. K.S.A. §59-505 (1983) - a surviving spouse, who is a resident of Kansas at any time

during the marriage, is entitled to one-half of all real estate which the other spouse had an interest in at any time during the marriage.

d. Because of the Kansas homestead rights, and rights created by K.S.A. §59-505, the marital status of all grantors should be stated in the instrument. Title Standards Handbook, Standard 14.3 (KBA 1985).

3. Ascertain the capacity of each party to enter into the conveyance. Who has the authority to convey property on behalf of a city, limited partnership, general partnership, corporation, or an incapacitated individual? Determine who has the authority and obtain the necessary documents to establish such authority.

B. Words of Conveyance. Handbook §5.04.

1. Technical words of conveyance are not required. Bryant v. Fordyce, 147 Kan. 586, 590, 78 P.2d 32, 35 (1938).

a. All that is required is language indicating grantor's intent to transfer the property to grantee.

b. Words of inheritance not required to convey an estate in fee simple. K.S.A. §58-2202 (1983).

2. Transfer of real estate, without specific reservation or exception, conveys all of the grantor's interest in the property. K.S.A. §58-2202 (1983).

3. K.S.A. §58-2203 (1983) suggests the elements of a conveyance. Word "conveys" is sufficient to transfer an interest in land.

C. Description of Property. Handbook §5.05.

1. Description which identifies the property, or which allows identification by reference to extrinsic evidence, is sufficient. In re Estate of Crawford, 176 Kan. 537, 271 P.2d 240, 244 (1954).

2. However, a description which is effective between the parties to the conveyance may not be sufficient as against parties who lack actual knowledge of the lands included within the

conveyance. Luthi v. Evans, 223 Kan. 622, 576 P.2d 1064 (1978). Assignment of "all Oil and Gas Leases in Coffey County, Kansas" owned by grantor is sufficient to bind persons with actual notice of the lands affected by the conveyance. However, it does not adequately describe the affected property to impart constructive notice.

3. Description of the land affected by the conveyance should be described by reference to a governmental survey or recorded plat, or by a metes and bounds description.

D. Consideration. Handbook §5.06.

1. General Rule - "conveyance is good without consideration in the absence of wrongful act on the part of the grantees such as fraud or undue influence." Briscoe v. Reschke, 170 Kan. 367, 376, 226 P.2d 255, 262 (1951).

2. Courts may inquire into "adequacy" of consideration when it is attempting to protect grantor from the grantee's wrongful acts. Sledd v. Munsell, 149 Kan. 110, 86 P.2d 567 (1939) (grantee committed wrongful act when he represented to grantor the instrument was a lease when it was actually a mineral deed). Serena v. Rubin, 146 Kan. 603, 72 P.2d 995 (1937) (grantee misrepresented mineral interest conveyance as a royalty conveyance, $200 consideration grossly inadequate).

3. To obtain benefit of recording statutes - conveyance must be for "valuable" consideration as opposed to merely "nominal" consideration. Edwards v. Meyers, 127 Kan. 221, 223-24, 273 P. 468, 470 (1929).

4. "[W]aiver of homestead rights must be supported by an adequate consideration . . . ." Schloss v. Unsell, 114 Kan. 69, 70-71, 216 P. 1091, 1092 (1923).

5. Modern approach - benefit of recording statutes when you rely upon them; adequacy of consideration not used to police the bargain.

6. Not necessary to recite consideration in the conveyance instrument. Suggest: "for valuable consideration."

7. Kansas - oil and gas lease considered a contract

as opposed to a conveyance. Therefore, the lease must be supported by consideration. Brinkman v. Empire Gas & Fuel Co., 120 Kan. 602, 245 P. 107 (1926).

E. Delivery and Acceptance. Handbook §§5.07 and 5.08.

1. To be effective as a transfer of title, the conveyance instrument must be "delivered." Hinchliffe v. Fischer, 198 Kan. 365, 369, 424 P.2d 581, 585 (1967).

2. Grantee must "accept" the conveyance. Hansen v. Walker, 175 Kan. 121, 124, 259 P.2d 242, 245 (1953).

F. Acknowledgment and Recording. Handbook §§5.09 and 5.10.

1. Conveyances of interests in land should be acknowledged when recording is desired.

2. Acknowledgment requirements - see generally the Uniform Law on Notarial Acts, K.S.A. §§53-501 et seq. (Supp. 1985). See also K.S.A. §58-2228 (1983).

3. Must record to provide constructive notice of your rights to subsequent purchasers and encumbrancers. K.S.A. §58-2222 (1983). A grantee's rights in an unrecorded conveyance can be defeated by subsequent purchasers or lenders who lack actual notice of the conveyance. See Luthi v. Evans, 223 Kan. 622, 576 P.2d 1064 (1978).

4. K.S.A. §58-2221 (1983) - "Every instrument in writing that conveys real estate, any estate or interest created by an oil and gas lease, or whereby any real estate may be affected, . . . may be recorded . . . ."

5. K.S.A. §55-205 (1983) - must file affidavit of production to extend constructive notice of recorded lease beyond primary term.

6. K.S.A. §§55-1601 et seq. (1983) - may require action to protect recorded but "unused" mineral interests.

7. K.S.A. §79-420 (1984) - requires "listing" of severed mineral interests for taxation. Must record mineral deed severing mineral from the surface estate within 90 days after execution or

the grant will be void if not listed for taxation. Compliance with the recording or listing requirements of K.S.A. §79-420 is a condition precedent to title vesting in a grantee. Becker v. Rolle, 211 Kan. 769, 774, 508 P.2d 509, 513 (1973) (mineral deed executed 22 April 1929 and recorded 5 April 1930 held void and subject to attack by grantor's successors 40 years later).

III. Defining "Minerals" and "Other Minerals."

A. Interpretive Rules. Handbook §6.02.

1. K.S.A. §58-2202 (1983) - "[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."

a. Requires that a "deed . . . be construed strictly against the grantor . . . to confer upon the grantee the greatest estate that its terms will permit." Keller v. Ely, 192 Kan. 698, 702, 391 P.2d 132, 135 (1964).

b. Example: Grantor owns a previously severed mineral interest and a surface interest in the same tract of land, deed conveying the real estate by surface description, without language qualifying, reserving, or excepting the grantor's mineral interest, conveys the grantor's surface and mineral interest in the land. Fast v. Fast, 209 Kan. 24, 27, 496 P.2d 171, 174 (1972).

2. Must carefully except from conveyance all rights which you intend to retain in the conveyed land. Handbook §5.11.

B. "Minerals." Handbook §6.04.

1. A conveys to B "all the minerals in Section 30." What substances does B receive by this grant of all the "minerals?" Does it include oil and gas? Helium? Carbon dioxide? Coal which is recoverable only through surface mining? All things not vegetable or animal in nature?

2. Apparently the only reported appellate decision addressing this issue in Kansas is Roth v. Huser, 147 Kan. 433, 76 P.2d 871 (1938). Roth concerns a 1904 conveyance which excepted, and reserved to the grantor, "the mineral deposits

thereon and therein, if any." The issue was whether this exception reserved the oil and gas rights to the grantor. Holding the exception reserved the oil and gas rights, the court made the following observations:

a. The exception was not ambiguous.

b. Certain types of extrinsic evidence was admissible to demonstrate that oil and gas, as minerals, could have been contemplated by the parties when the conveyance was made. Community Knowledge Test -

(1) If substance generally known to exist in the general community at the time the conveyance was made, it is included in the term "minerals."

(2) If substance unknown at the time the conveyance was made, it is not included in the term "minerals."

3. If the dispute concerned the inclusion of coal in the exception, another hurdle may prevent coal from being included in the exception. Although coal may have been known to exist in the general area at the time the conveyance was made, coal may not be included in the exception if its mining will require significant destruction of the surface. Surface Destruction Test -

a. Court will inquire whether certain mining techniques, such as open pit or surface mining, could have been contemplated at the time the conveyance was made. If so, the mineral will not be included in the general reference to "minerals" if it's extraction could destroy the surface estate. See Wulf v. Shultz, 211 Kan. 724, 508 P.2d 896 (1973) (lease granting right "to dig, drill, operate for and procure natural gas, petroleum and other mineral substances" does not include the right to mine limestone).

b. Surface Destruction Test has only been applied, in Kansas, to "other mineral" type conveyances where other interpretive aids have also been used. It is undecided how the Kansas Supreme Court would apply the test in defining the scope of "all minerals."

c. The Surface Destruction Test has proven to be unworkable in the states which have employed it. Creates uncertainty which causes litigation. Consider the Texas experience. Moser v. United States Steel Corp., 676 S.W.2d 99 (Tex. 1984).

d. Courts attempt to use a rule for determining "title" to a substance to adjust surface rights issues. Commentary - have a workable rule to determine title to the substance without reference to surface rights issues. Can address surface rights issue independent of the title issue.

(1) Rely upon K.S.A. 58-2202 (1983) to interpret "minerals" to include all mineral substances located anywhere on or in the land.

(2) Revise surface use rules to permit access but require payment for value of surface when actually used.

C. "Other Minerals." Handbook §6.04.

1. A conveys to B "all the oil, gas, and other minerals in Section 30." What substances are included in the grant of "other minerals?"

2. Kansas courts have applied the community knowledge and surface destruction tests to the "other minerals" situation, but have relied more strongly on the ejusdem generis maxim.

a. Ejusdem generis - where a general description follows a more specific description, the general is limited to items encompassed by the specific. Keller v. Ely, 192 Kan. 698, 702, 391 P.2d 132, 135 (1964).

b. Example: in Keller v. Ely a reservation of "all of the oil, gas, casing-head gas and other liquid semi-solid and solid minerals . . ." was held not to include gypsum because " . . . the general terms contained in the reservation must be deemed to embrace and include only those things similar in nature to those previously specifically enumerated - that is, oil, gas and kindred minerals." Keller, 192 Kan. at 703, 391 P.2d at 136.

c. Court in Keller also purports to apply the

community knowledge test, surface destruction test, and K.S.A. §58-2202. Similar analytical sequence used in Wulf v. Shultz to hold a lease, granting the right "to dig, drill, operate and procure natural gas, petroleum and other mineral substances," does not include the right to mine limestone. [Note: §58-2202 not applicable to a mining lease; construe against drafting party - usually grantee instead of the grantor].

(1) Problem with the current state of the law in Kansas - what sequence should be followed in deciding which test or maxim to apply before resorting to other tests or maxims?

(2) Same problems of uncertainty in applying the surface desruction and community knowledge tests as encountered in defining the scope of the term "minerals."

D. Substances Encompassed by Terms "Oil and Gas." Handbook §6.07.

1. A conveys to B "all the oil and gas in Section 30." What substances are included in the grant of "oil and gas?" Does it include helium or carbon dioxide - which are non-hydrocarbon gases? Does it inlcude substances which are produced as a component of the oil and gas stream?

2. Northern Natural Gas Company v. Grounds, 441 F.2d 704 (10th Cir. 1971), cert denied, 404 U.S. 951, 1063 (1971), rehearing denied, 404 U.S. 1065 (1971). Court had to determine whether a lease covering "oil and gas" included helium extracted from the gas stream by the lessee's gas purchaser.

a. Court refuses to apply ejusdem generis maxim to limit the term "gas" to oil-like hydrocarbon susbstances. Court holds: "absent specific reservations, the grant of gas by the leases covered all components of the gas, including helium." Northern Natural Gas Company, 441 F.2d at 715.

b. Here the helium was initially being produced as an impurity incidental to production of natural gas. It would have been impossible,

or uneconomic, for the lessee to separate the helium and produce only natural gas at the well. The court apparently thought the fair and workable result would be to find helium, produced as a component of the gas stream, would be included in the grant of the major gas stream substance - natural gas. The lessor would be obligated to specifically exclude component substances from the grant.

4. Kansas appellate courts have not addressed the issue.

5. Northern Natural Gas Company v. Grounds analysis would not apply when the substance in issue is not a "component" of the specifically conveyed substances ("oil and gas").

   a. Example: A conveys to B the "oil and gas" in Section 30. B, drilling for oil, strikes an almost pure deposit of carbon dioxide gas. Who owns the carbon dioxide under Section 30, A or B? Here the substance is not a component of the oil or gas stream. Instead the issue is the scope of the term "gas." Does it include a non-hydrocarbon gas like carbon dioxide? Kansas appellate courts have not addressed this issue.

      (1) Kansas courts may be more inclined to apply ejusdem generis maxim in this situation.

      (2) Community knowledge test may also be determinative - if the court chooses to apply it in this situation.

   b. Where the substance is not a component of a listed substance, essentially have an "other minerals" interpretive problem.

E. Drafting Suggestions. Handbook §6.08.

1. Kansas courts make it clear - if you have a specific substance in mind when conveying the mineral estate be sure and specifically list the substance.

2. Policy the court is probably attempting to promote in this area - protect the unwarry grantor from inequities which may arise when a substance, not even thought of during the bargaining process, is subsequently asserted to come within the general terms of the conveyance.

3. Ask your client what substances they intend to convey (or obtain) in the transaction. If the grantee wants "other minerals," find out what they are and state them specifically in the grant. Raise the issue during negotiations so it can be resolved. Consider asking the following questions:

   a. Do you want to convey all types of minerals, to include those not currently known to exist in the area?

   b. Do you want to convey mineral substances which are not currently of any commercial value, but which may become valuable in the future?

   c. Do you want to convey minerals which may require destruction of the surface for their extraction?

   d. Do you want to convey rights to ground water or geothermal resources?

   e. [Conveyance or reservation of "Oil and Gas"]

      (1) Do you want to convey non-hydrocarbon substances which may be produced as a gas?

      (2) Do you want to convey non-hydrocarbon substances which are produced as a component of the natural gas or oil stream?

4. Sample conveyances:

   a. <u>All Minerals -</u>
   <u>A</u> conveys to <u>B</u> all minerals, of any kind, whether a liquid, solid, or gas, to include minerals which require significant destruction of the surface for extraction, and including minerals not currently known to exist in the area, in or on the following land:

   b. <u>Oil and Gas Only -</u>
   <u>A</u> conveys [leases] to <u>B</u> all oil, gas, and similar hydrocarbon substances, including, to the extent they cannot be profitably separated at the lease, constituent non-hydrocarbon substances produced with the oil, gas, and similar hydrocarbon substances, in the following land:

c. Oil, Gas, and Other Minerals which can be mined without significant surface destruction -

A conveys [leases] to B all oil, gas, and other minerals, of any kind, whether a liquid, solid, or gas, hydrocarbon or non-hydrocarbon, including minerals not currently known to exist in the area, but excluding minerals which would require the significant destruction of the surface area overlying such minerals for their profitable extraction, in the following land:

(1) At what time will the mining technique be evaluated?

(2) Better approach - anticipate specific minerals which may create a problem and either exclude or include them specifically in the grant. Example: you have coal located 150 feet below the surface - address coal in specific terms.

d. All Minerals Including Gypsum and Carbon Dioxide -

A conveys to B all minerals, of any kind, whether a liquid, solid, or gas, to include, without limiting the scope of this grant in any way, gypsum and carbon dioxide, and including minerals not currently known to exist in the area and minerals which require significant destruction of the surface for extraction, in or on the following land:

IV. Deed/Lease Problem. Handbook §6.10.

A. Before Kansas courts recognized the defeasible term mineral interest, mineral conveyances were often found to be merely leases of the minerals. If the interest was found to create a mineral conveyance instead of a lease, and the conveyance was not recorded or listed as required by K.S.A. §79-420 (1984), the conveyance was void and the interest remained in the grantor.

B. If the interest was found to be a lease, the grantee (lessee) would have implied covenant obligations to the grantor which would otherwise not exist if it was held to be a mineral deed.

C. Problem probably created by the harsh consequences of K.S.A. §79-420. If courts could construe the instrument to be a lease instead of a deed, §79-420

would not apply. Gas Co. v. Neosho County, 75 Kan. 335, 339, 89 P. 750, 751 (1907) (predecessor to §79-420 does not apply to a mineral lease because the oil and gas lease creates merely an incorporeal hereditament). This is probably why Kansas courts treat oil and gas leases as personal property instead of real property.

V. Mineral/Royalty Problem. Handbook §6.14.

A. Has A conveyed to B a mineral interest or a royalty interest?

1. Mineral Interest - a right to oil and gas in place with the right to develop or authorize development.

2. Royalty Interest - a right to share in oil and gas when it is produced; no right to develop or authorize development of the minerals.

3. Problem - failure to use language which clearly identifies the interest intended.

a. Term "royalty" often inaccurately used to refer to a mineral interest owner's reversionary interest in minerals which are subject to an oil and gas lease. Since the mineral interest owner receives a "royalty" under the lease, conveyances often refer to royalty instead of the mineral interest - or the lessor's reversionary interest in the mineral interest.

b. A frequent lecture delivered by the Kansas Supreme Court:

"[T]he term `royalty' is often rather loosely and inaccurately used by men in the petroleum industry, those dealing in oil and gas holdings and at times by attorneys. Some persons refer to oil and gas in place as royalty. Others refer to royalty as the landowner's share in production. We have, therefore, repeatedly held the true nature and character of the instrument is not to be determined by the name or label attached thereto but by its intent as reflected by the terms, the contents thereof."

Lathrop v. Eyestone, 170 Kan. 419, 440-41, 227 P.2d 136, 140 (1951).

4. Importance of the distinction:

   a. If found to be a mineral conveyance which was not recorded or listed in accordance with K.S.A. §79-420 (1984), the interest is void.

   b. If found to be a perpetual royalty interest, it may be void as a violation of the rule against perpetuities.

   c. Royalty interest owner need not be included as a party to the oil and gas lease.

   d. Value of interest affected by whether it is cost-free (royalty) or whether it must pay a proportionate share of the development costs (unleased mineral interest). Example: a 1/8th royalty interest is more valuable than an unleased 1/8th mineral interest because the mineral interest owner will have to pay 1/8th of the costs of development from their 1/8th share of production.

   e. If the 1/8th mineral interest is subject to an existing lease paying a one-eighth royalty, the mineral interest owner will receive only a 1/64th (1/8 x 1/8) cost-free share of production.

B. Distinguishing a Mineral Interest from a Royalty Interest

   1. Primary goal - ascertain the intention of the parties.

      a. Look at all language used anywhere in the instrument. (Four-corners rule). Terms of the granting clause given particular weight.

      b. The title given an instrument is not determinative. However, the contents of the instrument must make it clear it is something other than what its title indicates.

   2. Factors Kansas courts have focused on to resolve the mineral/royalty issue include:

      a. Does the instrument convey an ownership interest in oil and gas prior to its actual production?

      b. Does the grantee have the right to enter the

property to conduct development operations?

c. Does the grantee have the right to lease the property and receive bonus, delay rental, and royalty?

3. Courts look for a conveyance or reservation of rights commonly associated with a mineral interest.

4. Does the grantee have any right to oil and gas prior to production? Handbook §6.15.

a. Look to granting clause, and the other parts of the instrument, to determine if it conveys any right to oil and gas "in and under" the land. This language indicates a right to oil and gas prior to its severance from the land - a mineral interest. Shepard, Executrix v. John Hancock Mutual Life Ins. Co., 189 Kan. 125, 132, 368 P.2d 19, 24-25 (1962).

b. Conveys a right to oil and gas when "produced," or otherwise severed from the land - indicates a royalty interest. Lathrop v. Eyestone, 170 Kan. 419, 422, 227 P.2d 136, 142 (1951).

c. Many times the instrument conveys an undivided portion of "the oil, gas and other minerals in and under, and that may be produced from" the land. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. 84, 91-92, 69 P.2d 4, 9 (1937) (court finds that the phrase "and that may be produced from" is not a limitation on the grant of "oil, gas and other minerals in and under" the land). Drach v. Ely, 237 Kan. 654, 658, 703 P.2d 746, 750 (1985) (similar language in a will "refers to a mineral interest rather than a royalty interest and standing alone does not create any ambiguity.").

d. Use of phrase "in and under and that may be produced from" probably originated to convey a right to minerals beneath the property and those which migrate to the property and are "produced from" the conveyed mineral interest. Account for the rule of capture. Shaffer v. Kansas Farmers Union Royalty Co.,

(1) Use of the "produced from" language is unnecessary and tends to confuse identification of the interest you intend to create. See Drach v. Ely,

237 Kan. at 657-58, 703 P.2d at 750.

(2) Such language, coupled with other ill-chosen words, may cause a court to find your intended mineral interest is a royalty interest. See, e.g., Drach v. Ely, 10 Kan.App.2d 149, 694 P.2d 1301 (1985), reversed, 237 Kan. 654, 703 P. 2d 746 (1985).

5. Does the grantee have the right to enter the property to conduct development operations? Handbook §6.16.

   a. The presence of language giving grantee the right to enter the property (right of ingress and egress) has been relied upon as indicating a mineral interest was intended. Shaffer v. Kansas Farmers Union Royalty Co., 146 Kan. at 90-91, 69 P.2d at 8 ("statement of the right of the owner of the oil to have some means of getting it.").

   b. Corbin v. Moser, 195 Kan. 252, 257, 403 P.2d 800, 804 (1965) (lack of right to enter property found significant in holding an instrument excepting "a one Sixteenth (1/16) Royalty interest in all oil, gas. or minerals in place" reserves a royalty interest).

6. Does the grantee have the right to lease the property and receive bonus, delay rental, and royalty? Handbook §6.17.

   a. Similar analysis to the presence of right of ingress and egress. If these rights are identified as incidents of the conveyance, the conveyance creates a mineral interest.

   b. If the interest does not possess these incidents, the conveyance may create a royalty interest.

7. What inferences should be drawn from the presence or absence of the right of ingress and egress, the right to lease the property and receive bonus, delay rental, and royalty?

   a. For example, if the instrument is silent regarding the grantee's right to enter and develop the property, or to lease it and receive bonus, delay rental, and royalty, should we infer the grantor intended to

convey a royalty interest instead of a mineral interest? However, since these are all incidents of a mineral interest, why should we state them at all? Would this tend to indicate we are creating something other than a mineral interest?

b. The Kansas cases are inconsistent on this issue.

c. Corbin v. Moser, 195 Kan. at 257, 403 P.2d at 804 - failure to mention rights incident to a mineral interest tend to indicate a royalty interest is being conveyed.

d. Hickey v. Dirks, 156 Kan. 326, 133 P.2d 107 (1943) - conveyance providing "that grantee shall have no interest in cash rentals or bonuses paid under any future oil and gas lease," tends to indicate instrument conveyed a royalty interest.

e. Contrast with Hickey the court's approach in Shepard, Executrix v. John Hancock Mutual Life Inc. Co. - instrument stated grantee "shall not be participating in bonuses or rentals, but shall be participating in other rights." Court notes had it not created a mineral interest there would have been no need to except rights to bonus and rentals.

f. Contrast the two most recent statements by the Kansas Supreme Court on the subject:

Cosgrove v. Young, 230 Kan. 705, 642 P.2d 75 (1982). Holding an instrument granting "one-half (1/2) of the royalty in Oil and Gas produced upon the . . . land" creates a royalty interest, the court considers the following factors:

"No right of ingress and egress is granted. No reference is made to oil, gas and other minerals in and under the land. In short, no further reservations were made in the contract relating to transferability, leasing rights, or other factors previously considered significant by the court. There is nothing in the instrument indicating that more than a bare royalty interest was intended to be conveyed."

Cosgrove, 230 Kan. at 712-13, 642 P.2d at 81-82.

Drach v. Ely, 237 Kan. 654, 703 P.2d 746 (1985). Instrument devised undivided interest in "the oil, gas and other minerals in and under and that may be produced from" six quarter sections of land. However, excluded from the grant were "any of the oil, gas or mineral lease rentals, delay rentals or bonuses which may be payable under any leases upon said real estate . . . ." Drach, 237 Kan. at 655, 703 P.2d at 748.

Holding this creates a mineral interest, the court notes:

"If the testator had intended to convey only a royalty interest to his children, there would have been no reason to specify that each surface owner would receive the rentals and bonus paid on his or her property. The other five children would have no claim to such payments and they would inure to the benefit of the surface owner without any such provision." Drach, 237 Kan. at 658-59, 703 P.2d at 750.

C. Drafting Suggestions. Handbook §§6.18 and 6.19.

1. Select appropriate title for your document.

   a. Mineral Interest - title it "Mineral Deed"

   b. Royalty Interest - title it "Royalty Assignment" [avoid phrase "Royalty Deed"]

2. For a mineral interest:

   a. Create a present right to oil and gas in the land. Avoid references to rights in production. Use language appropriate for a conveyance of real property.

   b. Consider whether it is advisable to specify the incidents of a mineral interest in the conveyance.

   c. If the interest is leased, indicate the grant includes any reversionary rights of the grantor in existing oil and gas leases.

   d. Ensure all collateral references to the transaction describe it as a mineral interest.

   e. See suggested form. Handbook §6.32.

3. For a royalty interest:

a. Indicate the grantee is entitled to a share of production free of costs associated with drilling, completing, and producing.

b. Clearly state that the interest is only in oil and gas produced and saved from wells operating on the premises.

c. Employ language appropriate for an assignment of personal property.

d. See suggested form. Handbook §6.35.

VI. Nonparticipating Mineral Interests. Handbook §4.16.

A. One reason for the mineral/royalty problem is that Kansas courts have had difficulty conceptualizing the nonparticipating mineral interest. This difficulty has been caused, to a great extent, by the inability of draftsmen to clearly create a nonparticipating mineral interest.

B. The incidents of mineral ownership can be divided. See Session 1, Paragraph VII at Outline Page 22 and Paragraph VIII at Outline Page 23. The grantor can create a nonparticipating mineral interest in the grantee which includes only the right to receive royalty under an oil and gas lease. This will look like a royalty interest, but, if properly drafted, the grantor can convey a mineral interest to a grantee which excepts the development rights, executive or leasing rights, and the right to any bonus or delay rental. The grantee will have a mineral interest which participates only in a share of oil and gas produced from the land.

1. Can avoid rule against perpetuities problems which prevent conveyance of a perpetual royalty interest. Handbook §4.15.

2. Suggested form to create nonparticipating mineral interest. Handbook §6.36.

C. The Kansas Supreme Court has recognized and enforced perpetual nonparticipating mineral interests.

1. H. Williams & C. Meyers in 2 Oil and Gas Law §323 (Matthew Bender 1985) state:

"Lathrop v. Eyestone [170 Kan. 419, 222 P.2d 136 (1951)] holds that perpetual, nonexecutive mineral interests . . . are void under the Rule

[against perpetuities], and this case was followed in 1982 by Cosgrove v. Young . . . ." Page 13.

"In short, the case [Lathrop] holds that perpetual nonparticipating royalty and nonexecutive mineral interests cannot be created in Kansas. An instrument purporting to create an interest in future bonus, rental or royalty, unlimited in time, is virtually worthless in that state under this decision." Page 16.

a. Lathrop v. Eyestone does not restrict the use of perpetual nonparticipating mineral interests. The interests involved in Lathrop were held to be royalty interests, not mineral interests. If the court had construed the instruments to create mineral interests, the conveyances would have been upheld.

b. Kansas cases recognizing perpetual nonparticipating mineral interests:

(1) Froelich v. United Royalty Co., 178 Kan. 503, 290 P.2d 93 (1955), modified, 179 Kan. 652, 297 P.2d 1106 (1956). Grant of undivided one-half mineral interest but excepting "the oil and gas bonus and oil and gas rental money" and "[t]hat in the leasing of said land for oil and gas . . . [the grantee] shall not be a necessary party . . . and [grantee] authorizes . . . [grantor] to lease said land for oil and gas purposes." 178 Kan. at 506, 290 P.2d at 95-96.

(2) Shepard, Executrix v. John Hancock Mutual Life Ins. Co., 189 Kan. 125, 368 P.2d 19 (1962) (grantor retained mineral interest less right to participate in bonuses or rentals).

(3) Drach v. Ely, 237 Kan. 654, 703 P.2d 746 (1985) (court upholds a mineral interest which was limited to grant only one-sixth of the royalty from designated lands, all other attributes of mineral ownership were given to the surface owner).

VII. Expressing Fractional Interests. Handbook §6.20.

A. Frequent problems in this area because the draftsman fails to recognize the landowner's continued ownership of an 8/8ths mineral interest even though it is under lease providing for a 1/8th royalty.

1. The error typically occurs as follows: A wants to convey a one-half mineral interest to B. A owns all the mineral interest in Section 30, but it is under lease to C. The lease provides that A will receive 1/8th of the production from the lease as royalty. A's conveyance to B states:

"A grants unto B an undivided 1/16 interest in and to all the oil, gas and other minerals whatsoever in and under Section 30. If such land is covered by a valid oil and gas or other mineral lease B shall have an undivided 1/2 interest in the royalties, rentals, and proceeds therefrom."

a. Does B have a 1/16th or a 1/2 interest in the Section 30 minerals?

b. Presented with a similar conveyance, the court in Heyen v. Hartnett, 235 Kan. 117, 679 P.2d 1152 (1984), found the conveyance ambiguous and employed rules of construction to ascertain the parties' intent. Holding the instrument conveyed a 1/2 mineral interest, the court was influenced by the "widespread confusion" associated with expressing fractional mineral interests which are under lease.

2. Confusion relates to what the grantor has when their mineral interest is leased. They still own all or 8/8ths of the mineral interest. The interest is merely limited by the terms of the lease contract. A cannot develop, because he has granted that right, by contract, to C. One of A's rights under the contract is receipt of a fractional share of all oil or gas produced from the lease. However, A can still convey all, or part, of his mineral interest.

3. Kansas courts will look at all provisions in the instrument, the surrounding circumstances, and applicable rules of construction [such as K.S.A. §58-2202 (1983)] to ascertain the intent and purpose of the parties in using fractions

to describe the interest conveyed.

4. Drafting to avoid the problem - when conveying fractional mineral interests, refer to the fraction conveyed without reference to the landowner's royalty.

   a. Example: A wants to convey B a 1/4th mineral interest, the land is under lease providing for payment of a 1/8th royalty. The instrument should refer only to the 1/4th mineral interest without addressing the grantee's resulting interest in royalty.

      A conveys to B an undivided 1/4th of 4/4ths of the oil, gas, and similar hydrocarbon substances in Section 30 . . . .

   b. A general statement, concerning the incidents of mineral ownership, can be used if it is phrased in terms of a "1/4th interest in all rights under existing leases on the property" as opposed to a "right to a 1/32 cost-free share of production from the property."

B. Fractional Royalty vs. Fraction "Of" Royalty. Handbook §6.21.

1. Landowner conveys "1/16th royalty," landowner conveys 1/16th of all production from the land. If mineral interest is leased giving landowner a 1/8th royalty, the landowner is deemed to have conveyed 1/2 of his 1/8th royalty. Bellport v. Harrison, 123 Kan. 310, 311, 255 P.52, 54 (1927) (contract for purchase of "1/16th royalty" in land conveyed 1/2 of landowners' 1/8th royalty).

2. Landowner conveys "1/16th of his 1/8th royalty," the landowner is deemed to have conveyed 1/16th of 1/8th or a 1/128th royalty. Hickey v. Dirks, 156 Kan. 326, 133 P.2d 107 (1943). Problem: 1/16th of 1/8th of royalty. Does this mean 1/16th of 1/8th of 1/8th? Or 1/16th of 1/8th?

3. Guide: If there is no limitation on the source for the fractional interest, it will be calculated based on an entire (8/8ths) mineral interest. See Corbin v. Moser, 195 Kan. 252, 403 P.2d 800 (1965).

C. Conveying Fractional Interests When Grantor Owns A Fractional Interest. Handbook §6.23.

1. A owns a 3/4ths mineral interest in Section 30. A conveys a 1/2 mineral interest in Section 30 to B. Does B get a 1/2 mineral interest (1/2 x 4/4) or a 3/8ths mineral interest (1/2 x 3/4)?

   a. B gets a 1/2 mineral interest.

   b. K.S.A. §58-2202 (1983) dictates that B receive a 1/2 mineral interest, even though A only owns a 3/4ths mineral interest and intended to convey only a 3/8ths (1/2 x 3/4) mineral interest.

   c. K.S.A. §58-2202 requires that A's intent "to pass a less estate shall expressly appear or be necessarily implied in the terms of the grant." See Handbook §6.02.

2. Suppose A excepts from his conveyance to B a 1/2 mineral interest in Section 30. What will A have? A 1/2 or 3/8ths mineral interest? - or perhaps a 1/4th interest? What will B receive? A 1/4th, 3/8ths, of 1/2 mineral interest?

   a. Problem is A has failed to designate the source which should be used to calculate the fractional mineral interest reserved to A.

   b. Drafting - simple remedy is to state the base fraction from which the excepted or conveyed fraction is to be taken. For example, A could state:

      (1) A conveys to B a 1/2 of 3/4ths mineral interest in Section 30. A could also make the same conveyance by giving B a 3/8ths of 8/8ths mineral interest. See suggested form. Handbook §6.33.

      (2) A excepts a 1/2 of 8/8ths mineral interest in Section 30.

3. Interpreting Fractional Conveyances. Although the drafting solution is simple, the process of interpreting inartfully drafted fractional conveyances is difficult. Consider the following case:

   In 1985 A conveys an undivided 1/2 mineral

interest to B; B records the conveyance. In 1986 A conveys, by warranty deed, the land to C "retaining unto A an undivided 1/2 interest in the minerals."

a. B has an undivided 1/2 interest in the minerals. Will C receive:

   (1) no interest in the minerals;

   (2) a 1/2 interest; or

   (3) a 1/4th (1/2 of A's 1/2) interest?

b. Apparently, the Kansas appellate courts have not addressed this issue.

c. Texas Supreme Court dealt with a similar factual issue in Duhig v. Peavy-Moore Lumber Co., 135 Tex. 503, 144 S.W.2d 878 (1940), which spawned the Duhig Doctrine.

d. Under the Duhig Doctrine C gets a 1/2 mineral interest, leaving A with no mineral interest.

e. In Duhig, since A made a warranty conveyance to C, the court, applying estoppel and after-acquired title principles, takes from A's excepted 1/2 mineral interest the amount (1/2) required to satisfy the warranted conveyance to C - a 1/2 mineral interest.

f. Commissioner Smedley, applying principles similar to K.S.A. §58-2202, notes: "the language of the deed as a whole does not clearly and plainly disclose the intention of the parties that there be reserved to the grantor Duhig an undivided one-half interest in the minerals in addition to that previously reserved to Gilmer's [B's] estate . . . ." Duhig, 135 Tex at 506-07, 144 S.W.2d at 879.

g. Supporters of Duhig Doctrine - can look at record title and determine who owns what. Duhig attackers - it seldom comports with the intent of the parties; should examine the subjective intent of the parties to determine intent.

h. What if C has knowledge, at the time of the A/C conveyance, of the 1/2 mineral interest

previously conveyed to B?

(1) K.S.A. §58-2222 (1983) - if properly recorded "all subsequent purchasers . . . shall be deemed to purchase with notice."

(2) Imputing notice to C still does not resolve the ambiguity surrounding A's intent. To determine A's actual intent, you would have to declare the deed ambiguous. On its face, it is not ambiguous.

(3) Should the court, as a matter of law, declare such conveyances ambiguous and allow extrinsic evidence of A's actual intent? Or should the court interpret the conveyance using rules similar to those employed in Duhig and leave A to seek relief through reformation?

VIII. Title Covenants. Handbook §6.27.

A. Types of mineral conveyances:

1. General warranty.

2. Special warranty.

3. No Warranty.

4. Quitclaim.

B. General Warranty Conveyance - created by phrase: A "conveys and warrants" to B. Covenants that A:

1. Lawfully possesses the property;

2. Has the right to convey the property;

3. Will guarantee B's quiet possession of the property;

4. The property is unencumbered; and

5. Warrants and will defend against adverse claims to B's rights listed in 1. - 4.

6. These covenants are created by K.S.A. §58-2203 (1983) when the phrase "conveys and warrants" or similar language is used.

C. Quitclaim Conveyance - conveys whatever interest

the grantor has in the property at the time the conveyance was made. Grantor not estopped from claiming after-acquired title.

D. No Warranty - Grantor not responsible for failure of title but is estopped from claiming after-acquired title against grantee.

E. Special Warranty - typically limits grantor's covenants of warranty to encumbrances and defects caused by the grantor. Grantor covenants to warrant and defend title against anyone claiming "by, through or under the grantor." Terms and scope of special warranty must be carefully stated in the conveynace.

F. After-Acquired Title - K.S.A. §58-2207 (1983) provides:

"Where a grantor by the terms of his or her deed undertakes to convey to the grantee an indefeasible estate in fee simple absolute, and shall not at the time of such conveyance have the legal title to the estate sought to be conveyed, but shall afterwards acquire it, the legal estate subsequently acquired by the grantor shall immediately pass to the grantee; and such conveyance shall be as effective as though such legal estate had been in the grantor at the time of the conveyance."

1. Quitclaim conveyance is not an "indefeasible estate in fee simple absolute . . . ." See Mosier v. Allenbaugh, 84 Kan. 361, 364-65, 114 P. 226 (1911) and Knight v. Dalton, 72 Kan. 131, 83 P. 124 (1905). See also K.S.A. §58-2204 (1983).

2. Conveyance "without any warranty, express or implied" still conveys an "indefeasible estate" so K.S.A. §58-2207 would apply. See Armstrong v. Building Co., 57 Kan. 62, 45 P. 65 (1896). No breach of warranty but grantor would be prevented from claiming a subsequent interest in the property adverse to his previous conveyance.

IX. Apportionment of Royalty. Handbook §§6.24 and 9.47.

A. Kansas Non-Apportionment Rule - Suppose A purchases a divided mineral interest in the West Half of Section 30 when all of Section 30 is subject to an oil and gas lease. A well is subsequently completed as a producer on the East Half of Section 30. Assuming no implied covenant problems,

production from the East Half will perpetuate the lease as to all of Section 30.

1. Unless the lease contains an entireties clause, or special provisions for apportionment are placed in the conveyance, A will not receive any royalties from production on the East Half - even though the West Half is subject to the lease. Carlock v. Krug, 151 Kan. 407, 99 P.2d 858 (1940).

2. Apportionment becomes an issue anytime there is a conveyance of a divided interest in minerals which are subject to an oil and gas lease covering the divided interest and other lands.

B. Entirety Clause.

1. To achieve an apportionment of royalties in the event the leased land is subsequently divided into separate tracts, oil and gas leases often contain an entirety clause similar to the following:

   "If the leased premises are now or hereafter owned in severalty or in separate tracts, the premises, nevertheless, may be developed and operated as an entirety, and the royalties shall be paid to each separate owner in the proportion that the acreage owned by him bears to the entire leased area."

   Brubaker v. Branine, 237 Kan. 488, 489, 701 P.2d 929, 920-31 (1985).

2. Example: A, owner of Section 30, leases it to X on 1 January 1985. On 2 January 1985 A conveys the SW1/4 to B and the SE1/4 to C. On 1 February 1985 a producing well is drilled on A's retained N1/2 of Section 30.

   a. If the lease does not contain an entirety clause, in Kansas A would receive all the royalty. B and C would receive nothing.

   b. If the lease contains a Brubaker type entirety clause, royalty would be divided as follows: A 1/2 B 1/4 C 1/4.

3. Can A, B, and C, by separate agreement, or by the terms of their conveyances, agree upon an apportionment scheme different from that required by an entirety clause in a lease on Section 30?

a. Some states view the entirety clause as a provision for the lessee's benefit and therefore cannot be changed or affected without lessee's consent. See, e.g., Foertsch v. Schaus 477 N.E.2d 566 (Ind. App. 1985).

b. Dicta in Brubaker suggests parties to the conveyance can alter the apportionment function of the entirety clause "if they had included an express provision for non-apportionment in the deed or if they had reserved the mineral rights." Brubaker, 237 Kan. at 492, 701 P.2d at 932.

c. Cannot adversely affect lessee's rights. Safest practice - have the grantor, grantee, and lessee agree on the new apportionment formula or amend the lease, before the conveyance is made, to delete the entirety clause.

4. Apportionment issue should be specifically negotiated whenever the property being sold includes a mineral interest subject to an existing oil and gas lease covering the conveyed land and other lands not included in the conveyance. Always review the lease to determine whether it addresses apportionment.

5. For a suggested Mineral Deed form providing for apportionment of royalties, see Handbook §6.34.

SESSION 3 - ASSIGNMENTS OUT OF THE LEASEHOLD INTEREST

I. The Assignment. Handbook §§7.01 to 7.03.

A. Typical oil and gas lease creates a profit a prendre in the lessee. "A profit a prendre is the right to take soil, gravel, minerals, and the like from the lands of another and is in the nature an incorporeal right." Burden v. Gypsy Oil Co., 141 Kan. 147, 150, 40 P.2d 463, 466 (1935).

1. Unlike typical landlord and tenant lease, Kansas courts hold the oil and gas lease does not convey an estate in the affected real property. Instead it merely licenses the lessee to enter the land to remove oil and gas. Kansas classifies the oil and gas lease as personal property. Burden v. Gypsy Oil Co.

2. Kansas courts treat the oil and gas lease as a contract. Brinkman v. Empire Gas & Fuel Co., 120 Kan. 602, 605-06, 245 P. 107, 110 (1926). However, the oil and gas lease "contract" has many of the characteristics of a conveyance.

3. Lessee's rights under an oil and gas lease called the "working interest" or "leasehold interest."

a. Lessee can divide and convey the leasehold interest much like the mineral interest owner divides and conveys the mineral interest.

b. Can convey or except divided and undivided interests, can divide the leasehold horizontally and vertically, limit it to a specified term or until the occurrence of a specified event, can convey or except operating and nonoperating interests.

4. Since we are conveying rights in personal property, represented by a contract, the conveyance instrument is generally termed an "assignment."

5. Convey less than all the lessee's rights under the lease - call it a "partial assignment."

B. Ability to Assign. Handbook §7.03.

1. Unless expressly prohibited by the lease terms, the oil and gas lease is freely assignable. Matthews v. Ramsey-Lloyd Oil Co., 121 Kan. 75, 81-82, 245 P. 1064, 1067 (1926).

2. Lessee, and intended assignee, must carefully review the lease to determine if it limits lessee's ability to assign. Consider Moherman v. Anthony, 103 Kan. 500, 175 P. 676 (1918).

3. K.S.A. §58-2511 (1983):

"No tenant for a term not exceeding two years, or at will, or by sufferance, shall assign or transfer his or her term or interest or any part thereof to another without the written consent of the landlord or person holding under the landlord."

a. Doubtful this would be applied to oil and gas lease.

b. Issue - to what extent should courts feel constrained to apply landlord tenant law to oil and gas lease disputes?

C. Requirements for a Valid Assignment. Handbook §7.04.

1. Although oil and gas lease not a real property interest, it still creates an interest in land and is governed by the same conveyance formalities required for a conveyance of real property. Therefore, requirements similar to those required for a conveyance. See Outline Session 2, paragraph II, page 27.

2. Parties to the assignment:

a. Lessee (assignor) and grantee (assignee).

b. Lessor not a necessary party - unless lease requires lessor's consent.

c. Lessee's spouse, unless a named grantee in the lease, is not a necessary party. Since lease is personal property, interest not subject to spouse's homestead or inchoate statutory rights.

3. Words of conveyance should be appropriate for an interest in personal property - "assigns" or "transfers."

4. Leases subject to the assignment must be adequately described. State the real property covered by the lease and assignment, followed by a description of each lease by its date, the names of the lessor and lessee, and the book, page, and county where the lease is recorded.

See generally Luthi v. Evans, 223 Kan. 622, 576 P.2d 1064 (1978).

5. Normally not signed by the assignee. However, since the assignment is not effective unless and until assignee accepts the conveyance, may be advisable to include an acceptance line for the assignee's signature.

6. Record to provide constructive notice. K.S.A. §58-2221 (1983) provides: "any estate or interest created by an oil and gas lease, or whereby any real estate may be affected . . . may be recorded . . . ."

II. Identifying the Interest Assigned. Handbook §7.05.

A. Can limit assignment by area, substance, and duration. Can impose new obligations on assignee.

B. Depth Limitations. Handbook §7.06.

1. Try to eliminate uncertainty concerning where the division begins and ends. Requires technical assistance concerning the location and configuration of underlying rock.

2. The problem - A conveys to B the leasehold rights in Section 30 from the surface down to 3,000 feet below the surface. If an oil and gas reservoir extends from 2,990 feet to 3,010 feet below the surface, which party can produce from the reservoir?

a. See, e.g., Carter Oil Co. v. McCasland, 190 F.2d 887 (10th Cir. 1951); Carter Oil Co. v. State, 205 Okla. 541, 240 P.2d 787 (1951); Palmer Oil Corp. v. Phillips Petroleum Co., 204 Okla. 543, 231 P.2d 997 (1951), appeal dismissed, 343 U.S. 390 (1952).

b. Goal is to use descriptions which avoid the possibility of splitting a reservoir.

3. Related problem - A conveys to B the leasehold rights to the Dakota Formation in Section 30. If the Dakota Formation, in Section 30, is readily identifiable, no problem arises. However, experts often differ about where one formation tops out and another begins.

4. Technical assistance from the geologist and the petroleum engineer can allow you to draft depth limitations which will avoid many of the common

problems associated with identifying where the parties rights begin and end.

5. Specific Depth Limitations - consult geologist to determine where a safe formation or depth break is located. If possible, use reference wells on adjacent lands to identify an acceptable place to divide the leasehold rights. May want to specify the depth as being the stratigraphic equivalent of a depth measured in a nearby marker well. This will account for the nonuniformity of subsurface structures. For example:

   A assigns to B the oil and gas leasehold interest created by an oil and gas lease dated 31 July 1985 between Fred Farmer as lessor and A as lessee, recorded in the Miscellaneous Book 143 at Pages 17-18 of the Eureka County, Kansas records, covering Section 30, Township 36 South, Range 10 East, from the Sixth Principal Meridian, Eureka County, Kansas, to the extent the lease includes A's interest from the surface down to the stratigraphic equivalent of 4,000 feet beneath the surface, as measured in the Farmer 1-30 Well completed in the Northwest Quarter of the Northwest Quarter of Section 30, Township 36 South, Range 10 East, from the Sixth Principal Meridian, Eureka County, Kansas. A excepts from this assignment all leasehold rights below the stratigraphic equivalent of 4,000 feet beneath the surface as measured in the bore of the Farmer 1-30 Well.

6. Specific Formation - the goal here is to limit disputes over where one formation begins and another ends. If it is difficult to distinguish two horizontally contiguous formations, perhaps a simpler dividing guide should be selected. If this is not possible, it is necessary to resolve any dispute over the limits of the assigned formation in the assignment document. This can be done by using an area marker well to indicate the depths the formation is agreed to occur, as shown by a particular log, in the marker well. For example:

   A wants to convey to B all of A's leasehold rights to the Dakota Formation in Section 30. There are no wells on Section 30, but there is a well on Section 29 which penetrates the Dakota Formation. A and B each examine the sonic log ran on the Section 29 well and agree that the Dakota Formation begins at 3,010 feet and ends at 3,250 feet below the surface - in the Section 29

well bore. Using this as a standard for log interpretation for wells in Section 30, the assignment can provide:

For reference purposes, A and B agree the Dakota Formation is identified by sonic log as beginning at 3,010 feet and ending at 3,250 feet in the Smith 1-29 Well located in [legal description].

7. Surface and Formation Rights - whenever an interest is limited by depth or formation, the assignment should reserve rights to each of the parties to use the surface of the leasehold, and to drill through excepted formations, to access their divided interest. For example:

   A reserves the right to enter and use the leasehold interest assigned to B as is reasonably required to explore, develop, and operate the portion of the leasehold right retained by A.

C. Fraction Problems. Handbook §7.07.

1. Owner of leasehold interest is entitled to a share of production determined by subtracting the lessor's royalty interest.

   a. Royalty traditionally 1/8th, leasehold or working interest often thought of as the right to 7/8ths of the production.

   b. If lessee A conveys a 1/16th overriding royalty to B, is B entitled to 1/16th of 8/8ths of production or 1/16th of 7/8ths of production?

   c. If lessee A conveys 1/16th of A's working interest, what is B entitled to?

2. Avoid problem by avoiding terms such as "working interest" and designate the base quantity of production from which the fractional share should be calculated. For example:

   a. If A wants to convey a 1/16th share of gross production: "A assigns to B 1/16th of 8/8ths of production."

   b. If A wants to convey a 1/16th share of A's share of production: "A assigns to B 1/16th of 7/8ths of 8/8ths production."

D. Proportionate Reduction. Suppose A owns only an undivided 50% leasehold interest in Section 30 but

assigns to B 1/16 of 7/8 of 8/8 of production from Section 30. Will B receive 7/128ths (1/16 x 7/8 x 8/8) or 7/256ths (1/2 x 1/16 x 7/8 x 8/8) of production?

1. These problems are usually avoided in assignments by using a proportionate reduction clause. Since the leasehold interest is often held in cotenancy with other operators, a clause is often used to make B's interest correspond to A's actual fractional leasehold ownership. Such clauses may also address the effect of pooling or unitization on B's share of production.

2. Sample proportionate reduction clause:

   To the extent A's leasehold interest in [the assigned property] covers less than 100% [8/8ths] of the mineral interest, B's overriding royalty interest shall be reduced in the proportion that A's interest bears to 100% [8/8ths] of the mineral interest. In the event all or part of the assigned property is pooled or unitized with other leasehold interests to form a drilling, spacing, or proration unit, or to effect fieldwide unitization, B's overriding royalty interest shall be further reduced in the proportion surface acreage covered by the assigned property included within the unit bears to the total surface acreage within such unit.

   a. If production from a unit is allocated by some formula other than surface acreage, the clause would have to be amended to incorporate the formula employed.

   b. See form assignment - Handbook §7.25.

E. Warranty. Handbook §7.08.

1. Since the oil and gas lease is classified as personal property, an assignment of the lease for a fair price implies a warranty of title in the lessee assignor. Ratcliff v. Paul, 114 Kan. 506, 509, 220 P. 279, 281 (1923).

2. Common to have assignments with no warranty or a special warranty.

3. Common to have special covenants of warranty addressing the current status of the lease - such as all delay rental and royalties have been paid and the lessee has complied with all lease

provisions in a timely and proper manner.

4. See sample form - Handbook §7.21.

III. Liability of Parties to the Assignment. Handbook §§7.09 to 7.12.

A. Liability to Lessor. Handbook §7.10.

1. If the assignment covers all of the lessee's interest, the assignee will become responsible to the lessor for performance of lease obligations. May be assignment/sublease problem. Handbook §7.12. If sublease recognized, and assignee is held to be a sublessee, no privity to lessor - no liability to lessor.

2. Unless relieved of further liabilty by the terms of the lease, the assignor remains responsible to the lessor in the event the assignee fails to comply with the lease terms.

3. Assignee's liability will extend from the time the assigned interest is received until it is disposed of through further assignment. See Hale v. Oil Co., 113 Kan. 176, 180, 213 P. 824, 826 (1923).

4. Lessee may try to terminate liability for actions occurring after assignment through standard lease provisions.

5. Assignor and assignees usually allocate their liabilities in the assignment. Customary to indemnify each other against liability arising for periods when the other had exclusive control over the leased premises. See, for example, suggested form - Handbook §7.21.

B. Effect of Assignment on Lease Obligations. Handbook §7.11.

1. If A, the mineral lessee of Section 30, assigns its leasehold interest in the West Half of Section 30 to B, to what extent will the lessor be required to treat the lease as a single 640 acre lease after the leasehold rights have been divided between A and B?

   a. The "divisibility" problem.

   b. Suppose, within the primary term of the lease, B obtains production from the West Half. When the primary term expires, B

continues to produce from the West Half but A has never had production on its East Half. Will A's lease on the East Half terminate?

c. Typically the lease continues for so long as there is production from the "described land." Here that would be Section 30. Then the issue becomes whether, by dividing the leasehold rights between A and B, it also divides the lease for purposes of the land from which production is required.

d. Under similar facts, the court in Cowman v. Phillips Petroleum Co., 142 Kan. 762, 51 P.2d 988 (1935), held the lease was not divided and production from B's portion of the lease would extend A's portion beyond the primary term.

The ~~modern~~ Typical ~~lease~~ form

The oil and gas lease expressly provides that division of working interest rights in the lease will not

2. Generally, absent an express provision in the lease, payment of delay rental is not divisible. For example, if, during the primary lease term, delay rental of $1 per acre is due under the Section 30 lease, if A tenders $320 (for his East Half), but B fails to pay (on his West Half), the entire lease is terminated for failure to pay delay rental.

a. Leases often contain provision permitting divisibility of lease for payment of delay rental. In such a case, A's portion of the lease would not terminate, although B's would. See Wilson v. Texas Company, 147 Kan. 449, 76 P.2d 779 (1938).

b. If the lease does not contain such a provision, or the leasehold assignment is by depth or undivided interest, assignment should address who will be responsible for payment of delay rental. See suggested form - Handbook §7.22.

IV. Allocation of Leasehold Burdens. Handbook §7.13.

A. Whenever a partial assignment is made, or a nonoperating interest is conveyed or retained, the transfer document should indicate how prior burdens against the leasehold will be satisfied.

B. "Burdens" against the leasehold include any third party right to production from the land covered by the lease.

C. Example: A leases Section 30 to B retaining a 1/8th

landowner's roylaty. B, owning the remaining 7/8ths of production, grants C an overriding roylaty of 1/16th of 8/8ths of gross production from the leased land. B then assigns an undivided 1/2 interest in the A/B lease to D. D's leasehold interest, depending upon the terms of the assignment, may be burdened by: A's 1/8th royalty and C's 1/16th overriding royalty.

1. When D accepted the assignment, he became obligated, by the terms of the lease, to pay A, in conjunction with B, a 1/8th royalty on any production from Section 30.

2. Did D, by accepting the assignment, become obligated to pay a portion of C's overriding royalty?

   a. Problem of interpreting the assignment.

   b. Usually depends upon whether B's assignment warrants a specified net interest to D or mentions prior burdens.

D. Issue also raised if B, instead of conveying an undivided interest in the lease, assigns the A/B leasehold to D, retaining in B a 1/8th overriding royalty. Will D be responsible for paying C's 1/16th overriding royalty out of D's share of production? Or is B obligated to pay C out of B's share of production?

E. Parties to the assignment should specify how prior burdens will be satisfied. Once the matter is discussed, the drafting task is simple. See sample form - Handbook §7.26.

V. Nonoperating Interest Problems. Handbook §§7.14 - 7.17.

A. Most problems relate to the limited nature of the nonoperating interest.

1. Overriding royalty and production payments are dependent upon the continued validity of the leasehold interest from which they are carved.

2. If the lease is cancelled, surrendered, or terminates, the working interest from which the nonoperating interest is carved, and the nonoperating interest, terminate. See Campbell v. Nako Corporation, 195 Kan. 66, 402 P.2d 771 (1965) and 198 Kan. 421, 424 P.2d 586 (1967).

3. To protect the nonoperating interest, they must

try and obtain, through the assignment document, some measure of control over the working interest owner.

B. Preventing Intentional Destruction of the Nonoperating Interest. Handbook §7.15.

1. Working interest owner may, through collusion with the lessor, attempt to terminate the lease to extinguish a nonoperating interest.

   a. What is the nature of the relationship between operator and nonoperator? Fiduciary?

   b. Robinson v. Eagle-Pitcher Lead Co., 132 Kan. 860, 297 P. 697 (1931). No fiduciary relation created by sublease. Court notes, however, if sublease contained provision making sublessor's rights [overriding royalty retained by sublessor] applicable to modifications, renewals, or extensions of the sublease, a fiduciary relationship may have been created - citing Probst v. Hughes, 143 Okla. 11, 12, 286 P. 875, 876 (1930).

   c. Howell v. Cooperative Refinery Ass'n, 176 Kan. 572, 271 P.2d 271 (1954). Howell assigned interest to CRA, reserving an overriding royalty. Assignment expressly provided override would burden the "oil and gas leasehold estate, or any extension or renewal thereof . . . ." CRA permitted the lease to expire in September 1950 and obtained a new lease directly from the lessor in October 1951. Howell asserted a breach of fiduciary duty and therefore CRA's new lease was burdened by Howell's override.

      Court finds that under certain factual settings the relationship of the parties may be fiduciary. Here the court finds Howell and CRA had a form of "joint interest" in the enterprise because Howell was obtaining leases for CRA. Therefore, a fiduciary relationship existed between Howell and CRA and the new lease was burdened by Howell's override. Howell, 176 Kan. at 577, 271 P.2d at 275.

2. Prevent problems by placing a broad extension and renewal clause in the assignment. For example:

   The obligation to pay the overriding royalty required by this assignment shall exist for the

life of the oil land gas lease plus any extensions and renewals of the lease. For purposes of this paragraph, any leasehold interest covering any portion of the Assigned Property, acquired by assignee within 2 year(s) following the termination, cancellation, or surrender of the oil and gas lease, shall be deemed an "extension or renewal."

C. Unintentional Destruction of Nonopertaing Interest. Handbook §7.16.

1. Can impose duties upon assignee to maintain the lease. Establish a standard of care so that if the assignee, for example - misses a delay rental payment, the assignor will be entitled to compensation.

2. Best way to protect assignee's interest is to impose a reassignment obligation upon the assignor. For example:

   Assignee will not surrender, abandon, or otherwise permit or cause the lease to terminate without offering to reassign the lease to assignee at least thirty days prior to any action or inaction by assignee which would terminate the lease.

   a. Will assignee warrant title to the reassigned interest? Will it be subject to burdens created by assignee prior to reassignment? How will assignor's damages be calculated in the event assignee fails to reassign the lease and it terminates? Market value of the override or market value of the leasehold?

   b. Should address these matters in the reassignment provision. For example:

      If assignor [A] elects to have the lease reassigned to it, assignee [B] will immediately prepare an assignment of the lease containing a special warranty that the lease is free of any encumbrances or defects caused by B and that B will warrant and defend title against anyone claiming by, through, or under B. Any liens, encumbrances, or burdens created against the Assigned Property after the date of this ASSIGNMENT, shall terminate upon reassignment to A.

   c. See suggested form - Handbook §7.25.

D. Working Interest Owner's Implied Obligations to Nonoperating Interest Owner. Handbook §7.17.

1. To what extent can the nonoperating interest owner assert, for example, an implied obligation to drill an initial well, further develop the leased land, or have it protected from drainage?

2. Matthews v. Ramsey Lloyd-Oil Co., 121 Kan. 75, 245 P. 1064 (1926). Assignor retained a $30,000 production payment. Court holds no obligation on assignee to drill well to try and obtain production to satisfy the production payment. No express provisions in assignment so look to the lease - delay rental clause allows assignee to delay development by paying lessor. NOTE: court found primary consideration for the assignment was a $12,000 cash payment, not the $30,000 production payment. May have a different result if the only cosideration for the assignment was the production payment.

3. Assignee may want express language in assignment to negate the possibility of implied obligations to nonoperating interest owner.

4. Nonoperating interest owner may want express covenants to protect their interest, or at least the right to enforce the express and implied obligations created by the oil and gas lease.

5. See sample form - Handbook §7.25.

SESSION 4 - THE OIL AND GAS LEASE

I. Function and Classification. Handbook §9.01.

A. Functional Characteristics.

1. The oil and gas lease has evolved as the standard relationship for development of oil and gas. Developer only wants the right to explore, develop, and produce oil and gas. The landowner retains ownership in the mineral estate which is subject to the developer's rights under the lease.

2. Typically, no obligation to develop. Payments prior to actual production usually nominal compared to lessor's potential royalty interest. No obligation to pay royalty until, and unless, oil or gas is produced.

B. Classification.

1. Although the oil and gas lease has many of the attributes of a conveyance, Kansas courts classify it as a contract. Brinkman v. Empire Gas & Fuel Co., 120 Kan. 602, 605-06, 245 P. 107, 110 (1926).

   a. Require consideration.

   b. Must comply with statute of frauds.

2. Oil and gas lease is an incorporeal hereditament - a right relating to real property (the right to enter and conduct operations on the land and remove oil and gas). Huston v. Cox, 103 Kan. 73, 74, 172 P. 992, 993 (1918).

3. Term used to describe the incorporeal hereditament created by the oil and gas lease - profit a prendre - right to take substances from land owned by another. Burden v. Gypsy Oil Co., 141 Kan. 147, 150, 40 P.2d 463, 466 (1935).

4. Kansas courts classify oil and gas lease as personal property. Burden v. Gypsy Oil Co.

5. Typical oil and gas lessor/lessee relationship not "fiduciary." Parties have duty to act "honestly and fairly" toward each other. Waechter v. Amoco Production Co., 217 Kan. 489, 510, 537 P.2d 228, 248 (1975) adhered to 219

Kan. 868, 546 P.2d 1320 (1976). Obligation of good faith in performing contract.

II. Requirements for an Effective Lease

A. Identify parties to the lease.

B. Describe property covered by the lease.

1. Geographic limits.

2. Geologic limits.

3. Substances.

C. Consideration.

1. Conveyance - generally no consideration required. See discussion at Outline, Session 2, Page 29.

2. Oil and gas lease similar to an option contract. Nominal consideration satisfactory if terms fair. Brinkman v. Empire Gas & Fuel Co., 120 Kan. 602, 605-06, 245 P. 107, 110 (1926) (payment of $1 sufficient consideration).

D. Statute of Frauds.

1. If the oil and gas lease is classified as a contract, lessee should sign the lease to ensure lessor can enforce the lease against lessee. Lessee typically does not sign the lease. Instead, a conveyance-type analysis is used to bind the lessee through the process of delivery and acceptance.

2. K.S.A. §33-106 (1981) provides, in part: "any contract for the sale of lands, tenements, or hereditaments, or any interest in or concerning them," there must be a writing evidencing the agreement which is "signed by the party to be charged."

a. White v. Green, 103 Kan. 405, 173 P. 974 (1918) and Robinson v. Smalley, 102 Kan. 843, 171 P. 1155 (1918) (contract to buy oil and gas lease; incorporeal hereditament is included in phrase "any contract for the sale of . . . hereditaments . . . .").

b. Contrast K.S.A. §33-105 (1981) concerning conveyances: "No leases, estates or interests of, in or out of lands, exceeding

one year in duration, 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 . . . ."

E. Acknowledgment and Recording.

1. Constructive notice of lessee's rights. K.S.A. §58-2221 (1983).

2. Constructive notice beyond primary term. K.S.A. §55-205 (1983).

III. Parties Required to Join in the Lease

A. Necessary Parties

1. Generally, must join all parties owning the executive or leasing rights to the mineral interests encompassed by the designated lease area.

2. Only exception - not <u>required</u> to join all cotenants of an undivided mineral interest. See Outline, Session 1, Pages 12-14.

3. Often difficult to distinguish mineral interest from a royalty interest. Royalty interest owner not required to join in lease. The mineral/royalty problem often requires protection leases in the event the "royalty interest" is subsequently held to be a "mineral interst."

4. Often difficult to determine which mineral interest owner has the executive or leasing rights. May require a protection lease.

5. Must ensure all required interests within the proposed lease area are included - geographic and geologic planes. For example, do I have the correct mineral interest owner for:

a. The <u>substances</u> I intend to lease;

b. The <u>surface</u> <u>area</u> I want included in the lease; and

c. The <u>depths</u> I want included in the lease?

B. Co-ownership.

1. <u>A</u> owns the minerals in Section 30. <u>A</u> conveys a

one-fourth undivided mineral interest to each B and C. A, B, and C, each thereafter own an undivided interest in the Section 30 mineral interest. They are each "cotenants" of the mineral interest. Suppose A leases his undivided interest to X, B leases his interest to Y, and C leases to Z. X, Y, and Z become cotenants of the leasehold or working interest in Section 30.

a. A, B, and C each have the right to immediate, but nonexclusive (as to each other), possession of the mineral interest in Section 30 and each may convey or lease their nonexclusive right of possession to others.

b. X, Y, and Z each have the right to immediate, but nonexclusive (as to each other), possession of the leasehold or working interest in Section 30.

2. In Kansas, each cotenant has the nonexclusive right to enter, or authorize another to enter, the property to explore for, develop, and produce oil and gas. Compton v. People's Gas Co., 75 Kan. 572, 89 P. 1039 (1907). It is not necessary to obtain the consent of the other cotenants. The same rule applies to cotenants of the working interest. Prewett v. Van Pelt, 118 Kan. 571, 235 P. 1059 (1925).

3. Producing cotenant must account to nonconsenting cotenants for their share of production. Prewett v. Van Pelt.

a. Producing cotenant can deduct proportionate share of development, production, and marketing costs from nonconsenting owner's share of production. Krug v. Krug, 5 Kan.App.2d 426, 428, 618 P.2d 323, 325 (1980).

b. Developing cotenant assumes all risk. Costs can be recovered from nonconsenting cotenants only to the extent the well produces oil or gas from which the nonconsenting cotenants' share of costs can be offset. Davis v. Sherman, 149 Kan. 104, 86 P.2d 490 (1939).

4. See Outline, Session 1, Pages 12-14.

C. Successive Interests.

1. If a life estate is involved, the developer ordinarily must join the owners of the present and future interest in the minerals.

2. See Outline, Session 1, Pages 14-18.

D. Authority to Bind Parties. Handbook §§9.10 - 9.14.

1. Homestead property and property subject to spouse's inchoate statutory rights - See Outline, Session 2, Pages 27-28. To properly lease homestead, or property subject to §59-505 (1983), must have husband and wife join in the lease. Handbook §9.11.

   a. Procedure for leasing homestead when spouse is incapacitated. See Article 15, Section 9, of the Kansas Constitution and K.S.A. §§59-2314 to 59-2322 (1983).

   b. Power of attorney under Kansas Uniform Durable Power of Attorney Act, K.S.A. §§58-610 et seq. (1983) not sufficient; must follow statutory procedure when spouse is incapacitated.

   c. Indicate lessors' marital status. Title Standards Handbook, Standards 14.3, 14.4, 14.5 (KBA 1985).

2. Property under estate or trust administration. Handbook §9.12.

   a. Look for authorization in the will or trust instrument.

   b. Look for statutory authority.

      (1) K.S.A. §59-1409 (1983) permits executor or administrator to execute oil and gas lease covering property in the estate, but all heirs and devisees must join in the lease.

      (2) If not possible to lease under §59-1409, consider K.S.A. §§59-2301 et seq. (1983) - court can direct the executor or administrator to execute a lease if it "appears to be for the best interests of the estate or the persons interested in . . . [the affected] real estate." K.S.A. §59-2302 (1983).

c. Real property held in trust, and the trust instrument does not limit the trustee's authority to lease, the Kansas Uniform Trustees' Powers Act can establish the trustee's authority to act. K.S.A. §§58-1201 et seq. (1983).

K.S.A. §58-1203 (1983) provides, in part:

"(a) From time of creation of the trust until final distribution of the assets of the trust, a trustee has the power to 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).

. . . .

(c) A trustee has the power . . . :

. . . .

(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;

. . . ."

3. Property under conservatorship. Handbook §9.13.

a. Leasing property owned by a minor or a person adjudged a "disabled person" pursuant to K.S.A. §§59-3001 et seq. (1983).

b. Conservator must follow procedure established by K.S.A. §§59-2314 et seq. (1983) to obtain court approval of an oil and gas lease. K.S.A. §59-3022 (1983).

c. For non-homestead property, can use durable power of attorney to authorize attorney-in-fact to lease interest. K.S.A. §§58-610 et seq. (1983).

4. Property of absentee owners. Handbook §9.14.

a. Absentee owner holds a "minority interest" in the minerals, K.S.A. §§55-219 et seq. establishes a procedure by which a receiver can be appointed to negotiate an oil and gas lease on behalf of the absent owner.

b. Alternative procedure - no "minority

interest" limitation - K.S.A. §§59-2701 et seq. (1983). Obtain appointment of a trustee to lease the absent owner's interest when "there is property of the absentee within the state subject to being lost or dissipated unless a trustee is appointed to manage and conserve the same." K.S.A. §59-2702 (1983).

(1) When appointed, trustee has the same power as a conservator.

(2) Actual leasing will be done pursuant to K.S.A. §§59-2314 et seq. [59-3022].

c. May want to consider use of the Kansas Mineral Lapse Act to "extinguish" a lapsed interest. See K.S.A. §§55-1601 et seq. (1983). Handbook §8.11.

IV. Basic Structure of the Oil and Gas Lease. Handbook §9.16.

A. Although the specific wording of oil and gas leases often varies, the rights and duties of parties to the lease are generally established through a standard relationship created by four basic clauses. They are:

1. Granting Clause.

2. Habendum (Term) Clause.

3. Drilling/Delay Rental Clause.

4. Royalty Clause.

B. Other lease provisions are generally designed to alter these four clauses in some fashion.

C. Recall goals of each party to the lease:

1. Lessee - obtain right to enter, explore, and develop the mineral potential of the land with minimal capital outlay while retaining sole discretion, during the lease term, over whether development will occur. If production is obtained, lessee wants the lease to continue so long as he can operate the lease at a profit.

2. Lessor - wants the lessee to develop the leased land to try and obtain production from which lessor will receive a royalty. Since lessor

has a cost-free share of production, he would like to see the maximum amount of development possible, as soon as possible.

V. Granting Clause. Handbook §9.17.

A. The granting clause defines the scope of the rights granted by the lessor.

B. Grant can be created by simply stating "A leases to B" followed by a description of the leased land and rights conferred by the grant.

C. Granting clause defines the land (mineral interest) subject to the grant, the substances it includes, and the lessee's rights to use the land to conduct operations.

D. Land subject to the grant. Handbook §9.18.

1. Legal description which defines the areal scope of the lease.

2. Avoid "Mother Hubbard" or "cover-all" clauses which are designed to include small strips of land adjacent to the specifically described land. Creates uncertainty.

3. Define depths. Unless limited, it will covey rights to all depths. See Outline, Session 3, Pages 56-58,

E. Substances granted. Handbook §9.19.

1. What is lessee authorized to produce from the land?

2. Avoid "oil, gas, and other minerals" descriptions. Outline, Session 2, Pages 31-37.

F. Right to use land to conduct operations. Handbook §9.20.

1. Lessee is typically granted the right to use the surface overlying the leased minerals to conduct exploration, development, and production activities. If the lease does not expressly confer these rights, they will be implied. Thurner v. Kaufman, 237 Kan. 184, 188, 699 P.2d 435, 439 (1984) ("Under an oil and gas lease, the lessee has the implied right to make reasonable use of the surface in order to develop the land for the oil and gas.").

2. Lessee-generated lease forms specify a number of permissible uses.

3. Difficulty in determining what it "reasonable use."

4. Parties should carefully address surface rights in the lease to avoid disputes when development begins.

VI. Habendum (Term) Clause. Handbook §§9.21 - 9.25.

A. The habendum clause establishes the duration of the lease. Other clauses, such as the drilling/ delay rental clause, may limit the duration of the lease. Other clauses may extend the lease.

B. Habendum clause consists of a primary term and secondary term.

1. Primary term is the definite period of time, stated in the lease, that the lease will be in effect.

a. Example: "This lease is for a term of two years from the effective date . . . ."

b. Also called the "term clause."

2. Secondary term is the indefinite period during which the lease will be extended by its express terms.

a. Example: "This lease is for a term of two years from the effective date and as long thereafter as oil or gas, or either of them, is produced from the leased land."

b. Also called the "thereafter clause."

C. Coordinating habendum clause with granting clause.

1. Should ensure production of any of the granted substances will extend the lease into the secondary term.

2. Substances should be stated in the disjunctive. Rostocil v. United Oil and Gas Royalty Ass'n, 177 Kan. 15, 274 P.2d 761 (1954).

a. Granting clause: "oil, gas, coal, and other minerals."

b. Habendum clause: "as long thereafter as

oil and gas is produced." Reversioner of defeasible term mineral interest unsuccessfully asserted 14 producing oil wells did not extend the interest because no gas was being produced. Ambiguity found because singular verb "is" was used with the plural subject "oil and gas."

D. Production must be from the granted land.

1. Effect of pooling and unitization on oil and gas lease:

a. If, pursuant to a valid pooling or unitization clause in the lease, or by separate agreement, some or all of the leased land is included in a unit, any production attributed to any portion of the leased land will extend the lease as to all the leased land.

b. A gives B a lease on Section 30. By separate agreement between A and B, B commits the South Half to a unit. At the end of the primary term there is no production from any wells located on Section 30. However, the South Half is sharing in production from other lands as a member of a unit. Has the lease, as to the North Half, terminated? Has it terminated as to the South Half?

(1) Somers v. Harris Trust & Savings Bank, 1 Kan.App.2d 397, 566 P.2d 775 (1977). The lease, as to both the North Half and the South Half of Section 30, would be extended by unit production attributed to the South Half.

(2) "The majority rule elsewhere is that where a portion of an oil and gas lease is committed to a unit, production anywhere in the unit extends the term of the entire lease." Somers, 1 Kan.App.2d at 400, 566 P.2d at 777.

(3) Basis for rule "conservation and public policy." Perhaps a more appropriate basis is contract.

2. Lessor can, by the terms of the lease contract, limit the area from which the required production must be obtained. See Mesa

Petroleum Co. v. Scheib, 726 F.2d 614 (10th Cir. 1984).

3. Different rule applied when a defeasible term mineral interest, as opposed to an oil and gas lease, is involved.

   a. Using the example in paragraph D.1.b., suppose A's mineral interest was a defeasible term mineral interest and X owned the reversionary interest. In Kansas, any portion of the interest not participating in unit production on the date the primary term expires would terminate and revert to X. Therefore, the mineral interest in the North Half of Section 30 would terminate and revert to X. Unless B has a lease from X covering the North Half, his rights will also terminate.

   b. Acreage included in the grant, but not participating in unit production, will not be held beyond the primary term by pooled or unitized operations. Classen v. Federal Land Bank of Wichita, 228 Kan. 426, 437-38, 617 P.2d 1255, 1264 (1980).

      (1) Parties could provide for a different rule in the conveyance document.

      (2) Agreements between grantor and third parties, and between grantee and third parties, will not affect the rights created by the original grant between grantor and grantee. See Dewell v. Federal Land Bank, 191 Kan. 258, 263, 380 P.2d 379, 383 (1963).

   c. Basis for rule - judicially articulated policy favoring conservation.

E. Habendum clause is a "special limitation" on the grant. Handbook §9.22.

   1. This is an area where the lease "contract" is treated more like a conveyance.

   2. If the requirements of the habendum clause are not met, the lease terminates. The terms of the habendum clause are a "special limitation" on the leasehold grant. Kansas courts will not extend the grant beyond the period stated in the lease. Reese Enterprises, Inc. v. Lawson,

220 Kan. 300, 310, 553 P.2d 885, 894-95 (1976).

a. Not a forfeiture; no equity to mitigate.

b. Acts of God and the lessee's good faith will not mitigate the termination. Kahm v. Arkansas River Gas Co., 122 Kan. 786, 791-92, 253 P. 563, 566 (1927).

F. Production Requirement. Handbook §9.23.

1. Typical habendum clause extends the grant "for so long as oil or gas is produced."

2. Must be actual production at the end of the primary term.

a. Substance must be produced and marketed on the date the primary term ends or the lease terminates. Baldwin v. Oil Company, 106 Kan. 848, 850, 189 P. 920, 921 (1920).

b. Similar rule applied to defeasible term mineral interests. Home Royalty Ass'n v. Stone, 199 F.2d 650, 653 (10th Cir. 1952).

3. Lessees responded with shut-in royalty clause to avoid situations like Elliott v. Oil Co., 106 Kan. 248, 187 P. 692 (1920), where lessee had, during the primary term, completed several productive gas wells on the land but was unable to get it hooked up to a pipeline prior to the end of the primary term. Held: lease terminated.

4. Most leases have a shut-in royalty clause to address the delayed marketing of gas. Consider Collins v. Oil & Gas Co., 85 Kan. 483, 487-89, 118 P. 54, 56 (1911) where the lessee completed five oil wells but failed to produce because of the depressed price of oil. Held: lease terminated.

5. Even though the lease is producing when the primary term ends, lease remains in effect only so long as production continues. See paragraph H. Cessation of Production, Outline Page 81.

6. Variations in wording of habendum clause:

a. So long as oil or gas "is produced from said land . . . , or the premises are being developed or operated." Adolph v. Stearns, 235 Kan. 622, 684 P.2d 372 (1984) (requires

lessee to be engaged in the diligent and good faith development or operation of the lease).

b. "Found in paying quantities" = "Produced in paying quantities." Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 311, 553 P.2d 885, 895-96 (1976).

c. Production from land "or land with which said land is pooled." Martin v. Kostner, 231 Kan. 315, 644 P.2d 430 (1982).

d. Statute may extend the area from which production can be obtained and the activity required to satisfy the habendum clause. Parkin v. Kansas Corporation Comm'n, 234 Kan. 994, 1007, 677 P.2d 991, 1002 (1984) (commission's unitization order extended lease habendum clause to continue "so long as unitized substances are produced in paying quantities and as long as unit operations are conducted . . . .").

7. Lease forms often expand the habendum clause by specifying events which will extend the lease without actual production or discovery of production. For example, gas storage, pooling, unitization, shut-in royalty, commencement of a well, operations, completion of a dry hole.

G. Paying Quantities. Handbook §9.24.

1. Phrase "so long as oil or gas are produced" means produced in paying quantities. Pray v. Premier Petroleum, Inc., 233 Kan. 351, 353, 662 P.2d 255, 257 (1983).

a. Same rule applied to defeasible term mineral interests. Texaco, Inc. v. Fox, 228 Kan. 589, 582, 618 P.2d 844, 847 (1980).

b. Commercial quantities = paying quantities. Texaco, Inc. v. Fox.

2. Depending upon the context in which it is used, "paying quantities" may have different meanings.

a. When used in habendum clause of lease or defeasible term mineral interest, it requires "production of quantities of oil

or gas sufficient to yield a profit to the lessee over operating expenses, even though the drilling costs, or equipping costs, are never recovered, and even though the undertaking as a whole may result in a loss to the lessee." Reese Enterprises, Inc. v. Lawson, 220 Kan. 300, 311, 553 P.2d 885, 895-96 (1976).

b. When used in a drilling or development contract, or continuous development covenant in a lease, the costs of drilling and completing the well would be included to determine whether a party was required to drill or continue development. Wolf Creek Oil Co. v. Turman Oil Co., 148 Kan. 414, 419-20, 83 P.2d 136, 139-40 (1938).

3. To maintain a lease, or defeasible term mineral interest, the lessee must:

"[O]perate the lease to produce those quantities of oil or gas which will produce a profit, however small, over operating expenses, after eliminating the initial cost of drilling and equipping the well or wells on the lease which are required to prepare the lease for production."

Reese, 220 Kan. at 314, 553 P.2d at 897.

4. To determine profit, Kansas courts use an objective test which employs a mathematical computation. If gross income exceeds lease operating costs, there is production in paying quantities.

a. Lessee's good faith judgment regarding profitability immaterial.

b. Objective approach goal - keep lessee from holding unprofitable leases for speculation. Reese, 220 Kan. at 314, 553 P.2d at 897.

NOTE: waiting for the price of oil to rise to make the operation profitable would seem to be the sort of speculation the objective approach is designed to prevent.

5. Two major problems in determining profitability:

a. What items to charge as expenses and

include as income; and

b. The period of time over which profitability should be considered.

6. Accounting Period.

a. Must select appropriate period before considering expenses and income. The accounting period will determine what items of expense and income will be included.

b. Well may not show a profit during a certain month or quarter, but may show a profit over a longer period of time. The test is not so "objective" when selecting the time frame for determining profitability - court may be inclined to consider whether lessee can reasonably anticipate operations will be profitable. Tertiary recovery - expenses may exceed income for long period of time before it begins paying back.

c. Courts have not offered much guidance in this area - up to litigants to convince the trial court what is a reasonable accounting period under all the facts. See generally Texaco, Inc. v. Fox and Reese Enterprises, Inc. v. Lawson.

7. Income - Income is calculated by crediting the lessee with all income generated by the lease except for amounts attributable to the landowner's royalty.

Amounts payable out of the working interest as overriding royalties are credited as income to the lessee. Reese, 220 Kan. at 314, 553 P.2d at 898.

8. Expenses - Expenses include "current costs of operations in producing and marketing the oil and gas." Called "direct costs."

a. May include more than costs actually paid. Held accountable for amounts a "prudent operator working for the common advantage of both the lessor and the lessee" would have paid. This creates certain "accrued" expenses which may not have been incurred, or paid, but should have been. Reese.

b. Cost of plugging abandoned wells included as an accrued cost which a prudent operator

would have paid. Wrestler v. Colt, 7 Kan.App.2d 553, 559, 644 P.2d 1342, 1347 (1982).

c. Direct costs include: "[L]abor, trucking, transportation expense, replacement and repair of equipment, taxes, license and permit fees, operator's time on the lease, maintenance and repair of roads, entrances, and gates, and expenses encountered in complying with state laws which require the plugging of abandoned wells and prevention of pollution." Reese, 220 Kan. at 314-15, 553 P.2d at 898.

d. Depreciation.

(1) Do not include, as an expense, depreciation on the original equipment used to complete the well. Kansas courts treat this as part of the initial cost of drilling and equipping the well. Texaco, 228 Kan. at 594, 618 P.2d at 848.

(2) Apparently, depreciation on equipment not associated with the initial cost of drilling and equipping the well will be included as an expense item.

e. What are the "initial costs of drilling and equipping the well?"

(1) Cost of building gas pipeline required to make intial gas deliveries to a market is part of the initial cost of drilling and completing well. It will not be included as an expense item.

(2) Pray v. Premier Petroleum, Inc., 233 Kan. 351, 662 P.2d 255 (1983). When lease contains a shut-in royalty clause, or a similar provision recognizing a delay between discovery and marketing, pipeline costs will be treated as costs of drilling and equipping the well. Conceptually, the well, under a lease with a shut-in royalty clause, is never completed until production is marketed.

H. Cessation of Production. Handbook §9.25.

1. If lessee quits producing during the primary

term, absent other lease clauses or implied covenant problems, the cessation will not affect the lease. Baker v. Huffman, 176 Kan. 554, 557, 271 P.2d 276, 278 (1954).

2. If lessee quits producing during the secondary term, the lease will terminate if the cessation is "permanent" as opposed to "temporary." Wrestler v. Colt, 7 Kan.App.2d 553, 556, 644 P.2d 1342, 1345 (1982).

3. If cessation is temporary, lessee has "only a reasonable time, under all the circumstances, to return the leasehold to production in paying quantities." Wrestler, 7 Kan.App.2d at 558, 644 P.2d at 1347.

4. Same rule applied to defeasible term mineral interests. Wilson v. Holm, 164 Kan. 229, 188 P.2d 899, 905-06 (1948).

   a. Special problem with the defeasible term mineral interest owner because they may not be able to enter the lease to remedy a temporary cessation.

   b. Courts will protect them from fraud where their lessee conspires with the reversionary mineral interest owner to terminate the defeasible mineral interest. Wagner v. Sunray Mid-Continent Oil Company, 182 Kan. 81, 318 P.2d 1039 (1957); Wilson v. Holm.

5. Reason for the temporary cessation exception - parties to the lease, recognizing the realities of oil and gas operations, must have intended "production" to mean production with its normal interruptions for well maintenance, reworking, and similar activities which require a temporary cessation of actual production. Wilson, 164 Kan. at 236, 188 P.2d at 905-06.

6. To determine whether cessation is permanent or temporary, Kansas courts will consider evidence addressing the following three questions:

   a. How long has the lease failed to produce in paying quantities?

   b. What caused the cessation of production?

   c. What was the lessee's intent when operations were discontinued?

7. Duration of the lessee's failure to produce.

   a. Time alone is not determinative. Kelwood Farms, Inc. v. Ritchie, 1 Kan.App.2d 472, 479, 571 P.2d 338, 344 (1977).

   b. The time factor will be significantly influenced by the cause of the cessation and lessee's actions during the cessation.

8. Cause of the cessation.

   a. Often it is the decisive factor.

   b. For example, all recoverable production has been obtained.

9. Lessee's intent.

   a. Court tends to look at objective acts as opposed to subjective intentions. Lessee's conduct during the cessation is important.

   b. Even though all recoverable production has been obtained through primary and secondary operations, lessee's conduct may indicate the cessation is temporary because of immediate acts to commence tertiary recovery. Contrast Wrestler v. Colt.

10. Cessation problem often addressed by special lease clauses.

VII. Drilling/Delay Rental Clause. Handbook §§9.26 - 9.39.

A. Purpose - state lessee's development obligations during the primary term. Avoid the implied covenant that lessee will drill a well to test the leased land within a reasonable time. See Mills v. Hartz, 77 Kan. 218, 94 P. 142 (1908).

B. Effect - conditions the continued validity of the lease, during the primary term, on lessee either commencing drilling operations on the leased land or paying lessor a sum of money to delay operations.

C. Compliance with the terms of the drilling/delay rental clause, i.e. commencement of a well, will not satisfy habendum clause which requires "production" at the end of the primary term. See Perkins v. Saunders, 109 Kan. 372, 198 P. 954 (1921).

D. Creates a "special limitation" on the grant. If the optional payment is not made when due, or operations commenced in lieu of the payment, the lease terminates. Gasaway v. Teichgraeber, 107 Kan. 340, 341, 191 P. 282, 282 (1920). Handbook §9.30.

1. Automatic termination only applies to the "unless" form of drilling/delay rental clause which makes payment of the delay rental optional with the lessee. For example: "If no well be commenced on or before the 18th day of December, 1934, this lease shall terminate as to both parties unless the lessee on or before that date shall pay or tender . . . the sum of (Fifty Cents) per acre, which sum shall operate as a rental . . . for the privilege of deferring the commencement of a well for 12 months . . . ." Stady v. Texas Company, 150 Kan. 420, 424, 94 P.2d 322, 326 (1939).

2. If lessee obligated to pay rental, failure to pay will be a breach of covenant and will not result in automatic termination - forfeiture principles apply. Early Kansas leases made payment of delay rental an obligation; these lease forms are called "or" leases. For example: "[Lessee] . . . agrees to drill a well upon said premises within two years from this date or thereafter pay to . . . [Lessor] eighty ($80) dollars until said well is drilled . . . ." Rhodes v. Mound City Gas, Coal & Oil Company, 80 Kan. 762, 764, 104 P. 851, 852 (1909).

3. Although Kansas courts have generally followed the special limitation analysis in enforcing "unless" leases, it has, under certain facutal settings, acted to prevent what it has termed a "forfeiture." See paragraph G of this Outline at Pages 86-87.

4. To avoid automatic termination, must either commence the required operations or pay the stipulated delay rental. In keeping with the special limitation approach, courts require strict adherence to the lease terms.

E. "Drilling" to satisfy the drilling/delay rental clause. Handbook §9.31.

1. Common variations of lease clauses require the lessee to "commence a well," "commence operations to drill a well," or "commence

operations."

2. Problem is determining what actions, short of actual drilling, will satisfy the drilling/ delay rental clause.

3. Activity to meet the clause must be taking place on the specified date.

4. Activity that will satisfy the drilling clause:

   a. Undecided in Kansas. Specific terms of each lease will control - but usually they are worded in general terms such as "commence operations to drill a well."

   b. In Herl v. Legleiter, 9 Kan.App.2d 15, 668 P.2d 200, 201 (1983), the court suggests something less than actual drilling may satisfy a commencement clause.

      It appears where something less than actual drilling is being relied upon, the lessee should be able to demonstrate what amounts to an irrevocable commitment to conduct operations, to completion, on the leased land. Such as a drilling contract with a third party to drill a well on the leased land.

   c. In Kansas, anything less than actual drilling is risky. Good faith of lessee no defense - "[Lessee] . . . may in good faith have attempted to commence a well, but as a matter of fact the steps he took fell short of accomplishing what he was attempting to do." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.

5. Once the well is properly commenced, the lessee must diligently continue operations. "[T]he duty to commence is accompanied by a duty to continue operations with due diligence." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.

F. "Paying" to satisfy the drilling/delay rental clause. Handbook §9.35.

1. Kansas courts require strict compliance with the delay rental provisions of the lease. Generally, there is no allowance made for honest mistakes - inadvertent error concerning the time, place, manner, or amount of payment can terminate the lease.

2. Date of payment. Handbook §9.36.

   a. A delay rental payment made after the date specified in the lease is too late. The lease terminates. Doornbos v. Warwick, 104 Kan. 102, 177 P. 527 (1919).

   b. Watch out for multiple dates in the lease.

3. Amount of payment. Handbook §9.37.

   a. Failure to pay the full amount due, if not corrected prior to the required payment date, the lease terminates. See Endicott v. Phillips Petroleum Co., 172 F.2d 372 (10th Cir. 1949).

   b. Seems fair since, under the unless form of lease, lessee is not obligated to pay the balance due.

   c. Rental expressed in dollars per acre may create calculation problems.

   d. Problems when acreage is assigned or parts of a lease are surrendered. Covenant to pay delay rental not divisible unless lease provision allows it.

4. Form of payment. Is payment by check authorized by the terms of the lease? Chapple v. Kansas Vitrified Brick Co., 70 Kan. 723, 79 P. 666 (1905).

5. Recipient of payment. Handbook §9.38.

   a. Payment must be to the appropriate payee.

   b. Change in ownership clause and designated depository bank.

G. Excuses for improper payment. Handbook §9.39.

1. Kansas recognizes a limited exception to the strict compliance/special limitation operation of the drilling/delay rental clause.

2. Kays v. Little, 103 Kan. 461, 175 P. 149 (1918). Delay rental payment sent registered mail in plenty of time to arrive before payment date. Lost in mail, found, then delivered three days after the payment due date.

   a. Court talks in terms of preventing a forfeiture.

b. Court considers the "equities" noting the lessee had done everything possible to make the payment on time. Held: lease did not terminate.

3. Young v. Moncreif, 117 Kan. 698, 232 P. 871 (1925). Lost in mail, check never arrived. Held: lease did not terminate. Court here, as in Kays, notes the lessee had spent "considerable sums in developing tracts in the vicinity." Young, 117 Kan. at 700, 232 P. at 872.

4. Stady v. Texas Company, 150 Kan. 420, 94 P.2d 322 (1939). Since lessee, under the unless lease, is not obligated to pay delay rental, lessee must act, prior to the payment date, to unequivocally and irrevocably manifest its intent to pay delay rental.

5. Browning v. Weaver, 158 Kan. 255, 146 P.2d 390 (1944). Applies unequivocal/irrevocable test to payment made to lessor's credit at the wrong bank.

6. Morton v. Sutcliffe, 175 Kan. 699, 266 P.2d 734 (1954). Due 22 April, paid 28 April. Court refuses to grant relief because there was no evidence of lessee's intention to comply with the terms of the lease.

7. How would the test be applied to a payment of the incorrect amount?

8. Modern lease forms often include a clause excusing the lessee from improper payment.

H. Excuse for non-payment of delay rental.

1. If lessor is attacking lessee's title, lessee will have a reasonable time, following resolution of the case in his favor, to pay delay rental [or proceed with drilling]. Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (1984).

2. No excuse when it is the lessor's title in issue; or when the lessee's title is being attacked by someone other than the lessor. Newell v. McMillan, 139 Kan. 94, 30 P.2d 126 (1934).

VIII. Royalty Clause. Handbook §§9.40 - 9.58.

A. The terms of the royalty clause determines the lessor's share of production, the substances it is payable on, how it will be valued and paid, the costs which can be deducted from lessor's share, and when it is payable.

1. In most cases the royalty clause will be silent or ambiguous on many of these matters.

2. Standard rule of lease interpretation - lessee always loses. Ambiguities in the lease are interpreted against the lessee and in favor of the lessor.

3. Same type of problems in determining what other nonoperating interest owners are entitled to from the working interest owner.

B. Substances subject to the royalty clause. Handbook §9.41.

1. Coordinate with the granting clause.

2. Royalty clauses generally limit the obligation to pay royalty to substances "produced and saved," "used," "sold," or "marketed." Used to avoid liability for royalty on production which is lost through typical prudent lease operations. Handbook §9.42.

a. Without such a clause, lessor can argue they are entitled to a royalty on all oil and gas brought to the surface.

b. Gas flaring and venting may create problems.

3. Lease often contains clause relieving lessee from paying royalty on production used to conduct operations on the lease.

4. It may be difficult to determine whether the oil royalty or gas royalty portion of the royalty clause applies to a particular substance.

a. "Distillate" and "condensate" are liquid hydrocarbons produced from a gas well.

b. "Casinghead gas" is gas produced from an oil well.

c. See generally Skelly Oil Company v. Savage, 202 Kan. 239, 447 P.2d 395 (1968) (whether condensate and distillate produced from gas well were subject to a lease clause pooling "gas rights only.").

C. Royalty on processed gas. Handbook §9.44.

1. Problem: calculating royalty when production from the lease has been altered by processing and marketed as different products.

a. "Wet" or unprocessed gas can be processed to separate hydrocarbon liquids from the remaining "dry" or "residue" gas. Value of the liquids and dry gas generally exceed value of the wet gas.

b. Gas royalty clause typically requires payment of royalty on gas sold "at the well" or sold or used "off the lease."

c. Problem is determining at what point in time will the royalty be calculated - before or after processing? The answer will vary depending on the lease terms, but leases seldom expressly address the issue. In most cases, the matter will be determined by the way the sale of the gas is structured.

2. Consider the following situations: (Assume X, Y, and Z, are purchasers unaffiliated with Lessee)

a. Lessee takes natural gas at the well and transports it to a processing plant where lessee, or an affiliate of lessee, separates liquid hydrocarbons from the gas stream and sells them to X. The "dry" or "residue" gas is sold to Y.

b. Lessee sells natural gas at the well to X but retains, in his gas sales contract, the right to process the gas to recover liquid hydrocarbons. Following delivery of the gas to X at the well, X, under the gas sales contract, redelivers it to lessee at lessee's processing plant. The gas is processed, the liquids are sold to Y, and the residue gas delivered to X.

c. Lessee sells natural gas at the well to X.

Lessee then repurchases the gas from X, processes it, and then sells the liquid hydrocarbons to Y and the residue gas to X.

d. Lessee sells natural gas at the well to X. X processes the gas, separates the liquids, and sells them to Y. Residue gas is sold to Z.

3. Possible solutions:

a. Pay royalty based on the market value of the gas at the wellhead or pay royalty on the market value of the liquids and residue gas. Proceeds lease - pay royalty based upon a share of the proceeds from sale of the liquids and residue gas. See Matzen v. Hugoton Production Company, 182 Kan. 456, 321 P.2d 576 (1958).

b. Are the reserved processing rights in the gas purchase contract a "proceed" of the lessee's sale of the gas? See Waechter v. Amoco Production Co., 217 Kan. 489, 537 P.2d 228 (1975). Also consider Matzen.

c. Is the repurchase a separate transaction? See Cline v. Angle, 216 Kan. 328, 532 P.2d 1093 (1975).

d. Generally, no problem. But see Northern Natural Gas Company v. Grounds, 441 F.2d 704, 723 (1971) (the unique statutory status of helium at this time probably explains the court's holding). See also McCue v. Deerfield Gas Production Co., 173 Kan. 302, 245 P.2d 1191 (1952).

4. Processing charges.

a. If the lessee pays royalty on processed gas, the lessee will typically charge the royalty owner with a share of the processing costs.

b. Usually this processing charge is determined unilaterally by the lessee and, as might be expected, the lessee treats itself very favorably.

c. Common industry practice - lessee pays royalty based upon 1/3 of the total value of the processed liquid hydrocarbons and

retains 2/3 as a processing charge. This practice is not binditng on the lessor without his prior consent. Lessor could argue, if he has to pay a share of costs, it should be calculated using the actual cost of processing.

D. Identifying lessor's share of production. Handbook §9.45.

1. Lease may provide for delivery of a fractional share of the production (right to take in kind), the market value of a fractional share of production, or a fractional share of the proceeds from the sale of production. Still may find flat rate gas royalty leases.

2. Must define the fraction of production the lessor is entitled to - See Outline, Session 2, Pages 46-50.

3. Measurement of production is critical to ensure the correct quantity of production is used in calculating royalty. Handbook §9.46.

4. Other lease clauses may affect the lessor's fractional share. For example: proportionate reduction clause, entirety clause, pooling clause, and unitization clause. Handbook §9.47.

E. Calculating the "gross value" of lessor's royalty - the proceeds and market value royalty clauses. Handbook §§9.48 - 9.50.

1. Oil royalty. Handbook §9.49.

a. Clause often gives the lessor the option to take oil in kind.

b. Crude oil purchasers generally buy oil by "posting" a price, called the "posted price," which establishes the price they will pay for oil in the field or area. Generally regarded as the market price for oil in the area.

c. Not many problems with valuation of oil because the competitive crude oil sales market reflects the current value of the oil when it is sold.

(1) Oil exchanges.

(2) Payment of "premiums" by crude oil purchasers.

d. Don't have transportation problems you encounter with the marketing of gas.

2. Gas royalty. Handbook §9.50.

a. Lots of litigation in Kansas, and elsewhere, over how the gross value of gas should be determined for royalty purposes. Three major issues:

(1) Does the lease clause require the calculation of royalties based upon "proceeds" for the sale of gas or the "market value" of the gas?

(2) If calculated on "market value," how will market value be determined when gas has been committed to a long-term gas sales contract?

(3) If calculated on "market value," will the value of lessor's share of production be limited by federal regulation of natural gas prices?

3. Kansas courts classify gas royalty clauses into three categories:

a. "Proceeds" leases;

b. "Market Value" ("Market Price") leases, or

c. "Waechter" leases.

4. Proceeds lease - gross royalty value calculated by multiplying the amount received by the lessee, in an actual sale of production, by the lessor's fractional royalty. For example:

"The lessee shall pay lessor, as royalty, one-eighth of the proceeds from the sale of gas, as such, for gas from wells where gas only is found . . . ."

Lightcap v. Mobil Oil Corp., 221 Kan. 448, 460-61, 562 P.2d 1, 10-11 (1977), cert denied, 434 U.S. 876 (1977), rehearing denied, 440 U.S. 931 (1979).

5. Market value lease - values production by

ascertaining the "'price which would be paid by a willing buyer to a willing seller in a free market.'" Holmes v. Kewanee Oil Co., 233 Kan. 544, 551, 664 P.2d 1335, 1341 (1983). For example:

"To pay the lessor one-eighth, at the market price at the well for the gas so used . . . ."

"Lessee shall pay Lessor for gas from each well where gas only is found . . . one-eighth . . . of the gross proceeds at the prevailing market rate, for all gas used off said tract."

6. Waechter lease - valuation is by proceeds or market value depending upon the point of sale. For example:

"Lessee shall pay lessor monthly as royalty on gas marketed from each well one-eighth (1/8) of the proceeds if sold at the well, or if marketed by lessee off the leased premises, then one-eighth (1/8) of the market value thereof at the well."

Waechter v. Amoco Production Co., 217 Kan. 489, 490, 537 P.2d 228, 231 (1975).

a. Sale of gas "at the well" or "on the lease" use proceeds calculation.

b. Sale "off the lease" use market value.

c. Point of sale and transfer of title to gas will determine how gas is valued. Lessee, in cooperation with the gas purchaser, can control the Waechter lease through structuring the point of sale in the gas sales contract.

7. Determining "market value."

a. Requires payment of gas royalty calculated by using the "value or price at the current rate prevailing when the gas is delivered rather than the proceeds of amount realized under a gas purchase contract." Holmes, 233 Kan. at 548, 664 P.2d at 1339.

b. Market value can therefore be in excess of the amount paid to lessee by his gas purchaser. Gas value determined at the time it is produced - not when the gas

contract was entered into.

c. Market value to be determined by what a willing seller will pay a willing buyer in a "free market." Lightcap. How does federal price regulation of gas affect this free market test?

(1) Not a limitation on what the lessor can receive as royalty.

(2) However, courts can consider the affect of federal price controls on the gas market when looking at "comparable sales" of gas from other area fields. A factor to consider in determining market value. Matzen v. Cities Service Oil Co., 233 Kan. 846, 667 P.2d 337 (1983).

8. Could the market value analysis be used to pay lessor the market value of their share of production when that amount is less than the fractional share of proceeds received by lessee?

a. Kansas cases do not limit determination of market value to situations where market value exceeds value of the proceeds.

b. The Kansas approach would seem to allow lessee to use the lower, market value price, to calculate royalty.

c. In effect, the lessee is being forced to assume the risk if his gas sales contract does not keep pace with market prices. Shouldn't the lessee enjoy the benefits of his willingness to assume the risk? Especially when it is at no risk to the lessor?

d. Lessor should consider lease clause which provides for an amount equal to the greater of: (1) the gross proceeds from the sale of gas; or (2) an amount equal to the market value of the substance at the well.

E. Calculating the "net value" of lessor's royalty. Handbook §9.51.

1. Royalty generally defined as a cost-free share of production paid or delivered to

the lessor.

2. "Cost-free" refers to costs associated with drilling, completing, and producing the well. However, the lessor may be assessed a share of costs incurred after production. Problem in Kansas is determining where the production function ends and the post-production function begins.

3. Does the production function include marketing?

   a. Implied covenant to market production.

   b. In Kansas, "production" for habendum clause purposes requires marketing.

   c. However, these rules do not necessarily mean lessee must absorb all the costs.

4. Transportation Charges - Early Kansas cases permit lessee to deduct the cost of transporting production to a market.

   a. Scott v. Steinberger, 113 Kan. 67, 213 P. 646 (1923) (can deduct cost of transporting gas to market and then calculate royalty using the net figure).

   b. Voshell v. Indian Territory Illuminating Oil Co., 137 Kan. 160, 19 P.2d 456 (1933) (can deduct cost of arranging for contract carriage of oil, by pipeline, to a market).

   c. Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943) (can deduct cost of trucking oil to market).

5. More recent cases, although not directly addressing the issue, cast doubt on whether transportation and other marketing costs are deductible, absent express lease provisions.

   a. Matzen v. Hugoton Production Company, 182 Kan. 456, 467, 321 P.2d 576, 585 (1958) (concurring opinion of Justice Fatzer).

   b. Gilmore v. Superior Oil Company, 192 Kan. 388, 388 P.2d 602 (1964) and Schupbach v. Continental Oil Company, 193 Kan. 401, 394 P.2d 1 (1964). Lessee not allowed to

deduct "compression costs" in calculating royalty.

Court in Gilmore, without discussion, quotes the following from M. Merrill, Covenants Implied in Oil and Gas Leases:

"'If it is the lessee's obligation to market the product, it seems necessary to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the costs of marketing or of preparation for sale is chargeable to the lessor.'" Gilmore, 192 Kan. at 393, 388 P.2d at 607.

c. Cline v. Angle, 216 Kan. 328, 333, 532 P.2d 1093, 1097 (1975) (court, by dicta, suggests helium extraction and purification costs may not be deducted from overriding royalty owner's share of production unless there are express provisions in the assignment allowing for the deduction).

F. Payment of royalty. Handbook §9.54.

1. Frequency of payment generally governed by the lease. If not specified in the lease, the division order will specify when royalty will be paid.

2. Division Orders. Handbook §9.55.

a. "[A]n instrument required by the purchaser of oil and gas in order that it may have a record showing to whom and in what proportions the purchase price will be paid. Its execution is procured primarily to protect the purchaser in the matter of payment for the oil or gas, and may be considered a contract between the sellers on the one hand and the purchaser on the other." Wagner v. Sunray Mid-Continent Oil Company, 182 Kan. 81, 92, 318 P.2d 1039, 1047 (1957).

b. Have been used by lessees to try and amend the oil and gas lease. These attempts have been unsuccessful in Kansas. See, e.g., Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983) and Maddox v. Gulf Oil Corporation, 222 Kan. 733, 567

P.2d 1326 (1977), cert. denied, 434 U.S. 1065 (1978).

3. Remedies for nonpayment of royalty. Handbook §9.56.

a. No legislation in Kansas.

b. Action to enforce the royalty covenant.

(1) Generally, cancellation of lease not a remedy - damages adequate. Edwards v. Iola Gas Co., 65 Kan. 362, 69 P. 350 (1902).

(2) However, for a "continuous unreasonable" failure to comply with essential lease covenants, cancellation of the lease may be an appropriate remedy. Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (1984) (surface use covenant).

c. Interest. Handbook §9.57.

IX. Implied Covenants. Handbook Chapter 10.

A. When lease fails to expressly address matters such as the degree or rate of exploration and development, the court will, by implication, address such matters to promote what it finds are the basic goals of the lease relationship. Handbook §10.01.

1. Typical oil and gas lease suggests the lessee will attempt to develop and produce the lease to generate production from which lessor will receive a royalty.

2. Lease will be interpreted against lessee and in favor of lessor. Interpreted to promote development and against delay.

B. Prudent Operator Standard - Lessee's compliance with implied covenants is measured by what a "prudent operator" would do under the circumstances.

1. Lessee must act in the manner that, "in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee . . . ." Brewster v. Lanyon Zinc Co., 140 F. 801, 814 (8th Cir. 1905). See also Fischer v.

Magnolia Petroleum Co., 156 Kan. 367, 373, 133 P.2d 95, 99 (1943), adhered to, 156 Kan. 722, 137 P.2d 139 (1943) (rejecting a lessee good faith standard and adopting the prudent operator standard).

2. Balance the lessor's cost-free royalty interest with the lessee's cost-bearing working interest in determining what action is prudent.

C. Implied covenants recognized in Kansas:

NOTE: The prudent operator standard establishes a minimum standard of contractual performance. Therefore, duties not traditionally associated with one of the six categories of implied covenants could be asserted.

1. Implied covenant to drill an initial well.

2. Implied covenant to diligently develop the lease.

3. Implied covenant to diligently explore the lease.

4. Implied covenant to market production after it is discovered.

5. Implied covenant to protect the lease against drainage.

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

D. Initial Test Well Covenant. Handbook §10.04.

1. If lease does not specify lessee's development obligations during the primary term, courts imply an obligation that lessee will drill a well on the leased land within a reasonable time. Mills v. Hartz, 77 Kan. 218, 94 P. 142 (1908).

   a. Primary reason for executing lease - prospect of royalty.

   b. Lessees responded by expressly addressing development obligations during the primary term with the drilling/delay rental clause.

2. Lessor and lessee can expressly agree that

lessee is not obligated to develop the lease during the primary term - even without the payment of delay rental.

a. Skinner v. Ajax Portland Cement, 109 Kan. 72, 197 P. 875 (1921) (lease with 99 year fixed term, express provision making it optional with lessee when development will take place).

b. Ability to disclaim covenant not affected by Deep Horizons Act because K.S.A. §55-223 (1983) applies only when a lease is "held by production." Provision which prohibits waiving covenants (§55-228) does not apply to initial well covenant.

E. Diligent Development Covenant. Handbook §10.05.

Upon discovery of oil or gas in paying quantities, the lease agreement, absent express terms on the matter, implies that lessee will diligently drill the number of wells necessary to develop the leased land.

1. Covenant operates from the date of discovery, even though the primary lease term has not expired. Berry v. Wondra, 173 Kan. 273, 277, 246 P.2d 282, 285 (1952).

2. Deep Horizons Act - §55-224 (1983) measures time from date of "initial" production.

3. Whether additional wells are required, and when they must be drilled, depends upon what a prudent operator would do under the circumstances.

4. A "continuing obligation" which lasts throughout the life of the lease. The lessee's performance of the obligation must be "judged in the light of the circumstances as they exist at various times during the term of the lease." Sanders v. Birmingham, 214 Kan. 769, 775, 522 P.2d 959, 965 (1974).

5. Courts will construe the lease "to promote development and prevent delay upon the theory that the lessor has a right to have his land developed as rapidly as possible. Adolph v. Stearns, 235 Kan.

622, 626, 684 P.2d 372, 376 (1984).

a. Lessor's "right" to rapid development must be balanced with lessee's "right" to develop the lease as a prudent operator.

b. A prudent operator would not conduct further development unless it is likely to be profitable. Adolph.

c. "Profitable" means a reasonable profit "'over and above the entire cost of drilling, equipping, and operating the well or wells drilled.'" Wolf Creek Oil Co. v. Turman Oil Co., 148 Kan. 414, 420, 83 P.2d 136, 140 (1938) (quoting from Summers on Oil and Gas).

6. Lessor has burden of proof to show, by substantial evidence, that under the circumstances a prudent operator would have conducted further drilling. Sanders.

a. Cases governed by the Deep Horizons Act - if initial production from the lease was obtained 15 years prior to the lessor's action, and the claim is for development of formations lying below the base of the deepest producing formation, K.S.A. §55-224 (1983) creates a presumption the covenant has been breached as to such deeper formations. Burden of proof shifts to lessee to demonstrate, "by a preponderance of all relevant evidence," that a prudent operator would not have further developed the lease. K.S.A. §55-225 (1983).

b. Matters the courts will consider: quantity of oil and gas capable of being produced, demand for the production, results of area operations, costs of drilling, producing, and marketing, price being paid for production, regulatory climate, market conditions. Sanders, 214 Kan. at 776, 522 P.2d at 966.

7. Court considers technical aspects of the reservoir, the economic situation, and some special factors which tend to indicate the lessee's intent towards

developing the lease.

a. Major factor - Time. How long has it been since the last well was drilled on the lease. Nigh v. Haas, 139 Kan. 307, 311, 31 P.2d 28, 30 (1934).

b. Deep Horizons Act uses time as a factor by establishing a rebuttable presumption the covenant has been breached after fifteen years have passed since first production from the lease.

c. However, passage of time is not determinative. Sanders.

d. Another factor - statements by the lessee concerning development. See, e.g., Berry v. Wondra, 173 Kan. 273, 246 P.2d 282 (1952); Sauder v. Mid-Continent Petroleum Corp., 292 U.S. 272 (1934).

e. Another factor - willingness of others to develop the lease if given the opportunity. Berry.

8. Rate of production. Lessee must consider not only his interests, but also those of the lessor. Lessee may be content to let one well drain the lease in thirty years instead of drilling two wells to drain in in fifteen.

a. "A lessor is entitled to the benefit of oil produced from the lease at the time it should be produced and not at some remote period of time in the future." Temple v. Continental Oil Co., 182 Kan. 213, 235-36, 320 P.2d 1039, 1056 (1958), on rehearing, 183 Kan. 471, 328 P.2d 358 (1958)

b. Although an operator, considering his own economic interests, may deem it imprudent to drill the additional well, the prudent operator standard requires the lessee to also weigh the lessor's interests when deciding what course of action is appropriate under the circumstances.

9. Development obligation continues even

though the lease is included within a field-wide unit or existing wells are shut in. However, the standard is what would a prudent operator do under these circumstances.

a. Parkin v. Kansas Corporation Comm'n, 234 Kan. 994, 1009, 677 P.2d 991, 1003 (1984) (field-wide unit).

b. Pray v. Premier Petroleum, Inc., 233 Kan. 351, 354, 662 P.2d 255, 779 (1977) (acreage held by shut-in royalty).

10. Requirement of prior demand for development.

a. To obtain cancellation as a remedy, generally must make prior demand on lessee for development - prior to bringing suit. [Limited to cancellation of the undeveloped part of the lease - may be depth, area, or substance]. Storm v. Barbara Oil Co., 177 Kan. 589, 599, 282 P.2d 417, 424 (1955) (demand requirement).

b. Failure to make prior demand appears to only limit your remedy - to damages or conditional cancellation [drill or lose lease]. Rook v. James E. Russell Petroleum, Inc. 235 Kan. 6, 17-18, 679 P.2d 158, 166 (1984).

c. See Amoco Production Co. v. Douglas Energy Co., Inc., 613 F.Supp. 730, 737 (D.Kan. 1985) (Deep Horizons Act does not affect existing law concerning demand for development). K.S.A. §55-229 (1983) indicates the Act does not alter or affect substantive rights or remedies under existing law.

d. Prior demand may not be required if it would be futile. Howerton v. Kansas Natural Gas Co., 81 Kan. 553, 106 P. 47 (1910) (attitude of lessee may excuse demand requirement).

F. Diligent Exploration Covenant. Handbook §10.06.

1. What happens when the lease, as to known reserves, has been fully developed? To what extent must the lessee engage in exploration activities to try and discover new reserves?

2. Profitability of the endeavor should not be the issue. Instead, when would a prudent operator make the decision to explore the lease - having in mind the interests of both lessee and lessor.

3. "If there was no duty to explore for oil, a lessee could hold the oil rights forever without exploring the productivity of oil-bearing sands simply because he has developed the lease for gas." Myers v. Shell Petroleum Corp., 153 Kan. 287, 306, 110 P.2d 810, 821 (1941) (concurring and dissenting opinion of Justice Wedell).

4. Webb v. Croft, 120 Kan. 654, 244 P. 1033 (1926). Court holds lessee should have explored for oil - no mention of whether it would be profitable. Instead, court assumes since there was new oil production in the vicinity, lessee had the obligation to explore the leased land or surrender it so others could explore.

5. Alford v. Dennis, 102 Kan. 403, 170 P. 1005 (1918). Lease covered two non-contiguous tracts. One had been extensively developed, the other had not been explored during the 13 years the lease was in effect. "Since . . . [Lessor's] lands are burdened with an oil and gas lease, he is entitled to have those lands prospected for oil and gas within a reasonable time." The court does not comment on the probability of success in drilling on the tract.

6. Sauder v. Mid-Continent Petroleum Corp., 292 U.S. 272 (1934). Lessee, after holding the lease by production for over seventeen years, stated it "had no present intention of further exploring or developing, unless and until developments in the immediate vicinity should convince them that it would pay to take such action." Sauder, 292 U.S. at 277.

   a. Conditional cancellation of the unexplored portion of the lease is appropriate.

b. "This attitude does not comport with the obligation to prosecute development with due regard to the interests of the lessor." Sauder, 292 U.S. at 280-81.

7. At some point in time the lessee is required to make a choice whether he will release undeveloped portions of the lease or conduct further exploration. Presumably, the expectation of profit, or probability of discovering new reserves, becomes less critical to lessor's case as time passes without exploration. This premise assumes at some point in time a prudent operator will explore all parts of the leased land.

8. Kansas Legislature follows this premise in the Deep Horizons Act.

   a. K.S.A. §55-223 (1983) states that any lease held by production includes an "implied covenant to reasonably explore and to develop the minerals which are subject to the lease."

   b. K.S.A. §55-224 (1983) recognizes the covenant of exploration is separate from the development covenant.

   c. K.S.A. §55-224 adopts time as a major factor by establishing a presumption the covenant is breached if:

      (1) there are unexplored or undeveloped formations beneath the base of the deepest producing formation on the lease; and

      (2) initial production from the lease began at least 15 years prior to commencement of the action.

9. Remedies are similar to those under the development covenant. Failure to make prior demand for development is a factor court may consider in determining whether cancellation is an appropriate remedy.

G. Marketing Covenant. Handbook §10.08.

1. After discovery of oil or gas in paying quantities, the lessee has the implied obligation to diligently produce and market production from the lease. Howerton v. Kansas

Natural Gas Co., 81 Kan. 553, 106 P. 47 (1910), reversed in part, 82 Kan. 367, 108 P. 813 (1910) (reversed as to remedy for breach of covenant; damages adequate in this case).

2. When well shut in the lessee's obligation is "to diligently search for a market and to otherwise conduct himself as would a reasonable and prudent lessee under the same or similar circumstances." Pray v. Premier Petroleum, Inc., 233 Kan. 351, 354, 662 P.2d 255, 258 (1983).

H. Covenant to Protect Against Drainage. Handbook §10.09.

1. Recognizes the rule of capture and the lessor's only protection is to have the lessee act to drill protection wells - or perhaps seek pooling or unitization.

2. Prudent operator standard used to determine when protection or offset wells are required.

3. "No implied duty rests upon a lessee to offset a nonpaying well, where the offset probably would result in a loss to him." Myers v. Shell Petroleum Corp., 153 Kan. 287, 287, 110 P.2d 810, 811 (1941) (Syllabus 3).

   a. Lessee may have to take other action.

   b. Prudent operator may seek pooling or some other form of protection from drainage.

4. Lessor has burden of proof to show, by substantial evidence:

   a. There is oil or gas beneath lessor's land which could be drained.

   b. There has been "substantial drainage" from his lease.

   c. Additional drilling on the lease is likely to be profitable.

5. Must introduce technical evidence to establish each element. Corr v. Continental Oil Co., 145 Kan. 78, 84, 64 P.2d 30, 33 (1937) (lessor failed to present evidence of the porosity and permeability of the reservoir and evidence of reservoir pressures).

6. Common lessee problem. What if the operator draining the lease is lessor's lessee?

   a. Early case seems to make lessee strictly liable for such drainage. Culbertson v. Cement Co., 87 Kan. 529, 125 P. 81 (1912).

   b. Seacat v. Mesa Petroleum Co., 561 F.Supp. 98 (D.Kan. 1983). Adopts the rule that if the lessor is able to prove substantial drainage, and that his common lessee is the cause of such drainage, lessor will recover whatever damages he can prove - unless the lessee can prove drilling an offset well would be unprofitable. Seacat, 561 F.Supp. at 103-04.

   c. Other possibilities besides drilling well: compensatory royalty agreement with lessor. Pooling, unitization.

7. Acceptance of delay rentals. Drainage claims are often made during the primary term when the lease is being held by delay rental. Does lessor have any right to complain about drainage during period when lease is held by payment of delay rental? Is lessor estopped by accepting rental?

   a. Issue raised but not addressed in Corr v. Continental Oil Co., 145 Kan. 78, 64 P.2d 30 (1937), adhered to, 147 Kan. 1, 75 P.2d 212 (1938).

   b. Storm v. Barbara Oil Co., 177 Kan. 589, 282 P.2d 417 (1955). General statements about accepting and retaining rents or royalties and then claiming a forfeiture.

   c. Rolander v. Sanderson, 141 Kan. 809, 43 P.2d 1061 (1935). Unique facts.

   d. If you intend to assert a drainage claim, do not accept delay rental.

   e. Purpose of delay rental clause not related to drainage issue.

8. Demand for a protection well.

   a. Not clear how it will be treated in Kansas.

   b. Lessee in the best position to know - has

the duty to know.

c. If you think there is drainage, or could be, demand a protection well. Help to establish a date for calculation of damages.

I. Covenant of Efficient Operation. Handbook §10.10.

1. Requires the lessee to take the appropriate action at the appropriate time to protect the collective interests of lessee and lessor.

2. Shaw v. Henry, 216 Kan. 96, 531 P.2d 128 (1975). Lessee improperly disposing of salt water cited by State Board of Health. Must take appropriate action to remedy the problem and put the lease back on production.

SESSION 5 - PART A
REPRESENTING THE LESSEE

I. Granting Clause. Handbook §11.02.

A. Lessee concerned with: substances covered by the grant, limits on the geographic and geologic scope of the grant, limits on lessee's ability to use the land to conduct operations.

B. Substances Granted. Handbook §11.03.

1. Interpretive problems - "other minerals."

2. List all targeted substances, do not rely on general descriptions to include the substance.

3. Ensure, if dealing with a severed mineral interest owner, they own rights to the listed minerals.

4. Coordinate with habendum and royalty clauses.

C. Operation Rights. Handbook §11.04.

1. Lessee must ensure they have adequate authority to access the leased land to remove, treat, store, and market the granted substances.

2. Reliance on the implied right of reasonable use is risky.

a. Be specific about lessee's surface rights.

b. State whether compensation for disruption of the surface will be paid and if so, provide a formula for calculating the amount due.

3. Address whether lessee can use oil, gas, water, and other substances found on or in the leased land to support lease operations.

a. Water - permit to appropriate water. See generally Nuefeld, "The Kansas Water Appropriation Statutes and Their Effect Upon the Oil and Gas Industry in Kansas," 50 J. Kan. B. Ass'n 43 (1981).

b. Can lessee use oil, gas, and the other substances free of charge or will he be required to pay a royalty on the substance?

4. What are lessee's rights to enter the lease to remove fixtures and equipment after the lease has terminated?

   a. Lease silent - appears lessee can enter the leased land within a reasonable time after the lease terminates to remove equipment and fixtures. See Pratt v. Gerstner, 188 Kan. 148, 151-52, 360 P.2d 1101, 1104 (1961); Newlands v. Ellis, 131 Kan. 479, 484, 292 P. 754, 757 (1930).

   b. Clause allowing removal at "any time" means it must be removed within a "reasonable time." Pratt, 188 Kan. at 151, 368 P.2d at 1103-04 (twenty-nine months after production had ceased not within a "reasonable time").

   c. Specific time period - must remove or title to the equipment and fixtures will vest in lessor. Newlands, 131 Kan. at 484, 292 P. at 757 (clause required removal within six months after termination - specific provision vesting title in lessor).

   d. General release may include right to remove equipment and fixtures. Pratt, 188 Kan. at 152, 360 P.2d at 1104 (concurring opinion). Release should expressly exclude lessee's removal rights.

5. Lessee should obtain the "exclusive" right to explore and develop the leased land, to include the exclusive right to conduct geophysical and geological exploration on the land.

   a. Mustang Production Co. v. Texaco, Inc., 549 F.Supp. 424 (D.Kan. 1982). Only rights to drill and produce are impliedly exclusive. However, geophysical operations can be conducted so as not to interfere with lessee's interests.

   b. If lessee doesn't have the exclusive right, lessor can sell it to others. No guarantee lessee will be able to gain access to the information to support operations on the lease.

D. Geologic and Geographic Extent of the Grant. What are the surface boundaries and subsurface boundaries of the grant. Unless expressly limited by depth, lease will cover all depths.

1. Avoid Mother Hubbard or cover-all clauses. Handbook §11.08.

2. Title to the grant.

   a. Warranty clause. Handbook §11.10.

      (1) After-acquired title clause.

      (2) Proportionate reduction clause.

   b. Liens against the leased land. Handbook §11.11.

      (1) Examine existing loan, mortgage, and similar documents to determine if lessor's right to lease is limited.

      (2) No express terms, Kansas follows a "lien" theory of mortgages. Mortgagor can permit mining to the extent it does not impair mortgagee's security. See generally Misco Industries v. Board of County Com'rs, 235 Kan. 958, 962, 685 P.2d 866, 870-71 (1985) (not an oil and gas case).

      (3) Subordination agreements with prior lien holders.

      (4) Subrogation clause. In Kansas it may negate a warranty against encumbrances. See Crum v. Oil Co., 117 Kan. 54, 56, 230 P. 299, 300 (1924).

      (5) At foreclosure stage, consider marshaling to offer the land subject to the lease before offering it free of the lease. Cities Service Oil Co. v. Grunder, 149 Kan. 82, 85, 86 P.2d 495, 496 (1939).

II. Habendum (Term) Clause. Handbook §§11.12 to 11.19.

   A. Completion Clause. Handbook §11.14.

      1. If oil or gas is not actually being produced and marketed when the primary term ends, the lease terminates.

      2. Lessee's have responded with express lease provisions which allow lessee to "complete" a well which was "commenced" during the primary

lease term but not "completed" until after the primary term.

3. Clause should be drafted to cover the following situations:

   1. Well commenced but not completed prior to end of primary term. See Sword v. Rains, 575 F.2d 810 (10th Cir. 1978).

   2. Well commenced and completed during primary term but lessee has not had an opportunity to market production following completion. See Tate v. Stanolind Oil & Gas Co., 172 Kan. 351, 240 P.2d 465 (1952).

4. Lessee must be diligent in continuing operations to complete the well. When completed, lessee must market production from the well within a reasonable time. See Tate and Medlin v. Mainline U.S.A., Inc., 8 Kan.App.2d 35, 648 P.2d 279 (1982).

5. In Kansas, a completion clause is absolutely necessary.

B. Dry Hole Clause. Handbook §11.15.

1. What if the well, commenced during the primary term and completed during the secondary term (pursuant to a completion clause), is incapable of producing in paying quantities? The lease terminates unless there is a special clause addressing this situation.

2. Dry hole clause designed to address this situation by permitting the lessee to commence operations to drill other wells to try and obtain production in paying quantities.

   a. Generally give lessee a stated period of time following "completion of the dry hole" to commence drilling operations on a new well.

   b. Provide for multiple dry holes so that if the second or subsequent wells are dry holes the lessee can maintain the lease by commencing operations to drill other wells.

3. Define the effect of a dry hole during the primary term of the lease. Will delay rental payments be required? If so, when will they be

due? Could provide that drilling any well on the lease, during the primary term, will eliminate any further need to pay delay rental.

C. Cessation Clause. Handbook §11.16.

1. If production in paying quantities ceases during the secondary term, the lease terminates unless the cessation is "temporary."

2. If the cessation is temporary, the lessee has a reasonable time, under the circumstances, to regain production in paying quantities.

3. Cessation clause designed to give lessee the right to drill wells to try and regain production from the lease.

   a. Eliminates the temporary/permanent cessation dichotomy.

   b. Permits lessee to extend the lease by commencing operations to drill new wells or rework existing wells if lessee acts within a specified time.

   c. Express clause may eliminate the benefit of more generous time frames allowed under the common law temporary cessation rule.

4. Dry hole clause should be coordinated with the cessation clause so that drilling a dry hole in an attempt to regain production will entitle lessee to drill other wells, to include dry holes, if he commences operations within a stated period of time from completion of the dry hole.

   a. Such a clause is called a "continuous operations" clause.

   b. Effect is to continue the lease so long as lessee is conducting operations in an attempt to complete a producing well.

5. Clauses often make it applicable to cessation during the primary term.

6. What if production ceases shortly before the primary term expires? Leases often provide for commencement of operations within a stated period of time following the primary term or cessation.

D. Shut-in Royalty Clause. Handbook §11.17.

1. "Production" for habendum clause purposes requires actual production and marketing to extend the lease beyond the primary term.

   a. Particularly difficult problem for the gas producer. See Justice Herd's discussion in Pray v. Premier Petroleum, Inc., 233 Kan. 351, 662 P.2d 255 (1983).

   b. Can have a well capable of producing, but a delay in marketing, or lack of a current market - lease terminates.

2. Lessee response has been the shut-in royalty clause.

   a. If you have a well capable of producing in paying quantities [Pray, 233 Kan. at 353, 662 P.2d at 258];

   b. But are unable to find a market for production from the well;

   c. Payment of a stated sum as "shut-in royalty" will extend the lease until a market is found and production resumes.

3. Most clauses limited to inability to produce and market gas.

   a. Would an oil clause be useful?

   b. Most clauses fail to state reason for lessee's decision to shut-in. Implied covenant to market would seem to limit the scope of the clause.

   c. What about an express clause permitting the lessee to shut-in well when price paid for production falls below a certain level?

      (1) Gas sales contract limitations.

      (2) Effect on paying quantities requirement?

4. Payment of shut-in "royalty."

   a. Consider making it "advance royalty" which can be deducted from lessor's share of production when, and if, production can be marketed.

b. Make payment an obligation instead of an option. Avoid automatic termination for failure to make proper payment.

c. Shut-in royalty title opinion to ensure proper individuals receive payments.

d. Clauses often require payment only after well has been shut-in a specified period of time - such as one year. Martin v. Kostner, 231 Kan. 315, 317, 644 P.2d 430, 432 (1982).

5. Presence of shut-in royalty clause may affect the expenses charged against the lessee in determining whether the lease is capable of producing in paying quantities. When the lease is being maintained by payment of shut-in royalty, "[p]ipeline costs fall in the same category as costs of drilling and equipping a well and . . . should not be taken into account in making . . . [the paying quantities] determination." Pray, 233 Kan. at 357, 662 P.2d at 260.

6. Most lease forms make clause applicable to primary and secondary term.

E. Force Majeure Clause. Handbook §11.18.

1. Typically, development of the lease is within lessee's control.

2. Development situations beyond lessee's control, but typically addressed by a lease clause:

a. Results of development - no control so provide for possibility of dry hole or cessation with the appropriate lease clause.

b. Market for production - no control so provide for possibility of well being shut-in awaiting a market.

3. Development situations beyond lessee's control, but often not addressed by a lease clause:

a. Poor weather, natural disaster, disease. Acts of God.

b. War, control of raw materials, markets, and lessee's activities.
Acts of Government.

4. Regardless of the equities involved, courts will not expand the lease contract to account for unforeseen and uncontrollable occurrences which prevent the lessee from complying with the express terms of the lease. Baldwin v. Oil Co., 106 Kan. 848, 850, 189 P. 920, 921 (1920) (lessee unable to complete well within primary term because of intervening drought followed by excessive rain and a blizzard; lessee's employees became diseased; federal government, reacting to wartime needs, prohibited the use of coal or iron in drilling wells on the leased land - HELD: no excuse because the obligation undertaken was absolute).

5. Draft clause broadly to include events which could prevent lessee from performing the lease terms.

6. Ensure the clause will excuse timely performance under all critical clauses - habendum, commencement, cessation, etc.

7. Provide lessee will have a period of time, equal to the amount of time remaining in the lease at the time the force majeure was declared, to perform under the lease. However, if the force majeure occurs during a time when there is less than, for example, ninety days remaining in the primary lease term, then lessee should have ninety days to perform.

8. State how the force majeure will be declared and when it will take effect.

F. Pooling and Unitization Clauses. Handbook §11.19.

1. Lessee often wants authority to expand the area from which production can be obtained to satisfy the habendum and related clauses.

2. Often necessary because lessee will be unable, because of economic or regulatory limitations, to drill well attributed solely to the leased acreage.

3. In Kansas, pooling must be accomplished through a lease clause or separate agreement.

4. For example: Spacing or proration regulation in effect permits only one gas well per 640 acres. Lessee A has a lease on the North Half of Section 30 containing a pooling clause. B has a lease on the South Half which also

contains a pooling clause. If A and B exercise their pooling authority to declare Section 30 a single pooled unit, a producing well anywhere within the pooled unit will, under a properly drafted pooling clause, satisfy the production requirement of the habendum clause in each lease.

5. Pooling clause should allow lessee to exercise the pooling power as to individual formations, and to exercise the pooling power whenever necessary to pool newly discovered formations in the leased land. This avoids having to calculate participation in subsequently created units based upon prior pooling of all formations. See Rogers v. Westhoma Oil Company, 291 F.2d 726 (10th Cir. 1961).

   a. CAUTION: The pooling clause should make it clear that although you are only pooling a specified formation, production from that formation will hold all leases included in the pooling declaration as to all formations. See Morgan v. Mobil Oil Corp., 726 F.2d 1274 (10th Cir. 1984).

   b. See Rogers v. Westhoma Oil Company.

6. If you have a properly drafted pooling clause, the lessor's consent should be unnecessary when rights under the pooling clause are exercised. Kennoyer v. Magnolia Petroleum Co., 173 Kan. 183, 187-88, 245 P.2d 176, 180 (1952).

7. Questions the pooling clause should answer:

   a. Does the pooling right apply to all substances granted under the lease?

   b. Is there a geographic limit on the pooling right?

   c. Is there a geologic limit on the pooling right?

   d. What effect will pooling part of the leased acreage have upon leased acreage outside (not participating in) the pooled unit?

   e. What effect will operations on the pooled unit have on the habendum clause and clauses which affect the habendum clause?

   f. How will the royalty of each lessor subject to the unit be calculated?

g. How is the pooling power exercised? When does the unit take effect? Can the pooling power be used on a recurring basis?

8. Unitization - in Kansas, leases seldom give lessee authority to unitize on a field-wide basis.

a. Have what is called "compulsory" unitization. K.S.A. §§55-1301 et seq. (1983). Not of much assistance to the operator.

b. Would be desirable to include unitization clause to permit consolidation of leases to conduct primary or enhanced recovery operations on part or all of a reservoir.

c. When area unitized pursuant to statute, must look to the statutes, the order approving unitization, and any agreements signed by the unitized parties to determine their rights. See Parkin v. Kansas Corporation Comm'n, 234 Kan. 994, 677 P.2d 991 (1984).

III. Drilling/Delay Rental Clause. Handbook §11.20.

A. Most Kansas leases use an unless form of drilling/delay rental clause. Unless a well is commenced, or rental paid, in strict compliance with the terms of the clause, the lease terminates.

B. Matters the clause should address:

1. What must be done?

a. What does "commence" or "commencement" mean?

b. What are the delay rental requirements?

2. Delay Rental:

a. When is it due?

(1) No drilling.

(2) Drill dry hole, producing well ceases production, producing well shut-in?

(3) Any obligation during secondary term? Will it be used, by reference, for events occurring during the secondary term?

b. On what specific date is it due?

c. How much is due?

(1) Effect of a partial assignment.

(2) Effect of a partial surrender.

(3) Effect of lessor's failure of title.

d. Who can it be paid to?

(1) Depository bank.

(2) Change of ownership clause.

e. How can it be paid?

f. What if lessee improperly pays or fails to pay?

(1) Automatic termination.

(2) Obligation to pay.

(3) Mistake, notice before forfeiture, and judicial ascertainment clauses.

C. Current thoughts on the drilling/delay rental clause:

1. Use "paid up" lease. Should address effect of lessor's assignment after the delay rental is paid. See generally, Sidwell Oil & Gas Co. v. Loyd, 230 Kan. 77, 630 P.2d 1107 (1981).

2. Use an or form lease to avoid automatic termination.

3. Eliminate the drilling/delay rental clause altogether. Kansas law would permit the parties to expressly provide that lessee is not obligated to drill any well on the lease during the primary term. See Skinner v. Ajax Portland Cement, 109 Kan. 72, 197 P. 875 (1921); Ringle v. Quigg, 74 Kan. 581, 87 P. 724 (1906); Monfort v. Lanyon, 67 Kan. 310, 72 P. 784 (1903).

a. In Kansas, the parties to the lease can contract to avoid the implied covenant to drill an initial test well.

b. Deep Horizons Act only prohibits limitation

of the implied covenants to develop and explore. These do not take effect until an initial well has been drilled.

c. Problem will be getting lessors to break with tradition of receiving delay rental. The break can be accomplished by payment of a larger bonus.

IV. Royalty Clause. Handbook §11.21.

A. Most problems under the royalty clause, for lessee and lessor, can be resolved by stating, in the lease:

1. How the gross value of royalty will be determined.

2. What costs lessee can deduct from the gross value to arrive at lessor's royalty.

B. Calculating gross and net value:

1. At what point in the production process will gross value be determined?

a. At the well?

b. First sale?

c. What's the effect of lessee using the production or a sale to lessee or its affiliate?

d. What if the gas is processed to separate it into its liquid and gas components for sale?

e. What if other components of the production stream are removed in treating or processing the gas?

f. What if the production is not sold, but instead "exchanged" for other production?

2. What expenses can lessee deduct (charge against lessor's share of production) to arrive at the net value of production to calculate royalty?

a. A stated formula or actual costs? Lessee better off using a stated formula.

b. If lessor receives royalty on processed

gas, must lessor pay his share of processing costs?

c. Will lessor be responsible for its share of treating, compression, transportation, and other marketing costs?

d. What is the effect of lessee reserving certain rights under a gas purchase agreement?

3. Proceeds Lease.

a. Define proceeds to exclude other gas contract benefits.

b. Address lessee's rights to amend or otherwise manage the gas contract.

c. Address how proceeds will be calculated in situations noted in paragraphs 1 and 2 of this section.

4. Market Value Lease.

1. Define market value and how it will be determined.

2. If a Waechter lease, structure gas sales agreements to ensure a sale and transfer of title to the gas at the well - if you want to avoid a market value calculation of the royalty obligation.

C. General Advice - Be sensitive to situations where it is necessary, or advisable, to include lessor in the lease operation decision-making process.

1. A concept foreign to lessees.

2. Kansas Supreme Court has often noted the lessee's failure to consult the lessor on matters directly affecting lessor's economic interest. See, e.g., Schupbach v. Continental Oil Co., 193 Kan. 401, 406, 394 P.2d 1, 5 (1964).

3. What do you think a lessor would have done in 1965 if the lessee had gone to them and said: "We have a gas purchaser willing to enter into a gas purchase agreement to buy all the gas from our well for the next 20 years - under these terms . . . ." If the price and other contract terms were reasonable, at that time,

do you think the lessor would have been willing to amend the lease to accept the gas contract proceeds for calculating royalty?

V. Miscellaneous Clauses. Handbook §11.22.

A. Make covenants created by the lease "run with the land." Binding on successors and assigns of lessor and lessee.

B. Merger or integration clause. Try to avoid the problem of: "The landman [lease broker] told me they would drill a well within the next 30 days."

C. Consider whether you want to try and restrict oral modification or rescission of the lease.

VI. Remember - if it isn't clearly stated in the lease, the lessee will probably lose in a contest to resolve an ambiguous or unstated right or obligation.

SESSION 5 - PART B
REPRESENTING THE LESSOR AND SURFACE OWNER

I. Granting Clause. Handbook §12.02.

A. Area Encompassed by the Grant. Handbook §12.03.

1. How much acreage should the landowner include in the lease?

2. Habendum clause will maintain the lease in effect so long as there is production anywhere on the "leased land."

a. One well could hold 5 acres or 5000 acres, depending upon how much land is included in the granting clause. Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905) (lease covered three tracts of land which were located from eight to fourteen miles apart - production from one tract held other tracts). See also Robinson v. Continental Oil Company, 255 F.Supp. 61 (D.Kan. 1966).

b. Unless lease language clearly indicates otherwise, production anywhere from the leased land will maintain all the leased acreage. McCammon v. Texas Company, 137 F.Supp. 256 (D.Kan. 1955).

3. Lessor can use several separate leases to avoid having lessee hold large blocks of acreage with minimal drilling. See, e.g., Stamper v. Jones, 188 Kan. 626, 364 P.2d 972 (1962) - Same lessors leased 560 acres using seven different leases of 80 acres each.

a. If one 560 acre lease was used, at end of primary term, lessee could maintain all the acreage with one well. Using separate leases, to maintain the same amount of acreage, lessee would need seven wells at the end of the primary term (assuming no pooling rights).

b. Implied covenants also apply on a lease basis so development of one 80 acre lease will not satisfy development on a separate 80 acre lease.

4. Implied covenants offer some protection, but they generally require legal action to enforce and are complex and expensive cases to litigate.

a. Separate leases, habendum clause acts to terminate the lease automatically.

b. Whether development of the lease would be prudent is not an issue under the habendum clause.

5. If a large block of acreage is included in a single lease, or the lease contains a pooling or unitization clause, you should ensure the lease contains a "Pugh" clause.

   a. Pugh clause limits the leasehold area that is held by production from a particular well.

   b. Operates, in conjunction with habendum clause, to limit the area perpetuated by production to the spacing, proration, or pooling unit, or a specified amount of acreage in absence of such a unit, where a producing well is located.

   c. Must "explicitly" provide for this limited effect of production by "obvious, clear and direct" language. Mesa Petroleum Co. v. Scheib, 726 F.2d 614, 616 (10th Cir. 1984). See also Morgan v. Mobil Oil Corp., 726 F.2d 1474 (10th Cir. 1984).

6. Lessor can limit the horizontal scope of the lease as well as its areal (or vertical) scope.

   a. Expressly limit grant to certain depths or formations.

   b. Can use a Pugh clause to limit the geologic effect of production on the habendum clause as well as its geographic effect.

   c. For example, the lease could limit the perpetuating effect of a producing well to the specific formation, or formations, from which it is producing at the end of the primary term. See Rogers v. Westhoma Oil Company, 291 F.2d 726 (10th Cir. 1961). It is doubtful the clause employed in Rogers could meet the court's requirement of an explicit expression, by "obvious, clear and direct" language to limit the effect of the habendum clause. Mesa Petroleum Co. v. Scheib [court, however, cites the Rogers clause as an example of language meeting the test].

7. Avoid Mother Hubbard and cover-all clauses.

B. Substances encompassed by the grant. Handbook §12.04.

1. Avoid general descriptions such as "other minerals" or "other hydrocarbons."

2. Granted substances can also affect the scope of lessee's surface rights.

3. Problem substances known to exist in the area - such as helium, address it specifically in the lease.

C. Surface rights. Handbook §§12.05 and 12.06.

1. Typical granting clause in lessee-generated lease forms too broad. Protection of lessor's surface rights very limited:

a. Bury pipelines below plow depth.

b. No well drilled nearer than 200 feet to house or barn.

c. Lessee pay for damage to "growing crops."

2. Goal should be to specify the lessee's surface rights, lessor's retained surface rights, and how they will be adjusted when they conflict.

3. Absent specific lease terms limiting lessee's right to access and use the surface: "Under an oil and gas lease, the lessee has the implied right to make reasonable use of the surface in order to develop the land for the oil and gas." Thurner v. Kaufman, 237 Kan. 184, 188, 699 P.2d 435, 439 (1984).

a. Similar rule applied to give severed mineral interest owner access to its mineral estate. Brooks v. Mull, 147 Kan. 740, 746-47, 78 P.2d 879, 883 (1938).

b. See also: Mai v. Youtsey, 231 Kan. 419, 424, 646 P.2d 475, 479 (1982); Monfort v. Layton, 1 Kan.App.2d 622, 628, 571 P.2d 80, 85 (1977); Mcleod v. Cities Service Gas Company, 131 F.Supp. 449, 452 (D.Kan. 1955), aff'd, 233 F.2d 242 (10th Cir. 1956).

c. It is contemplated that in the course of operations some disruption and damage will occur to the surface of the land. If this disruption and damage is what would normally occur in prudent operations, it will fall within the lessee's implied right to make "reasonable use" of the surface.

(1) No liability to the lessor/surface owner will arise.

(2) No surface damage or drill site payments will be due unless the lease expressly provides for such damage payments. See Fast v. Kahan, 206 Kan. 682, 683, 481 P.2d 958, 960 (1971).

d. The surface use easement, without any obligation to pay for surface damage (other than unreasonable use), is being challenged by state legislatures and, to a lesser degree, by the courts that created the rule.

(1) Rule has caused courts to take a distorted approach to defining what is included in a grant of "minerals" or "other minerals."

(2) Give them the easement - but why should the rule give it to them without liability for damage to the surface estate while using the easement?

(3) Kansas cases directly addressing the matter would seem to allow the court to fashion a new rule. Most statements of the rule have been dicta. Some stray language in Jensen v. Southwestern States Management Co., 6 Kan.App.2d 437, 441, 629 P.2d 752, 756 (1981) that mineral grantee would have access to the coal but would have to pay for any surface used to extract the coal. This was dicta since the mineral deed specifically required payment for the surface used.

4. What happens when the lessee's surface use interferes with lessor's use? Or lessor's use interferes with lessee's use?

a. Does lessee have an obligation to try and accommodate lessor's existing or future use of the surface?

b. Kansas does not employ the dominant/servient estate analysis when an oil and gas lease is involved. In Rostocil v. Phillips Petroleum Company, 210 Kan. 400, 401, 502 P.2d 825, 826 (1972), the court states:

"The obvious intent of the parties under . . . [an oil and gas] lease is that the licensed privileges of the lessee are to run hand in hand with those reserved to the lessor with neither interfering more than need be with the continuing uses of the other - the one for the exploration, production and transportation of minerals and the other for the pursuit of agriculture.

The lessee, under an oil and gas lease, does not own a dominant easement."

(1) Apparently, the owner of a severed mineral interest is not required to accommodate lessor to the extent that a lessee must accommodate. Rostocil distinguishing Potter v. Northern Natural Gas Co., 201 Kan. 528, 441 P.2d 802 (1968).

(2) Lessee of severed mineral interest owner should also obtain a grant of owner's rights to use the surface during the term of the lease.

5. "Reasonable use" standard does not protect surface owner's existing and future land use, nor will it entitle him to compensation for damage to the land which may be significant, but not unreasonable. Should inform lessor of the oil and gas development process and the demands it makes on the surface estate. Ascertain the surface owner's present and future land use needs. Draft specific provisions to accommodate surface owner's needs with the lessee's needs. Provide for payment by lessee of fees and damages for use of surface. See generally Nordling, "Landowners' Viewpoints in Pipeline Right-of-Way and Oil and Gas Lease Negotiations," 52 J. Kan. B. A. 35 (1983).

6. Under existing leases, consider other contracts which may give you rights, as a third party beneficiary, to compensation for surface use. Cornwell v. Jespersen, 238 Kan. 110, 708 P.2d 515 (1985)

7. Courts will enforce lessor's surface use restrictions by awarding damages and, in appropriate cases, cancellation of the lease. Thurner v. Kaufman, 237 Kan. 184, 699 P.2d 435 (1984).

8. Consider statutory rights. Grade abandoned drill site. K.S.A. §55-132a (1983). Damages imposed by statute. See §§8.03 to 8.05.

9. Performance bond to secure plugging and compliance with surface use covenants. Kansas does not require posting of a plugging bond. See generally K.S.A. §55-140 (Supp. 1985).

D. Warranty. Handbook §12.07.

1. Most lessee forms provide lessor warrants and will defend title to the leased interest.

   a. Unreasonable, in light of the small up-front consideration the lessor normally receives,to expect them to warrant and defend title. Especially when damages to the lessee could have been avoided by a title search prior to taking the lease.

   b. Practice to have lessor convey the entire interest and then rely on the lesser interest clause to reduce lessor's rights to their actual ownership interest.

   c. Kansas cases indicate the lessor can be held responsible for damages to lessee under the warranty clause.

2. Since the oil and gas lease is a sale of a personal property interest, should include a clause expressly disclaiming any warranty. In Kansas, "a sale of personal property in the seller's possession for a fair price implies an affirmation by him that the property is his own, and implies a warranty of title by him unless the contrary is shown . . . ." Wood v. Stewart, 158 Kan. 729, 732, 150 P.2d 331, 333 (1944).

   a. Lessee can be adequately protected with a

lesser interest clause and an after-acquired title clause.

b. Lessee can also provide for recoupment of bonus, rental, and royalty. But - should require exercise of this right within a specified time - e.g., within one year from receipt.

3. Before leasing property, landowner should review the terms of any existing mortgages, installment contracts, easements, agricultural leases, or other preexisting rights in the property.

a. May limit ability to lease.

b. May require special provisions in the lease to account for their interest.

4. Lesser interest or proportionate reduction clause:

a. Inform lessor of its affect - determine if the amounts in the lease have already been reduced.

b. Specifically exclude bonus from its operation. See Brooks v. Mull, 147 Kan. 740, 78 P.2d 879 (1938).

E. Free Gas Clause. Handbook §12.08.

1. Lessee forms sometimes contain a free gas clause entitling lessor to:

"'[H]ave gas free of charge from any gas well on the leased premises for stoves and inside lights in the principal dwelling house on said land by making his own connections with the well, the use of said gas to be at the lessor's sole risk and expense.'"

Jackson v. Farmer, 225 Kan. 732, 733, 594 P.2d 177, 179 (1979).

2. The free gas clause is:

a. Part of the "rent" paid by lessee for the oil and gas lease.

b. Obligation to provide free gas and right to receive it is a covenant which "runs with the land" and not a personal covenant.

c. Right to receive free gas is a right which runs with the surface estate - not the mineral estate. Jackson, 225 Kan. at 737-38, 594 P.2d at 182.

(1) Surface owner, who has no interest in the mineral estate, and is not a party to any oil and gas lease, can demand free gas rights where he owns the only "principal dwelling house" on the leased land.

(2) House could be one in existence at time lease given, or one built after the lease.

(3) Cannot expand lessee's obligation.

3. How will pooling affect the free gas clause?

Suppose A owns the surface and mineral rights in the South Half of Section 30 and B owns the minerals in the North Half; C owns only the surface in the North Half. B leases his mineral interest to X - the lease contains a free gas clause identical to the one set out in paragraph 1 of this section. A leases his mineral interest to X. X, through the pooling clauses in each lease, pools the North Half and South Half to create a 640 acre unit. A gas well is completed on the South Half of Section 30. Twenty years later C builds a house on the North Half, the only house on Section 30, and demands his free gas rights under the lease. What is he entitled to?

a. In Farmer v. Jackson the court holds C is entitled to free gas from the unit well, even though it is not located on his land.

b. Rationale:

(1) Pooling clause in lease, and the declaration creating the pooled unit, specified that the gas rights in both leases were being consolidated "for all purposes." Jackson, 225 Kan. at 738, 594 P.2d at 182.

(2) Holding limited to the "peculiar terms of the documents before us" but terms of the pooling clause and the document declaring the pooled unit are fairly common.

4. Negotiating a free gas clause today - consider expanding clause for use in farming operations such as irrigation pumps and grain dryers. May want to avoid dispute by specifying a maximum quantity that can be taken, free of charge, each month. Include gas from oil well?

   a. May want to specify that lessee will pipe the gas to within a certain distance of a designated point on lessor's land. Could be a very valuable right to the lessor - and burdensome obligation to the lessee, in light of Jackson v. Farmer.

   b. Lessor should include a clause to permit him to take over the well, at his option, and purchase casing and related well equipment at their salvage value.

F. Take-Over Clause. Handbook §12.08.

1. Although well may be unprofitable for lessee to operate, lessor may be able to continue operations at a profit; or lessor may derive other benefits from the well such as free gas.

2. Most lease forms give lessee the right to pull all casing and equipment from the well and have it plugged when it becomes uneconomical for the lessee to operate.

3. Clause giving lessor the option to take over operations on the well may be desirable.

4. CAUTION: Lessor should determine what the plugging costs will be and ensure there are no other problems or potential expenses associated with taking over the well.

   a. Lessee may require lessor to indemnify lessee.

   b. Lessor becomes an "operator" subject to state and federal law concerning oil and gas operations. See, e.g., K.S.A. §55-140 (Supp. 1985) (operator of well responsible for improper or ineffective plugging - 1985 amendment no relief to lessor taking over operations).

5. Surface owner can request the Kansas Corporation Commission to notify them when the lessee files its notice of intent to abandon a well on the leased land. K.S.A. §55-128a (1983).

II. Habendum (Term) Clause. Handbook §12.09.

A. Ensuring prompt development of the lease. Handbook §12.10.

1. Short primary term.

2. During secondary term:

a. Lease small tracts.

b. Use Pugh clauses.

c. Specific drilling obligations.

3. Continuous drilling obligations:

a. Specify development of lease to a specified density - spacing or proration units, or, if not spaced, using a stated tract size such as ten acres. See, e.g., Endicott v. DeBarbieri, 189 Kan. 301, 369 P.2d 241 (1962).

b. Consider both the geographic and geologic planes.

4. Initial drilling obligation:

a. Require lessee, to obtain the lease, to agree to drill a test well within a certain time to a certain depth.

b. Provide for liquidated damages for failure to comply with drilling covenant.

B. Pooling and Unitization. Handbook §12.11.

1. Pooling clause.

a. Use Pugh clause.

b. Limit right to pool to formation of unit to meet spacing or proration requirements of Kansas Corporation Commission.

c. Obligation to pay delay rental on acreage not participating in unit production during the primary lease term.

d. Limit to gas? Special provisions for oil?

e. Consider effect of a lease in the pooled unit with a free gas clause.

f. Special compensation in the event the unit well is located on your property - surface damages, rental for unit tanks, etc.

g. Eliminate clause altogether.

2. Unitization clause - unacceptable. When they have a definite plan, they can present it to you and a separate agreement can be used.

C. Clauses extending the lease without production. Handbook §12.12.

1. Ensure terms in completion, dry hole, cessation, and shut-in clauses are defined to protect your interests.

a. Terms such as commence, commencement, complete, dry hole, and cessation.

b. Lessee will want to define these also, but his definitions may be too broad.

2. Are the clauses too broad in scope?

a. Does the shut-in clause indicate the situations in which lessee can declare a well shut-in?

b. Proper definitions of the terms in paragraph 1.a. will help to narrow the potential scope of these clauses.

3. Does the clause give the lessee too much discretion or control over what must be done to maintain the lease, without production?

a. How long does lessee have to regain production after it has ceased?

b. After lessee commences a well, when must it be completed?

4. Should lessee pay for the right to extend the lease without production?

a. During the primary term?

b. During the secondary term?

5. Shut-in royalty clause:

a. Reasons for being shut in.

b. Payment due when shut in.

c. Rental not advance royalty.

d. Consider outside time limit for having well shut in.

6. Force majeure clause.

a. Pare it to eliminate matters within lessee's control, such as: lessee's action, inaction, negligence, or economic condition.

b. Consider an outside time limit.

c. Eliminate the clause altogether.

III. Drilling/Delay Rental Clause. Handbook §12.13.

A. Should clearly address when it is required, when it is excused, the amount due, the date it is due, how it must be paid, and what will happen if improperly paid.

B. Payment should be made a condition (special limitation) on the grant.

a. Eliminate clauses which would excuse lessee from improper payment.

b. Especially judicial ascertainment and notice before forfeiture clauses.

C. Require payment during primary term when the lease is not held by actual production.

1. Require resumption of payments in the event a well is a dry hole or ceases to produce.

2. Kansas law appears to allow the lessee, absent specific lease provisions, to hold the lease during the primary term, without payment of delay rental, even though the well is a dry hole or otherwise not capable of producing in paying quantities.

D. What must lessee do to "commence" a well to meet the drilling portion of the drilling/delay rental clause? This should be defined as "actual drilling" to keep lessee from merely "looking busy" on the lease with no present intent to begin drilling.

IV. Royalty Clause. Handbook §12.14.

A. Economic Considerations. Handbook §12.15.

1. Nothing sacred about one-eighth royalty.

2. Bargaining power and prowess will determine what you can get.

3. How will gross value be calculated?

a. Want to avoid using proceeds when sales are to affiliates of lessee.

b. Want share of production to represent the current value of the product as it is produced and marketed.

c. Market value may be only safe route unless the proceeds provision has a number of conditions placed on it.

d. Proceeds and the long term gas sales contract - may be acceptable when lessor has ability to review contract and have royalty based upon his share of all of lessee's contract benefits and rights - even though lessee fails or is unable to exercise its rights. Such as price escalations and take-or-pay obligations.

e. Right to royalty based upon value of processed gas.

f. Option to take substance in kind.

g. Will royalty be paid on gas that is used by someone other than lessor under a free gas clause?

h. Will royalty be paid on flared or vented gas?

i. Will royalty be paid on oil or gas used for lease operations? Do such operations include reinjecting gas?

4. How will net value be calculated?

a. Specify that royalty will be free of any expenses or charges relating to drilling for, producing, operating, treating, gathering, compressing, transporting, processing, manufacturing, or marketing

production from the leased land.

b. If this is not possible, specify what costs will be deducted prior to determining the royalty. Specify how the amount of such costs will be determined (exclude lessee's overhead expenses, and amounts paid or payable to lessee or its affiliates).

B. Payment Procedure. Handbook §12.16.

1. How often must royalty be paid?

2. What will be the effect of late payment?

a. Interest.

b. After period of time, automatic cancellation.

c. Attorney fees, litigation costs.

3. Authority to inspect lessee's records, test well, receive copies of reports. Right to have the information required to ensure proper amount is being paid to lessor as royalty. Copies of contracts.

C. Assignment Restrictions. Handbook §12.17.

1. Limit assignment clause to make lessee's liability continue after assignment unless lessor consents, in writing, to the assignment.

2. If you limit the right to assign, provide for a remedy for improper assignment.

D. Other Clauses Affecting Royalty. Handbook §12.18.

1. Entireties clause.

2. Proportionate reduction (lesser interest) clause.

3. Pooling and unitization clauses.

4. Community lease.

a. Created when separate landowners enter into a single lease which covers all their lands. Production anywhere on the leased land extends the lease as to all included land. Royalty is apportioned among the parties joining in the lease according to

their proportionate contribution of acreage to the community lease.

b. No reason to enter into a community lease.

E. Remedies for Noncompliance With Lease. Handbook §12.19.

1. Use the express condition whenever possible.

2. Remember - enforcement of implied lease obligations is difficult, expensive, and the outcome is generally unpredictable.

3. Lessor should enhance his position in the event of lessee's nonperformance by including a clause permitting the recovery of reasonable attorney fees, litigation costs, and when appropriate, interest. Liquidated damages should be used when the lease calls for a performance which may be important to the lessor, but damages for nonperformance may be difficult to calculate.

F. Beware of persons bearing "division orders."

G. Lessor is in the oil and gas business - manage your investment accordingly. Lease audit. Handbook §12.20.

SESSION 6 - PITFALLS UNIQUE TO KANSAS

I. Classification of Oil and Gas Interests. Handbook §§4.10 to 4.12.

A. Real or Personal Property. Handbook §4.11.

1. Surface and mineral estates are real property. Froelich v. United Royalty Co., 178 Kan. 503, 290 P.2d 93, 96 (1955), modified, 179 Kan. 652, 297 P.2d 1106 (1956).

2. Non-mineral interests, even though their duration may technically create a freehold estate, are classified as personal property.

a. Royalty interest is personal property. Magnusson v. Colorado Oil and Gas Corp., 183 Kan. 568, 571, 331 P.2d 577, 580 (1958).

b. Lessor's interest in future production under a lease may actually be referring to lessor's mineral interest and not merely a right to current production. See, e.g., In re Estate of Sellens, 7 Kan.App.2d 48, 51, 637 P.2d 483, 486 (1981); In Re Randolph's Estate, 175 Kan. 685, 691-92, 266 P.2d 315, 320 (1954).

c. Kansas classifies the oil and gas lease as personal property. Burden v. Gypsy Oil Co., 141 Kan. 147, 150, 40 P.2d 463, 466 (1935).

(1) Personal property classification probably adopted to exempt oil and gas leases from K.S.A. §79-420 (1984).

(2) K.S.A. §79-420 does not apply to leases (although it was probably intended to do so). Gas Co. v. Neosho County, 75 Kan. 335, 337, 89 P. 750, 751 (1907).

3. Classifying oil and gas lease as personal property has created a number of problems. How do we fit this personal property interest, which affects interests in land, into the Kansas property administration scheme?

a. Personal property - can be abandoned but not lost by adverse possession. K.S.A. §60-503 (1983) (adverse possession) applies only to real property.

b. Where do we record a security interest in an oil and gas lease? UCC records - as a personal property interest; or with the register of deeds as a mortgage?

(1) See Ingram v. Ingram, 214 Kan. 415, 521 P.2d 254 (1974). Bank filed as a mortgage affecting real estate, if UCC applied, bank would loose its priority position. Court notes Kansas treats the oil and gas lease as a "hybrid property interest" and holds: "the legislature has determined oil and gas leasehold interests are to be treated as real property under the statutes pertaining to the recording of instruments conveying or affecting real estate." Ingram, 214 Kan. at 420-21, 521 P.2d at 259 (emphasis by the court).

(2) Kansas has elected, by statute, to treat oil and gas leases as real property for many purposes. See, e.g., K.S.A. §§58-2221 and 58-2222 (1983).

c. Also have problems determining whether a particular statute or remedy applies to the oil and gas lease. For example, in Utica Nat. Bank and Trust Co. v. Marney, 233 Kan. 432, 661 P.2d 1246 (1983), the issue was whether oil and gas leases held by Marney were subject to the automatic judgment lien provisions of K.S.A. §60-2202 (1983). Court holds K.S.A. §60-2202 places a lien only on "real estate" of the judgment debtor and therefore does not apply to an oil and gas lease.

4. Must recognize the "hybrid character" of oil and gas property interests and plan your transactions accordingly. Must classify the interest and then determine if there have been any judicial or statutory reclassifications to fit it into the Kansas property administration system.

B. Possessory or Non-Possessory. Handbook §4.12.

1. Surface and mineral estates are "possessory" (corporeal) rights.

2. Lessee's interest in an oil and gas lease is

classified as non-possessory (incorporeal). Gas Co. v. Neosho County, 75 Kan. 335, 337, 89 P. 750,751 (1907).

3. Kansas Court of Appeals has noted:

"Admittedly an oil and gas lease is a hybrid instrument. It has all of the characteristics of a realty interest yet the relationship of landlord and tenant does not arise. The lessee does not obtain possession of the land."

In re Estate of Sellens, 7 Kan.App.2d 48, 50, 637 P.2d 483, 485 (1981).

4. The possessory or non-possessory classification can affect the remedies available to the owner of the property interest.

II. Rule Against Perpetuities. Handbook §§4.13 to 4.16.

A. NO INTEREST IS GOOD UNLESS IT MUST VEST, IF AT ALL, NOT LATER THAN TWENTY-ONE YEARS AFTER SOME LIFE IN BEING AT THE CREATION OF THE INTEREST.

McEwen v. Enoch, 167 Kan. 119, 124, 204 P.2d 736, 740 (1949).

1. Interests must be able to "vest in interest," but not necessarily vest in "possession."

2. Must vest within a specified period of time from creation of the interest.

a. Created by will, clock begins upon testator's death. See generally In re Freeman's Estate, 195 Kan. 190, 404 P.2d 222 (1965).

b. Created by an inter vivos transaction, clock begins when delivery is complete or the interest otherwise becomes effective. Kenoyer v. Magnolia Petroleum Co., 173 Kan. 183, 186, 245 P.2d 176, 179 (1952).

3. Interest must vest within a specified period of time measured by any reasonable number of "lives in being" (people alive at the time the interest was created) plus twenty-one years.

a. Rule treats a person as "in being" upon conception so a gestation period is allowed where appropriate. McEwen, 167 Kan. at 124, 204 P.2d at 740.

b. No measuring life or lives used - merely determine whether the interest will vest within twenty-one years from the time it was created or became effective. McEwen, 167 Kan. at 125, 204 P.2d at 741.

4. If there is any possibility the interest will not vest within the time required by the rule, it is void. McEwen, 167 Kan. at 124, 204 P.2d at 740.

5. The problem is one of "vesting." When does an interest become "vested?"

B. Future Interests. Handbook §4.14.

1. A conveys the minerals in Section 30 to B "for 10 years and so long as the Dakota Formation is used for gas storage."

   a. B has a present interest and right to possession of the mineral estate in Section 30.

   b. A has a future interest, called a "possibility of reverter," in the Section 30 mineral estate.

   c. B's estate is a "fee simple determinable," also called a "fee simple subject to a special limitation," and more commonly known in oil and gas circles as a defeasible term mineral interest.

   d. Note that A's future right to possession is contingent (conditioned) upon an event which conceptually may never occur. However, for purposes of the rule, the possibility of reverter, and the right of entry, are not subject to the rule.

2. Suppose A conveys the minerals in Section 30 to B "for 10 years and so long as oil or gas is produced in paying quantities, then to C."

   a. Not a possibility of reverter or right of entry because the estate does not go back to the grantor.

   b. C does not have a "remainder," since the conveyance to B is a fee simple estate (even though it is defeasible). A remainder cannot follow a fee simple estate. Remainders are not subject to the rule.

c. Since C's interest cannot be a remainder, it is classified as an "executory interest." Although a remainder is not subject to the rule, executory interests are.

d. Is C's interest sure to vest within 21 years from the date of the conveyance? No, production from Section 30 could extend B's interest for over 21 years from the date it was created. C's interest is void. See generally, Nelson v. Kring, 225 Kan. 499, 502, 592 P.2d 438, 442 (1979).

3. A conveys the minerals in Section 30 "to B for life, then to C. C has a remainder which will become vested at B's death. Rule does not apply. But note, it would be satisfied even if it did. The interest will vest within a life in being - B's.

4. A conveys the minerals in Section 30 "to B for life, then if oil or gas is being produced from the premises at B's death, to C."

a. C has a "contingent remainder." Vesting of C's interest is subject to a condition precedent: oil or gas production from the land at B's death.

b. Contingent remainders are subject to the rule. C's interest complies with the rule.

c. Note that C's interest may never vest; there may not be production at B's death. This accounts for the vest "if at all" part of the rule. You merely need to demonstrate the interest will surely vest, if all conditions to vesting are met, within lives in being plus 21 years. The vesting event must take place within the period specified by the rule.

d. Even though no condition precedent to vesting exists, the remainder is deemed contingent if it is not possible to identify the persons, or class of persons, who would take when the remainder vests.

C. In applying the rule against perpetutities, the first task is to determine if you have a future interest that is subject to the rule.

1. Possibility of reverter, right of entry,

reversion, and remainder are not subject to the rule.

2. Contingent remainder and executory interest are subject to the rule.

   a. Must detemine if the interest could, under all feasible (though highly unlikely) factual assumptions, vest within the rule's limitations.

   b. If it meets the rule, the interest is enforceable, if it will not vest as required by the rule, it is void.

D. Rule should not apply to interests which are excepted from a conveyance and retained by the grantor. Nelson, 225 Kan. at 502, 592 P.2d at 442.

E. Perpetual Royalty Interest. Handbook §4.15.

1. Mineral interest vests immediately when the conveyance is complete. Lathrop v. Eyestone, 170 Kan. 419, 423-24, 227 P.2d 136, 141 (1951).

2. In Kansas (and only Kansas) a royalty interest vests only when oil or gas are actually produced.

   a. Example: A assigns B a 1/16th royalty interest in oil and gas produced from Section 30.

   b. The grant to B will not vest until oil or gas is produced from Section 30. Cosgrove v. Young, 230 Kan. 705, 715, 642 P.2d 75, 83 (1982). This is not certain to occur within 21 years from the conveyance so it is void.

   c. Similar result if A assigns to B one-half the royalty provided for under existing and future oil and gas leases on Section 30. No interest will vest until production. Lathrop, 170 Kan. at 428-29, 227 P.2d at 143-44.

3. Court apparently intends to treat the royalty interest as an executory interest (a springing executory interest).

4. Other cases taking inconsistent approach:

   a. Miller v. Sooy, 120 Kan. 81, 242 P. 140

(1926). Really avoids the issue because the right being contested was the right to delay rental. Interest not binding upon successors and assigns so it was a personal covenant and right to rental would vest at lessee's death.

b. Howell v. Cooperative Refinery Ass'n, 176 Kan. 572, 271 P.2d 271 (1954). Rights in overriding royalty vested when the assignment was made. [Court could have relied upon assignor excepting the interest from the rest of the assignment.]

c. Kenoyer v. Magnolia Petroleum Co., 173 Kan. 183, 245 P.2d 176 (1952) (pooling rights under oil and gas lease).

d. First Nat. Bank & Trust Co. v. Sidwell Corp., 234 Kan. 867, 678 P.2d 118 (1984) (right to 1/4th working interest in oil and gas leases obtained in future).

e. Drach v. Ely, 237 Kan. 654, 703 P.2d 746 (1985) (nonparticipating mineral interest leaving the owners with an interest identical to a royalty interest).

5. THIS IS AN AREA RIPE FOR CHANGE. THE COURT MAY RECONSIDER ITS RULE GIVEN THE APPROPRIATE SET OF FACTS.

III. Listing Mineral Interests for Taxation. Handbook §5.10

A. K.S.A. §79-420 (1984) requires severed mineral interests to be recorded or "listed" for taxation. Recording must occur within 90 days after the conveyance is executed or the interest will be deemed void if not listed for taxation.

1. Purpose of statute is to ensure mineral interests are promptly listed for taxation following severance from the surface estate. Goodspeed v. Skinner, 9 Kan.App.2d 557, 559, 682 P.2d 686, 688 (1984).

2. Compliance with the statute is a condition precedent to title vesting in the grantee. Becker v. Rolle, 211 Kan. 769, 774, 508 P.2d 509, 513 (1973).

B. Judicial attempts to temper K.S.A. 79-420 - transactions not subject to the statute:

1. Statute provides: "When such reserves or leases are not recorded within 90 days after execution, they will become void if not listed for taxation."

2. First major exception: Statute does not apply to oil and gas leases. Gas Co. v. Neosho County, 75 Kan. 335, 89 P. 750 (1907).

   a. This is probably why oil and gas leases are classified as personal property.

   b. Birth of the deed/lease problem.

3. Second major exception: Statute does not apply to a royalty interest. Hickey v. Dirks, 156 Kan. 326, 133 P.2d 107 (1943). This probably helped to fuel the mineral/royalty problem.

4. Does not apply when grantor excepts the mineral interest. Medford v. Board of Trustees of Park College, 162 Kan. 169, 177, 175 P.2d 95, 100 (1946).

5. Apparently, does not apply when there has been a prior recorded or listed severance. Johnson v. Johnson, 150 Kan. 541, 545, 95 P.2d 329, 331-32 (1939).

C. Judicial attempts to temper K.S.A. §79-420 - liberal procedural interpretations:

1. Even though not recorded within 90 days of execution, if brought to the attention of the county assessor in time to be placed on the tax rolls, the statute is satisfied.

2. Richards v. Shearer, 145 Kan. 88, 64 P.2d 56 (1937). Conveyed 26 June 1934, recorded 30 January 1935 - timely because it was brought to assessor's attention by the register of deeds prior to the tax listing date of 1 March 1935.

3. Ford v. Willits, 9 Kan.App.2d 735, 688 P.2d 1230 (1984), aff'd, 237 Kan. 13, 697 P.2d 834 (1984). Conveyed 30 September 1946, recorded 18 January 1947 - timely listing because listing deadline was 1 March 1947.

4. Burgin v. Newman, 160 Kan. 592, 164 P.2d 119 (1945). Signed 11 July 1936 but pursuant to an oral agreement not delivered until June 1937. 90-day period begins to run from June 1937. Same result when interest held in escrow - delivery date used to commence the 90-day period. Ochs v. Blankenship, 192 Kan. 423, 388 P.2d 626 (1964); Volker v. Crumpacker, 154 Kan. 403, 118 P.2d 540 (1941).

5. Goodspeed v. Skinner, 9 Kan.App.2d 557, 682 P.2d 686 (1984). Mineral deed executed 30 January 1964, recorded 3 July 1967. The interest was subject to a life estate in the grantors. Last surviving life tenant died 6 May 1979. 90-day period began to run on 6 May 1979 so the 1967 recording was timely.

D. What is the current "listing date?"

1. K.S.A. §79-402 and §79-403 have been repealed - they established the March 1 listing date referred to in previous cases

2. It would appear, therefore, that the listing date for a conveyance made after 1959 would be December 15. K.S.A. §79-408 (1984); See 1959 Kan. Sess. Laws ch. 365, §10.

3. However, the Kansas Supreme Court in Ford v. Willits indicates, without comment, the listing date for personal property will be used. Ford, 237 Kan. at 14, 697 P.2d at 835. K.S.A. §79-306 (1984) provides for listing "[b]etween January 1 and March 1 of each year . . . except a corporation . . . in which case the filing date shall be April 1 . . . ."

4. Should always record within 90 days and if you are relying on a "listing" date, try to act prior to December 15.

IV. Statutory Release Obligations. Handbook §8.08.

A. General rule - if lessor gives lessee notice under either K.S.A. §55-201 (1983) or §55-206 (1983), and lessee refuses to release the oil and gas lease described in the notice, if lessor prevails he can recover a statutory penalty, attorney fees, litigation costs, and actual damages under K.S.A. §55-202 (1983).

1. Lessor's should always make a prior demand for a release when they believe the lease has become forfeited for some reason.

a. If lessor prevails, and they have made a prior demand complying with 55-201 or 55-206, they can seek attorney fees and litigation costs under 55-206. Adolph v. Stearns, 235 Kan. 622, 684 P.2d 372 (1984) (lessor recovered $100 statutory penalty, court costs, deposition expenses, publication expenses, and $4,000 in attorney fees).

b. If you don't follow the procedure, you can't get the benefits of K.S.A. §55-202. Nelson v. Hedges, 5 Kan.App.2d 547, 619 P.2d 1174 (1980).

2. If, after litigation, the lease is held to be forfeited, does the statute require, in all cases, an automatic award of the items listed in §55-202?

a. Lessees seem to assume it is a form of strict liability. If they loose on the merits, they will suffer the rath of 55-202 for not releasing the lease when demanded.

b. Lessees should argue the award is discretionary with the trial court judge and s ould not be awarded when lessee has, in good faith, refused to release.

c. Develop your defense against 55-202 using Mollohan v. Patton, 110 Kan. 663, 668-69, 205 P. 643, 643-44 (1922) (opinion denying rehearing). In Mollohan the lessor recovered $1,000 in attorney fees and $10,000 in damages for lessee's refusal to release when demanded.

d. In Adolph v. Stearns the court notes, "[t]he awarding of damages, costs, attorney fees and additional damages under K.S.A. 55-202 is discretionary with the trial court." Adolph, 235 Kan. at 631, 684 P.2d at 379.

B. Can a lessor, using the K.S.A. §55-201 procedure, terminate lessee's rights in the lease - without further judicial action?

1. If lessor makes the demand for a release, publishes the notice required by §55-201, and lessee fails to respond, can lessor file the statutory affidavit and terminate lessee's rights in the lease?

a. Suppose the lease is arguably still in effect - at least there is an issue of whether lessee had forfeited their rights. Can failure to respond eliminate lessee's ability to assert the lease is still in effect?

b. Purpose of statute - give lessor a method to easily rid their title of questionable oil and gas leases.

c. Arguably, if lessee fails to respond to lessor's notice, the only arguments lessee can raise in a subsequent judicial proceeding is whether lessor followed the statutory procedure and met due process notice requirements.

2. Issue mentioned but not addressed in Nigh v. Haas, 139 Kan. 307, 314, 31 P.2d 28, 32 (1934).

3. Issue addressed in Christiansen v. Virginia Drilling Co., 170 Kan. 355, 226 P.2d 263 (1951). Court would not allow 55-201 proceeding to effect a partial cancellation of a lease for an alleged failure to comply with the implied covenants to diligently explore and develop the leased land.

a. Majority limits 55-201 to instances where the lease is allegedly terminated, or "forfeited," by its "express" terms. Effect is lessor must litigate the implied covenant issue.

b. Dissent suggests such a requirement defeats the purpose of 55-201 and renders it useless. See Christiansen, 170 Kan. at 364-65, 226 P.2d at 269.

4. Court, today, may be willing to adopt the views of the dissenting justices in Christiansen.

a. Representing lessor - use 55-201 procedure.

b. Representing lessee - ensure you respond to any notice given under 55-201 and comply with the statutory provisions.

V. Notice of Producing Leases - Affidavits of Production Handbook §8.12.

A. K.S.A. §55-205 (1983) limits the constructive notice effect of a recorded oil and gas lease to its primary term.

1. Most oil and gas leases will terminate unless a contingency in the lease is satisfied - usually production in paying quantities.

2. To maintain the constructive notice provided by the recorded lease, beyond the primary term, the lessee can file an affidavit indicating a contingency required to continue the lease has been satisfied.

B. Since production is the typical contingency, the lessee files what has become known as an "Affidavit of Production."

1. Statute requires that it be filed for record "before the expiration of the definite term" of the lease.

a. If you are unable to file prior to the end of the primary term, a late filing should give persons examining the records actual notice of your continued interest.

b. If operations are being conducted on the lease, possession should also give persons notice of your rights.

2. Affidavit must state:

a. Description of the lease;

b. Affiant is the owner of the lease; and

c. Facts showing the required contingency has happened.

C. Failure to comply with the statute will not result in a forfeiture of the lease. Storm v. Barbara Oil Co., 177 Kan. 589, 600, 282 P.2d 417, 425 (1955).

1. It is merely a notice statute.

2. Failure to file an affidavit may result in a third party attaining the status of a bona fide purchaser or encumbrancer and defeating or subordinating lessee's leasehold interest. Cities Service Oil Company v. Adair, 273 F.2d 673 (10th Cir. 1960).

a. Ensure partial assignments of divided portions of the lease are accounted for by an affidavit of production which gives notice of production as to the entire area encompassed by the original lease.

b. See also Davis v. Cities Service Oil Company, 338 F.2d 70 (10th Cir. 1964).

VI. Kansas Mineral Lapse Act. Handbook §8.11.

A. Under K.S.A. §§55-1601 et seq. (1983) any "unused" "mineral interest" can be terminated and become vested in the surface owner.

1. Uses defined in K.S.A. §55-1603 (1983).

2. Broad definition of "mineral interest" - includes severed mineral interests, leases, royalty interests, "an interest of any kind" in minerals. K.S.A. §55-1601 (1983).

3. Period of continuous nonuse - twenty years.

B. Mineral interest owner can prevent lapse by:

1. Using the interest during the twenty years.

2. Filing a "statement of claim" to the interest within the twenty-year period.

3. Filing a "statement of claim" to the interest prior to 1 July 1986.

4. Filing a "statement of claim" within sixty days of surface owner's lapse notice.

5. Even if you fail to file, if the interest was actually "used" during the preceding twenty years, prove use in a subsequent judicial action to establish your title.

a. Lapse procedure only applies to unused interests.

b. Failure to respond to surface owner's lapse notice will not affect an interest which has been used - assuming you can prove the use.

C. Following the lapse procedure will not vest surface owner with marketable title to the lapsed interest - still must quiet title to give mineral interest owner an opportunity to establish a use or defect in notice.

D. Surface owner initiates process by sending notice of lapse to mineral interest owners. If they fail to respond and file a statement of claim within the prescribed time, the interest is "extinguished" and vests in the surface owner. K.S.A. §§55-1604 and 55-1605 (1983).

VII. Abandonment. Handbook §8.10.

A. The oil and gas lease, being an interest in personal property, can be abandoned. Rook v. James E. Russell Petroleum, Inc., 235 Kan. 6, 679 P.2d 158 (1984).

B. To establish abandonment, must show:

1. An act of abandonment coupled with the present intent to abandon all rights to the property. See generally Botkin v. Kickapoo, Inc., 211 Kan. 107, 505 P.2d 749 (1973).

2. Can prove intent to abandon through surrounding facts and circumstances. See Chapman v. Continental Oil Co., 149 Kan. 822, 89 P.2d 833 (1939); Amoco Production Co. v. Douglas Energy Co., Inc., 613 F.Supp. 730, 733-34 (D.Kan. 1985); and Rook.

3. No requirement for prior demand for development to obtain cancellation of the lease. Rook, 235 Kan. at 19, 679 P.2d at 167.

C. Before implied covenants became an accepted adjunct to oil and gas jurisprudence, courts often relied upon abandonment as a remedy for failure to explore and develop leased lands. See, e.g., Nigh v. Haas, 139 Kan. 307, 31 P.2d 28 (1934).

1. The same set of facts may give rise to claims of termination under express lease provisions, violation of an implied covenant, and abandonment.

2. Consider abandonment as a theory.

a. Avoid demand requirement.

b. May be able to make expanded use of K.S.A. §55-201 (1983).

c. However, generally no damages will be recoverable by lessor for failure to develop - although may be entitled to damages for failure to release after a demand under 55-201 or 55-206. See K.S.A. §55-202 (1983).

Continuing Legal Education

Malpractice Avoidance Guidelines

Kansas lawyers are being sued for legal malpractice in greater numbers each year. The St. Paul, insurer of the Kansas Bar Association sponsored Legal Malpractice policy, reports that losses for the first six months of 1984 are almost twice as much as the losses reported for the first six months in 1983.

Below are listed some suggestions to help avoid malpractice claims. While these suggestions certainly will not provide a cure for all types of legal malpractice claims, it is hoped that these suggestions will reduce the number of claims.

Docket Control

The Docket Control system of each law office should have at least two individuals who keep track of various critical dates. In addition, the office should maintain a Master Calendar. It may be helpful to also keep a 3 x 5 card file keyed to the days of the year with two or possibly three cards for each case. These cards should be designed to be pulled two weeks, one week, and one day before the critical dates. The cards should include the individual's name, office file number and type of work.

Statute of Limitations

Be certain that you know when these toll for each case. Make notations on your Docket Control cards and Master Calendars. KEEP CURRENT.

Client Communications

One of the main causes of legal malpractice claims appears to be that the client does not feel he or she has been given all of the answers or clients think they have been promised one result and are greatly disappointed when that result is not achieved. Another cause is that clients feel their lawyer was impersonal and didn't really care.

1. Afford your clients the same courtesy you would expect to be extended to you if you are the client.
2. Do not make promises or allude to results which you cannot absolutely guarantee.
3. Return client phone calls promptly, even if you have nothing new to tell them.
4. Written communications with client should be clear, concise, friendly and with as little legalese as possible.

Remember, the majority of the population will see a lawyer only once or twice in their lifetime and they are a little fearful of the legal process.