SIGNIFICANT TRENDS & DEVELOPMENTS IN OIL AND GAS LAW 1992

October 16, 1992

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I. OWNERSHIP ISSUES

A. Production Payments

1. Interest creating a right to an "oil payment" was ambiguous concerning whether money generated by the sale of gas should be included in retiring the payment. Pan Oil & Gas Exploration, Inc. v. Kelt Kansas, Inc., 17 Kan. App.2d 121 (1992).

2. LCO assigned all its interest in a lease to Berry subject to the following reservation:

   "This assignment is subject to an oil payment of $100,000 out of 1/16th of 7/8ths W.I. to be paid $50,000.00 to LCO, Inc. and $50,000.00 to Hughes Industries, Inc."

   a. LCO assigned its interest to Pan Oil; Berry assigned his interest to Kelt.

b. At the time the assignment was made only oil was being produced from the lease. A gas well had been completed, but had not been hooked up to a pipeline.

3. Pan Oil contends "oil payment" includes gas and other hydrocarbons; Kelt contends it covers only oil.

4. Trial court held "oil payment" includes only "oil."

5. Court of Appeals reverses holding the term is ambiguous and "the trial court must consider extrinsic evidence in order to determine the intent of the parties at the time the reservation was executed." 17 Kan. App.2d at 124.

B. Easements

1. Construction of racetrack on pipeline easement was a structure which materially interfered with pipeline's easement rights and justified a mandatory injunction to have the structure removed. Mid-America Pipeline v. Lario Enterprises, 942 F.2d 1519 (10th Cir. 1991).

2. Lario Enterprises constructed a racetrack over a pipeline easement owned by Mid-America Pipeline Company (MAPCO).

3. MAPCO's easement provided:

"Grantor shall have the right to fully use and enjoy the above described premises subject to the rights herein granted. Grantee shall have the right to clear and keep clear all trees, undergrowth and other obstructions from the herein granted right of way, and Grantor agrees not to build, construct or create, nor permit others to build, construct or create any buildings or other structures on the herein granted right of way that will interfere with the normal operation and maintenance of the said line or lines." 942 F.2d at 1522.

4. The easement was granted in 1960 and MAPCO constructed two high-pressure liquid gas pipelines on the easement.

5. In 1988 MAPCO learned that Lario planned to build a racetrack over the easement; MAPCO informed Lario of its easement and objected to the construction.

6. MAPCO sought injunctive relief which was denied by the trial court.

   a. Court held that since the City of Topeka currently held title to the land and project, MAPCO's claim was for damages for an inverse condemnation.

   b. Court refused to enjoin racetrack construction although it found that it was a "structure" which would "interfere with the normal operation and maintenance of the pipelines" and therefore violates MAPCO's easement rights.

   c. Court balanced the equities and held that MAPCO had an adequate remedy in condemnation or damages and therefore the court would not require removal of the violating structure.

7. Applying Kansas law, the Court of Appeals reverses holding:

   a. The district court applied the Restatement (Second) of Torts § 936 to balance the equities in determining whether injunctive relief should be granted to enforce the easement. However, Kansas courts have not adopted this analysis.

      (1) Instead, court applies analysis articulated in the Kansas Supreme Court case of Mid-America Pipeline Co. v. Wietharn, 246 Kan. 238, 787 P.2d 716 (1990).

      (2) At the time the district court issued its opinion, the Wietharn opinion had not been issued.

   b. The racetrack was a structure that would materially interfere with MAPCO's operation and maintenance of its pipelines. However, the court also found that fences and movable barriers were not structures that would materially interfere with pipeline activities.

   c. Damages are not an adequate remedy.

   d. MAPCO was entitled to a mandatory injunction to remove the racetrack because it was a continuing violation of MAPCO's clearly defined rights under the easement that will be

"'recognized and protected by law.'" 942 F.2d at 1530.

C. Trespass and the Negligent Waterflood

1. Court will not stay damage action to refer issues to Kansas Corporation Commission under the doctrine of primary jurisdiction. Morsey v. Chevron USA, Inc., 770 F. Supp. 150 (D. Kan.1991).

   a. Morsey operates a waterflood operation on a section of land adjacent to a waterflood operated by Chevron.

   b. Morsey sued Chevron asserting that Chevron was injecting water into the reservoir at such a high pressure that it fractured the formation and created channels in the formation damaging the adjoining land owners.

2. Chevron sought to have the case stayed until the KCC could address issues concerning the secondary recovery permits and the parties' operations under the permits.

   a. Morsey did not dispute that Chevron operated its waterflood pursuant to a valid KCC permit and that Chevron was operating its wells and wellbores in accordance with KCC rules.

   b. Court notes that primary jurisdiction is a discretionary doctrine but finds that in this case the goals of uniformity of regulation and the exercise of agency expertise would not be furthered by the KCC's action.

3. The most significant portions of the court's opinion address matters unrelated to the primary jurisdiction issue:

   a. A KCC order authorizing a waterflood does not immunize the permit holder from liability if its flooding operations harm others. 779 F. Supp. at 153.

   b. The KCC lacks jurisdiction to award damage relief.

   c. "The fact that Chevron operates its waterflood with KCC permission does not absolve it from liability for any property damage it may have

caused to plaintiff's land." 770 F. Supp. at 153.

4. These damage issues are the sort that can be dealt with by a judge and jury; no public rights are involved.

D. Mineral Interest

1. Ownership of uranium under pre-June 8, 1983 conveyance of "minerals" depends upon whether solution mining is a reasonable method of extraction and, if so, whether it would consume, deplete, or destroy the surface. Crews v. Plainsman Trading Co., 827 S.W.2d 455 (Tex. App.--San Antonio 1992).

   a. March 14, 1963 Cattle Land Oil Company conveyed land to Crews expressly reserving to Cattle Land "an undivided one-half (1/2) of the minerals in and under said land." Cattle Land subsequently conveyed its reserved interest to Plainsman.

   b. The parties stipulated that the uranium was located within 200 feet of the surface.

   c. Quoting from Reed v. Wylie, 554 S.W.2d 169, 172 (Tex. 1977), the court noted:

   "[T]he surface estate owner must prove that, as of the date of the instrument being construed, if the substance near the surface had been extracted, that extraction would necessarily have consumed or depleted the land surface."

      (1) Using this Reed I rule, the focus would be on mining techniques used on March 14, 1963.

      (2) Crews' expert testified that on March 14, 1963 open pit mining was the only method utilized in South Texas for mining uranium.

   d. The court noted that the Reed I decision was subsequently modified in Reed II as follows:

   "That portion of Reed which would require that the near surface 'must' be removed by surface

destruction methods is overruled.

. . . .

"The test now is whether any reasonable method, including such a method as of the date of this opinion (March 19, 1980), of removal of the . . . [minerals] will consume, deplete or destroy the surface."

(1) Using the Reed II rule, the focus would be on reasonable mining techniques used on March 14, 1963, or at any subsequent time up to the date of trial, would consume, deplete, or destroy the surface.

(2) Plainsman's expert testified that in 1989 open pit mining would not be a reasonable method of mining uranium ore and the reasonable method would be the solution mining method.

e. The court remands the case to determine: "whether solution mining is a reasonable method of mining uranium under the surface of the Crews' Property and whether such mining will substantially damage or destroy the surface of the land."

f. The court states the rule that should be applied as follows:

"The surface owner . . . will prevail if it is proven that the uranium is at the 'near surface' (200 feet or less), and any reasonable method of extraction will consume, deplete, or destroy the surface, including such a method as of date of trial." Crews, 827 S.W.2d at 462.

E. Gas Storage Rights and Correlative Rights

1. Pipeline company liable for damages incurred by lessee due to negligent gas storage operations. Reese Exploration, Inc. v. Williams Natural Gas Co., 768 F. Supp. 1416 (D.C. Kan. 1991).

2. Williams Natural Gas Company (WNG) was assigned the following gas storage rights in leases owned by Reese Exploration, Inc. (Reese):

"[A]ll the gas and gas rights (except gas and gas rights in formations below a depth of one thousand and fifty (1050) feet from the surface and except the gas used for recycling purposes now in the producing oils and while the same is so used) and all gas storage rights, and rights of way under or incident to all and singular the oil and gas leases, storage leases, and supplemental oil and gas lease agreement . . . ."

"To have and to hold the same unto the said Assignee, its successors and assigns forever, subject to the terms and conditions of said oil and gas leases, storage leases and supplemental oil and gas lease agreements, and subject to the terms and conditions of that certain contract dated March 18, 1936 between Assignor and Assignee herein, and supplemental contract between the same parties, dated March 31, 1937."

3. After this assignment, WNG owned the gas rights and gas storage rights from the surface down to 1050 feet below the surface. Reese retained the oil rights in the property.

4. WNG completed wells to inject and produce gas from the Bartlesville formation which is 900 feet below the surface.

5. Reese conducts enhanced oil recovery operations in the Squirrel formation which is 800 feet below the surface.

6. For over a decade, WNG knew that gas was migrating from the Bartlesville formation storage reservoir up to the Squirrel formation. There are many unplugged or improperly plugged wells in the field that could permit migration to occur.

7. The higher gas pressures in the Squirrel formation interfered with Reese's oil operations and Reese brought a negligence action against WNG for damages caused by WNG's migrating gas.

8. WNG defended arguing since it had the right to store gas from the surface to 1050 feet, it had elected to store gas in the Squirrel formation as well as the Bartlesville formation.

9. In Reese the court narrows the scope of WNG's storage rights holding WNG "has elected to store gas in the Bartlesville sand . . . and does not now

have the right to change its gas storage zone to the detriment of other mineral interest owners."

a. The court treats WNG's storage rights as a general easement that has been defined to cover only the Bartlesville formation--due to fifty years of gas storage activities.

b. The court concludes that WNG had a duty not to interfere with Reese's oil operations, WNG violated that duty by allowing gas to escape into the Squirrel formation, and WNG's storage activities caused Reese damage.

10. As a remedy, Reese sought an injunction requiring WNG to reduce its storage pressure from 440 psig to 285 psig; the court holds this is a matter for the Federal Energy Regulatory Commission (FERC) to decide since FERC authorized storage at the 440 psig level.

11. The court also refuses to authorize Reese to produce the gas migrating into the Squirrel formation distinguishing Anderson v. Beech Aircraft Corp., 237 Kan. 336, 699 P.2d 1023 (1985), as dealing only with horizontal migration instead of vertical migration.

12. However, the court holds that Reese is entitled to $147,733.11 for permanent damage to Reese's oil rights applying the difference in the fair market value of the property before and after the injury.

13. It is difficult to tell, from the court's opinion, exactly why WNG's storage rights were in effect reduced to accommodate Reese's oil operations. However, the court's findings suggest that the agreements between the parties contemplated that oil operations would continue in the Squirrel formation after the storage rights were conveyed. The court seems to suggest that when WNG is merely using the Bartlesville to store gas, it must do so in a manner that will not unreasonably interfere with the owners of the oil rights in other formations.

a. The court felt WNG's failure to try and control the escape of gas from the Bartlesville formation was unreasonable under the facts and could not be justified by saying they were also entitled to store gas in the Squirrel formation.

b. WNG and Reese each had interests in the property which could be developed so long as WNG properly accommodated Reese's use by not permitting gas to escape into the Squirrel formation.

c. However, the court's reliance upon a relocation of easement theory is troublesome because it has the effect of taking away storage rights which were granted to WNG.

(1) If at some later date WNG decides to use the Squirrel formation for legitimate storage activities, WNG should have the right to do so--based upon its existing rights in the property.

(2) However, if we apply the court's rationale in Reese, apparently these rights have reverted to the lessee or mineral interest owner due to WNG's prior use of the Bartlesville formation.

d. The court's rejection of an Anderson v. Beech Aircraft capture remedy was based upon the difference between horizontal and vertical ownership issues. However, even states like Texas, which reject a capture analysis in gas storage cases, would permit use of the rule of capture where the gas is not confined in a well-defined reservoir.

(1) If the gas is not being confined in the Bartlesville, and WNG has not formally declared the Squirrel formation for storage purposes, perhaps the Kansas Supreme Court's Anderson analysis would offer an appropriate remedy.

(2) Perhaps, under the facts, the best approach would be to develop an accommodation doctrine that will protect Reese from unreasonable interference in its Squirrel formation activities until WNG decided to actually use the Squirrel for storage activities that are incompatible with continued oil operations.

(3) The accommodation doctrine could also give the oil operator a reasonable period of

time to complete its oil activities once a previously unused formation is approved for storage. If the entity having the gas storage rights didn't want to wait the reasonable period of time, they could acquire that right by purchase or condemnation.

(4) However, the storer would not be acquiring the gas storage rights--they already own them. They would merely be obtaining the right to begin storage activities immediately instead of accommodating the existing oil operations.

F. Leasehold Interest

1. Allocation of royalty in 1949 lease cannot be changed by subsequent pooling statute. Burtner-Morgan-Stephens Co. v. Wilson, 586 N.E.2d 1062 (1992).

a. In 1949 mineral owners entered into oil and gas lease covering a 100-acre tract which provided:

"If the leased premises at any time should be owned in separate parcels this lease nevertheless shall be treated as an entirety, except that royalties or well rentals as to any producing well shall be payable to the owner or owners upon whose respective parcel the producing well is located . . . ."

b. In 1975 the 100-acre tract was divided and sold into numerous parcels. One tract contained 33 acres which was subsequently made part of a 59 acre drilling unit. A producing well was drilled on the 33-acre portion of the drilling unit.

c. The owners of the 33-acre tract assert a right, under their lease, to all the royalty from the well located on their parcel.

d. The trial court held the parties were entitled, by statute, to share in production from the well on a pro rata basis with regard to their acreage contribution to the 59-acre drilling unit.

e. Supreme Court reverses the trial court because the 1960 drilling and pooling statutes cannot operate to alter rights established by the 1949 lease contract.

f. Such action would be a retroactive application of statute that would violate Section 28, Article II of the Ohio Constitution by impairing an obligation of contract.

2. Oil and gas lessee entitled to intervene in action to condemn surface to construct electric transmission line. Grand River Dam Authority v. Brogna, 827 P.2d 901 (Okla. App. 1991).

a. Brogna owned a leasehold interest in a producing oil and gas well on land being condemned by GRDA to construct a power line.

b. Only the surface owner was named in the condemnation action.

c. Brogna asserted a right to intervene because the power line would impair his ability to operate his existing well and the drilling of intended offset wells.

d. The court agrees with Brogna: "A leasehold interest in oil and gas, i.e., the right to enter the surface for purposes of exploration, is in the nature of a property right." Brogna, 827 P.2d at 902.

e. The court permits Brogna to intervene stating: "All owners of the estate being condemned are entitled to be heard and to claim their share of the condemnation money." Brogna, 827 P.2d at 902.

3. Condemnation of surface interest and rights of existing lease holder did not compensate for interference with mineral estate (and subsequent lessee) caused by partial flooding of 80-acre tract. Haupt, Inc. v. Tarrant County Water Control and Improvement Dist. No. 1, 1992 WL 151011 (Tex. App.-Waco July 1, 1992).

a. Mineral interest owners, and current oil and gas lessee, brought inverse condemnation claim against water district when 67 acres of an 80-acre tract were inundated by the filling of a reservoir.

b. The water district had previously condemned the surface estate and the rights of a lessee who had two oil and gas wells on the property.

(1) At the time of the condemnation, the water district:

"[K]new and appreciated the risk of merely condemning the working interest of a lease holder without acquiring the executory rights and cutting off the right of the mineral owner to execute other leases. The Water District knew that under those circumstances it could be faced with having to repeatedly condemn working interests under subsequent leases on the same tract."

(2) The court hammers the Water District attorney for comments contained in his brief suggesting that the Water District would be required to pay twice for the same rights.

(a) "Considering the Water District's own minutes and the admission in its brief, we find that asserting this rationale for the court's ruling borders on contumacy."

(b) "Despite this demonstrated knowledge of the applicable legal principles and being faced with the risk envisioned, counsel nevertheless blatantly assert that requiring the Water District to condemn and pay for Bar J B Company's working interest would not only be a misapplication of public funds but an irrational result."

(c) "Lawyers occasionally resort to hyperbole in defending their client's position. In this instance, however, hyperbole crosses the line between credible argument and knowing misstatement."

c. Finding that an inverse condemnation took place, the court stated:

"Condemnation of the surface did not automatically take or damage the mineral estate as long as the common law right to access the minerals through reasonable use of the surface remained unimpaired. However, if the Water District later damaged the mineral estate by interfering with the right of access without initiating condemnation proceedings, that would constitute a separate taking of the minerals by inverse condemnation."

d. The water district argued that "inundating the surface did not take or damage the minerals because they could be accessed either by directional drilling from the shore or vertical drilling from a platform over the lake."

(1) Several expert witnesses called by the plaintiffs testified that the loss in mineral value caused by the flooding ranged from $1.6 to $3 million.

(2) The Water District's expert estimated the market value of recoverable reserves at $1.2 million to $1.6 million before inundation and "close to zero" afterwards.

4. Frac job that extended beyond lease boundaries would constitute a subsurface trespass. Geo Viking, Inc. v. Tex-Lee Operating Co., 1992 WL 80263 (Tex. April 22, 1992).

a. Tex-Lee hired Geo Viking to perform a frac job on Tex-Lee's oil well in the Austin Chalk Formation. Tex-Lee sued Geo Viking for failing to adequately perform the frac job.

b. At trial the evidence indicated that the frac extended beyond the lease boundaries and into adjacent properties.

c. Geo Viking requested the following jury instruction regarding damages:

"[Y]ou shall not consider or include the value of oil and gas reserves, if any, outside the 80 acre unit that would have been recoverable from the White 1 well because of fracing beyond the boundaries of such unit. [Y]ou shall consider only those reserves that would have been recoverable as a result of fracing within the boundaries of the lease in question."

d. The trial court rejected the instruction and the jury found for Tex-Lee and awarded damages; the court of appeals affirmed the trial court's refusal to grant the instruction, relying upon the rule of capture.

e. Supreme Court reverses the lower courts and remands the case for a new trial noting:

"Fracing under the surface of another's land constitutes a subsurface trespass. . . . Therefore, the rule of capture would not permit Tex-Lee to recover for a loss of oil and gas that might have been produced as the result of fracing beyond the boundaries of its tract."

G. Rule Against Perpetuities

CHAPTER 302

Senate Bill No. 624

AN ACT concerning uniform laws; relating to the uniform commercial code; enacting the uniform statutory rule against perpetuities; enacting the uniform conservation easement act; amending K.S.A. 84-2-403 and K.S.A. 1991 Supp. 84-1-105 and repealing the existing sections; also repealing K.S.A. 84-6-101, 84-6-102, 84-6-103, 84-6-104, 84-6-105, 84-6-106, 84-6-107, 84-6-108, 84-6-109, 84-6-110, 84-6-111 and 84-9-111 and K.S.A. 1991 supp. 58-3803, 58-3804, 58-3805, 58-3806, 58-3807, 58-3808 and 58-3809.

Be it enacted by the Legislature of the State of Kansas:

New Section 1. (a) *Validity of Nonvested Property Interest.* A nonvested property interest is invalid unless:

(1) When the interest is created, it is certain to vest or terminate no later than 21 years after the death of an individual then alive; or

(2) the interest either vests or terminates within 90 years after its creation.

(b) *Validity of General Power of Appointment Subject to a Condition Precedent.* A general power of appointment not presently exercisable because of a condition precedent is invalid unless:

(1) When the power is created, the condition precedent is certain to be satisfied or becomes impossible to satisfy no later than 21 years after the death of an individual then alive; or

(2) the condition precedent either is satisfied or becomes impossible to satisfy within 90 years after its creation.

(c) *Validity of Nongeneral or Testamentary Power of Appointment.* A nongeneral power of appointment or a general testamentary power of appointment is invalid unless:

(1) When the power is created, it is certain to be irrevocably exercised or otherwise to terminate no later than 21 years after the death of an individual then alive; or

(2) the power is irrevocably exercised or otherwise terminates within 90 years after its creation.

(d) *Possibility of Post-death Child Disregarded.* In determining whether a nonvested property interest or a power of appointment is valid under subsection (a)(1), (b)(1) or (c)(1), the possibility that a child will be born to an individual after the individual's death is disregarded.

(e) *Effect of Certain "Later-of" Type Language.* If, in measuring a period from the creation of a trust or other property arrangement, language in a governing instrument (i) seeks to disallow the vesting or termination of any interest or trust beyond, (ii) seeks to postpone the vesting or termination of any interest or trust until, or (iii) seeks to operate in effect in any similar fashion upon, the later of (A) the expiration of a period of time not exceeding 21 years after the death of the survivor of specified lives in being at the creation of the trust or other property arrangement or (B) the expiration of a period of time that exceeds or might exceed 21 years after the death of the survivor of lives in being at the creation of the trust or other property arrangement, that language is inoperative to the extent it produces a period of time that exceeds 21 years after the death of the survivor of the specified lives.

New Sec. 2. (a) Except as provided in subsections (b) and (c) and in section 5(a), the time of creation of a nonvested property interest or a power of appointment is determined under general principles of property law.

(b) For purposes of this act, if there is a person who alone can exercise a power created by a governing instrument to become the unqualified beneficial owner of (i) a nonvested property interest or (ii) a property interest subject to a power of appointment described in section 1(b) or 1(c), the nonvested property interest or power of appointment is created when the power to become the unqualified beneficial owner terminates. For purposes of this act, a joint power with respect to community property or to marital property under the uniform marital property act held by individuals married to each other is a power exercisable by one person alone.

(c) For purposes of this act, a nonvested property interest or a power of appointment arising from a transfer of property to a previously funded trust or other existing property arrangement is created when the nonvested property interest or power of appointment in the original contribution was created.

New Sec. 3. Upon the petition of an interested person, a court shall reform a disposition in the manner that most closely approximates the transferor's manifested plan of distribution and is within the 90 years allowed by section 1(a)(2), (b)(2) or (c)(2) if:

(1) A nonvested property interest or a power of appointment becomes invalid under section 1, statutory rule against perpetuities;

(2) a class gift is not but might become invalid under section 1, statutory rule against perpetuities, and the time has arrived when the share of any class member is to take effect in possession or enjoyment; or

(3) a nonvested property interest that is not validated by section 1(a)(1) can vest but not within 90 years after its creation.

New Sec. 4. Section 1, statutory rule against perpetuities, does not apply to:

(1) A nonvested property interest or a power of appointment arising out of a nondonative transfer, except a nonvested property interest or a power of appointment arising out of (i) a premarital or postmarital agreement, (ii) a separation or divorce settlement, (iii) a spouse's election, (iv) a similar arrangement arising out of a prospective, existing or previous marital relationship between the parties, (v) a contract to make or not to revoke a will or trust, (vi) a contract to exercise or not to exercise a power of appointment, (vii) a transfer in satisfaction of a duty of support, or (viii) a reciprocal transfer;

(2) a fiduciary's power relating to the administration or management of assets, including the power of a fiduciary to sell, lease or mortgage property, and the power of a fiduciary to determine principal and income;

(3) a power to appoint a fiduciary;

(4) a discretionary power of a trustee to distribute principal before termination of a trust to a beneficiary having an indefeasibly vested interest in the income and principal;

(5) a nonvested property interest held by a charity, government or governmental agency or subdivision, if the nonvested property interest is preceded by an interest held by another charity, government or governmental agency or subdivision;

(6) a nonvested property interest in or a power of appointment with respect to a trust or other property arrangement forming part of a pension, profit-sharing, stock bonus, health, disability, death benefit, income deferral or other current or deferred benefit plan for one or more employees, independent contractors or the beneficiaries or spouses, to which contributions are made for the purpose of distributing to or for the benefit of the participants or their beneficiaries or spouses the property, income or principal in the trust or other property arrangement, except a nonvested property interest or a power of appointment that is created by an election of a participant or a beneficiary or spouse; or

(7) a property interest, power of appointment or arrangement that was not subject to the common-law rule against perpetuities or is excluded by another statute of this state.

New Sec. 5. (a) Except as extended by subsection (b), this act applies to a nonvested property interest or a power of appointment that is created on or after the effective date of this act. For purposes of this section, a nonvested property interest or a power of appointment created by the exercise of a power of appointment is created when the power is irrevocably exercised or when a revocable exercise becomes irrevocable.

(b) If a nonvested property interest or a power of appointment was created before the effective date of this act and is determined in a judicial proceeding, commenced on or after the effective date of this act, to violate this state's rule against perpetuities as that rule existed before the effective date of this act, a court upon the petition

of an interested person may reform the disposition in the manner that most closely approximates the transferor's manifested plan of distribution and is within the limits of the rule against perpetuities applicable when the nonvested property interest or power of appointment was created.

New Sec. 6. This act may be cited as the uniform statutory rule against perpetuities.

New Sec. 7. This act shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this act among states enacting it.

New Sec. 8. This act supersedes the rule of the common law known as the rule against perpetuities.

II. CONVEYANCES

A. The Duhig Problem

1. Burden created by prior royalty conveyance must be satisfied out of grantor's mineral interest. Acoma Oil Corp. v. Wilson, 471 N.W.2d 476 (N.D. 1991).

   a. 1915 Moen obtained fee simple title to 160-acre tract.

   b. 1937 Moen conveyed a 6.5% royalty in oil and gas produced from the 160-acre tract.

   c. 1944 Moen conveyed and warranted 160-acre tract to Wilson.

   d. 1952 Wilson conveyed and warranted to Leach, by separate mineral deeds, an undivided 35/320th and 5/320th interest in all the oil and gas "in and under" the tract.

      (1) Each deed contained a warranty clause and stated the grantors intent to convey 35 and 5 "mineral acres".

      (2) Neither deed indicated the conveyed interest was burdened by the 6.5% royalty interest.

      (3) The grantee had a title opinion prepared at the time of purchase which noted the outstanding 6.5% royalty interest.

e. Subsequent conveyances from Leach to United and from United to Acoma did not refer to the 6.5% royalty.

f. Dispute over whether the 6.5% royalty is a proportionate burden on all the mineral interests or solely burdens the Wilson interest.

g. Supreme Court holds the 6.5% royalty is a burden solely against the Wilson interest.

h. Court states:

"Like Duhig, in cases where a grantor conveys some mineral interests while keeping some mineral interests in the same tract of land without an explicit reservation, the focus is on whether or not the grantor has enough mineral interests in that tract of land to satisfy the conveyance. . . . We believe that result follows under our law even though the Wilson parents' minerals deeds did not contain a specific reservation clause because 'a grant [without a reservation] shall be interpreted in favor of the grantee' [Section 47-09-13, N.D.C.C.] and 'a conveyance of land, without any exception or reservation of the minerals constitutes a conveyance of 100 percent of the minerals as well as the surface.'" 471 N.W.2d at 482.

i. With regard to the grantee's knowledge concerning the 6.5% royalty, the court states:

"Leach's [grantee's] actual or constructive knowledge of the outstanding 6.5% royalty does not diminish the Wilson parents' warranty because the risk of title loss is on the grantor. . . . We conclude that Duhig and our previously cited statutory provisions govern this case." 471 N.W.2d at 482.

j. Court also notes that the production purchaser could be protected from a claim for a greater interest when the interest owner had signed a division order authorizing payment after deducting a proportionate share of the 6.5% royalty. Remedy is for underpaid interest owner to seek recovery from the overpaid interest owner, not the purchaser.

(1) Purchaser only protected while the division order is in effect.

(2) If division order is not signed, it will not protect the purchaser.

B. Delivery

1. When father gave executed mineral deed to son for recording, delivery was complete and operated as a valid conveyance of real estate. Carlile v. Carlile, 830 P.2d 1369 (Okla. 1992).

a. September 12, 1968 Paul Carlile (father) executed a mineral deed and two warranty deeds and gave them to J.C. Carlile. The warranty deeds were filed for record one on May 8, 1969 and the other on October 9, 1973. The mineral deed was never filed for record.

b. Paul Carlile died August 15, 1973. Apparently the deeds had been given to J.C. for recording in 1968. Later, in 1973, Paul got upset with his son Jack, who was one of the mineral deed grantees, and Paul asked J.C. not to record the deed unless Jack divided his mineral interest with the other kids.

c. Court held the deed had been delivered.

(1) Court noted the basic rules:

(a) "Delivery of a deed is essential in order to pass title."

(b) "A valid delivery occurs only when the grantor parts with dominion over the deed with the intention to pass title." Carlile, 830 P.2d at 1371.

(2) "The father's subsequent decision to take the mineral deed back is irrelevant to his initial intention concerning delivery."

(3) "When the owner of land executes a deed during his lifetime and delivers it to a third party who acts as a depository, intending at the time of the delivery to forever part with all lawful right and power to retake or repossess the deed, the delivery to the third party is sufficient

to operate as a valid conveyance of real estate." Carlile, 830 P.2d at 1372.

C. Future Lease Clause

1. Court gives effect to future lease clause in interpreting effect of a royalty conveyance. Luckel v. White, 819 S.W.2d 459 (Tex. 1991).

   a. In 1935 Mary Etta Mayes executed a royalty deed to L.C. Luckel, Jr. At the time the minerals were leased to Coe. The deed provided, in part:

   [Granting Clause]

   "I, Mary Etta Mayes . . . [convey to] L.C. Luckel, Jr. an undivided one thirty-second (1/32nd) royalty interest in and to the following described property . . . ."

   [Habendum Clause]

   "TO HAVE AND TO HOLD the above described 1/32nd royalty interest . . . unto the said L.C. Luckel, Jr. his heirs and assigns forever . . . ."

   [Present Lease Clause]

   "It is understood that said premises are now under lease originally executed to one Coe and that the grantee herein shall receive no part of the rentals as provided for under said lease, but shall receive one-fourth of any and all royalties paid under the terms of said lease."

   [Future Lease Clause]

   "It is expressly understood and agreed that the grantor herein reserves the right upon expiration of the present term of the lease on said premises to make other and additional leases . . . and the grantee shall be bound by the terms of any such leases . . . [and] shall be entitled to one-fourth of any and all royalties reserved under said leases."

[Previous Conveyance Clause]

"It is understood and agreed that Mary Etta Mayes is the owner of one-half of the royalties to be paid under the terms of the present existing lease, the other one-half having been transferred by her to her children and by the execution of this instrument, Mary Etta Mayes conveyed one-half of the one-sixteenth (1/16th) royalty <u>now reserved by her.</u>"

b. The Coe lease expired and subsequent leases were entered into that provided for a 1/6th royalty.

   (1) Issue is whether Luckel is entitled to a 1/32nd royalty or a 1/24th royalty.

   (2) 1/24th would equal 1/4 x 1/6.

c. The court held the deed was unambiguous.

d. If the court applied the reasoning of <u>Alford v. Krum</u>, 671 S.W.2d 870 (Tex. 1984), the future lease clause would be deemed "repugnant" to the granting clause and the granting clause would control: Luckel would be entitled to a 1/32nd royalty.

e. The court expressly overrules <u>Alford</u> and holds the fundamental rule of construction is the "four corners" rule which ascertains the parties' intent from a consideration of <u>all</u> the language in the deed.

   (1) "The court, when seeking to ascertain the intention of the parties, attempts to harmonize all parts of the deed."

   (2) The court holds: "The provisions of the deed are harmonized by construing the grant to be of a 1/32nd interest (or one-fourth of the reserved royalty under the existing lease) until the existing lease expired. The interest conveyed was an undivided one-fourth of the total reserved royalty interest, which applied to future leases. . . . The proper way to harmonize the provisions of the Mayes-Luckel deed . . . is to hold that upon the termination

of the Coe lease, Luckel owns an undivided one-fourth of the reserved royalty in all future leases."

f. Four justices dissented stating: "Construing the deed as a whole, I would conclude that the parties intended the future-lease clause merely extend the effect of the grant of a permanent 1/32nd royalty interest to future leases."

2. Court gives effect to future lease clause in interpreting effect of a mineral conveyance. Jupiter Oil Co. v. Snow, 819 S.W.2d 466 (1991).

a. In 1918 Henderson owned all of the minerals which were subject to an oil and gas lease held by State Oil Corporation and providing for payment of a 1/8th royalty.

b. On September 27, 1918 Henderson conveyed a portion of their mineral interest to Joseph M. Weaver. The deed provided, in part:

[Granting Clause]

"[Henderson conveys] all that certain undivided 1/16 interest in and to all the oil, gas, and other minerals of whatsoever kind and character in and under the following described lot . . . ."

[Present Lease Clause]

"In the event the lease now on said land is forfeited or terminated without producing mineral of any kind, then the grantee herein or his assigns are to have and hold under this conveyance an undivided 1/2 of all the oil, gas or other mineral of whatsoever kind character in and under the land herein described, and it is the intention of the grantors herein that in the event said lease is forfeited, then in that event the grantee is to have and hold an equal undivided one half of all such minerals."

c. Court holds the deed granted:

(1) "Immediately" a 1/16th interest in the mineral estate; and

(2) "Upon termination of the States lease" the grantee's interest in the mineral estate

"expanded into a full one-half by operation of law." Jupiter, 819 S.W.2d at 469.

d. Court held the deed was unambiguous and therefore the court of appeals erred when it resorted to rules of construction.

(1) Such as the Alford repugnant to the grant rule of construction.

(2) Court states: "Although we hold Alford to be inapplicable, we note that it has been overruled this date in Luckel v. White, 819 S.W.2d 459 (Tex. 1991)."

(3) The mineral deed in Jupiter is much more like the mineral deed in Alford than the royalty deed that was the subject of Luckel. See Justice Hecht's concurring opinion in Jupiter at 819 S.W.2d at 469.

e. Couldn't you argue that once the lease terminated that the grantee owned 9/16ths of the minerals (1/16 + 1/2)?

D. Executive Rights

1. Conveyance of right to receive bonus and delay rental does not imply conveyance of the executive right (power to execute leases). Antelope Production Co. v. Shriners Hospital for Crippled Children, 464 N.W.2d 159 (Neb. 1991).

a. Deed provided, in part:

"Grantor expressly reserving unto themselves an undivided one-half interest in the oil, gas and other minerals . . . provided however, grantee, its successors and assigns, shall have the right to have an receive all of the bonuses and delay rentals which may result from the oil and gas leases executed on an after August 12, 1960 . . . ."

b. Issue was whether the grantor or the grantee held the executive rights with regard to the reserved one-half mineral interest.

c. Court notes that in Texas and Mississippi the grantor would have the executive rights since

they were not expressly conveyed away from the mineral interest. However, in Oklahoma the executive rights would pass to the grantee by implication from the grant of bonus and delay rental.

d. Court notes:

"It is generally recognized that there are four distinct incidents to ownership of a mineral estate which relate to leases. These are the right or power to lease (the executory right), the right to bonuses, the right to delay rentals, and the right to royalties. . . . These rights may be separately alienated." 464 N.W.2d at 161.

e. Court adopt the approach followed by Texas and Mississippi noting:

"This approach is consistent with the provisions of Neb. Rev. Stat. § 76-104 (Reissue 1990), which states that an otherwise effective conveyance of property transfers the entire interest of the grantor unless an intent to transfer a lesser interest is effectively manifested, and with the provisions of Neb. Rev. Stat. § 76-106 (Reissue 1990), that an otherwise effective reservation of property by the grantor reserves the interest the grantor had prior to the conveyance unless and intent to reserve a different interest is effectively manifested." 464 N.W.2d at 162.

f. The court holds: "[T]hat the executory right as to the grantor's undivided one-half interest remained with that interest and was not transferred to the grantee incident to the grant of the rights to bonuses and delay rentals. Shriners Hospital, as a successor in interest to the grantor, holds the executive power for its interest." 464 N.W.2d at 162.

2. Executive who leased to family corporation on terms unfavorable to the non-executive breached fiduciary duty owed to the non-executive. Dearing, Inc. v. Spiller, 824 S.W.2d 728 (Tex. App.--Fort Worth 1992).

a. In 1943 Haag conveyed a 600-acre tract to Dearing reserving to Haag an undivided 1/2 mineral interest and also granting to Dearing

"the exclusive right to execute leases on the minerals provided that the royalty reserved was 'no . . . less than the usual one eighth (1/8) royalty.'"

b. Dearing subsequently leased the land to a family-owned corporation providing for no bonus and a 1/8th royalty.

c. Dearing had previously received offers to lease the property, one was for a $100/acre bonus, a 1/4th royalty, and a continuous drilling clause.

d. Court notes that the Texas Supreme Court has applied the standard of "utmost good faith" to the executive relationship and has specifically equated the utmost good faith standard with a fiduciary obligation.

e. Court holds: "Dearing has a duty to manage the executive interest by obtaining the highest royalty possible, and was likewise prohibited from self-dealing." Dearing, 824 S.W.2d at 733.

(1) "[M]ust exact for the non-executive every benefit that he exacts for himself."

(2) However, court states:

> "We do not mean to imply that an executive is barred, as a matter of law, from developing the premises himself. However, when the market value of a lease is so much greater than the terms the executive grants to himself, this is clear evidence of a breach of his duty of utmost good faith." Dearing, 824 S.W.2d at 734.

(3) No defense that Dearing relied upon the advice of counsel.

f. Exemplary damages are proper against a fiduciary who has been guilty of unfair self-dealing.

(1) Jury awarded $300,000 in punitive damages against each defendant.

(2) Court notes: "The malicious breach of a fiduciary duty will support an award of

exemplary damages. . . . Furthermore, there was evidence here from which a jury could conclude that the breach was malicious." Dearing, 824 S.W.2d at 734.

3. Mineral interest owner who leased to son on terms unfavorable to the royalty interest owner breached fiduciary duty owed to the royalty interest owner. Mims v. Beall, 810 S.W.2d 876 (Tex. App.-Texarkana 1991).

   a. In 1947 Beall sold 200-acre tract to Mims retaining an undivided 1/4th non-participating interest in the royalties obtained through leasing the tract.

   b. In 1979 the area became a "hot prospect" and Mims leased to their son, Angus Mims, for a 1/8th royalty with no cash bonus. Angus then assigned the lease to Henderson Clay Products, Inc. in return for a 1/16th overriding royalty.

   c. Beall asserted this leasing action constituted a breach of duty owed by Mims to Beall. The jury awarded Beall actual and punitive damages against Mims and their son. The trial court also imposed a constructive trust on 1/4th of the 1/16th overriding royalty interest owned by Angus Mims.

   d. Court holds that a fiduciary relationship applies in this case, even though "the executive controls only the amount of the royalty interest" instead of "the royalty interest and the bonus and delay rentals."

      (1) Distinguish Pickens v. Hope, 764 S.W.2d 256 (Tex. App.-San Antonio 1988, writ denied), where the court refused to apply a fiduciary standard when the non-executive was entitled to 1/4th of any production from the property.

      (2) "[I]n Pickens there was no duty to manage the non-participating royalty interest because the amount of that royalty was specifically set out as 1/4 and could not be altered . . . ." Mims, 819 S.W.2d at 879.

e. In defining the scope of the fiduciary duty, the court notes:

"[T]he fiduciary duty is owed only in the area of the executive interest owner's duty to obtain appropriate benefits for the non-participating royalty holders. Furthermore, in Manges, the Supreme Court does not apply the customary standard that the fiduciary must subordinate its own interest to those of the non-participating interest owner, but instead charges the fiduciary with acquiring for the non-executive every benefit that he exacts for himself." Mims, 810 S.W.2d at 879.

f. Court holds the Mims breached their duty and Angus Mims, although not owing a fiduciary duty to Beall, was liable for inducing or participating in the executive's breach of duty.

(1) "This participation or inducement to breach contractual obligations is similar in nature to an action for tortious interference with contractual relations. So long as the lessee maintains an arm's length position in the transaction, he does not owe a fiduciary duty or a duty of utmost good faith to the owner of a non-executive interest."

(2) "If, however, the lessee agrees with the executive to an arrangement made for the purpose of excluding or minimizing the benefits of an outstanding or non-participating interest owner, the lessee can be held liable to the injured third party." Mims, 810 S.W.2d at 880-81.

(3) The court holds there was sufficient evidence for the jury to infer that Angus knowingly participated in a breach of duty owed to the Bealls.

(4) NOTE: Court states that "Angus Mims was put on constructive notice of the reservation of the 1/4 non-participating royalty held by the Bealls because the lease had been filed with the county clerk." Mims, 810 S.W.2d at 881.

(5) Court upholds imposition of a constructive trust on 1/4th of Angus' 1/16th overriding royalty--based upon "breach of fiduciary duties.". Mims, 810 S.W.2d at 881.

(6) Court upholds imposition of punitive damages for "the malicious breach of a fiduciary duty."

4. Trial court properly appointed a receiver to exercise executive rights. Hawkins v. Twin Montana, Inc., 810 S.W.2d 441 (Tex. App.-Fort Worth 1991).

a. Shoemate (Hawkins) owned the surface, right to execute oil and gas leases, and the right to receive all bonus and delay rentals in a large tract--except for a 40-acre tract in which Twin Montana owned a 12.5% non-executive mineral interest.

b. The executive rights owner had the following lease offers:

(1) Primary term: 2 Years
Royalty: 1/8
Bonus: $100/acre
Surface Damages: $3,000

(2) Primary term: 1 Year
Royalty: 1/4
Bonus: $100
Surface Damages: $500

c. The executive entered into lease #(1) after suit was filed but before a receiver was appointed.

d. Court affirms trial court's holding that the executive failed to adequately protect the non-executive's interests and breached their fiduciary duty by entering into the lease.

e. Court notes:

"[Executive does] not have a duty to sacrifice their desire to protect the surface of the land, and they would be entitled to negotiate the best surface protection possible as long as they maintained good faith in their consideration of the royalty owners. The Jones lease [#(1)] contains a more generous payment for surface damages, but we cannot say the

trial court erred in holding appellants were not acting in good faith when they accepted a one-eighth royalty instead of a one-fourth royalty." Hawkins, 810 S.W.2d at 446.

E. Unitization Agreements

1. Impact on oil and gas lease. Akandas, Inc. v. B. W. Klippel, 250 Kan. 458, 827 P.2d 37 (1992).

2. In 1975 the lessee of 13 leases covering a contiguous block of acreage circulated a document titled "Unitization Agreement" and obtained the signature of all the lessors to form the "Buffalo Field Unit."

   a. The Agreement allocated a share of production to each tract owner and recited that "the unitized management, operation and further development of the Buffalo Field Unit is economically feasible and reasonably necessary to prevent waste . . . ."

   b. However, the Agreement did not contain any provisions concerning how unit development would be conducted, nor did it state whether production from within the unit area would maintain all leases encompassed by the Agreement.

3. At the time the unit was formed there were producing wells on each of the 13 leases comprising the unit area.

4. In 1989 several of the mineral interest owners brought suit contending that as production ceased from any of the 13 leases they would terminate by the express terms of their habendum clause.

5. Since the Unitization Agreement failed to modify the individual habendum clause of each lease, the mineral interest owners argued that the lease habendum clause would define the duration of the lessee's rights in the lease.

6. The Kansas Supreme Court rejects the mineral interest owners' argument and holds that "absent an express agreement to the contrary, production within the unit will perpetuate the individual leases within the unit."

7. The Court, promoting what it perceives to be oil and gas conservation interests, refuses to interpret the Agreement strictly against the lessee and in favor of the lessor, but instead finds that the Unitization Agreement impliedly modified the habendum clause of each lease included in the unit.

8. In an effort to define the duration of the Unit Agreement, the Court holds that "the agreement must be read in conjunction with the leases" and therefore the agreement "has the same termination date as the leases."

9. The Court concludes its analysis on this issue stating: "The plaintiffs do not have the authority to terminate the Klippel Agreement so long as any lease in the unit is producing oil or gas pursuant to the terms of the applicable lease."

10. It is not clear whether this means that the unit will continue in effect so long as any single lease is producing in paying quantities or whether paying production will be measured by comparing total unit production with total unit expenses.

11. This is an issue of first impression.

    a. In previous cases addressed by the courts, the issue concerned the *scope* of clauses, statutes, and pooling orders which expressly state that leases included in the unit area would be perpetuated beyond their stated term.

    b. The Akandas case is the first to address the issue when the unit agreement is silent concerning its duration and impact on the habendum clauses of leases included in the unit.

    c. Instead of adopting an interpretive rule that would resolve any doubt in favor of the express terms of the oil and gas lease, the Court relies upon perceived conservation goals as an interpretive guide.

    d. The Court suggests that the lessors' remedy in such cases, at least in Kansas, is not through contract interpretation but rather through direct attacks on the unit operator's performance under theories such as bad faith unitization, failure to produce in paying quantities, or breach of implied lease/unit

obligations.

III. OIL AND GAS LEASE ISSUES

A. Commencement Clause and the Habendum Clause

1. Unique commencement clause was satisfied by lessee's minimal development activities. Petroleum Energy v. Mid-America Petroleum, 775 F. Supp. 1420 (D. Kan. 1991).

2. By an oil and gas lease dated December 26, 1979 Williams leased to Mid-America; the primary term of the lease would expire on December 26, 1984. However, if the lessee "shall commence to drill a well" within the primary term, the lessee would have the right to complete the well and maintain the lease so long as oil or gas was produced in paying quantities.

3. The lease was unique in that it specifically defined "commence to drill a well" to include:

   "[W]hen the first material is placed on the leased premises, or when the first work, other than surveying or staking the location, is done thereon which is necessary for such operations . . . ."

4. Mid-America took the following action on the indicated date:

December 17, 1984	Staked the well location.
December 19, 1984	Intent to drill filed with Kansas Corporation Commission.
December 22, 1984	Dirt contractor hired to prepare site for drilling rig. Contractor worked on site from December 22 to January 8, 1985.
December 26, 1984	Filed an "affidavit of commencement of drilling operations" with the Register of Deeds.
December 28, 1984	Drilling contract signed.
December 30, 1984	Drilling rig moved on location.
January 3, 1985	Drilling operations commenced.

5. On December 28, 1984 Williams entered into an oil and gas lease covering the same property with Petroleum Energy Inc. (PEI).

6. On January 2, 1985 PEI obtained a restraining order enjoining Mid-America from further work at the lease site.

7. The court holds the Williams/Mid-America lease had not expired at the time PEI obtained its lease on the property.

   a. The court found that the preparatory actions taken on the leased land satisfied the commencement clause of the Williams/Mid-America lease.

   b. Although the court could have based its opinion solely on the express language of the lease, it chose to evaluate the lease as though it did not contain the specific language defining commencement of drilling operations.

8. The court fails to analyze Kansas Supreme Court cases on the subject but instead adopts the basic rule that "preparatory work prior to the actual drilling of a well," when pursued with "reasonable diligence," meets the commencement requirement.

   a. Although this is the law in many states, it is arguably not the law of Kansas. *See, e.g.,* Phillips v. Berg, 120 Kan. 446, 243 P. 1054 (1926) (court held that activities on the property preparatory to drilling a well were not "commencement of operations").

   b. Although the court holds that the Williams/Mid-America lease is still in effect, and the Williams/PEI lease is invalid, the court also holds Mid-America failed to prove any damages arising out of the top lease and restraining order.

   c. The court rejects Mid-America's breach of warranty, slander of title, trespass, conspiracy, and tortious interference claims. The court finds that Williams and PEI acted without malice in a "good faith belief by PEI that the 1984 lease was valid."

9. It would seem that the express language in the oil and gas lease defining "commencement" could arguably support a slander of title claim.

a. In such a case, third parties would not need to resort to the more nebulous case law definitions of "commencement" to determine if the lease was still in effect.

b. They would merely need to read the recorded lease and determine whether "material" had been taken to the leased premises or "work," other than surveying or staking, was taking place on the lease.

10. It is difficult to understand why the court bothers to discuss the commencement issue since the oil and gas lease specifically states that commencement can include actions that are something less than actual drilling.

a. The court's subsequent discussion of the rules governing the commencement issue fail to consider the Kansas cases, cited in the court's opinion, which suggest that absent special language in the lease pre-drilling activities are not a sufficient "commencement" of operations.

b. The court instead relies on several Oklahoma cases which take perhaps the most liberal view of what constitutes commencement.

c. In attempting to distinguish one of the more recent Kansas cases on the issue, Herl v. Legleiter, the court notes that here the lessee had made "arrangements" to get a drilling rig "by the last day of the primary term of the lease."

(1) However, the facts in the opinion indicate that a drilling *contract* was not signed until December 28, 1984--two days after the lease primary term expired.

(2) It is arguable that as of December 26, 1984 the lessee had not made the sort of unambiguous and irrevocable commitment to actually drill on the lease that is required by the Kansas commencement cases.

(3) Up until December 28, when the drilling contract was signed, the lessee had a minimal investment in the property--when compared to the cost of drilling a well on the property.

(4) Therefore, if the lease had not contained express language authorizing something less than actual drilling, the lease, under Kansas law, arguably terminated.

11. Although not critical to this decision, the court found that the lessee had until the end of the day of December 25, 1984 to commence drilling.

a. It would appear that if the lease was entered into on December 26, 1979, and would continue for five years from that date, it would terminate at the end of the day on December 26 instead of December 25.

b. Although Mid-America won on the lease issue, its victory was a hollow one since the court holds that Mid-America failed to prove it had been damaged by PEI's actions.

(1) Since the well was never drilled, Mid-America had the difficult task of proving lost profits from a well that might have been a dry hole.

(2) The court looks to Texas law for guidance on the evidence required to prove lost profits on an undrilled oil and gas well and adopts the approach of the court in County Management, Inc. v. Butler, 650 S.W.2d 888 (Tex. Civ. App. 1983).

(3) The evidence requires expert testimony concerning geology, production costs, and other matters that relate to the probability of obtaining production from the property.

(4) Mid-America offered the testimony of its office secretary who testified about production from two "nearby" wells. This didn't meet the Butler standard of proof.

B. Commencement Clause and Drilling Permits

1. In Texas a drilling permit is not required in order to meet the commencement provisions of an oil and gas lease. Gray v. Helmerich & Payne, Inc., Case No. 07-91-0233-CV, 1992 WL 168529 (Tex. App.--Amarillo July 21, 1992).

2. Gray entered into an oil and gas lease on 14 June 1976 with a primary term that would end on 14 June 1981.

3. The lease provided: "[I]f lessee commences mining, drilling or reworking operations . . . at any time while this lease is in force, this lease shall remain in force . . . ."

4. The lessee engaged in the following activities:

   a. 9 June 1981, pooling agreement entered into by lessees.

   b. 11 June 1981, drill site leveled.

   c. 12 June 1981, applied with Texas Railroad Commission for a drilling permit.

   d. 13 June 1981, constructed road to drill site and installed cattle guard.

   e. 6 July 1981, drilling permit issued by Commission.

   f. 15 July 1981, actual drilling began--resulting in a dry hole.

5. Gray brought suit for trespass and damages.

6. Parties stipulated that the work performed prior to the end of the primary term was sufficient to meet the terms of the lease, and the only issue was whether a drilling permit must have been obtained prior to the end of the primary term.

   a. Texas law requires a permit before drilling can lawfully begin.

   b. Michigan case of Goble v. Goff, 327 Mich. 549, 42 N.W.2d 845 (1950) requires that a drilling permit be obtained prior to end of primary term to meet the commencement requirement--even though the lessee is engaged in actual (but unlawful) drilling.

   c. Court refuses to follow the Michigan case.

   d. Unless the lease requires that a drilling permit be obtained prior to drilling, the Commission's rule did not incorporate the

drilling permit requirement into the lease.

e. "[O]btaining the drilling permit was not a prerequisite to the preliminary drilling operations which, the parties agreed, otherwise perpetuated the Grays' lease beyond its primary term."

C. Paying Quantities; Cessation of Production; Shut-In Royalty

1. Shut-in royalty payment would not perpetuate lease that ceased producing in paying quantities beyond time-frame specified in cessation of production clause. Fisher v. Grace Petroleum Corp., 830 P.2d 1380 (Okla. App. 1991), cert. to Okla. Sup. Ct. denied May 19, 1992.

2. The court holds that the Morlan No. 1-25 well did not produce in paying quantities because during the 12-month period immediately prior to lessor's demand for a release the well did not generate sufficient revenue to cover lifting costs.

   a. Trial court properly refused to consider production obtained from the well following the demand for a release "in this case". 830 P.2d at 1386.

   b. Trial court properly refused to consider a 5-year period of time to determine the paying quantities issue. 830 P.2d at 1386.

   c. Court holds the 12-month period immediately prior to the lessor's demand for a release was a reasonable period of time to reflect the status of the well. "The appropriate time period for determining profitability is a time appropriate under all the facts and circumstances of each case." 830 P.2d at 1386.

3. Impact of cessation clause on the appropriate time period. Dicta.

   a. Court notes that some of the leases covering the well had a 60-day cessation clause; others had a 6-month cessation clause.

   b. "[Lessors] contend the 12-month period far exceeded the 6-month and 60-day temporary cessation of production provisions found in the

leases as further evidence that the 12-month period was reasonable in this case. We agree." 830 P.2d at 1386.

c. "Under the leases here in question, the failure of the well to produce in paying quantities for the time period specified in the temporary cessation clauses, terminated the leases." 830 P.2d at 1386.

4. Impact of shut-in status of the well during the selected accounting period.

a. During the one-year accounting period applied by the court to determine paying quantities, the well was shut-in for periods of up to 3 months.

b. The lessees argued that periods of time during which the well was shut-in should not be considered in calculating paying quantities.

c. Court holds it need not address this issue because the well was <u>not a shut-in well</u> because it was not "capable of production in paying quantities."

d. "A well which is incapable of production in paying quantities cannot be considered 'shut-in' as that term is used in a shut-in royalty clause and is insufficient to hold the lease under the habendum clause." 830 P.2d at 1388.

5. Effect of cessation of production clause. The leases involved contained the following types of cessation clause:

TYPE A:

"Should production from the above described land . . . cease from any cause after the expiration of the primary term this lease shall not terminate provided lessee succeeds in bringing back production within six (6) months from such cessation or within such six (6) month period commences drilling another well on the above described land or on land pooled therewith . . . ."

TYPE B:

"[I]f, after discovery of oil, liquid hydrocarbons, gas or their respective constituent

products, or any of them, the production thereof should cease from any cause, this lease shall not terminate if lessee commences reworking or additional drilling operations within sixty (60) days thereafter . . . ."

a. Temporary cessation doctrine does not apply when the lease contains a specific clause addressing cessation.

b. "Production" as used in the cessation clause means production in paying quantities.

"Because 'production' requires production in paying quantities, the fact that the well actually produced some gas within the time period specified in the temporary cessation clause will not necessarily save the lease." 830 P.2d at 1387.

6. Lessees contended "the physical 'capability' or possibility that a well may produce in paying quantities is sufficient to maintain an oil and gas lease under the terms of the habendum clause after the expiration of the primary term."

a. Court distinguishes cases that give the lessee a reasonable period of time after production is obtained to actually produce and market from the well.

b. Court notes:

"Those cases stand for the proposition that to extend the primary term of a 'completion' type oil and gas lease by production, it is sufficient if the lessee has completed a well within the specified primary term and the well is capable of producing oil or gas in paying quantities. Provided, lessee must within a reasonable time thereafter, obtain a market for the oil or gas and produce and sell such oil or gas. After such marketing has occurred, the *production and marketing* must continue in paying quantities with the privilege of temporary cessation of production." 830 P.2d at 1387.

c. "Capability alone does not operate to suspend the application of this temporary cessation clause which operates when a well ceases production in paying quantities for any cause

for longer than the provided time." 830 P.2d at 1388.

7. Lessor did not need to make any prior demand on lessee to obtain the requisite production. Demand and an opportunity to cure not necessary since the leases would terminate automatically--by their express terms.

8. Lessor also asked for damages arising out of lessee's alleged breach of the implied covenant to market.

   a. Assert lessee failed to renegotiate a gas contract to obtain the same deal as was obtained for an adjacent well operated by the lessee.

   b. Main issue was whether the lessee should have installed a compressor on the lease, like they did on the adjacent lease. However, the purchaser wanted to lessee to forego and take-or-pay obligations under the new contract and extend the contract for the life of the lease.

   c. Court holds the trial court properly found that no breach of the implied covenant had been established.

9. Trial court ordered that lessee plug the well; lessor appealed asserting a right to pay the salvage value of the equipment, etc. in the well and take over its operation.

   a. Lease gave lessee the right to remove the equipment and casing from the well.

   b. Note there is not Oklahoma law on the issue; but Texas cases have permitted the lessor to take over the well by paying the reasonable value of the equipment, etc. in the well.

      (1) Court notes that Texas cases based in part upon public policy in obtaining the reserves that would otherwise be lost.

      (2) Court holds:

      "[A] lessee may, under certain circumstances, be denied the right to pull casing from a well which has ceased production in paying quantities if there

is sufficient geological and engineering evidence to indicate that the well could be made capable of production in paying quantities." 830 P.2d at 1392.

c. Court holds for lessee on this issue stating:

"On the basis of the evidence before us, we do not believe [lessors] presented sufficient evidence that the Morlan No. 1-25 well could be made capable of production in paying quantities and probably would produce in paying quantities. Accordingly, we find no error by the trial court in ordering [lessees] to remove equipment and plug the well." 830 P.2d at 1392.

(1) Recoverable reserves left in the well were estimated at 500 to 600 million cubic feet.

(2) Profitable production depended upon installation of compressor and renegotiation of a gas contract.

d. Court does not address the lessee's plugging and environmental liabilities.

D. Impact of Horizontal Pugh Clause

1. Court interprets depth limit created by horizontal Pugh clause. Sandefer Oil & Gas, Inc. v. Duhon, 961 F.2d 1207 (5th Cir. 1992).

2. The clause provided:

"After expiration of the primary term, this lease will terminate automatically as to all horizons situated 100 feet below the deepest depth drilled (a) from which a well located on the land or acreage pooled therewith is producing in paying quantities, or (b) in which there is completed on the land or acreage pooled therewith a shut-in gas well which cannot be produced because of lack of market, marketing facilities, or because of governmental restrictions, whichever is the greater depth."

3. Before the expiration of the primary term the Marceaux No. 1 well was drilled to a total depth of 17,609 feet, but production was obtained from the Middle Miogyp formation which is found at a depth

between 17,100 and 17,250 feet.

4. At the end of the primary term the lessees tendered to lessors a release of all depths below 17,700 feet. The lessors rejected the release asserting they were entitled to a release of all depths below 17,350 feet.

5. Court holds the lessee is entitled to depths measured from the bottom of the sand from which the well is producing, not the depth to which the well was drilled.

   a. Court relies upon the basic purpose of the Pugh clause--requiring development to maintain all portions of the lease.

   b. In the clause the word "depth" has three modifiers: "deepest," "drilled," and "from which a well . . . is producing."

   c. "One must not only drill, under this clause, but one must produce." 961 F.2d at 1210.

6. To determine the depths to which the lessee is entitled, the court interprets the word "horizon" and holds lessee is entitled to "100 feet below the bottom of the Middle Miogyp, at whatever depth it is found throughout the leased tract." 961 F.2d at 1211.

   a. Therefore, the bottom of the Miogyp, regardless of its vertical depth from the surface, will determine the lessee's rights. The "stratigraphic equivalent" of the depth as measured in the Marceaux No. 1 well.

   b. To the extent that the Lower Miogyp is found within 100 feet of the Middle Miogyp, the lessee may still have an interest in the pooled production from the Lower Miogyp.

E. Paying Quantities: Depreciation 840 S.W.2d 500 19

1. Only actual royalty expense and actual depreciation can be considered in calculating paying quantities. Evans v. Gulf Oil Corp., Case No. 13-91-008-CV, 1992 WL 111599 (Tex. App.--Corpus Christi May 29, 1992).

2. Lessors asserted lessee failed to produce in paying quantities from January 1981 through April 1982 and

June 1983 through December 1984, and therefore their lease had terminated.

3. Court restates the basic Clifton v. Koontz analysis:

   a. Two-step analysis:

      (1) Whether the production yields a profit after deducting operating and marketing costs (if it does, stop, the lessor loses, if it does not, go to step 2);

      (2) Whether a prudent operator would continue, for profit and not for speculation, to operate the well as it has been operated. ["'Whether there is a reasonable expectation of profitable returns from the well is the test.'"]

   b. "To terminate a lease the landowner must show both (1) and (2)."

4. Trial court properly refused to consider what the royalty expense would have been had the lessee qualified it for NGPA § 108 stripper well pricing.

   a. Look to the actual royalty incurred; not what it might have been under different circumstances.

   b. In any event, had the well qualified for § 108 pricing the lessee would have enjoyed 7/8ths of the increased revenue.

5. Based upon a valuation of the lessee's compressor, the lessor's expert witness allocated $5,066.56 in compressor depreciation during the first period and $5,099.98 for the second.

6. Court refuses to permit lessor to use a "bookkeeping" value for depreciation; instead, lessor must prove actual depreciation.

   a. "For example, in a pumping well the lessee may be using some equipment which has been 'written off' completely and on which lessee is no longer taking any depreciation. Still that piece of equipment may have a current salvage value. To some extent continued operations are wearing out that equipment and reducing its salvage value."

b. This "physical" depreciation can be charged as a lifting expense--to the extent the lessor can present proof of "the cost of the particular equipment and its rate of depreciation."

7. Court rejects the lessors depreciation argument for lack of proof.

a. Compressor was originally purchased in April 1964 for $7,000. However, lessors failed to show "at what rate the compressor was subject to depreciation during the times in question."

b. Lessor must base depreciation calculations on actual cost of the equipment, not replacement cost or current market value.

c. Court notes that spreading the $7,000 compressor cost over the over 20 years it was in service could not negate the profit shown by the lessees during the relevant time frames.

d. In calculating costs, "exclude the cost of drilling or re-working a well . . . ."

F. Royalty Clause

1. Lessee cannot deduct on-lease compression costs in calculating royalty. Wood v. TXO Production Corp., 1992 WL 153553 (Okla. July 7, 1992).

a. Certified question from U.S. District Court for the Eastern District of Oklahoma:

"Is an oil and gas lessee/operator who is obligated to pay the lessor '3/16 at the market price at the well for the gas sold', entitled to deduct the cost of gas compression from the lessor's royalty interest?"

b. Court answers: "We find that in Oklahoma the lessee's duty to market involves obtaining a marketable product. The certified question is answered in the negative." Four justices dissented.

2. Production pressure from two TXO gas wells fell below the purchaser's line pressure and TXO found it necessary to install compressors on the leased premises to continue delivering gas from the wells

into the purchaser's line.

a. TXO deducted the compression costs prior to calculating the lessor's royalty.

b. The lessor objected to the deduction.

3. Court notes that Arkansas and Kansas would not allow deduction of such compression costs; Louisiana and Texas would permit deduction when the compression is not required to bring the gas to the wellhead.

4. Distinguishing Johnson v. Jernigan, the court noted:

"We have not yet held that the lessor is required to bear any costs of transportation where the point of sale is on the leased premises. In our view, the gas is 'sold' when it enters the purchaser's line. Here that line is on the leased premises and there is not 'transportation' cost."

5. "One of the risks borne by the lessee in exploring for gas is that the gas will be low pressure. In our view, the implied duty to market means a duty to get the product to the place of sale in marketable form. Here the compressors and the connection to the gas purchasers' pipelines are on the leased premises."

6. "We interpret the lessee's duty to market to include the cost of preparing the gas for market."

7. The court then tries to characterize the lessor/lessee relationship to justify its rule stating:

"[W]orking interest owners who share costs under an operating agreement have input into the cost-bearing decisions. The royalty owners have no such input after they have leased. In effect, royalty owners would be sharing the burdens of working interest ownership without the attendant rights. If a lessee wants royalty owners to share in compression costs, that can be spelled-out in the oil and gas lease."

8. Four dissenting justices would follow the approach advocated by Chief Justice Opala:

"Gas compression necessary to effect delivery of gas into the pipeline is a post-production cost which

should be borne equally by the lessor and lessee. In the absence of a specific provision prohibiting the deduction of post-production compression costs, I would allow a lessee to deduct this expense from the lessor's royalty payments."

IV. GAS CONTRACT ISSUES

A. Take-Or-Pay Obligations

1. Court tempers take-or-pay claims and defenses. Benson Mineral Group, Inc. v. Enron Gas Processing Co., 1991 U.S. Dist. LEXIS 1387 (D. Kan. 1991).

2. In 1978 Benson Mineral Group, Inc. (BMG) agreed to sell natural gas to the predecessor of Enron Gas Processing Company (Enron).

3. As gas prices on the open market plummeted each party tried to make the most out of their gas contract:

   a. BMG by maximizing the quantities of gas Enron must purchase at the now above-market contract price; and

   b. Enron by minimizing the quantities it must take, or pay for if not taken.

4. In the court, addressing the parties' motions for summary judgment, tempers the interpretations of each party by resolving the following issues:

   a. BMG is not entitled to summary judgment because there are genuine issues of material fact which must be resolved before it can be known whether Enron has complied with the gas contract.

   b. After determining the initial contract quantity Enron was required to take, or pay for, there must be deducted (credited to Enron) gas volumes attributable to:

      (1) BMG's failure to deliver gas on certain days in accordance with the contract; and

      (2) Reductions in gas volumes BMG could produce and deliver due to governmental controls, such as well allowables.

5. The court notes: "Since the Contract . . . states . . . it is subject to existing . . . orders of government authorities . . . [Enron] is correct in its assertion that in Kansas state-assigned allowables limiting production from natural gas wells establish a purchaser's maximum take-or-pay obligation under a gas purchase contract even though the contract would impose a higher obligation."

6. No evidence was presented concerning the allowables assigned to the wells dedicated to the contract.

   a. BMG argued it was unnecessary to indicate what could be lawfully produced because the take-or-pay contract provided for "an alternative means of performance -- the purchaser can either take and pay for the minimum amount of gas or the purchaser can pay for gas not taken up to the minimum amount."

   b. The court rejects this "alternative performance" analysis noting that the issue is not one of an impracticable means of performance but rather defining the performance required by the contract.

   c. The court notes:

      "The issue is whether, in fact, there is any outstanding take-or-pay obligation due. In other words, since the Kansas Supreme Court in Northern, <u>and the Contract</u>, instruct that before any take-or-pay obligation is due, credit must be given for any deficiency arising by reason of limits imposed by state allowables, there is a factual issue over whether any take-or-pay liability ever came into existence."

7. Enron argues that since BMG failed to conduct and file annual well tests required by Kan. Admin. Regs. 82-3-304(d) to establish its well allowables, Enron was not required to take any of BMG's gas and is entitled to summary judgment.

   a. The court rejects this argument holding that it is unreasonable to say, as a matter of law, that failure to conduct the well tests was intended to nullify the take-or-pay provisions of the contract.

b. The court states that "[t]o give the Contract such a construction is simply contrary to common sense."

c. However, the court notes the effect of the "government authority" section is open to interpretation so summary judgment is improper.

8. Enron asserts the contract contained a 2-year contractual statute of limitations for BMG to raise its take-or-pay claims. The court holds the clause is open to interpretation and cannot be resolved through summary judgment.

9. The court holds that several wells were never dedicated to the contract so Enron's take obligation must be calculated excluding the undedicated properties. However, to the extent Enron actually took gas from the undedicated wells, the court holds Enron, at the summary judgment stage, is not entitled to credit against its take-or-pay obligations.

10. The Benson case is a refreshing approach, by litigants and the court, to the take-or-pay contract. Instead of wandering off into attacks on the validity of the contract, each party recognizes they have a valid agreement--the only issue is determining its meaning.

a. Judge Kelly applies what should probably be the hallmark rule of interpretation in this area: "common sense."

b. Judge Kelly rejects the dogma of the take-or-pay warriors by refusing to be led by producer slogans of "alternative performance contract" or pipeline interpretations that gut the very existence of the take-or-pay obligation.

c. The Benson case seems to fit neatly into what I have termed the second generation of take-or-pay litigation. See Pierce, *Developments in Nonregulatory Oil and Gas Law: Relationships, Contracts, Torts, and the Basics*, 41 **Institute on Oil and Gas Law and Taxation** 1-1, 1-29 to 1-31 (1990).

B. Agency Defense to Take-Or-Pay

1. Barbara Oil Co. v. Kansas Gas Supply Corp., 250 Kan. 438, 827 P.2d 24 (Kan. 1992).

2. Kansas Gas Supply Corporation (KGS) operates an intrastate natural gas pipeline that originates in Western Kansas and terminates at two Kansas Gas and Electric Company (KG&E) gas-fired electric generating facilities in Wichita.

   a. KGS has traditionally purchased gas from producers and then resold the gas to KG&E, and other purchasers.

   b. However, KGS's primary gas customer has always been KG&E.

   c. KGS sells gas to KG&E which KG&E uses to operate its two gas-fired power plants.

   d. KGS's contracts with various producers contained take-or-pay clauses which would require KGS to pay for a minimum quantity of gas even though it failed to take the gas.

   e. At one time KGS had similar take-or-pay provisions in its contracts with KG&E. However, the Kansas Corporation Commission required that KG&E pay only for gas actually taken from KGS.

3. From 1976 to 1983 KG&E provided KGS with 10-year gas requirements forecasts so KGS could formulate its gas acquisition program.

   a. Relying on the forecasts, KGS entered into gas contracts with producers to acquire gas to meet KG&E's projected requirements.

   b. However, as early as 1980 KG&E knew it would be reducing its gas requirements once the Wolf Creek nuclear power plant became operational; however, these reductions were not reflected in KG&E's forecasts, nor were they communicated to KGS.

4. As KG&E reduced its gas takes, KGS incurred take-or-pay liabilities to various gas producers, including Barbara Oil Company and Pickrell Drilling Company.

5. KGS sued KG&E asserting, among other theories, that KGS entered into the gas purchase agreements as KG&E's agent and therefore KG&E should indemnify KGS for any take-or-pay liability associated with the gas purchase agreements.

6. The Kansas Supreme Court upholds the jury's finding that "when KGS extended its contracts with Barbara and Pickrell, KGS had acted as KG&E's agent."

7. The Court also upholds the jury's award to KGS of $5,250,000 as indemnity for gas purchase contracts entered into by KGS as KG&E's agent.

8. The most interesting aspect of this case is that KGS's implied agency theory accomplished what the 1984 KGS/KG&E contract expressly sought to avoid: KG&E liability for take-or-pay contracts entered into between KGS and gas producers.

   a. The agency theory also accomplishes what the Kansas Corporation Commission had prohibited since 1981: any obligation that KG&E pay KGS for gas which KG&E fails to take.

   b. In light of these known regulatory and contractual limitations on KGS's ability to pass take-or-pay costs on to KG&E, it is not surprising that KG&E would be reluctant to reduce its gas forecasts when, it appeared at the time, KG&E had nothing to lose if its forecasts were too high.

   c. It is surprising, however, that KGS would, under such circumstances, place total reliance in KG&E's forecasts when entering into take-or-pay contracts.

   d. Perhaps the outcome on the agency issue is revealed by the jury's finding that KG&E "had fraudulently concealed anticipated changes in its gas requirements." However, the jury found that this claim was barred by the statute of limitations.

9. The Court's holding dictates that a clause be added to gas purchase contracts which expressly addresses the agency status of the parties. I would guess that in 100% of the situations the clause will be a disclaimer that the party reselling gas is <u>not</u> the agent of the ultimate gas purchaser.

C. Royalty on Take-Or-Pay Settlements

1. Royalty due on take-or-pay payments received by lessee. Frey v. Amoco Production Co., 1992 WL 153912 (La. June 26, 1992).

   a. Lease provided for: "royalty on gas sold by the Lessee [of] one-fifth (1/5) of the amount realized at the well from such sales."

   b. Lessee had entered into a take-or-pay gas contract which was subsequently renegotiated and payments made to the lessee representing price disputes and take-or-pay liabilities.

      (1) Lessee paid royalty on the price dispute payments ($280.2 Million).

      (2) Lessee paid royalty on recoupable take-or-pay payments as the volumes were recouped ($45.6 Million).

      (3) Lessee did not pay royalty on the "non-recoupable" portion of the take-or-pay payment ($20.9 Million).

   c. Rely heavily on Henry v. Ballard & Cordell Corp., 418 So.2d 1334 (La. 1982), the Louisiana approach to the "market value royalty" issue. Market value royalty = Lessee's contract price.

      (1) "[L]ease arrangement is in the nature of a cooperative venture in which the lessor contributes the land and the lessee the capital and expertise necessary to develop the minerals for the mutual benefit of both parties."

      (2) "An economic benefit accruing from the leased land, generated solely by virtue of the lease, and which is not expressly negated, is to be shared between the lesscr and lessee in the fractional division contemplated by the lease."

   d. Court holds:

      (1) The take-or-pay payments to Amoco form part of the "amount realized" by Amoco from the sale of gas to Columbia and are subject to the lessor's royalty clause.

(a) Sale of gas took place at the time the gas was committed to the pipeline by the contract.

(b) A sale of future goods.

(2) The take-or-pay payments are part of the price paid to Amoco by Columbia for the gas actually delivered to Columbia under their contract.

(a) "Price" includes price paid for gas delivered; and

(b) The "economic benefits" derived from the lessee's right to develop and explore the leased land.

(3) The take-or-pay proceeds constitute economic benefits which are derivative of Amoco's right to develop and explore the leased property, a right conferred by and dependent upon the lease between Amoco and Frey.

(a) "Amount realized" connotes the "sum total, the whole, or the final effect of the economic benefits obtained by Amoco . . . ."

(b) "[B]ut for the Lease there would be no Morganza Contract, no Settlement Agreement, and ultimately no take-or-pay payments made to Amoco."

2. Royalty due on take-or-pay payments received by lessee. Roye Realty & Developing, Inc. v. Watson, Case No. 76,848 (July 14, 1992), unpublished.

a. Roye had a take-or-pay gas contract with Arkla and an oil and gas lease with Watson. Roye entered into a settlement with Arkla concerning its take-or-pay obligations under the gas contract. Watson seeks 1/8th of the settlement benefits under two theories:

(1) Royalty clause of the oil and gas lease;

(2) Third party beneficiary of the gas contract.

b. Roye and Arkla refused to disclose terms of their settlement to Watson, asserting a court-sanctioned confidentiality agreement and Watson's lack of interest in the contract.

c. Trial court held for Roye and Arkla; on appeal this court reverses.

d. Court states:

"[A] lessee can receive value for the exercise of its rights over the oil and gas within its production capability and thereby 'market' the oil and gas without severance. The take or pay arrangement is simply a marketing substitute or alternative to severance and sale. . . . By receiving payment <u>either</u> for the severance and taking of oil and gas by a purchaser <u>or</u> for granting a right to refuse to take oil and gas that the purchaser was obligated to take, a lessee markets the oil and gas. The lessee also incurs liability to pay the lessor a royalty on the revenue generated from such marketing."

e. Court holds:

"[T]he Watsons were entitled to a partial summary judgment recognizing their royalty interest in any payments received in connection with the marketing of gas that was subject to the production capability of Roye. This includes take or pay payments or a settlement of take or pay liability."

(1) "It was also error to deny the Watsons' discovery requests concerning the settlement of the take or pay liability and any payments thereunder."

(2) Reverse the summary judgment in favor of Roye and Arkla.

3. No royalty due on take-or-pay payments received by lessee. <u>Hurd Enterprises, Ltd. v. Bruni</u>, 828 S.W.2d 101 (Tex. App.-San Antonio 1992).

a. Lease provided for royalty:

"[O]n gas . . . <u>produced from said land and sold or used off the premises</u> . . . the market value at the mouth of the well of one-eighth

of the gas so sold or used provided that on gas sold at the well the royalty shall be one-eighth of the amount realized from such sale . . . ."

b. Court holds that "production" means "the actual physical extraction of the mineral from the soil."

c. Court also holds that the relationship between lessor and lessee is "purely contractual" absent some other "special relationship" between the parties.

(1) Lessee's marketing decisions tested by what a reasonably prudent operator under the same or similar circumstances would have done.

(2) "A lessee is not an agent with respect to the sale of the lessor's gas, because the lessor has no gas to sell. An oil and gas lease conveys to the lessee title to the gas in place, subject only to the contractual obligation to pay royalty on gas, if, as, and when produced."

D. Gas Pricing

1. OXY entitled to collect retroactive payments under gas contract for tight sands gas delivered prior to pipeline's exercise of market-out clause. OXY U.S.A., Inc. v. Seagull Natural Gas Co., 949 F.2d 799 (5th Cir. 1992).

a. OXY entered into gas contract with Seagull while tight sands designations were pending for the Travis Peak formation in Texas.

b. Contract met the regulatory requirements to authorize collection of the tight sands incentive prices.

c. Area was subsequently designated as qualifying for tight sands incentive pricing.

d. Issue over whether the contract's silence regarding retroactive collection of the price prevented such collection.

(1) Court approves OXY's interpretation that

retroactive collection is prohibited only if the contract expressly so provides.

(2) Presence of market-out clause did not prohibit retroactive collection of the tight sands price.

e. OXY was permitted to collect the tight sands price until the purchaser exercised their rights under the market-out clause.

(1) $2,717,871.66 in the Toolan Field.
(2) $780,409.47 in the Appleby N. Field.

V. MINERAL LAW ETHICS 101

Consider the following not-so-hypothetical hypothetical:

Mr. Sneed, a petroleum landman working for Entente Mineral Company, negotiated with Mr. Young to purchase one-half of Young's 1/16th royalty interest in a tract of land.

February 23: Sneed and Young orally agreed that Entente would purchase one-half of Young's interest for $25,000. Sneed then gave Young a draft for $25,000 and a royalty deed.

Young wanted his banker, Mr. Edwards, to review the deed before Young signed. When presented with the deed, Edwards suggested that Young take it to his attorney.

Young took the deed to his attorney Derek Parker, a partner in the Mississippi law firm of Barrett, Barrett, Barrett, and Patton.

That afternoon Sneed and Young met with Parker. Parker reviewed the deed and said it appeared to coincide with their oral agreement. However, Parker advised Young that he should have a title examination prepared to ensure he had title to a 1/16th royalty interest. Young instructed Parker to conduct the title search. Sneed left the deed and draft with Parker.

After Sneed and Young left, Parker telephoned his brother, "who was an oil and gas lease and royalty speculator," and asked him what he knew about a well being drilled on Young's property. His brother said the well looked promising and that he would finance Parker's purchase of the royalty from Young and suggested offering Young $30,000 for the one-half royalty.

Parker said he did not want to pay $30,000 but could probably buy it for $27,000.

Later that day, Parker asked his partner, Pat Barrett, Jr. whether he thought there was anything wrong with a lawyer's purchasing mineral interests from a client, and Barrett replied that he did not see anything wrong with it.

February 24: Parker called Edwards and said "he knew of someone who could make Young a better offer and to have Young contact Parker. Young agreed to meet Parker at the bank and when he got there Parker indicated he wanted to purchase the royalty for $27,000. Young agreed and they executed Sneed's deed with Parker's name as the grantee. Sneed arrived later that day to close the sale and was informed that Young had received a better offer.

Guess Who Sued Parker and the Law Firm?

[Entente Mineral Co.]

Who *Should Have* Sued Parker and the Law Firm?

A. Attorney/Client Activities and Tortious Interference

1. Parker was not acting within the scope of his law firm employment, as to Entente, when he purchased the royalty interest from his client. Entente Mineral Co. v. Parker, 956 F.2d 524 (5th Cir. 1992).

2. When Young told Sneed the deal was off, Sneed asked who had purchased the royalty interest. Young refused to disclose the purchaser. Sneed later discovered, when the deed was recorded, that Parker had purchased the interest.

3. In June 1987 Entente sued Parker and his law firm asserting Parker's actions constituted tortious interference with business relations and contract in violation of Mississippi law, and that the law firm was vicariously liable for Parker's tortious conduct.

4. Trial court held that Parker had not been acting within the scope of his employment when he purchased the royalty and granted the firm's motion for directed verdict.

5. Shortly after the directed verdict, Entente and Parker entered into a settlement. Their agreed

judgment settled all claims as to Parker but reserved all rights against the firm and the individual partners.

a. NOTE: in Kansas the settlement with the agent could also absolve the principal.

b. SEE: Atkinson v. Wichita Clinic, P.A., 243 Kan. 705, 763 P.2d 1085 (1988). In medical malpractice action doctor (employee/agent) entered into settlement with plaintiff and plaintiff entered into a covenant not to sue the doctor but explicitly reserved the right to proceed against the Clinic (employer/principal).

c. Court holds settlement with the employee/agent precluded action against the employer/principal because the employer's liability was solely predicated on the imputed negligence of its employee.

6. Court notes basic agency principles:

a. "Every partner is an agent of the partnership for the purpose of its business . . . ."

b. "Where, by any wrongful act . . . of any partner acting in the ordinary course of business of the partnership . . . loss or injury is caused to any person . . . the partnership is liable therefor to the same extent as the partner so acting . . . ."

c. Restatement (Second) of Agency § 228:

An agent or employee's conduct is within the scope of employment only if

(a) it is of the kind he is employed to perform;

(b) it occurs substantially within the authorized time and space limits;

(c) it is actuated, at least in part, by a purpose to serve the master, and

(d) if force is intentionally used by the servant against another, the use of force is not unexpected by the master.

d. Restatement (Second) of Agency § 219(2):

> (2) A master is not subject to liability for the torts of his servants acting outside the scope of employment, unless:
>
> . . . .
>
> (d) the servant purported to act or to speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation.

7. Court holds Parker was not acting within the scope of his employment since the firm was not in the business of buying minerals.

   a. Entente argues the court should focus on the transaction as a whole, not the last act.

   b. Court holds Parker engaged in a "frolic of his own" when he proceeded to try and purchase the royalty from Young.

8. Since Parker had departed from pursuit of partnership business, the next issue is whether the agency relationship aided Parker in committing the allegedly tortious acts under Restatement (Second) of Agency §§ 219(2)(d) and 261.

   a. Court finds that such liability does not exist in this case.

   b. "In this case, there was no relationship between the firm and Entente that could be imputed to the firm's agent. It is undisputed that neither Parker nor the firm represented Entente. The premise underlying § 219(2)(d) and § 261 liability, a relationship between the principal and an innocent third party, is absent in this case. Therefore, as a matter of law, the firm could not have been held vicariously liable for Parker's acts." 956 F.2d at 529.

   c. *Note, however, that the requisite relationship exists between Parker and Young, the firm's client, in the event Young has a claim against Parker, and the firm.*

B. The Ethical Issues

1. Kansas Supreme Court Rule 226; Model Rules of Professional Conduct

2. Preamble to the Model Rules:

   a. "As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications."

   b. "A lawyer acts as evaluator by examining a client's legal affairs and reporting about them to the client or to others."

3. RULE 1.7 Conflict of Interest: General Rule

   (b) A lawyer shall not represent a client if the representation of that client may be materially limited by . . . the lawyer's own interests, unless:

   (1) the lawyer reasonably believes the representation will not be adversely affected; and

   (2) the client consents after consultation. . . . .

4. Comment to RULE 1.7

   a. "Loyalty to a client is . . . impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests. The conflict in effect forecloses alternatives that would otherwise be available to the client."

   b. "A lawyer may not allow related business interest to affect representation . . . ."

5. RULE 1.8 Conflict of Interest: Prohibited Transactions

   (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client; and

(2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and

(3) the client consents in writing thereto.

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation.

. . . .

6. Comment to RULE 1.8:

"As a general principle, all transactions between client and lawyer should be fair and reasonable to the client. In such transactions a review by independent counsel on behalf of the client is often advisable. Furthermore, a lawyer may not exploit information relating to the representation to the client's disadvantage. For example, a lawyer who had learned that the client is investing in specific real estate may not, without the client's consent, seek to acquire nearby property where doing so would adversely affect the client's plan for investment. . . ."

C. Attorney Misconduct in Arguing Fact or Law

1. Condemnation of surface interest and rights of existing lease holder did not compensate for interference with mineral estate (and subsequent lessee) caused by partial flooding of 80-acre tract. Haupt, Inc. v. Tarrant County Water Control and Improvement Dist. No. 1, 1992 WL 151011 (Tex. App.-Waco July 1, 1992).

   a. Mineral interest owners, and current oil and gas lessee, brought inverse condemnation claim against water district when 67 acres of an 80-acre tract were inundated by the filling of a reservoir.

b. The water district had previously condemned the surface estate and the rights of a lessee who had two oil and gas wells on the property.

(1) At the time of the condemnation, the water district:

"[K]new and appreciated the risk of merely condemning the working interest of a lease holder without acquiring the executory rights and cutting off the right of the mineral owner to execute other leases. The Water District knew that under those circumstances it could be faced with having to repeatedly condemn working interests under subsequent leases on the same tract."

(2) The court hammers the Water District attorney for comments contained in his brief suggesting that the Water District would be required to pay twice for the same rights.

(a) "Considering the Water District's own minutes and the admission in its brief, we find that asserting this rationale for the court's ruling borders on contumacy."

(b) "Despite this demonstrated knowledge of the applicable legal principles and being faced with the risk envisioned, counsel nevertheless blatantly assert that requiring the Water District to condemn and pay for Bar J B Company's working interest would not only be a misapplication of public funds but an irrational result."

(c) "Lawyers occasionally resort to hyperbole in defending their client's position. In this instance, however, hyperbole crosses the line between credible argument and knowing misstatement."

2. Sundheim v. Reef Oil Corp., 806 P.2d 503 (Mont. 1991) (interpretation of case reasonable so as to avoid Rule 11 sanctions).

VI. ENVIRONMENTAL ISSUES

A. Oil Pollution Act

1. Public Law No. 101-380, 104 Stat. 484-575 (1990).

2. The fallout from the Exxon Valdez spill is the Oil Pollution Act of 1990 ("OPA").

   a. Prospectively, the OPA creates a liability-based regulatory regime very similar to the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA").

   b. The OPA also adopts many measures to try and prevent oil spills from occurring, such as phasing out single hulled tankers and requiring training of vessel personnel.

3. The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) excludes from its coverage:

   "[P]etroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance . . . ."

   CERCLA § 101(14), 42 U.S.C. § 9601(14) (1988) (defining "hazardous substance"); CERCLA § 101 (33), 42 U.S.C. § 9601(33) (1988) (defining "pollutant or contaminant").

4. This is commonly called the "petroleum exclusion" and has been interpreted to apply to "unrefined and refined gasoline even though certain of its indigenous components and certain additives during the refining process have themselves been designated as hazardous substances within the meaning of CERCLA." Wilshire Westwood Associates v. Atlantic Richfield Corp., 881 F.2d 801, 805 (9th Cir. 1989).

5. The Oil Pollution Act of 1990 (OPA) establishes a CERCLA-like liability regime for oil to fill the void created by CERCLA's petroleum exclusion.

   a. The OPA/CERCLA connection is created by OPA § 1001(23) which defines "oil" to include:

      "[O]il of any kind or in any form, including,

but not limited to, petroleum, fuel oil, sludge, oil refuse, and oil mixed with wastes other than dredged spoil, *but does not include petroleum, including crude oil or any fraction thereof, which is specifically listed or designated as a hazardous substance under . . . [CERCLA]*."

OPA § 1001(23), 33 U.S.C.A. § 2701(23) (West Supp. 1991).

b. The scope of the CERCLA petroleum exclusion also defines the scope of the OPA.

(1) If it is covered by CERCLA, by definition it is exempt from the OPA.

(2) If it is not covered by CERCLA, and it meets the definition of "oil," it will be covered by the OPA.

6. The scope of the petroleum exclusion should continue to be a contested issue because <u>liability</u> is generally more extensive under CERCLA but the <u>recoverable damages</u> are more extensive under the OPA. <u>Compare</u> CERCLA § 107(f)(1), 42 U.S.C. § 9607 (f)(1) (1988) (damages to natural resources) <u>with</u> OPA § 1002(b)(2), 33 U.S.C.A. § 2702(b)(2) (West Supp. 1991) (damages to natural resources <u>plus</u> damages relating to real and personal property, subsistence use, lost revenues, profits, and earning capacity).

7. Section 311 of the Clean Water Act addresses the government's cleanup concerns with regard to oil spills; the OPA addresses who is liable for cleanup costs and damage caused by a spill.

8. Section 1002(a) of the OPA states:

"[E]ach responsible party for a vessel or a facility from which oil is discharged, or which poses a substantial threat of a discharge of oil, into or upon the navigable waters . . . is liable for the removal costs and damages specified in subsection (b) that result from such incident."

OPA § 1002(a), 33 U.S.C.A. § 2702(a) (West Supp. 1991).

9. The "responsible party" for an onshore facility includes "any person owning or operating the

facility" except for a governmental body that merely owns the facility and leases it to another person. OPA § 1001(32)(B), 33 U.S.C.A. § 2701 (32)(B) (West Supp. 1991).

10. The term "discharge" includes "intentional or unintentional" emissions including "spilling, leaking, pumping, pouring, emitting, emptying, or dumping." OPA § 1001(7), 33 U.S.C.A. § 2701(7) (West Supp. 1991).

11. The OPA could apply to underground storage tanks which are "leaking." However, the discharge of oil must be into or upon the "navigable waters or adjoining shorelines or the exclusive economic zone." OPA § 1002(a), 33 U.S.C.A. § 2702(a) (West Supp. 1991).

12. "Navigable waters" is defined as "the waters of the United States, including the territorial sea." OPA § 1001(21), 33 U.S.C.A. § 2701(21) (West Supp. 1991).

    a. Presumably courts will interpret the phrase "waters of the United States" at least as broadly as the term has been interpreted under the Clean Water Act.

    b. It is also likely that private litigants will attempt to expand the definition beyond the limits previously established by the EPA under the Clean Water Act. See Pierce, The Emerging Role of "Liability-Forcing" in Environmental Protection, 30 **Washburn L. J.** 381, 414-16 (1991).

13. Section 1002(b)(1)(B) permits "any person" to recover their removal costs and section 1002(b)(2) permits any person ("claimant") to recover damages for injury to real or personal property, lost profits, and similar consequential damages. OPA § 1002(b), 33 U.S.C.A. § 2702 (b) (West Supp. 1991).

    a. Private parties seeking reimbursement for their losses caused by a release of oil will surely attempt to employ an expansive definition of "waters of the United States."

    b. This may federalize the management of oil and gas operations traditionally regulated by State agencies.

14. The OPA only applies to "an incident occurring after the date of the enactment of . . . [the OPA]." Oil Pollution Act of 1990, Pub. L. No. 101-380, 104 Stat. 484, 506 (1990) (OPA § 1020).

    a. This means the OPA only applies to incidents that occur after August 18, 1990.

    b. However, this should not limit action when the problem creating the threat of a discharge continues after the August 18, 1990 effective date.

    c. This same analysis could be applied to leaking underground storage tanks.

        (1) Although they have leaked for several years before the August 18 effective date, this should not exempt the responsible party from liability for discharges after August 18.

        (2) With the leaking underground storage tanks there is a present "threat" of continuing discharges that can give rise to OPA cleanup actions.

15. The OPA contains the same CERCLA-type defenses to liability and authorizes contribution "against any other person who is liable or potentially liable under this chapter or another law." OPA § 1003, 33 U.S.C.A. § 2703 (West Supp. 1991) (defenses to liability); § 1009, 33 U.S.C.A. § 2709 (contribution).

16. The OPA relies upon the National Contingency Plan to guide cleanup activities and establishes the procedures private parties must follow to recoup their cleanup costs. OPA § 1002(b)(1)(B), 33 U.S.C.A. § 2702(b)(1) (B) (West Supp. 1991).

17. The statute also creates a "superfund" for oil, called the "Oil Spill Liability Trust Fund." OPA § 1001(11), 33 U.S.C.A. § 2701(11) (West Supp. 1991). See generally Pierce, The Emerging Role of "Liability-Forcing" in Environmental Protection, 30 **Washburn L. J.** 381, 414-16 (1991).

18. Liability Under the Act

    a. To impose liability under the OPA you must establish the following:

b. A "discharge" or a "substantial threat of a discharge";

(1) Of "oil";

(2) From a "vessel" or a "facility";

(3) Into "navigable waters" or "adjoining shorelines" or the "exclusive economic zone."

c. The Act provides that "[n]otwithstanding any other provision or rule of law" the owner or operator of the vessel or facility is "liable" for "removal costs and damages," specified in the Act, "that result from such incident."

(1) The definition section provides that the term "liable" must be "construed to be the standard of liability which obtains under section 311 of the Federal Water Pollution Control Act (33 U.S.C. 1321); . . ." OPA § 1001(17), 104 Stat. at 487.

(2) The § 311 standard has consistently been held to be strict liability.

(3) In the Joint Explanatory Statement of the Committee of Conference considering the OPA, the Committee observes:

"The term 'liable' or 'liability' is taken from the Senate amendment and is to be construed to be the standard of liability which obtains under section 311 of the FWPCA for liability for removal costs and damages from discharges of oil. <u>That standard of liability has been determined repeatedly to be strict, joint and several liability</u>."

H.R. Conf. Rep. No. 101-653, 101st Cong., 2d Sess. 103 (1990).

d. However, § 1003 of the Act provides three limited defenses to liability. § 1002(c) also excludes certain "discharges" from the Act. Also, the costs and damages must "result from" the "incident."

e. The owner or operator will be liable for costs and damages <u>unless</u> they can prove:

(1) The discharge was pursuant to a permit issued by Federal, State, or local law;

(2) The costs or damages did not result from the discharge "incident."

(3) The discharge, and the resulting costs and damages, were caused <u>solely</u> by:

(a) An act of God;

(b) An act of war; or

(c) An act or omission of a "third party."

f. The act of God, war, and third party defenses can be lost if the party fails to comply with reporting requirements and cooperate in the cleanup.

19. Recoverable Cleanup Costs and Damages

a. Under CERCLA, the government can recover its cleanup costs plus damages for natural resources that are injured due to a hazardous substance release. A non-governmental litigant under CERCLA can recover only its cleanup costs.

b. The range of damages under the Oil Pollution Act of 1990 are much broader than those provided for under CERCLA. In addition to cleanup costs, the Act authorizes private parties to recover for the following:

(1) Damages for injury to real or personal property, and "economic losses" resulting from the destruction of real or personal property, owned or leased by the claimant;

(2) Damages for loss of profits or impairment of earning capacity due to injury or destruction to real or personal property, <u>or natural resources</u>;

(3) Damages for loss of "subsistence use" of natural resources by any claimant who makes such use of natural resources.

(4) However, a "claimant" cannot recover against the responsible party "to the extent that the incident is caused by the gross negligence or willful misconduct of the claimant."

(5) In addition to cleanup costs and damages for injury to natural resources, the Act authorizes governmental parties to recover for the following:

(a) The cost of assessing damages to natural resources;

(b) Damages equal to the "net loss of taxes, royalties, rents, fees, or net profit shares due to the injury, destruction, or loss of real property, personal property, or natural resources . . . ;"

(c) Damages equal to the "net costs of providing increased or additional public services during or after removal activities, including protection from fire, safety, or health hazards, caused by a discharge of oil . . . ."

(6) Under certain circumstances a "foreign claimant" can also recover against the responsible party.

c. All claimants who are entitled to damages or reimbursement of cleanup costs can recover interest on their claim. Section 1005(b) of the Act states how interest will be calculated, how settlement offers will be handled, and the formula for determining the interest rate.

20. Liability Limits

a. As with previous oil pollution acts, the OPA places a cap on the total amount a responsible party must pay as a result of a discharge.

b. However, the liability limit can be lost in the following situations:

(1) If the incident was caused by the "gross negligence or willful misconduct" of the

responsible party;

(2) If the incident was caused by the responsible party's violation of "an applicable Federal safety, construction, or operating regulation . . . ."

(3) The responsible party fails to properly report the incident;

(4) The responsible party fails to cooperate with the government in cleanup efforts;

(5) The responsible party fails to comply with certain governmental orders under the Clean Water Act and the High Seas Act.

c. In situations where the liability limit applies, the responsible party's maximum liability for cleanup costs and damages cannot exceed the following amounts:

(1) Tank Vessel: The greater of $1,200 per gross ton or:

(a) If 3,000 gross tons or less: $2,000,000;

(b) If more than 3,000 gross tons: $10,000,000.

(2) Other Vessels:

(a) The greater of $600 per gross ton or $500,000.

(b) Offshore Facilities: The total of all cleanup costs plus $75,000,000.

(3) Onshore Facilities and Deepwater Ports: $350,000,000.

(4) Outer Continental Shelf Facility or Vessel: No limit on the amount of cleanup costs incurred by the United States Government or any state or local official or agency.

d. Subsection (d) of § 1004 permits the President, by regulation, to establish liability limits for onshore facilities that are less than the $350,000,000 figure.

(1) In establishing the lesser limit, the President must consider the "size, storage capacity, oil throughput, proximity to sensitive areas, type of oil handled, history of discharge, and other factors relevant to risks posed by the class or category of facility."

(2) In no event can the limit be set at less than $8,000,000.

21. Leveraging Liability

a. Although the owner or operator of the facility will be initially responsible for cleanup costs and damages, they may be able to recover some or all of their outlay from the Oil Spill Liability Trust Fund or other persons who are "liable or potentially liable" under the Act "or another law."

b. The responsible party can also use insurance and indemnity agreements to leverage the ultimate financial burden of its liability.

B. RCRA LIABILITY

1. RCRA § 7003, 42 U.S.C. § 6973 (1988) gives the EPA authority to take action with regard to the past or present disposal of *solid waste or hazardous waste* to deal with a situation that may present an "imminent and substantial endangerment to health or the environment."

2. RCRA § 7003(a) provides, in part:

a. "[U]pon receipt of evidence that the *past or present handling, storage, treatment, transportation or disposal of any solid waste or hazardous waste may present an imminent and substantial endangerment to health or the environment* the Administrator may bring suit . . . against any person *(including any past or present generator, past or present transporter, or past or present owner or operator of a treatment, storage, or disposal facility) who has contributed or who is contributing to such handling, storage, treatment, transportation or disposal* to

restrain such person from such handling, storage, treatment, transportation, or disposal, *to order* such person to take such other action as may be necessary, or both."

b. RCRA § 7003(a) gives the EPA the authority to "take other action under this section including, but not limited to, *issuing such orders as may be necessary to protect public health and the environment*."

3. NOTE: the petroleum exclusion under CERCLA would not prevent the EPA from taking action under RCRA § 7003.

a. RCRA § 7003 also provides for its remedy "Notwithstanding any other provision of this chapter . . . ."

b. That would seem to include the RCRA E&P waste exemption under RCRA § 3001(b)(2)(A).

4. RCRA § 7002 contains a "citizen suit" provision which confers authority on private parties similar to the EPA's authority under § 7003.

5. RCRA § 7002 provides, in part:

"[A]ny person may commence a civil action on his own behalf--

(1)(B) against any person . . . , and including *any past or present generator, past or present transporter, or past or present owner or operator of a treatment, storage, or disposal facility,* who has contributed or who is contributing to the *past or present handling, storage, treatment, transportation, or disposal of any* ***solid or hazardous waste*** *which may present an* ***imminent and substantial endangerment*** *to health of the environment* . . . ."

6. The remedies available to the citizen include:

"[A court order] *to restrain* any person who has contributed or who is contributing to the past or present handling, storage, treatment, transportation, or disposal of any solid or hazardous waste . . . *to order such person to take such other action as may be necessary* . . . ."

a. Such as an order to have them clean up the

site.

b. The "prevailing party" can also recover attorney fees, expert witness fees, and litigation costs. RCRA § 7003(e).

7. **Be careful to comply with the pre-suit notice provisions under RCRA § 7002(b). Failure to comply is jurisdictional.** *See* Hallstrom v. Tillamook County, 493 U.S. 20 (1989), *reh'g denied*, 493 U.S. 1037 (1990).

8. *See* Zands v. Nelson, No. 89-0989-GT, 1991 U.S. Dist. LEXIS 19321 (Dec. 3, 1991).

a. Court holds that purchaser of property which was contaminated by leakage of gasoline from an underground storage tank stated a claim under § 7002 against the property seller.

b. Court first holds that § 7002 can be used to clean up gasoline leaking from an underground storage tank.

(1) CERCLA petroleum exclusion is not limitation. Court notes:

"[W]hereas CERCLA has an explicit exclusion for petroleum, no such similar exclusion exists in RCRA."

(2) Underground storage tank statute, 42 U.S.C. § 6991 (1988), is no limitation.

c. Court holds: "RCRA [§ 7002] applies to individuals who do no more than create solid waste." The leaking of the gasoline from the tank created a solid waste and the property seller, prior owners of the property, a prior lessee, and the company that installed the piping and pumps to the tanks, "could" each be a RCRA § 7002 "contributor" under the facts alleged by the plaintiff/purchasers.

C. CERCLA/RCRA Issues

"Tank Bottoms" and the Scope of the CERCLA *"Petroleum Exclusion"*

CERCLA applies to a vast array of hazardous substances, but it specifically excludes:

> *"[P]etroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance . . . and the term does not include natural gas, natural gas liquids, liquefied natural gas, or synthetic gas usable for fuel . . . ."*

CERCLA § 101(14), 42 U.S.C. § 9601(14) (1988). In Wilshire Westwood Associates v. Atlantic Richfield Corp., 881 F.2d 801 (9th Cir. 1989), the court held the petroleum exclusion applied to gasoline from leaking underground tanks; even though the gasoline contained the listed hazardous substances benzene, toluene, xylene, ethyl-benzene, and lead. The court held:

> "[T]he petroleum exclusion in CERCLA does apply to unrefined and refined gasoline even though certain additives during the refining process have themselves been designated as hazardous substances within the meaning of CERCLA."

In two recent cases, the courts consider whether hazardous substances contained in "tank bottoms" are exempt from CERCLA. In Cose v. Getty Oil Company, Civ. No. S-90-0610, 1991 U.S. Dist. LEXIS 13593 (E.D. Cal. September 10, 1991), the court holds that tank bottoms from crude oil storage are covered by the CERCLA petroleum exclusion. The court defines tank bottoms as follows:

> "When crude oil is stored in tanks, suspended solids in the crude oil settle to the bottom of the tank. Because water is heavier than oil, it separates from the oil and also collects at the bottom of the tank. The bottom layer of the tank is known as basic sediment and water or 'tank bottoms.' Tank bottoms are typically drained from the crude oil storage facilities to sump facilities nearby." Cose, 1991 U.S. Dist. LEXIS 13593, pp. 1-2.

However, in United States v. Western Processing Co., 761 F. Supp. 713 (W.D. Wash. 1991), the court holds that sludge (tank bottoms) from leaded gasoline tanks, a diesel oil tank, and an unleaded gasoline tank, and the rinse water from washing out the tanks, are not covered by the CERCLA petroleum exclusion. The court notes that the sludge contained "a rust-like scale of corrosion products from the oxidation of steel in the tank walls." This caused various hazardous substances to be formed which are not ordinarily found in refined or unrefined petroleum. The court also

notes that the "tank bottom sludge is contaminated waste product, and not a petroleum fraction, as that term is used in the statute."

The court in Western Processing notes the EPA view that the waste found in tank bottoms, "including 'unrecovered product, water, sludge, scale, etc., are presumed to be hazardous,' testing being the only method to remove the presumption." The court also holds:

> "The rinse water, being a mixture of water and sludge, would contain small concentrations of the hazardous compounds in the sludge. Since CERCLA does not impose any quantitative requirement on the term 'hazardous substance' . . . the rinse water itself should be considered a hazardous substance."

Impact of RCRA E&P Waste Exemption on CERCLA Liability

RCRA § 3001(b)(2)(A), 42 U.S.C. § 6921 (b)(2)(A) (1988) provides, in part:

> *"[D]rilling fluids, produced waters, and other wastes associated with the exploration, development, or production of crude oil or natural gas or geothermal energy shall be subject only to existing State or Federal regulatory programs in lieu of this subchapter [until EPA completes a study on whether such wastes should be regulated as hazardous wastes]."*

Pursuant to 42 U.S.C. §§ 6921(b)(2)(A) and 6982(m) (1988), EPA completed its study of oil and gas wastes and delivered to Congress in December of 1987 its report titled: **Management of Wastes from the Exploration, Development, and Production of Crude Oil, Natural Gas and Geothermal Energy.** In July, 1988 EPA issued its decision to exempt many, but not all, exploration and production wastes from RCRA's hazardous waste provisions. (Exempt wastes will be regulated under Subtitle D of RCRA instead of Subtitle C). *Regulatory Determination for Oil and Gas and Geothermal Exploration, Development and Production Wastes*, 53 **Federal Register** 25446 (July 6, 1988). The EPA's current lists of exempt and non-exempt wastes are include the following items:

EPA's LIST OF EXEMPT RCRA EXPLORATION AND PRODUCTION WASTES

1. Produced Water.

2. Drilling Fluids.

3. Drill Cuttings.

4. Rigwash.

5. Drilling fluids and cuttings from offshore operations disposed of onshore.

6. Well completion, treatment, and stimulation fluids.

7. Basic sediment and water and other tank bottoms from storage facilities that hold product and exempt waste.

8. Accumulated materials such as hydrocarbons, solids, sand, and emulsion from production separators, fluid treating vessels, and production impoundments.

9. Pit sludges and contaminated bottoms from storage or disposal of exempt wastes.

10. Workover wastes.

11. Gas plant dehydration wastes, including glycol-based compounds, glycol filters, filter media, backwash, and molecular sieves.

12. Gas plant sweetening wastes for sulfur removal, including amines, amine filters, amine filter media, backwash, precipitated amine sludge, iron sponge, and hydrogen sulfide scrubber liquid and sludge.

13. Cooling tower blowdown.

14. Spent filters, filter media, and backwash (assuming the filter itself is not hazardous and the residue in it is from an exempt waste stream.

15. Packing fluids.

16. Produced sand.

17. Pipe scale, hydrocarbon solids, hydrates, and other deposits removed from piping and equipment prior to transportation.

18. Hydrocarbon-bearing soil.

19. Pigging wastes from gathering lines.

20. Wastes from subsurface gas storage and retrieval, except for the listed nonexempt wastes.

21. Constituents removed from produced water before it is injected or otherwise disposed of.

22. Liquid hydrocarbons removed from the production stream but not from oil refining.

23. Gases removed from the production stream, such as hydrogen sulfide and carbon dioxide, and volatilized hydrocarbons.

24. Materials ejected from a producing well during the process known as blowdown.

25. Waste crude oil from primary field operations and production.

26 Light organics volatilized from exempt wastes in reserve pits or impoundments or production equipment.

EPA's LIST OF *NON*EXEMPT RCRA EXPLORATION AND PRODUCTION WASTES

1. Unused fracturing fluids or acids.

2. Gas plant cooling tower cleaning wastes.

3. Painting wastes.

4. Oil and gas service company wastes, such as empty drums, drum rinsate, vacuum truck rinsate, sandblast media, painting wastes, spent solvents, spilled chemicals, and waste acids.

5. Vacuum truck and drum rinsate from trucks and drums transporting or containing nonexempt waste.

6. Refinery wastes.

7. Liquid and solid wastes generated by crude oil and tank bottom reclaimers.

8. Used equipment lubrication oils.

9. Waste compressor oil, filters, and blowdown.

10. Used hydraulic fluids.

11. Waste solvents.

12. Waste in transportation pipeline-related pits.

13. Caustic or acid cleaners.

14. Boiler cleaning wastes.

15. **Boiler refractory bricks.**

16. **Boiler scrubber fluids, sludges, and ash.**

17. **Incinerator ash.**

18. **Laboratory wastes.**

19. **Sanitary wastes.**

20. **Pesticide wastes.**

21. **Radioactive tracer wastes.**

22. **Drums, insulation, and miscellaneous solids.**

Nonexempt wastes should be tested to determine if they meet any of the four hazardous waste characteristics. If they do, they must be dealt with as hazardous wastes. If the waste is exempt, but nevertheless possesses one or more hazardous characteristics, it should be carefully managed to ensure it does not become a future liability. Management should include segregation of exempt wastes from non-exempt wastes.

An issue that continues to be debated is whether the RCRA exemption for oil and gas wastes applies to cleanup obligations created by the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). Although RCRA exempts certain wastes from regulation as a "hazardous waste" (such as oil and gas wastes, mining wastes, and household wastes), these wastes may become the target of a CERCLA cleanup action. Since CERCLA only applies to a release or threatened release of a "hazardous substance," litigants have argued that *a waste exempt from hazardous waste regulation under RCRA should also be exempt under CERCLA*.

United States v. Hardage, Case No. CIV-86-1401-W (W.D. Okla. 1991), appears to be the first case to address this issue under the E&P waste exemption. In its April 15, 1991 Order the court held Arrow Tank Trucks, Inc. liable under CERCLA for the disposal of drilling mud, salt water, frac water, and oil that was drained from reserve pits that contained drilling mud and frac water. Arrow had drained the reserve pits in 1973 and took the drilling mud and water to the Hardage disposal site, which is now the object of a $150,000,000+ CERCLA cleanup. Apparently the drilling mud in 1973 and 1974 contained asbestos and sodium hydroxide additives. A lead based "thread dope" was also used at the site and the empty dope buckets routinely thrown into reserve pits for disposal.

Lead, asbestos, and sodium hydroxide are hazardous substances under CERCLA. However, Arrow argued that the RCRA E&P waste

exemption specifically excludes "drilling fluids and cuttings" and well "completion, treatment, and stimulation fluids" and therefore it cannot be a potentially responsible party under CERCLA. The court, however, holds that Arrow is liable as:

> "[A]ny person who accepts or accepted any hazardous substances for transport to disposal . . . facilities . . . selected by such person . . . ."

Without much discussion of Arrow's defense, the court concludes:

> "The intent of Congress in incorporating the substances listed in other federal statutes was to include as many substances as possible within CERCLA's ambit and to be hazardous, a substance need only be designated as hazardous under one of these referenced statutes. . . . ***To likewise incorporate the various exclusions found in these other statutes would defeat this purpose.***"

RCRA Citizen Suit Provisions May Offer Remedy for Recovering Cost Of Cleaning Up Leaking Underground Storage Tanks

Nelson owned the land in question from 1961 to 1976. In 1972 Nelson hired Nachant Co. to connect piping and pumps to gasoline tanks for a service station. Nelson operated the service station until 1975 when they leased it to Kramer, who operated the station from 1975 to 1979. From 1976 through 1980 the real property was owned as follows:

1976-78	Tacey
1978-80	Goodwin
1980	Purchased by Zands, the plaintiffs.

Apparently the underground storage tank leaked gasoline into the soil and Zands, as the current owner of the property, is attempting to force Nelson, Nachant Co., Kramer, Tacey, and Goodwin to clean up the problem.

Zands brought a "citizen suit" against the parties pursuant to RCRA § 7002(a)(1)(B), 42 U.S.C. § 6972(a)(1)(B) (1988), which provides:

> "[A]ny person may commence a civil action on his own behalf-- . . . against any person . . . including any past or present generator . . . or past or present owner or operator of a . . . disposal facility, who has contributed or who is contributing to the past or present . . . disposal of any solid or hazardous waste which may present an imminent and substantial endangerment to health or the environment . . . ."

Although the remedy sought by Zands is not disclosed in the court's opinion, RCRA § 7002(a) gives the court jurisdiction in a citizen suit to enjoin the disposal or "to order such person to take such other action as may be necessary . . . ." Zands, if successful, will most likely seek an order requiring the defendants to clean up the property. The citizen suit provision does not provide for payment of damages to private parties. However, it does authorize the assessment of civil penalties.

In Zands v. Nelson, Case No. 89-0989-GT, 1991 U.S. Dist. LEXIS 19321 (S.D. Cal. Dec. 3, 1991), the court holds that gasoline leaking from an underground storage tank, and the contaminated soil, constitute disposal of a solid waste. Once the gasoline ceases to be a useful product, it becomes a solid waste subject to RCRA. The court also holds that RCRA § 7002(a) *supplements* the federal underground storage tank statutes found at 42 U.S.C. §§ 6991 to 6991i (1988).

The court refuses to restrict RCRA's scope by holding that the CERCLA "petroleum exclusion" does not apply to RCRA. As the court notes: "[W]hereas CERCLA has an explicit exclusion for petroleum, *no such similar exclusion exists in RCRA.*"

The court also holds that the "mere creation of solid waste, and the subsequent abandonment of it in the ground, will support a cause of action under section 6972(a)(1)(B) [RCRA § 7002(a)(1)(B)]." Potentially responsible parties under RCRA can include any person who: (1) Creates ("generates") the waste, (2) transports the waste, or (3) owns the site where the waste is located. In holding that the parties who created the waste are subject to RCRA the court states: "The Court simply will not accept defendants' interpretation of the statute which would allow individuals to create solid waste, and avoid the requirements of RCRA *by never making any attempt to clean up the mess.*"

Before a person can be ordered to take action under § 7002, there must be a showing that the person "contributed" or "is contributing" to the past or present disposal giving rise to the suit. The court holds the contribution issue is a factual issue which cannot be resolved, in this case, by summary judgment. However, the court does hold that each of the defendants *could be* a contributor under the statute. The court observes:

> "Here, the defendants are individuals who owned the land during which time the gasoline allegedly leaked, individuals who operated the pumps during which time the gasoline allegedly leaked, and individuals responsible for the installation of the piping and pumps for the gasoline tanks that allegedly leaked. *None of these individuals are so far removed that it can be said that, as a matter of law, they did not contribute to the*

leakage."

Comments:

This case appears to be the first instance where the RCRA citizen suit provision has been used by a property owner to try and force third parties to clean up storage tank contamination. This is particularly significant since the cost recovery provisions of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) cannot be used to recover cleanup costs from other responsible parties. To date, courts interpreting CERCLA's "petroleum exclusion" have held that gasoline leaking from underground storage tanks comes within the exclusion and therefore in not actionable under CERCLA. Wilshire Westwood Associates v. Atlantic Richfield Corp., 881 F.2d 801 (9th Cir. 1989). This means that in many instances the only way the current landowner can respond is to clean up the site and then try to sue other responsible parties relying upon tort theories to recover their cleanup costs. The RCRA citizen suit provision may provide a statutory remedy where the current landowner can force other responsible parties to conduct the cleanup. The prevailing party in a RCRA citizen suit can recover their litigation costs, including attorney and expert witness fees. RCRA § 7002(e), 42 U.S.C. § 6972(e) (1988).