FINAL EXAMINATION

MINERAL LAW

P.N. Davis

Friday, December 10, 1999: 1:00 - 3:30 PM
Thursday, December 16, 1999: 8:30 - 11:00 AM

THIS IS A TWO AND ONE-HALF (2½) HOUR EXAMINATION.
THIS EXAMINATION CONTAINS SIX (6) PAGES.
THIS EXAMINATION CONTAINS SIX (6) QUESTIONS.
I = 30 min. II = 30 min. III = 30 min. IV = 15 min. V = 15 min. VI = 30 min.
FILL IN YOUR EXAMINATION NUMBER ON THE BLUEBOOK STICKER.

Instructions:

1. These questions will be graded on the basis of the times indicated with each questions. The indicated time for the questions total 2½ hours. You will be given 2½ hours to write the examination. Budget your time carefully or you may not finish.
2. Be sure to state a result whenever a question asks for one. Merely stating the arguments on both sides of a legal issue will result in only partial credit because you will not have completed the analysis required by that type of question.
3. If you find it necessary to make factual assumptions in order to answer a question, be sure to state the assumption.
4. Do not assume additional facts for the purpose of avoiding a legal issue or making its resolution easier.
5. Comment briefly on each legal issue reasonably raised by the questions and on each reason for your answer, even when you decide that one legal issue or reason controls the result.
6. The difference between triumph and disaster may lie in a **careful** reading of the questions.

I.
(30 minutes)

After considerable negotiations, Herbert Q. and Jennie Henry executed an oil and gas lease to James Perdy. It differed from a standard form oil and gas lease in four respects:

(1) It provided that wells would be drilled only during the summer months (apparently to avoid potential damage to the surface in the wetter spring, fall and winter months).

(2) It provided that the first well was to be drilled within seven months of lease execution, rather than the standard 12 months.

(3) It provided for a 90-day cessation of production clause.

(4) It contained an interlineation (in italics) in the standard habendum clause, as follows:

> To have and to hold the same for a term of one year from this date, and as long thereafter as oil, or gas or either or any of them is produced therefrom **, or as much longer thereafter as the lessee in good faith shall conduct drilling operation thereon and should production result from such operations, this lease shall remain in full force and effect as long as oil or gas shall be produced therefrom.
>
> *** Lessor shall receive at least $1,000.00 per year royalty payment from lessee, in order to be considered "production".*

The lease was executed on April 18, 1997.

In November 1997, Perdy completed drilling on the Henry's property. Gas was sold in January and February 1998, and Perdy tendered royalty checks to the Henrys for those months in the amounts of $39.72 and $ 23.83. The Henrys negotiated those checks. No gas was produced in March, April, and May, but was produced in June 1998. A check for the royalties due for June in the amount of $32.03 was tendered on July 11, 1998. The Henrys returned that check accompanied by a letter from Henry's attorney stating that the lease had expired under its terms and conditions. The same day the Henrys posted "No Trespassing" signs on the leased property. Perdy did not attempt to access the leased tract thereafter.

On September 29, 1998, Perdy filed suit against the Henrys alleging that the lease was still in full force and effect, asking for an injunction requiring the Henrys to give him access to his lease. It was accompanied by a check for $980.02 representing the difference between the $1000.00 minimum payment and the $63.55 previously paid to the Henrys as royalties with interest from April 18, 1998, the anniversary date of the lease, to the date of tender. Also included was a retender of the $32.03 June 1998 royalty check. The Henry defended, alleging that production had ceased and that the $1,000 minimum royalty was paid too late.

Should the court declare the lease valid, or invalid from July 11, 1998, the date the Henrys repudiated it? Discuss all relevant issues. State a result.

II.

(30 minutes)

Robert and Hazel Wolfe executed a lease to Monarch Minerals on June 25, 1969, of a 1000 acre tract. The lease is entitled "OIL AND GAS LEASE" and provides in part:

> ... [H]ereby granting to Monarch Minerals full and exclusive authority to enter upon said premises and to dig, drill, operate for and procure natural gas, petroleum and other mineral substances ... .
>
> There is already on said premises two producing oil wells and one gas well ... and it is agreed that Monarch Minerals are to pay to Robert and Hazel Wolfe as royalty, one-eighth of the oil and gas sold or marketed from said premises. ...
>
> In the event of the discovery of petroleum or other mineral substances Monarch Minerals shall deliver as royalty to Robert and Hazel Wolfe in tanks near the mouth of the well or wells or at the mouth of pit or shaft or into pipeline without cost to Robert and Hazel Wolfe 1/8th of such product or pay the market price in cash therefor at the option of Robert and Hazel Wolfe and the remainder of such production shall belong to Monarch Minerals.
>
> ... Monarch Minerals agrees to drill no wells or conduct other operations within two hundred feet of any building now on said premises. ...

The lease had a term of 90 years. It has no provisions relating to removal of overburden and use of surface mining technology.

About three feet beneath the surface is a strata of limestone 30 to 35 feet thick on much of the tract. Also, there are several limestone outcroppings. It would be relatively easy to quarry and is of considerable value to make cement. At the time the lease was executed in 1969, limestone was being quarried by surface mining methods a short distance away.

Oil and gas was produced from the lease continuously since 1969. On July 10, 1998, Monarch Minerals gave notice to the Wolfes that they intended to open a limestone quarry on the tract in 1999. Its notice acknowledged that the areas near the Wolfe's house and outbuildings, and the driveway leading to them, as provided for the lease, would not be disturbed.

The Wolfes brought suit to enjoin Monarch Minerals from opening a quarry or conducting other mining operations on the tract, alleging that the lease provided only for the drilling and operation of oil and gas wells. Should the court grant the injunction. Discuss all relevant legal issues. State a result.

III.
(30 minutes)

Stanley Woods began taking leases and drilling for natural gas in the western part of the South Barnard Field. Some 30 years later he decided to explore the eastern part of the field and in 1990 his company, Southeastern Gas Company, drilled a "wildcat" test well on a 320-acre lease that it had acquired from Zela Leveridge. The test well was successful, ultimately producing more than three million cubic feet of gas per day. With the success of that test well, Southeastern sought to protect its interest in the field from drainage by another operator, and in early 1996 negotiated three-year leases on Robert Thomas's adjacent property to the north totaling 160 acres. Southeastern did not drill on those Thomas leases to the north, but drilled two more successful wells on the original Leveridge tract.

Farther to the north of both the Leveridge and Thomas leases were other leases and gas wells, owned by third-parties, which began draining the Thomas leases in 1997. Evidence suggests that about one-third of the gas originally in place beneath the Thomas leases is being drained to the north onto the third-party tracts and two-thirds of that gas is being drained to the south to the Leveridge tract wells.

In 1998, Thomas formally complained to Southeastern about the drainage and demanded that it drill a natural gas well on the Thomas leases, and if necessary, to drill an offset well. Southeastern formally responded that it saw no physical or legal reason to drill either type of well.

In late 1998, Southeastern sought to extend its leases on the northern Thomas tracts for three more years. Thomas, believing that Southeastern had not diligently developed his acreage, refused. Four days before the northern Thomas leases were to expire, Southeastern pooled the Thomas leases with acreage surrounding one of the new wells on the Leveridge tract to form a 320-acre pooled unit. Half of the unit's acreage came from the Leveridge lease (160 acres) and the other half from the Thomas leases (160 acres).

The Thomas leases had a conventional 3-year primary term and secondary term "for as long as production continues." Both the Leveridge lease and the Thomas leases gave Southeastern "the right, at its option, to pool or unitize any land covered by this lease ... with any other land, lease, or leases ...." Evidence suggests that the wells on the Leveridge lease are draining two-thirds of the gas underlying the Thomas tracts (as mentioned above).

Thomas sued Southeastern after expiration date of the leases seeking a declaration that the leases had expired. Identify possible reasons for declaring the lease terminated. Should the court declare the Thomas leases expired or terminated? Discuss all relevant legal issues. State a result.

IV.
(15 minutes)

In 1928, George Brown conveyed to Modesto White the fee simple in a tract of land, reserving an interest, as provided as follows:

> Grantors herein reserve for themselves, their heirs, assigns and legal representatives a undivided 1/16 interest in and to all minerals of every kind and description, including oil and gas, in upon and under said land;
>
> but the right to control and manage and make any and all gas and oil leases or other mineral leases upon said land is hereby granted exclusively to grantees herein, their heirs, assigns and legal representatives, and they shall be entitled to any and all cash bonus or bonuses paid on any and all oil and gas leases on said land together with all cash rentals under such leases;
>
> but an undivided 1/16 of any and all oil and gas and other minerals developed from said land shall be owned by grantors herein, their heirs, assigns and legal representatives.

When successors of White began to mine uranium from the land, they brought suit against George Brown, Jr., successor to George Brown, to determine the nature of Brown's reserved interest.

A.

What type of interest in minerals should the court find had been reserved by George Brown? Discuss all relevant legal issues. State a result.

B.

Are the successors to White entitled to deduct from 1/16 of the minerals produced a 1/16 portion of the costs of production? Discuss all legal issues. State a result.

V.
(15 minutes)

Wilma Woods leased her mineral rights to Grand Marais Oil Company for a fixed primary term "and as long thereafter as oil, gas, or other mineral is produced from said land hereunder, or drilling or reworking operations are conducted thereon." Grand Marais drilled one producing well by the end of the primary term, but did not drill any others later. The well showed a net profit of $7,600 from January 1996 through April 1997 and of $5,200 from June 1998 through December 1999. It produced oil but did not show a net profit between May 1997 and May 1998, at which time it was reworked.

Woods brought suit against Grand Marais to declare the lease terminated for failure to meet the production requirement of the secondary term. Should the court grant the requested relief? Discuss all relevant legal issues. State a result.

VI.
(30 minutes)

Briefly define the following terms:

(1) open mine doctrine

(1) abandonment

(1) accommodation doctrine

(1) market demand prorationing

(1) implied covenant

(1) delay rental

(1) nonownership theory

(1) shut-in royalty

(1) dormant mineral rights statute

(1) lands unsuitable for surface mining

MINERAL LAW
Fall 1999

I. (30 min.)

<u>Primary & secondary terms</u>:

- lease provides for a 1 year primary term
- lease requires drilling to begin within 7 months of lease execution
    - drilling did begin within that period
- lease provides for a secondary term "as long as o&g is produced"
    - lease contains a 90-day cessation of production clause
        - production of gas in 1998 did cease, but only for 3 months
    - *bonus:* lease contains a continuous drilling clause

<u>Does the primary term end prematurely if o&g is produced before the end of 1 year?</u>

- No!
- the lease by its express terms runs for not less than 1 year
- production of o&g, and subsequent cessation of production during the first year, does not shorten the primary term
- there must be production at the end of the primary term
- and there was

<u>Minimum royalty clause</u>:

- lease requires the payment of a minimum royalty of $1,000 for actual production for the lease year to qualify as meeting the "production" requirement of the secondary term
- royalty checks must be tendered at the time, place, and amount specified by the lease
- since the $900+ check was tendered before the end of the 1st year of the secondary term, it was paid on-time.
- also, the secondary term can be interpreted as requiring either actual production or tender of the minimum royalty be the end of the 90-day cessation of production period to save the lease.
- the minimum royalty check was tendered in the 3rd month (Sept. 1998) after cessation of production by July 1998.
- no violation of the requirements of the secondary term

<u>Must a $1,000 minimum royalty check be paid for the primary term?</u>

- No!
- the interlineation is inserted into the language specifying the secondary term production requirement; therefore; it does not apply to the primary term.
- no violation of the requirements of the primary term

<u>Result</u>: the lease is still in force.

II. (30 min.)

<u>Right to surface mine</u>:

- lease does not expressly authorize use of surface mining technology
- lease could be interpreted as impliedly allowing surface mining
    - "minerals" are included in lease
    - "dig[ging]" is mentioned along with "drilling" as an authorized operation
    - "pits", "shafts" and "mine mouths" are mentioned in connection with delivery of royalties in kind

- "pits" arguably contemplates use of surface mining technology

Is limestone a "mineral"?

- lease conveys right to recover oil, natural gas, and "other minerals"
- there are several interpretative rules:
  - conventional legal definition: metallic ores, jewels, hydrocarbons, and useful rocks
    - limestone for cement has been considered a useful rock
  - sand, gravel, clay, soil & water are "common varieties" ordinarily not considered "minerals"
    - limestone for gravel crushing may not be included
  - *ejusdem generis* rule provides that a collective term following a specific list is to be interpreted as including only similar items; hence, "minerals" ought to mean only other types of hydrocarbons (*e.g.*, asphalt, tar sand, etc.)
  - minerals recoverable only by surface mining methods not considered a "mineral" (under a repudiated Texas line of cases)

Understanding in region:

- limestone was known to be in area
- it was being quarried at time of lease execution
- the quarrying being done then was a surface mining technology
- these facts are relevant to both the "minerals" definition issue and use of surface mining technology issue

Result: decide!

III. (30 min.)

Possible reasons for declaring the lease invalid:

(1) failure to drill production well(s) into "known" productive formations

(2) failure to drill offset well(s) to black drainage to off-tract wells to the north

(3) improper pooling to save lease

failure to drill production well(s) into "known" productive formations

- secondary term extends lease only if there is production of oil & gas
- there is an implied covenant to drill and produce
- that covenant must be satisfied by the end of the primary term, but not before (where the primary term is short – here, 3 years)
- *effect of pooling:*
  - under pooling, production anywhere on the pooled unit is treated as production from all portions of the pooled unit
  - it is presumed that production is derived uniformly from the entire unit
- hence, there was production by the end of the primary term, and the lease is extended into the secondary term

failure to drill offset well(s) to black drainage to off-tract wells to the north

- lessee has an implied obligation to protect the lease from drainage to off-tract wells
- failure to drill offset well(s) will be a breach of that obligation if the drainage is significant (as here – 2/3 + 1/3 of underlying gas)
- lease can be terminated for breach of that obligation, after a demand is made and rejected (as here)

- *effect of pooling:*
    - once leases are pooled, there is no obligation to protect against drainage within the pool
        - because royalties are divided pro-rata and there is no damage
    - but the obligation to protect drainage from the pooled unit to off-tract wells continues (and was breached here)
- the lease can be declared terminated

<u>improper pooling to save lease</u>

- there is no right to pool productive and unproductive lands
    - but this is an offense against the lessor of the productive lands, because it creates a windfall for the lessor of unproductive lands
- but it is proper to pool productive lands with other productive lands, even though there are well(s) on only one of them
    - here, the Thomas lease expressly provided for pooling
    - the Thomas lands were known to contain gas
- however, it is bad faith to pool just as a lease is about to expire in order to extend the lease without on-site development & production
    - especially if the pool unit boundaries are unusually configured (not the case here)

<u>result</u>:

- because a formal demand to protect against drainage had been made and rejected, Thomas is entitled to termination of his lease

IV. (15 min.)

A. <u>Language of interest</u>:

- typical language:
    - minerals "in, on and under" the land — [fractional] mineral interest
    - minerals "produced and saved" from the land — royalty interest
- here, the deed uses "in, on and under" language
- but then it goes on to describe the nature of the interest in functional language
- it specifies that the executive right (the power to execute leases) passes exclusively to grantees
    - that is characteristic of a nonparticipating royalty
    - the holder of a [fractional] mineral interest retains an [undivided] executive right
- thus, the second paragraph (nonparticipating royalty interest) modifies the meaning of the first paragraph (fractional mineral interest)
- the third paragraph is not inconsistent with a nonparticipating royalty interest, but merely specifies the division of the mineral production

B. <u>Costs of production</u>:

- No!
- the holder of a royalty interest takes the fractional share of production free of costs

V. (15 min.)

- "production" in a secondary term means production in "paying quantities"
- "paying quantities" means a net profit of revenues over operating costs
    - capital costs of drilling the well are irrelevant

- but, if a “reasonable prudent operator” would continue operating a well although it was not producing in paying quantities, the secondary term does not end
- a reasonable prudent operator is one who, for purposes of making a profit in the future, and not merely for speculation, would continue to operate a well at less than paying quantities
- here, the period of production at less than paying quantities was 13 months
    - it produced paying quantities both before and after that period
- thus, it would appear that lessee expected to be able to resume production in paying quantities
- when the lease does not contain a “cessation of production” clause, cessation of work may extend for only a reasonable period
    - when the lease does not specify or imply some other period, the industry norm of 60 days is used
- but here, there was not a total cessation of production
    - although the “paying quantities” test can be used to define “production” for cessation of production purposes, the “reasonable prudent operator” exception kicks in when the period of substandard production exceeds the 60-day norm
- there is no outer limit to the period of substandard production, except the reasonableness test
    - one assumes that the closer to paying quantities the production is, the longer lessee has to improve the production rate before the lease terminates
- here, lessor did not seek termination until 18 months after production in paying quantities resumed
    - *laches* probably is a valid defense under that circumstance

VI. (30 min.)

Briefly define the following terms:

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(6) delay rental
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(10) lands unsuitable for surface mining