Question 10 – July 2012 - Selected Answer 1

1. Sean was entitled to a bonus payment at the beginning of the lease and to one delay rental on December 1, 2007. The issue is when is the bonus of an oil and gas lease due and when is a delay rental due. Unless otherwise specified in the lease the bonus is a payment from the lessee to the lessor at the signing or beginning of the lease an incentive to enter into the lease with the oil and gas company. As such, the bonus payment should have been paid to Sean at the very beginning of the lease (or at least within a reasonably time period after the beginning of the lease). Since the north 1000 acres was leased for a 1,500 bonus, Sean should have received 1.5 million at the beginning of the lease.

Sean was also entitled to a delay rental on December 1, 2007 and possible December 1, 2008. The issue is how should the language of the oil and gas lease be interpreted concerning the delay rental clause in the lease. Generally, delay rentals are not treated as uniformly as the bonus. In some cases a delay rental is only owed at the end of the primary term, and other times a delay rental needs to be paid annually regardless of the length of the primary term. In either case, the language of the lease should control. Here, the lease provides for delay rentals on the anniversary of the lease for any period where production operations have commenced. At the very least the first anniversary of the lease was December 1, 2007 and drilling operations had not yet commenced. Under the terms of the lease, Sean is entitled to a delay rental of 750 per acre for the entire first year of the lease where production had not commenced. In addition, there is a period from the beginning of December to December 30, 2007 where there was also no production operations commenced. The terms of the lease are ambiguous as to this "period" without production, but it is possible that Productions Co. must also pay a pro rata share of 750 per acre for the period without commencement in the second year of the lease. However, due to the language ambiguity, it is more likely that a court would decide that a "period" without commencing production refers to a full year period when another anniversary of the of the lease arrives. This is a more likely reading because delay rentals are often paid on the basis of lack of production in a given year, so a pro rate delay rental for such a short time seems unlikely.

2. Sean's right to receive royalty payments began the moment that Productions Co. began producing oil or gas on the property and that right continues for so long as oil or gas is produced on the property. The right to royalty by a lessor begins the moment production begins because the royalty is taken off the top of production, such that the royalty interest is not accountable for any costs. From a practical perspective the royalty interest owner might not receive payments until the end of the first month of production, but ideally the right to such payments began the moment the lessee has a producing well. In addition, although the oil and gas lease uses the word production to mean "production in paying quantities" (i.e. proceeds from selling the oil or gas minus the operation costs minus taxes must be a positive figure), the royalty interest, since it does not account for production costs, technically can receive payment on any oil and gas produced before any costs are taken into account. Here, Sean's right to begin receiving royalty payments began in mid-2008 when Productions drilled its first producing well. Under the terms of the lease, the beginning of production pushed the lease into its second term, which is limited only by the language that the lease shall continue so long as oil and/or gas is produced on the land. This means that Sean's right to royalty payments continue so long as Productions continues to produce. Production can continue to produce so long as it is in paying quantities. This means that Sean's right to royalty payments in indefinite so long as Productions continues to operate its wells. In addition, although Sean sold the 2000 acres to Riley, he explicitly reserved

the mineral interests in himself, thereby maintaining his right to the royalty payments.

3. No Riley could not have prevented the new well, nor require Productions to remove its equipment by the end of November 2011. The issue is what rights does a surface owner have in preventing continuing production by and oil and gas lessee. In general, as stated above, the oil and gas lessee may continue production so long as it continues to have productive wells on the land. The secondary term is indefinite because of this clause, and thus a lessor may not force the oil and gas lessee from producing on the land. Also, unless the lease expressly states otherwise, once the lease is in the second term, there is no limitation on the lessee to drill new wells to maintain production. Since the old wells continue to produce, Productions has the right to continue to explore the land under lease for so long as the lease continues and drill wells where it sees fit (in a reasonable manner). Riley, however, is not even the lessor, since Sean reserved the mineral interest, and thus as the surface owner his estate is servient to the mineral estate and the lessee. The implied easement to go on the surface to explore and drill the land is granted to the lessee, and the surface owner may not prevent that, albeit with some narrow exceptions. Thus, Riley has no right to prevent drilling the new well, or trying to remove Productions equipment already on the land.

4. No, Riley cannot challenge the new lease as to the Southern 1000 acres. The issue is to what extent may a surface owner prevent a mineral estate owner from entering into an oil and gas lease. The mineral estate owner has the executive right to enter into lease for the mineral estate they own. This is a necessary result since otherwise the mineral estate would be worthless if a surface estate could dictate access to the minerals. Since Sean maintained the ownership right in the mineral estate, Riley has no right to prevent Sean's new lease. Riley's claim that because the lease did not exist before the sale of the Southern 1000 acres to him means the executive interest is extinguished is simply incorrect. By reserving the mineral estate in himself, Sean was saving the executive right. Finally, Riley has no other claims to prevent the lease, such as the accommodation doctrine, because he has established no prior use of the land.

Question 10 – July 2012 - Selected Answer 2

(1) Sean was entitled to a bonus payment upon entering the lease with Production Co for the North 1000 acres and was entitled to a delay rental for the period between December 1, 2007 and December 30, 2007. At issue is the amount and entitlement of a lessor to certain payments made under an oil and gas lease. Under the oil and gas lease, the lessor was entitled to a delay rental for any delay in operations after the first anniversary of the lease. Here, the lease was executed on December 1, 2006. Therefore, if operations had not commenced by December 1, 2007, the lessee would be obligated to make delay rental payments to the lessor. The facts do not state whether the delay rental clause was written as a condition or a covenant. If written as a condition then the lease would have terminated once the lessee failed to make the requisite delay rental payments. However, there are no facts to this issue. Also, the lease provided for a $1500 bonus. A bonus is an amount of money that is paid to the lessor upon entering the lease. It is a cash payment which is due immediately upon the execution of the lease and is not conditioned upon production or operations of the lessee. Therefore, under the current facts, Production Co was required to make delay rental payments for the period between the anniversary of the lease and the commencement of operations totaling $750 per acre and was required to make a full payment of the bonus upon the execution of the lease in December

2006.

(2) Sean was entitled to begin receiving royalty payments once the completed wells on the North 1000 acres began producing oil and gas and the right remained thereafter as long as production in paying quantities was maintained. Under and oil and gas lease and under Texas law, a royalty is due to the lessor of a valid oil and gas lease when any oil is produced under the lease. There is no requirement that the production be in paying quantities, which requires production which outmatches the costs of that production, because the royalty owner is entitled to payment free and clear of the costs of production. Additionally, under the terms of the lease in question and indeed most leases in the state of Texas, production in paying quantities will hold a lease beyond the primary term in perpetuity. Therefore, the right to a royalty payment under a lease will extend to the end of the primary term for any production and part the primary term for production that holds the lease, namely in paying quantities.

(3) No Riley could not have prevented Production co from drilling a new well in January 2012 and it is not required to remove its equipment and abandon all wells as of November 2011. The issue is whether production in paying quantities is holding the lease past the primary term and whether Production Co. as the owner of the dominant estate may continue to use the surface estate for the benefit of the mineral estate.. Under Texas law, the owner of the surface estate owns the dominant estate of the surface estate. Therefore, the owner of the mineral estate may use as much as is reasonably necessary of the surface estate in order to enjoy their interest in the mineral estate. However, the owner of the surface estate may enjoin some uses of the surface estate if it can be proven that the surface use being obstructed is a pre-existing use, that there are alternatives available to the mineral estate which would not result in the obstruction, and those alternatives a reasonably available. Here, Riley might claim that the drilling of the new well in January obstructs his intended uses of the property as a wind farm and therefore they may be enjoined from drilling the new well. However, this argument is not likely to be successful because the wind farm is not a preexisting use and there is no reasonable alternative available should Production wish to drill another well other than to drill another well.

Also, Under Texas law, an oil and gas lease that states that it will be in effect during a primary term and a secondary term as long as oil and gas a produced on said law will entitle to lessor to continuation of the lease after the primary term until there is no longer production in paying quantities. Production in paying quantities means production that is larger than the costs of that production, namely the royalty interest, the costs of producing and other costs.

Here, it states that there are currently three wells on the property at the end of the primary term in November, 2011. There is no mention as to whether the wells are producing paying quantities. However, it is likely that the well as producing in such paying quantiies. If there is sufficient product as of November 30, 2011, then the lease will continue onward until there is no longer production in paying quantities to hold the lease. Therefore, since the lease is still valid, Production co. may drill another well in January of 2012 and may continue to use as much of the surface as is reasonably necessary past that time until there is no longer production in paying quantities.

(4) No. Riley cannot successfully challenge Sean's execution of a new lease on the south 1000 acres. The issue is the right of the mineral and therefore executive interest holder to execute a lease over the objection of the surface estate holder.

Under Texas law, the holder the mineral interest in property owns, often along with that mineral

interest, the executive rights. The executive right holder has the right to enter into oil and gas leases on the property. The mineral interest holder, as discussed above, is the owner of the dominant estate and therefore does not need the approval of the surface estate holder before executing any oil and gas lease. In the deed from Sean to riley, Sean expressly reserved all of the mineral interests in the land to Sean. There is no mention in the facts that the Executive Rights to the property have been severed to anyone else and are therefore assumed to have passed with the Mineral interest in the reservation to Sean. As a result, Sean holds the dominant estate over the surface interest holder, Riley, and may enter into oil and gas lease without the approval of Riley. Therefore, Riley cannot successful challenge Sean's March 2012 lease to Production Co.

Question 10 – July 2012 - Selected Answer 3

1. Yes, Sean was entitled to a bonus payment and delay rentals payments. A mineral lease generally provides for a bonus payment, which is an up front payment that the mineral interest holder receives as consideration for leasing the interest in the minerals to the lessee. A mineral lease also generally includes a delay rental term, which is "rent" during the primary term of the lease for periods in which the lessee does not have production in paying quantities. Here, the lease provided for a bonus payment of $1,500 per acre. At the commencement of the lease, Sean should have received this one time payment of $1,500 for each of his 1,000 acres that he leased to Productions Co. The lease also explicitly provide for delay rentals of $750 per acre, which were to be paid on the anniversary of the lease if there was no production in paying quantities. Since Production Co did not being to drill until December 30, 2007, it went at least to the first anniversary of the lease without producing in paying quantities. Thus, on December 1, 2007, the first anniversary of the lease, Production Co should have paid Sean a delay rental of $750 per each of his 1,000 acres. Further, it is not entirely clear when the three wells began producing in paying quantities. If another anniversary passed before the wells began producing in paying quantities, another delay rental of $750 per each 1,000 acres would be due to Sean.

2. Sean's right to begin receiving royalty payments arose the moment that Productions Co. produced oil or gas from the from the wells that it drilled on his land and continued so long as Productions Co continued to produce oil or gas from the wells on the land. A mineral lease generally provides for a royalty payment, which is a percentage of the value of the oil and gas produced from the land during the term of the lease. The right to a royalty payment does not turn on paying quantities; it is an off the top cut that the lessor gets from the proceeds from the sale of any minerals produced under the terms of the lease. Generally a lease has a primary and a secondary term. The primary term is generally for a fixed period of time, and the secondary time is so long as oil and gas are produced. Production is means production in paying quantities. Here, Sean’s lease provided that he was to get a 1/16 royalty interest and the lease provided that the lease term was to continue so long as oil and/or gas is produced on the land. Productions Co. began drilling operations on the land on December 30, 2007 and continued to drill wells which have produced gas in paying quantities "since then." Therefore at some point, these wells began producing oil. At that point in time, Sean was entitled to a 1/16 royalty payment for on all oil produced. Since the wells continue to produce in paying quantities, the lease term is still in place and Sean continues to have rights to a 1/16 royalty payment for any oil produced.

3. No, Riley could not have prevented Productions Co. from drilling the new well in January 2012 or required it to remove its equipment and abandon all wells at the end of November 2011. As described in question (2) above, a lease has a primary and secondary term. The secondary term generally continues, giving the lessee a continued right to drill wells and produce oil and gas under the lease, so long as the lessee continues to produce in paying quantities. When a buyer purchases land with a valid oil and gas lease on the land, he buys subject to that lease. His purchasing the property does not terminate the preexisting rights of the lessee. Additionally, in Texas, the surface estate is servient and the mineral estate is dominant. When an oil and gas company has a valid lease as to a mineral estate, they have a fee simple determinable in that mineral estate. Since the mineral estate is the dominant estate, they can burden the surface estate in order to develop the mineral (including by drilling wells) subject to a duty of reasonable accommodation to the surface uses.

Here, as described in response to question (2) above, Production co has a valid lease to mineral estate of the 1,000 acres which contains a secondary term. Because Production Co continues to produce in paying quantities, the secondary term of the lease continues, giving Production Co. a continued right to develop the mineral on the property. This includes a right to drill new wells on the property, to the detriment of the surface estate owner. Granted, Production Co must make reasonable accommodations to the surface owner. However, the facts have not shown any requests for reasonable accommodation by Riley. Riley simply desires to prevent Production Co. from drilling a new well. As the owner of the servient surface estate, Riley cannot prevent production Co from drilling a new well or force it to remove its equipment and abandon all wells.

4. Riley could not have successfully challenged Sean’s March 2012 lease to Production Co. At issue is who has owns the mineral estate under the south 1,000 acres and the executive interest to those 1,000 acres. When property is transferred, the mineral estate and the surface estate can be transferred separately. As to whether the mineral estate has been transferred, the courts will look to the terms of the deed. Unless otherwise, agreed by parties, the party who is deemed to own the mineral estate is generally the one who has the executive interest in the land. The owner of the executive interest has the right to lease the mineral estate. Here, Sean explicitly reserved "all mineral interests." These terms show that Sean held the entire mineral interest in the land, thus he owned the mineral estate. Because it does not say otherwise, he owned the executive right as well. Therefore, Sean could lease the land and Riley, as owner of the surface estate only, could not successfully challenge his March 2012 lease to Production Co.