

Question 3 – February 2015 – Selected Answer 1

1. During the term of the lease with Molly, Major Oil Company owns a fee simple determinable in the mineral estate.

The issue is what type of estate in land a lessee in an oil and gas lease owns during the term of the lease. When a lessor signs a lease with a lessee oil company, the lease grants to the company a temporary interest in the estate, the rights to which will revert back to the grantor (lessor) upon termination of the lease. This type of estate in land is considered a fee simple determinable. It is also called the "working interest."

Here, it appears from the facts that Molly owns the mineral estate of Cuero Ranch in fee simple. She has signed a 10-year lease with Major Oil, during which time Major Oil has the right to enter the land, drill and explore in order to produce oil and/or gas. Upon the expiration of this term, all the rights to Cuero Ranch will revert back to Molly.

Therefore, Major Oil has a fee simple determinable or "working interest" in the mineral estate during the term of the lease.

2. During the term of the lease with Major Oil, Molly retains a possibility of reverter.

The issue is what type of estate in land a lessor owns during the term of an oil and gas lease. As stated above, when a lessor signs a lease with a lessee oil company, the lease grants to the company a fee simple determinable. The estate in land following a fee simple determinable is a possibility of reverter, which goes into effect automatically after the termination of the fee simple determinable estate. In the case of an oil and gas lease, the lessor retains what is called the "royalty interest."

Here, Molly has granted a fee simple determinable to Major Oil Company during the term of the lease. Upon the expiration of the 10 years, her interest in the land will automatically vest and she will return to possession of a fee simple interest in the mineral estate of Cuero Ranch.

Therefore, Molly retains a possibility of reverter during the term of the lease with Major Oil.

3. Molly does not have a duty to extend the primary lease term based on Major Oil's offer to make a delay rental payment.

The issue is whether a lessor has a duty to extend a lease based on a lessee's offer to make a delay rental payment. Where a lease provides for delay rental payments, failure to make payment on time and in the correct manner may operate to terminate the lease. A lessor may make demand of these delay rental payments in the case that a well has not been drilled or production has not begun, depending on the terms of the lease. A lessor certainly does not have a duty to extend the lease beyond the primary term, regardless of a lessee's offer to make a delay rental payment or other payment. A lessor may agree to extend the primary term of the lease, in which case an extension should be signed and filed in the Land Records of the County Clerk's office where the mineral estate is located, and any new signing bonuses must be paid to the lessor.

Here, Major Oil Company has failed to make any delay rental payments despite the lease clause providing for the payment of delay rentals. It has failed to produce oil and gas in paying quantities pursuant to the lease. Molly may make demands for the delay rental payments owed to her, regardless of Major Oil's offer to make a payment.

Therefore, Molly does not have a duty to extend the primary lease term.

4. Molly owns nothing if she sells the entire mineral estate to Major Oil Company, but she may choose to reserve an interest.

The issue is what interest a mineral estate owner may retain if he or she conveys the mineral estate. In Texas, the mineral estate can be severed from the surface estate. Both the surface owner and the mineral owner may own a fee simple interest in their respective estates. Additionally, the owner of a mineral estate can convey the minerals

and reserve unto themselves a portion of the mineral estate and executive rights, a portion of the mineral estate without executive rights, or simply a non-participating royalty interest.

Here, the facts are unclear as to whether Molly owns the surface estate as well. If that is the case, and she conveys the entire mineral estate to Major Oil, then she retains a fee simple interest in the surface subject to the dominant mineral estate and the Accommodation Doctrine. If she owns only the mineral estate and conveys the entire mineral estate to Major Oil, she retains nothing. However, she may choose to reserve a portion of the mineral interest, a royalty interest, or the executive rights (leasing rights) in the minerals.

Therefore, Molly will own nothing if she does not own the surface and chooses not to reserve an interest in the conveyance to Major Oil.

Question 3 – February 2015 – Selected Answer 2

1. During the term of the lease, Major Oil Company owns the following interests: (i) a fee simple determinable in the mineral estate, which provides it with a working interest to explore, produce and develop and (ii) the rights to all profits from the minerals other than the benefits granted to Molly under the lease.

Under Texas law, the entrance into an oil and gas lease results in the creation of various property interests. During the term of a lease, the Lessee is given a working interest. It has the right to produce, develop and explore. Most leases give the lessees an exclusive right to do these acts. The interest granted is a fee simple determinable. As the holder of the fee simple determinable, the lessee will have the rights to all profits from the mineral interests except those reserved for the lessor or other persons under the lease or, where there are multiple tenants, the interests of the other tenants created by law. Here, Major Oil entered into a standard lease and has a fee simple determinable. Outside of the royalty interest paid to Molly, it appears to have all other interest in the mineral interests during the term of the lease.

2. During the term of the lease, Molly has the following interests: (i) a possibility of reverter in the mineral estate and (ii) a 1/8 royalty interest in the profits earned by the production of oil, which she will receive free of production costs.

Under Texas law, the lessor under an oil and gas lease retains a possibility of reverter in the mineral estate. This means that upon the termination of the lease, the entire mineral estate will be owned by Molly in fee simple absolute. Also, Molly retained a 1/8 royalty interest under the terms of the lease. Under Texas law, this is a property interest.

3. No, Molly does not have a duty to extend the primary lease term because Major Oil failed to timely pay a delay rental.

The issue is whether an offer to pay a delay rental after its due date can extend a lease.

A delay rental clause generally provides that a lease will terminate if a lessee has not begun drilling by a stated date. The use of delay rentals essentially has the effect of extending the primary term of the habendum clause. However, failure to drill by the specified time will result in either the termination of the lease or a breach of the lease, depending on the language used. Under Texas law, a lessor is under no obligation to accept a late delay rental. However, if the lessor does accept the late payment, the lease may be revived under Texas doctrine that uses a "loose theory of estoppel". This theory generally requires an act by the lessor on which the lessee detrimentally relies (e.g., cashing the late delay rental check).

Here, the primary term stated in the habendum clause is 10 years. The secondary term was set to last as long as there was production in paying quantities ("PPQ"). At the expiration of the primary term, Major Oil failed to pay the delay rental and there was no PPQ. Therefore, the lease has expired.

Although Major Oil offered to pay the delay rental late, Molly is under no obligation to accept and did not

take any action (e.g., cashing the check) on which Major Oil to rely. Therefore, the lease was not revived and remains expired.

4. If Molly sells the mineral estate to Major Oil, she will no longer have any interest in the Cuero Ranch (unless she also owns the surface estate, which the facts do not stipulate and, therefore, will not be discussed).

Under Texas law, a mineral estate is generally free assignable; provided that the language of any grant will be strictly construed. Therefore, if Molly sells the entire mineral estate to Major Oil Company, she will not retain any interest in the estate unless it is expressly reserved. Notat that, since the lease expired, she no longer has right to a royalty interest.

Question 3 – February 2015 – Selected Answer 3

1. Major Oil Company owns a working interest in the mineral estate of Cuero Ranch. At issue is the interest conveyed to a lessee of an oil and gas lease. An oil and gas lease conveys a working interest in the mineral estate which gives the lessee the right to drill and/or mine the minerals with the obligation to pay Royalties to holders of royalty interests, in this case Molly. In this case, the working interest is akin to a fee simple determinable in the mineral estate and the right to drill and develop terminates upon the expiry of the lease.

2. Molly has a royalty interest, the executive right as well as the possibility of reverter of the working interest. At issue is the rights retained by the lessor of an oil and gas lease.

Executive Right and Possibility of Reverter. The holder of a mineral estate has the executive right to enter into leases and may drill on the land. This is contrasted with a non-participating royalty interest holder (of which Molly is not), which is a passive interest and while it has the rights to royalties has no right to enter leases or drill on the land itself. The mineral estate holder may not, however, drill on the land if she has granted the working interest to another party, but if the lease expires and the working interest owner no longer has rights to drill on the land, the working interest reverts to the grantor and then she may drill. In this case Molly is the sole owner of the mineral estate and thus she has the right to enter into oil and gas leases and receive their benefits, such as bonus payments and delay rentals. Molly has conveyed the working interest to Major Oil and thus she cannot currently drill on the land herself, but if the lease expires she will be able to drill in her own right.

Royalty. When a executive right holder enters into an oil and gas lease, she retains a royalty interest in the land and has the right to receive all the benefits of the lease, the bonus, delay rental and royalty payments. The royalty is a fraction interest in oil and gas produced from land free of the costs of production, thus she has the right a share of to proceeds from the operator's drilling operations without having to pay her share of production expenses. Here Molly has a 1/8 royalty and thus she is entitled to 1/8 of the proceeds of the oil and gas produced from the Ranch by Major Oil paying only her share of transportation and marketing expenses.

3. No, Molly has no duty to extend the lease based on Major Oil's offer to make delay rental payments. At issue is whether a secondary term in a Habendum clause may be extended based on delay rentals. Generally no, a lease may not be extended into the secondary term by the payment of delay rentals.

A delay rental is a payment made by the lessee to the lessor for periods after the lease has been signed but drilling has not commenced. Under the lease, Major Oil should have been paying Molly delay rentals during the primary term if it had not commenced drilling. The fact that Major Oil has not paid Molly any delay rental payments to date could suggest that they have commenced drilling but have simply yet to produce a well with paying quantities.

Once the primary term of a lease has expired, the lessee may only continue to operate under the lease if it produces in paying quantities (PPQ). Even though the lease here doesn't specify that production must be PPO, that is inferred in all oil and gas leases. PPQ means that the revenues received less the lessor's royalty and production costs will be a positive number. If Revenues are not sufficient to cover the lessor's royalty and production costs, then the lease is not PPQ and if it is in the secondary term, will terminate. We are told that

Major Oil is not PPQ and that the primary term of the lease has expired. Thus the lease has terminated and Major Oil has no further right to drill on the land.

If the lease contained a shut-in royalty clause whereby a lessor is paid a fixed amount to hold the lease in production, then a lessee may be able to extend the lease without producing in paying quantities provided that it makes the necessary payment to lessor. In this case we are not told that the lease contains such a clause, and thus the only method of extending the lease into the secondary term would be for Major Oil to produce in paying quantities.

4. After a sale of the mineral estate to Major Oil, Molly will own no further rights to the minerals. If an owner sells a mineral estate in fee simple absolute he or she retains no further interest in the mineral estate. If the owner also owns the surface estate and conveys just the mineral estate, he retains the legal interest in the surface and may use it as he pleases subject to the easements of the dominant mineral estate holder. We have no information in this case suggesting that Molly owned both the surface interest and the mineral estate, thus if she sells the mineral estate to Major Oil, she will have no further rights in the mineral estate and if she doesn't own the surface estate, she will have no right of entry on the Cuero Ranch at all.

If an owner sells the mineral estate he or she may reserve a non-participating royalty interest (NPRI) which would entitle the holder of the NPRI to royalties from any leases but not delay rentals or bonus payments. There is no indication here that Molly intends to reserve an NPRI so if she sells the mineral estate in fee simple with no reservations, she will own no further rights in the mineral estate.