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Chapter 12

Division of Royalties — Who Gets What?

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Synopsis

§ 12.01. Introduction.

The royalty clause is the most important clause for the lessor; it is the principal compensation they receive for leasing their property. It can also be one of the most difficult clauses to determine and calculate in terms of who receives what amount. Factors such as the particular laws of the state, the wording of the clauses, and whether or not the well is within a unit, all play a part in determining how to divide royalties amongst landowners. The paragraphs that follow will discuss how title issues, the apportionment rule versus the nonapportionment rule, unitization and pooling provisions, entireties clauses, estates issues and other issues affect the division of royalties.

§ 12.02. Royalty Basics.

[1] — Minimum Royalty.

Historically, the payment of royalties for oil and gas received different treatment. Royalties on oil were paid "in kind"; the royalty owner received a share of the oil as produced. Conversely, gas royalties were based upon the sale of gas, which was measured by the value or market price of the royalty owner's share of the product. Today, most royalty owners receive their share of the royalties "in money," or a share of production.[1]

Typically, a royalty is one-eighth of production, but it may be any other fractional share of production.[2] Royalties can be expressed as a percentage; the state of California calculates royalties in this way.[3] Some states have statutes that impose a minimum royalty. Pennsylvania has such a statute entitled "Guarantee of Minimum Royalties,"[4] which states,

> A lease or other such agreement conveying the right to remove or recover oil, natural gas or any other designation from lessor to lessee shall not be valid if such lease does not guarantee the lessor at least one eighth-royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property.[5]

Another example of a minimum royalty comes from the state of West Virginia. West Virginia requires that a minimum one-eighth royalty must be paid before a permit will be issued. In addition, West Virginia has a statute for coalbed methane wells. The statute, entitled, "Coalbed Methane Wells and Units,"[6] states, "The royalty interest in a well shall include the right to receive one-eighth of the gross proceeds resulting from the sale of methane at the wellhead and such interest shall exist in the coalbed methane owners . . ."[7]

[2] — Royalty Definition and Construction.

A royalty interest means the lessor/owner is entitled to a share of production, or income from production without bearing any of the expense

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1 Howard R. Williams & Charles J. Meyers, *Oil and Gas Law* § 659.1 (3rd ed. 2008)[hereinafter Williams & Meyers].

2 Williams & Meyers § 642.1.

3 *Id.*

4 Guarantee of Minimum Royalties, 58 Pa. Cons. Stat. § 33 (1979).

5 *Id.*

6 "Coalbed Methane Wells and Units," W. Va. Code, § 22-21-17 (2009).

7 *Id.*

of drilling or operating the well.[8] Royalties are freely assignable and treated as a separate property interest created in an oil and gas lease, after severance by royalty deed.[9]

Specifically, a royalty deed is an instrument in writing conveying a royalty interest. The royalty deed must contain: a grantor, a grantee, describe the land, state the size of the interest, and have the signature of the grantor.[10] The duration of a royalty interest can exist forever, for a term of years and so long thereafter as oil or gas is produced, a fixed term of years, or for the duration of an existing oil or gas lease. Usually, payments made by the lessee are paid monthly or quarterly to the lessor.[11]

[3] — "Post-Production Costs."

"Post-production costs," the costs incurred after production of the oil and gas, include gathering taxes, costs of treatment of the product to render it marketable, and costs of transportation to market.[12] "Post-production costs" have sparked much controversy over the years as to what can be deducted and how much the royalty owner is entitled to receive. In turn, this has created a platform for litigation. The most recent example of this controversy was displayed in the West Virginia case of *Tawney v. Columbia Natural Resources, LLC*.[13] This case ruled in favor of the lessors, forcing the lessee to be more specific when determining and explaining post-production costs.

In *Tawney* plaintiffs filed a class action suit for damages due to allegedly insufficient royalty payments. Approximately 8,000 plaintiffs joined the suit, which involved 2,258 leases to Columbia Natural Resources (CNR), or a predecessor in interest. Since 1933 CNR took deductions from plaintiffs' one-eighth royalty for "post-production costs," both in the form of monetary

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8 Williams & Meyers § 920.

9 *Id.* § 924.

10 *Id.*

11 *Id.* § 655.

12 *Id.* § 921.

13 Estate of Tawney v. Columbia Natural Res., L.L.C., 633 S.E.2d 22 (W. Va. 2006) W. Va. LEXIS 60.

and volume deductions. The "post-production costs" included CNR's delivery of gas from the well to the Columbia Gas Transmission (TCO) point of delivery, CNR's processing of the gas to make it satisfactory for delivery into TCO's transportation line, and losses of volume of gas due to leaks in the gathering system or other volume loss from the well to the TCO line. CNR did not disclose these deductions on the accounting statements the lessors received.[14]

The court stated that West Virginia recognizes that a lessee to an oil and gas lease must bear all costs incurred in marketing and transporting the product to the point of sale, unless the oil and gas lease provides otherwise.[15] The question was posed to the court,

> Is the lease language that provides that the lessor's one-eighth royalty is to be calculated "at the well," "at the wellhead" or similar language, or that the royalty is "an amount equal to one-eighth of the price, net of all costs beyond the wellhead," or "less all taxes, assessments, and adjustments" sufficient to indicate that the lessee may deduct post-production expenses from the lessor's one-eighth royalty, presuming that such expenses are reasonable and actually incurred?[16]

The court explained the phrases "at the wellhead" and others used by CNR were ambiguous and therefore to be construed against the lessee. The court commented that the drafters of theses leases should have taken more care and used more specific language stating the calculation of royalties and what post-production costs would be deducted.[17] The court answered the above question in the negative, stating the language was insufficient to indicate that the lessee may deduct post-production expenses from the lessor's one-eighth royalty, if the expenses were actually incurred.[18] The court further

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14 *Id.*

15 *Id.*

16 *Id.* at 24-5.

17 *Id.*

18 *Id.*

explained the lease must expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale.[19]

[4] — Specific Types of Royalties.

There are two specific types of royalties that may be payable from oil and gas production. There is the standard royalty payable to the lessor, an overriding royalty which is, generally carved out of the working interest created by an oil and gas lease. Both are an interest in oil and gas produced at the surface. Both are free of the expense of production. Generally, the overriding royalty interest only exists for the time of the lease under which it was created,[20] however, in some cases it may be applicable to renewals or extensions of a lease.

The working interest acts as an operating interest under an oil and gas lease. The owner of the working interest, typically an oil and gas company, has the exclusive right to exploit the minerals on the land.[21] An example of a working interest occurs when a lessor executes a lease, reserving one-eighth royalty, to a lessee who creates no burdens on his estate. Under a one-eighth royalty lease, the entire working interest generally consists of seven-eighths of production subject to all costs of exploration and development; the lessor receives his one-eighth of production free of such costs. A lessee owning the working interest may transfer out an overriding royalty, oil payment, net profit interest, partial working interest, or carried interest, usually leaving himself still as owner of at least part of the working interest, and is usually entitled to exclusively operate the lease. However, even though the lessee owns the working interest, if he conveys out much of this interest, he can end up as the owner of very little production and the recipient of a small fraction of the income from the property.[22]

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19 *Id.*

20 Reynolds Rexwinkle Oil, Inc. v. Petex, Inc., 1 P 3d 909, 914 (Kan. 2000).

21 Howard R. Williams and Charles J. Meyers, *Manual of Terms*, 1137-39. (8th ed. 2008).

22 *Id.*

A different type of royalty that can exist in an oil and gas lease is the shut-in royalty. This clause is inserted in the lease for the purpose of maintaining the lease if the wells become shut-in or cease production. If the wells become shut-in for a time, then the lessee pays a shut-in royalty to the lessor. The purpose of this type of royalty is to keep the lease in effect without production of oil or gas.[23] The shut-in royalty acts as a hold on the lease to insure the lessee still maintains their working interest.

The following is an example of a shut-in royalty clause, "The royalties to be paid by lessee are . . . a royalty of $50 per well on each gas well from which gas only is produced while gas therefrom is not sold or used off the premises, and while such royalty is so paid, said well shall be held to be a producing well . . ."[24]

§12.03. Apportionment vs. Nonapportionment.

[1] — Apportionment.

Jurisdictions either follow the apportionment rule or the nonapportionment rule when situations call for the division of royalties. These rules are particularly important to the royalty owner or lessor because sometimes, depending on which rule is applied, the owner of a portion of the leased premises may or may not receive royalties at all.

William and Meyers defines royalty apportionment as, "The division of royalties among the owners of interests in the land subject to the lease."[25] Apportionment issues arise when there is production by a lessee, under a lease, on segregated parcels in which separate mineral or royalty interests exist.[26] The idea behind the apportionment rule is each owner of mineral or royalty interests in the several parcels subject to the lease, is entitled to a share of the royalty paid upon the production from the well. This share of production is based upon acreage.[27]

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23 Williams & Meyers at 973.
24 *Id*. at 972.
25 *Id* at 923.
26 *Id* § 520.
27 *Id*.

The following example describes how the apportionment rule works. When a party owns one-half of a 20-acre parcel or is entitled to one-half of the royalty interest in said 20-acre parcel, said party is entitled to receive one-tenth of the royalty accruing from the one producing well on the 100-acre leasehold.[28] In the earliest reported case dealing with the issue of dividing royalties, the apportionment rule was adopted.[29] However, by the weight of modern authority, most states favor the nonapportionment rule.[30] Judicial precedent in the following states has established the apportionment rule: California,[31] Mississippi,[32] and Pennsylvania.[33]

[a] — *Wettengel v. Gormley.*

The Pennsylvania case establishing apportionment, *Wettengel v. Gormley,*[34] exemplifies the basics of the apportionment rule. The facts of the case state, James Gormley owned a farm containing a total of 600 acres of land. On July 14, 1888 James Gormley executed an oil and gas lease of the 600 acres (the lease stated 600 acres, but actually the exact acreage was 570 acres) as a single body to J.A. Tominson for a term of 15 years reserving a royalty of one-eighth.[35]

The lease agreement ended with the statement, "All conditions between the parties hereto shall extend to their heirs, executors or assigns."[36] This statement severed the leasehold from the freehold estate. A sale of the freehold

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28 *Id.*

29 Wettengel v. Gormley, 28 A.934 (Pa. 1894), *reh'g*, 39 A. 57 (Pa. 1898).

30 Cent. Pipe Lines Co. v. Hutson, 82 N.E.2d 624 (Ill. 1948).

31 Higgins v. Cal. Petroleum & Asphalt Co., 41 P. 1087 (Cal. 1895).

32 Griffith v. Gulf Ref. Co., 60 So. 2d 518 (Miss. 1952), *rehearing*, 61 So. 2d 306 (Miss. 1952), the court expressed the view that the apportionment rule was sound and supported apportionment in that case. The court appears to take the position that the adoption of conservation laws by the state subsequent to the decision in the *Merrill Eng'r Co.* case required the application of the apportionment theory in a case involving so-called "equitable pooling" or "judicial pooling."

33 Wettengel v. Gormley, 28 A.934 (1894), *reh'g*, 39 A. 57 (Pa. 1898).

34 *Id.*

35 *Id.*

36 *Id.* at 565-66.

to any person having notice, actual or constructive, of the lease would have been subject to its provisions, and would in no way have impaired the rights or interest of the lessee. James Gormley died on October 1, 1890, testate. By the terms of his will James Gormley divided the 600 (570) acres into three tracts and devised one of these to each of his three children: James T. Gormley (204 acres), Anna B. Wettengel (202 acres), and Maria J. Lockhart (164 acres).[37]

The three heirs took title subject to the provisions of the oil and gas lease. After the death of James Gormley the lessee placed ten wells on the property of James T.; six of these wells produced oil in paying quantities. James received the royalty payments from the oil and sold it. The plaintiffs (Anna B. and the heirs of Maria J.) wanted James T. to pay over a pro rata share of the proceeds based upon their ownership in the acreage of the three farms. James claimed that because all the producing wells were on his property, he was entitled to all of the royalties.[38]

The question was, whether James T. owed a portion of the royalties to the other landowners of the 600-acre leasehold (Anna B. and Maria J.), when the producing wells were located on his property, but the lease was for the land owned by all three persons? The court held that each child was entitled to receive such share of the royalty as his or her share of the land bore to the whole tract, no matter whose farm the wells were located upon.[39] The rationale of the court is stated as follows,

> To give the entire royalty to one of the devisees under these circumstances would be inequitable. We do not consider it to be the law governing the case. The whole tract when devised in severalty to the three, was burdened by this previous grant. It is a common burden. The benefits should be shared. Had there been a lease on the whole tract for ten years, the rent reserved being one half the grain raised on 150 acres, to be put in wherever the tenant chose on the whole tract, (he to have pasture, timber, meadow, building, etc., on

37 *Id.*
38 *Id.*
39 *Id.*

> the whole tract,) and the tenant in full possession should see fit to do all his cropping on the portion devised to Mrs. Wettengel — surely she would not be entitled to all the rent thus derived from the whole tract. Yet, it would be no more inequitable than to give all the royalty in the present to one devisee. We do not see that it is important to determine whether this royalty be rent, or product, or a part of the land, or whether the contract be a lease or a grant of an interest in the land—the governing facts and the principles are the same.[40]

The ruling precisely states the apportionment rule. The total amount of proceeds came out to $10,091.89, which was distributed amongst the devisees based upon their ownership in the land. James T. Gormley received $3,611.84 (204/570 x $10,091.89), Maria Lockhart's heirs received $3,576.42 (202/570 x $10,091.89), and Anna J. Wettengel received $2,903.63 (164/570 x $10,091.89).[41]

In a subsequent case the court stated that James T. was entitled to compensation for the decrease in the value of his property. Damages such as debris from the wells, damages from the removal of derricks, structures, pipes, etc., and the effects from oil, salt water, gutters, and roads can remain for years. The lease did not contain a covenant stating the lessee was to repair these injuries. The court believed that this damage to the property of James T. deserved compensation, and further determined the extraction of oil and the damage to the property depreciated the farm by one-fourth. Therefore, James T. was entitled to monetary compensation.[42] The court also determined the cost of repairing injuries to the realty should be postponed until the termination of the lease.[43]

[2] — Nonapportionment.

Nonapportionment is the allocation of royalties to a royalty owner having an interest in the specific parcel on which a producing well is located, rather than dividing royalties among the owners of interests in the segregated

40 *Id.*
41 *Id.*
42 Wettengel v. Gormley, 39 A. 57 (Pa. 1898).
43 *Id.*

parcels subject to the lease.[44] The following states have established the nonapportionment rule through judicial precedent, Arkansas,[45] Colorado,[46] Illinois,[47] Indiana,[48] Kansas,[49] Kentucky,[50] Louisiana,[51] Nebraska,[52] New Mexico,[53] Ohio,[54] Oklahoma,[55] Texas,[56] and West Virginia.[57]

Although the majority of the states follow the nonapportionment rule, the apportionment rule may still be applied under certain situations: such as when the lease includes a pooling or unitization clause, when a community lease is involved, an entirety clause is in the lease, a "subject-to" clause exists in a mineral or royalty deed, a proportionate reduction clause is in the lease, as a result of spacing and drilling regulations, the duty of fair dealing, or the implication of intent arising from the duration of a mineral or royalty grant.[58]

It is important to remember that if the parties make a specific provision for treatment of royalties, no matter what state they are in, the agreement will control.[59] *Burtner-Morgan-Stephens Co. v. Wilson*[60] involved an oil and gas lease which contained a clause specifically calling for the application of the nonapportionment rule to the distribution of royalties. The trial court adhered to the Ohio unitization statute rather than the lease, and held that royalties

44 Williams & Meyers at 657.
45 Osborn v. Ark. Territorial Oil & Gas Co, 146 S.W. 122 (Ark. 1912).
46 Mosheik v. Lininger, 274 P.2d 965 (Colo. 1954).
47 Cent. Pipe Line Co. v. Hutson, 82 N.E.2d 624 (Ill. 1948).
48 Fairbanks v. Warrum, 104 N.E. 983 (Ind. App. 1914).
49 Carlock v. Krug, 99 P.2d 858 (Kan. 1940).
50 Hammond v. Hammond, 167 S.W. 2d 865 (Ky. 1943).
51 French v. Querbes, 8 So. 2d 631 (La. 1942).
52 Hafeman v. Gem Oil Co., 80 N.W.2d 139 (Neb. 1956).
53 Raley v. Moore, 289 P.2d 957 (N.M. 1955).
54 N.W. Ohio Natural Gas Co. v. Ullery, 67 N.E. 494 (Ohio 1903).
55 Investors Royalty Co. v. Lewis, 91 P.2d 764 (Okla. 1939).
56 Gillette v. Mitchell, 214 S.W. 619 (Tex. Civ. App. 1918).
57 Pittsburgh & W. Va. Gas Co. v. Ankrom, 97 S.E. 593 (W. Va. 1918).
58 Williams & Meyers § 521.
59 Burtner-Morgan-Stephens Co. v. Wilson, 586 N.E. 2d 1062 (Ohio 1992).
60 *Id.*

should be distributed on a pro rata basis, thus applying the apportionment rule.[61] The appellate court reversed and the Ohio Supreme Court affirmed that royalty provisions of the statute could not be retroactively applied to determine distribution of royalties. The oil and gas lease specifically provided for the nonapportionment of royalties, and therefore the parties should follow the agreement.[62] The court also noted that the lease was entered into and recorded prior to the enactment of the statutory provision.[63]

[3] — Pooling or Unitization Agreement and the Effect on Apportionment or Nonapportionment of Royalties.

If a lessee pools or unitizes separately owned tracts, royalties from production on the pooled or unitized tract will be apportioned among all interested parties.[64] Statutory compulsory unitization or pooling laws also cause the apportionment of royalties from production on pooled or unitized tracts.[65] When this occurs, the royalty provisions of the individual leases are given effect as to an apportioned share of the production. The royalty provisions of the lease pertaining to the land on which the well was drilled do not govern the rights of lessors of other parcels included within the pool or unit.[66]

A specific instance dealing with pooling or unitization agreements arises when the nonapportionment rule deprives a nonoperating owner of any interest in production from a producing well. The question then is whether the nonoperating owner may obtain a share of such production by seeking compulsory pooling or unitization? The answer to this question is unclear under many of the pooling and unitization statutes; however, *Coleman v. Railroad Commission*[67] has stated that a nonoperating owner was entitled to

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61 Unitization Statute, Ohio Rev. Code Ann. § 1509.24, 1509.26-7 (West 1984).

62 *Wilson*, 586 N.E. 2d 1062.

63 *Id.*

64 Merrill Eng'g Co. v. Capital Nat'l Bank of Jackson, 5 So. 2d 666 (Miss. 1942).

65 Dillon v. Holcom, 110 F.2d 610 (5th Cir. 1940).

66 Williams & Meyers § 521.1.

67 Coleman v. R.R. Comm'n, 445 S.W.2d 790 (Tex. Civ. App. 1969)(*aff'd as modified,* 460 S.W.2d 404 (Tex. 1970)).

invoke the jurisdiction of the regulatory commission to effect pooling under the provisions of the Texas compulsory pooling statute, thereby nullifying the operation of the nonapportionment rule in the facts of the particular case.[68]

On appeal, the Supreme Court of Texas held, under the Texas statute, the Commission's power to pool could be invoked only by those owners who have drilled or proposed to drill on the proration unit to the common reservoir, declaring:

> [W]e are satisfied that it was not the purpose or intention of the Legislature in enactment of the statute to abolish the *Japhet v. McRae* nonapportionment rule; and, absent a clear expression of that intent by the Legislature, we would be reluctant to hold that the statute abolished a rule of property which at the time of the statute's enactment had existed for some forty years.[69]

This opinion distinguished the language of the Texas statute from the language of other pooling statutes providing that nonoperating owners may invoke compulsory pooling.[70]

There was a legislative response to *Coleman* in 1971. The pooling statute was amended to permit the application for pooling to be made by "(1) the owner of any interest in oil and gas in an existing proration unit or with respect to a proposed unit, (2) the owner of any working interest, or (3) any owner of an unleased tract other than a royalty owner."[71]

[4] — Community Leases and the Effect on Apportionment or Nonapportionment of Royalties.

A community lease is formed when several owners of separate tracts join in a single lease of the combined tracts as a unit to one lessee.[72] Many

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68 *Id.*

69 *Id.*

70 *Id.*

71 Tex. Nat. Res. Code Ann. § 102.012.

72 Robert E. Hardwicke and Robert E. (Jr.) Hardwicke, "Apportionment of Royalty to Separate Tracts: The Entirety Clause and the Community Lease," 32 *Tex. L. Rev.* 660, 676 (1954).

cases have held that the community lease is a unitized or pooling instrument and therefore, the apportionment of royalties in proportion to the interests owned in the entire premises is appropriate. One of the cases, *Farrell v. Simms,*[73] involved an oil and gas lease that covered 133 acres of land made to Thrift Oil & Gas company, Inc. Emma Simms owned ten of the acres, Emma Simms and Corinne Smith owned 40 acres, Corinne Smith owned 60 acres, and I.J. Ferguson owned the remaining 20 acres, ten of which were not contiguous to the other tracts of land.[74]

The lessees entered into an agreement with the lessors specifying the royalty proportions that each lessor would receive. Subsequently, Elizabeth Mayfield and I.J. Ferguson sold another oil and gas lease on the 20-acre tract owned by I.J. Ferguson to United Gas Public Service Company, successor of the lease. I. J. Ferguson then sold the 20-acre tract of land, mineral rights and royalties to Jule W. Parks. Royalties from the gas well were paid continually to Emma Simms, Corinne Smith, I.J. Ferguson, and the widow and heirs of Jule W. Parks, in conformity with the Thrift lease and pooling agreement.[75]

The heirs and widow of Jule W. Parks claim they were entitled to all the royalties accruing from the 20-acre tract of land on the grounds that the Thrift lease had been abandoned as to this tract. All other landowners under the Thrift lease contend that the royalties should be paid under the terms of the Thrift lease and pooling agreement. The trial court held the royalties were correctly paid based upon the provisions of the Thrift agreement.[76] The court of appeals affirmed and stated that when the parties entered into the contract and agreed to unitize an entire tract of land composed of contiguous and noncontiguous tracts, the contract was indivisible and the land was treated as a whole.[77] Thus, holding to the apportionment rule in a community lease.

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73 Farrell v. Simms, 26 So. 2d 143 (La. 1946).
74 *Id.*
75 *Id.*
76 *Id.*
77 *Id.*

Similarly, if the several owners of minerals in segregated portions of a tract by separate leases purport to lease the entire tract to a single lessee, courts have held that this results in a communitized lease and therefore the apportionment of royalties.[78] Some cases contain language that indicates the joinder of interest owners of separate tracts in a lease creates a pooled or communitized lease as a matter of law.[79] However, by the weight of authority, pooling and apportionment of royalties in this situation is a matter of intent of the parties. "Evidence of contrary intent may rebut the presumption, arising from the execution of a community lease that the lessors intended royalties should be apportioned."[80]

If the parties to the lease intended not to apportion royalties and to apply the nonapportionment rule, evidence to support this intent includes separately owned tracts that are non-contiguous,[81] contemporaneous construction by the parties in failing to apportion royalties,[82] and partition of the land after execution of a community lease but prior to production.[83]

[a] — Partial Surrender of a Community Lease.

When a community lease is surrendered or released as to a portion of the acreage covered thereby, an important question arises. If production is thereafter obtained on the portion of the premises as to which the community lease was surrendered or released, whether royalties on such production must be apportioned just as they would have been had such production been obtained under the original lease?[84] Two notable cases have addressed this question.

The first case that merits discussion is the California case of *Clark v. Elsinore Oil Co.*[85] Plaintiffs owned a 40-acre tract of land as tenants in common and defendant owned an adjoining tract containing the same

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78 Magnolia Petroleum Co. v. Ovart, 192 P.2d 698 (Okla. 1947).

79 Ward v. Gohlke, 279 S.W.2d 422 (Tex. Civ. App. 1955).

80 Williams & Meyers § 521.2.

81 Lusk v. Green, 245 P. 636 (Okla. 1936).

82 Cox v. Acme Land & Inv. Co., 188 So. 742 (La. 1939).

83 Garza v. De Montalvo, 217 S.W.2d 988 (Tex. 1949).

84 Williams & Meyers § 521.2.

85 Clark v. Elsinore Oil Co, 31 P.2d 476 (Cal. App. 1934).

acreage. The parties signed a lease for oil and gas to Signal Oil and Gas Co. Two provisions of the lease contract are of importance. The first related to the division of royalties among the lessors and stated, "It is understood and agreed that all of the lessors herein shall participate in the bonuses, rentals and royalties covering all of the demised premises in the proportion that their respective interests shall bear to the whole of said demised premises."[86]

The second provision expressly authorized the lessee at any time during the terms of the lease to surrender and turn back to the lessors all or any part of the leased property. Parties to the original lease amended by providing that all payments to be made by the lessee should be made "as to one-half thereof to the Elsinore Oil Company, and as to one-half to Elsinore Oil Company, Trustee." The same provisions were repeated in the amendment.[87]

Subsequent to the execution of the original lease the lessee entered into possession of the demised premises and drilled an oil well on the portion of defendant's property. Thereafter, the lessee each month paid to the defendant the royalty provided for in the lease contract in the form of two checks. One representing one-half of the royalty for the preceding month and the second check representing one-half of said royalty was drawn to the defendant as trustee.[88]

On December 10, 1932 the lessee executed a quitclaim deed "unto the person or parties legally entitled thereto" of all right, title and interest of said lessee in the demised premises expressly excepting ten acres of land surrounding the oil well, which had been drilled by the lessee on defendant's land.[89] On January 23, 1933, the defendant received from the lessee a check in the amount of $1,905.14. This was one-half of the royalty for the month of December 1932. Defendant then paid plaintiffs the sum of $795.68 and retained the balance of $1,109.46.[90] Plaintiffs claimed they were entitled to an equal division of the royalties.[91]

86 *Id.*
87 *Id.*
88 *Id.*
89 *Id.*
90 *Id.*
91 *Id.*

The court stated it was undoubtedly the intention of the lessors for the parties to receive an equal division of any royalties, and this should continue in the event that the lessee should surrender any portion of the demised premises covered by the joint lease. This case held the surrender of a portion of the leased premises does not alter the pre-existing rights of the community lessors under the original lease to an apportioned share of royalties from production anywhere on the communitized premises.[92]

Furthermore, in California the original lessor of premises included within a community lease acquires a separate incorporeal interest in the lands of his co-lessors, which survives surrender of his premises by the lessee and which does not pass with a subsequent conveyance of his own premises unless expressly granted in such conveyance.[93]

The second case, *Duffy v. Callaway,*[94] addressed this issue. Owners of separate mineral interests joined as lessors in a lease. Although the lease did not contain a surrender clause, the lessee executed a release of the lease as to one parcel (tract one) covered by the lease but he retained his lease as to another parcel (tract two). All lessors accepted the release. New leases on the released parcel (tract one) were subsequently executed and production was obtained on both tract one and tract two.[95]

In an action to determine the right to share in royalties on production from the two tracts, the trial court held that the original lease did not affect pooling or royalties and each lessor was entitled to all the royalties paid on oil produced from his own land.[96]

On appeal the court reversed the judgment and the case was remanded. The appellate court indicated that as to the unreleased acreage (tract two) all parties having an interest in said tract were entitled to an apportioned share of the royalties based on their mineral interest in that tract. This distinguished

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92 *Id.*

93 Tanner v. Title Ins. & Trust Co., 129 P.2d 383 (Cal. 1942).

94 Duffy v. Callaway, 309 S.W.2d 853 (Tex. Civ. App. 1958).

95 *Id.*

96 *Id.*

the parties from their interest in the two tracts affected by the original lease. As to the released acreage, tract one, the court indicated the action of the parties "evidenced an intention to terminate the pooling agreements to the released minerals and to partition the same. As to tract one, the court applied the nonapportionment rule.[97]

On remand the court asked the question, "Whether it was the intention of such owners to terminate the presumed pooling agreement as to the released minerals and to partition the same?"[98] The court in a non-jury trial held that all parties to the original lease were entitled to share in the royalty from all lands covered by the lease (tracts one and two) in proportion to their ownership of the minerals. The appellate court affirmed this decision.[99]

Because of the above decisions it is important, particularly for the lessor, to include two provisions in the surrender clause of a community lease. The first provision should state the rights of the owners of interests in the surrendered premises to share in production from unsurrendered premises. The second provision should state the effect of leasing or of production from the surrendered premises upon the sharing of production from unsurrendered premises.[100]

[5] — Entirety Clause and the Effect on Apportionment or Nonapportionment of Royalties.

An entirety clause is included by the lessee for their own benefit, to provide that inside property lines created by later divisions of the fee ownership or by royalty conveyances shall not affect the lessee's duties of development and operation.[101] The following is a typical example of an entirety clause:

> If more than one person executes this lease as Lessor or is now or shall hereafter become entitled . . . to share in or receive the benefits accruing to Lessor hereunder, this lease shall nevertheless always be

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97 *Id.*

98 *Id.*

99 *Id.*

100 Williams & Meyers § 521.2.

101 Cont'l Oil Co. v. Blair, 397 So. 2d 538 (Miss. 1981).

> operated and developed by Lessee as a single tract, without regard to any such division in or change of interest or ownership, or right to receive payment, which shall not operate to enlarge the obligations or diminish the rights of Lessee.[102]

Absent an entirety clause, it is clear that the lessor or lessors may not increase the duties of the lessee as a result of subsequent transfers.[103]

By virtue of an entirety clause in the lease, royalties from production under the lease are usually apportioned among mineral and royalty owners in accordance with their interest, wherever the well or wells may be located on the leased premises.[104] One case has held that when a lease covers non-contiguous tracts and includes an entirety clause in the lease, the clause still has the effect of apportioning royalties among the owners of mineral interests.[105]

Absent an entireties clause, if the state follows the nonapportionment rule, it will be applied.[106] An example of this situation is the case entitled, *Pittsburgh & West Virginia Gas Co. v. Androm*.[107] In this case, the owner of a tract that contained a well, subdivided after the execution of a lease, was entitled to all the royalties attributable to production from the well on the subdivided tracts. Conversely, the owners of the remaining tracts did not receive any royalties from the well.[108]

A number of cases have applied the nonapportionment rule despite the inclusion of an entirety clause in the lease where the conveyances subsequent to the lease clearly manifest intent not to apportion royalties. The following is an example of one of those cases. In *I.M. Alsip's Administrator v. Onstott,*[109]

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102 Wooley v. Standard Oil Co., 230 F.2d 97, 99 (5th Cir. 1956).

103 *Id.*

104 Schwarm v. Mexia Holdings, L.P., 720 N.E. 330 (Ill. 1999).

105 Rauner v. Jones, 67 N.W.2d 347 (Neb. 1954).

106 Williams & Meyers § 521.3.

107 Pittsburgh & W. Va. Gas Co. v. Androm, 97 S.E. 593 (W. Va. 1918).

108 *Id.*

109 I.M. Alsip's Adm'r (E.B. Alsip) v. Onstott, 283 S.W. 2d 711 (Ky. Ct. App. 1955).

an oil and gas lease was executed on 130 acres by A.W. Ankeny in August 1947. Alsip was to receive a one-eighth royalty. A further provision stated, if the premises were ever subsequently divided, the lease should nevertheless be treated as one lease and, "All royalties accruing hereunder shall be treated as an entirety and shall be divided among, and paid to, such owners in the proportion that the acreage owned by each separate owner bears to the entire leased acreage."[110]

In January 1948, Alsip then conveyed 16 acres to Oba Chapman and 45 acres to the Onstotts, retaining 69 acres of the original 130-acre tract. Chapman received a general warranty deed and Onstotts' deed contained this specific provision:

> The above described property . . . If the first well drilled under the Ankeny lease is a producer of oil and gas, or either of them, in commercial quantities, then the party of the first part reserved to himself one-half of the royalty payable under the said lease, such reservation to be effective for a period of fifteen years, and over all wells drilled, including the first well, and at the expiration of the said fifteen year period the parties of the second part, and the survivor of them, his or her heirs, shall then be entitled to all the mineral rights and royalties under the said property. In the event the first well drilled on the said property under the Ankeny lease is a dry hole, or in the event no well is drilled thereunder, and the lease expires or is terminated, then on the happening of either of said contingencies, the parties of the second part, and the survivor of them, his or her heirs, shall be entitled to all of the minerals and the royalties thereon. The intention of the parties is that the party under the Ankeny lease only if the first well drilled thereon is a producing well, and that this one-half of the royalty shall be vested in the first party only for fifteen years, said fifteen years to be calculated from the date of this deed.[111]

Prior to the execution of the deeds, and to the recording of the Ankeny lease, two dry wells were drilled on the 16-acre portion conveyed to Chapman

110 *Id.*
111 *Id.*

and two dry wells were drilled on the 69-acre portion retained by Alsip. The lessor drilled eight wells on the Onstott tract, seven of the wells produced oil. A dispute arose as to the ownership of royalties and Alsip and Chapman instituted proceedings against Onstott. The trial court found that the Onstotts' were entitled to all the royalties from the seven producing wells.[112]

The court of appeals held that the Onstott deed modified the lease provisions relating to proportional royalties in the event of future severances of the 130-acre tract. The deed was meant to protect the lessee under the Ankeny lease, and put the Onstotts on notice that their title would be subject to the lessee's rights in the property. The reservation in the Onstott deed of one-half the royalty payable under the lease was called a further reservation because it placed a further encumbrance upon Onstotts' title; it was not intended to supplement Alsip's royalties under the lease.[113]

Therefore, any interest the Chapmans had in the royalties must be derived from the royalty reservation in the Onstott deed. That deed contained no reservation in favor of the other landowners; they have no interest in the royalties.[114] The court held that the royalties were paid only to the Onstotts with the exceptions of the reservations to Alsip. Therefore, the court followed the nonapportionment rule.

[a] — *Foertsch v. Schaus*.

Another ruling affecting royalties and an entireties clause has held that the parties to the later mineral or royalty deeds may not effectively provide for nonapportionment if the lessee whose lease contains an entirety clause insists on his right to rely on the clause. *Foertsch v. Schaus*[115] involved an oil and gas lease for 156.5 acres in Indiana. The lease contained an entireties clause. The owner, Foertsch, sold to his nephew, Schaus, a 60-acre tract, 40 acres of which was included in the lease. Foertsch attempted to avoid

112 *Id.*
113 *Id.*
114 *Id.*
115 Foertsch v. Schaus, 477 N.E.2d 566 (Ind. App. 1985).

apportionment through a provision in the deed and a separate agreement, which were both executed in 1968.[116] The agreement stated,

> ". . . It is the desire of said Foertsch and the said Schaus not to be bound by the terms of said oil and gas lease insofar as it pertains to the usual entireties clause concerning division of royalties in the event the leased premises are ever owned in severalty or separate tracts:
>
> 1. That said entireties clause of said oil and gas lease shall be inoperative and of no force and effect and said [lessors'] royalties shall not be divided or apportioned, but, instead, shall be paid to the landowner in accordance with the production from the separate tracts.
> 2. That the royalty payment due under the aforementioned oil and gas lease in respect to the lands this date purchased by Schaus from Foertsch shall be the absolute property of Schaus, the same as if said lands were leased under a separate lease.
> 3. That any royalties due the said Foertsch in connection with said oil and gas lease aforementioned in respect to the lands now owned by Foertsch shall be the absolute property of Foertsch, the same as if said abovementioned 60 acres had not been included in said lease."[117]

At the time of trial Schaus' property had one producing oil well and three water injection wells. Foertsch's property contained eight producing wells and five water injection wells. The lease operators continued to develop the property as one leasehold estate. The court was proposed with the question, "Whether a lessor may convey an interest in land subject to a lease containing an entirety clause, which would have the effect of placing the conveyed tract upon a nonapportionment basis?"[118] The court first stated the general rule, "Where no entirety clause is involved the lessor, as owner of the fee, owns

116 *Id.*

117 *Id.* at 568.

118 *Id.*

all of the oil beneath the surface of his acreage." The court went on and held, the 1968 agreement entered into by Foertsch and Schaus was ineffective to change the division of royalties established by the entirety clause in the oil and gas lease, even though both parties intended royalties to be paid on a nonapportionment basis.[119]

[b] — The *Cockrell* Case.

The case of *Cockrell v. Texas Gulf Sulpher Co.*[120] deals with two issues affecting the apportionment of royalties. The first is an express provision for apportionment of royalties. *Cockrell* involved a complex set of facts, which are as follows: A owned 729.7 acres of land and executed a lease upon the property in 1925. The lease was later released by the lessee as to a portion of this tract, and the lessor executed a second lease as to the previously released portion of the tract. Each of these two leases contained an express provision for apportionment of royalties. Specifically, each lease provided for a royalty of 50 cents per long ton of sulphur.[121]

After the execution of the leases A conveyed portions of her mineral and royalty interests until she was left with a one-eighth interest under the west 400 acres of the tract and a one half interest under the east 329.7 acres of the tract. She retained a 50-acre mineral interest in the west 400 acres and a 164.85-acre mineral interest in the east 329.7 acres, a total of 214.85-acre mineral interest in the 729.7-acre tract. Thereafter, A conveyed to B her remaining interest in the 729.7 acres, excepting and reserving a royalty of 61/2 cents per long ton on all sulphur produced and marketed from the west 400 acres and 25 cents per long ton on all sulphur produced and marketed from the east 329.7 acres. The interest which was conveyed to B was subsequently acquired by defendant as were the two leases covering the two portions of the 729.7-acre tract. Production of sulphur was obtained on the west 400 acres but not on the east 329.7 acres.[122]

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119 *Id*. at 569.

120 Cockrell v. Tex. Gulf Sulpher Co., 299 S.W.2d 672 (Tex. 1956).

121 *Id*.

122 *Id*.

The court asked the question, was the royalty payable to plaintiff, (the successor in title to A), the present owner of the royalty interest excepted and reserved by A when her remaining interests were transferred by the conveyance above mentioned? The plaintiff claimed he was entitled to 14.72180247 cents per long ton of sulphur produced rather than 61/2 cents per ton. The supreme court held that plaintiff was entitled to judgment for the difference between the 61/2 cents per ton paid to plaintiff by defendant and the 14-plus cents per long ton to which he claimed.[123]

The court explained their decision:

> By reason of the express provision in the leases quoted above for apportionment of royalties and the fact that the transfers were "subject to" the lease, royalties on production must be apportioned among the owners of interests in the premises subject to the leases in proportion to their interests in the premises without regard to the subdivided portions of the 729.7-acre tract from which production was obtained.[124]

At the time of the last conveyance by A to B, A owned a one-eighth interest in the west 400 acres and a one half interest in the east 329.7 acres. Her interest in the 50 cent royalty was calculated on the basis of her interest in the entire 729.7 acres:

1/8 x 400/729.7 x 50 cents = 3.42606551 cents per ton

1/2 x 329.7/729.7 x 50 cents = 11.29573796 cents per ton

Total 14.72180347 cents.[125]

The second issue dealt with by this case is whether the presence of an entirety clause in the lease requires apportionment when the later executed mineral or royalty deed makes no reference to apportionment or nonapportionment. *Cockrell*[126] stated that when a lease contains an entirety

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123 *Id.*

124 *Id.*

125 *Id.*

126 *Cockrell*, 299 S.W.2d at 672 (Tex. 1956).

clause this precludes a lessor from conveying a portion of the leased premises with an express provision for nonapportionment. The court reminded the parties of the contract theory which states, parties to the conveyance by their contract may not alter the rights of other persons.[127]

To note, Pennsylvania, and subsequently any other state that follows the apportionment rule established by judicial precedent, does not frequently have entireties clauses in their oil and gas leases. If landowners intend to convey their property subject to the lease and wish nonapportionment of royalties when there is an entireties clause present they should execute a royalty division agreement signed by the grantor, the grantee and by the lessee. This is especially important to the lessee, to prevent paying an extra royalty, as exemplified by the *Cockrell* case.

[6] — A "Subject-to" Clause in a Mineral or Royalty Deed and the Effect on Apportionment or Nonapportionment of Royalties.

The following is an example of a "subject-to" clause:

> Said lands, or portions thereof, being now under oil and gas lease executed in favor of any lease of record it is understood and agreed that this sale is made subject to the terms of said lease but covers and includes 5 acre royalty interest of all the oil royalty, and royalty from other minerals or products, due and to be paid under the terms of said leases.[128]

The reason to insert this type of clause into a deed is to protect the grantor as warrantors and not for the purpose of showing that the parties intended apportionment of royalties. Generally, in the absence of clear intent of the parties to the contrary, the rules of the particular state should control whether the apportionment rule or nonapportionment rule would apply. However, at least in one case, *Grelling v. Allen*,[129] the court has given a "subject-to"

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[127] *Id.*

[128] Grelling v. Allen, 218 S.W.2d 897 (Tex. Civ. App. 1949, *error ref'd n.r.e.*).

[129] *Id.*

clause the same effect as an entirety clause requiring the apportionment of royalties.

Grelling involved a lease executed in 1941, which covered five contiguous tracts forming one general body of land comprising 88.5 acres. Thereafter, the lessor made several royalty transfers covering the entire spread of the 88.5 acres excluding one of the tracts. The tract, which was excluded, was tract three which contained 28 acres. Other transfers were made, totaling 13 royalty acres under tract three for 15 years, and as long thereafter as oil and gas is produced.[130]

Controversy developed over the division of royalties since production was obtained by the lessee on tract three, but not on other portions of the leased premises. The court applied the rule of apportionment and divided the royalties amongst all landowners subject to the lease. The court stated in their rationale:

> We think that the royalty conveyance . . ., under a reasonable construction, in the granting clause conveys an undivided royalty interest in the minerals produced from the 28-acre tract for a period of 15 years, irrespective of any existing lease. In addition, . . . a royalty interest to be paid under the existing lease is conveyed. Should the existing lease lapse, then for a period of 15 years the grantees would have a royalty interest paid under any future lease on minerals produced from the 28-acre tract within the 15-year period. The last clause . . . specifically provides that the sale is made subject to the terms of an existing lease, but includes a royalty interest on "all the royalty. . . to be paid under the terms of said lease." Since Grelling, and others, own 13 acres of royalty under the 28-acre tract, but subject to the terms of a lease existing at the time of the acquisition of such royalty interest, the said Grelling, and others, are entitled to be paid 13/88.5 royalty interest rather than 13/28ths interest. Under this construction of the clauses of the royalty deeds in question there is no repugnancy between the granting clause and the last clause quoted.[131]

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130 *Id.*

131 *Id.* at 898.

A second rationale for the result reached by the court was to avoid the increased burden on the lessee arising from the nonapportionment rule.[132]

This case is contrary to the general policy, which states that: In the absence of clear intent of the parties to the contrary, the court should apply the rule followed by each state as to apportionment or nonapportionment. Cases litigated on the issue of apportionment or nonapportionment do not turn upon the fact that the deed by terms was "subject-to" the existing lease. Courts usually focus upon the parties' intentions at the time of conveyance regarding the apportionment or nonapportionment of royalties.[133]

[7] — A Proportionate Reduction Clause in the Lease and the Effect on Apportionment or Nonapportionment of Royalties.

The purpose for placing a proportionate reduction clause in a lease is to protect the lessee in the event the title of the lessor should fail in whole or in part as to some or all of the land purported to be leased.[134] To note, there was one case, *Parker v. Parker,*[135] where the proportionate reduction clause was given the same effect as an entirety clause and the court applied the apportionment rule.[136] This was a mistake as to the purpose and effect of the clause, which has been indicated by a number of courts.[137]

[8] — The Effect of Spacing and Drilling Regulations and the Effect on Apportionment or Nonapportionment of Royalties.

The following is a typical example of the problems that arise with spacing and drilling regulations and the division of royalties. For example, an operator, without consent of lessors or of mineral or royalty owners, attributes

132 *Id.*
133 Williams & Meyers § 521.5.
134 *Id.* § 532.5.
135 Parker v. Parker, 144 S.W.2d 303 (Tex. Civ. App. 1940).
136 *Id.*
137 Moshick v. Lininger, 274 P.2d 965 (Colo. 1954).

all or parts of separate tracts to a well or drilling unit in order to comply with a spacing regulation or obtains an allowable based wholly or in part upon the acreage attributed to the well or unit. In one situation, assume that an operator has a single valid lease upon the entire area attributed to the well or drilling unit, but there are separate mineral or royalty owners as to separate portions of the area. Silence by the lease would indicate the apportionment or nonapportionment rule of the jurisdiction would apply.[138]

An example of the above mentioned statement happened in a Texas case, *Muller v. Sutherland*.[139] It should be noted that Texas is a nonapportionment state. In *Muller* a lessee formed two drilling units of 20 acres each (as required by the applicable spacing regulations), and attributed to each unit a 12-acre parcel owned by the plaintiff and an eight-acre parcel owned by the defendant. In both cases the wells were drilled on the portions of the drilling unit in which the plaintiff owned the minerals. The court held to the nonapportionment rule and the plaintiff received all of the royalties.[140]

A different situation arises when the operator does not have a single valid lease upon the entire area attributed to the well or drilling unit. A reason for this could be that the interested parties, at the time of the severance of the separate interests, may not have made express provisions for apportionment or nonapportionment, particularly if the severance occurred prior to discovery of oil in the area.[141] A few cases have ruled upon this type of factual circumstance — Arkansas,[142] Texas,[143] and West Virginia[144] would deny apportionment in accordance with their normal nonapportionment rule.[145]

Mississippi grants apportionment, although it may well be held that Mississippi[146] has elected to follow the apportionment rule as a general

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138 Williams & Meyers § 521.6.

139 Muller v. Sutherland, 179 S.W.2d 801 (Tex. Civ. App. 1943, error ref'd w.o.m.).

140 *Id.*

141 Williams & Meyers § 521.6.

142 Grayson v. Berry Asphalt Co., 243 S.W.2d 1 (Ark. 1951).

143 Ryan Consol. Petroleum Corp. v. Pickens, 285 S.W.2d 201 (Tex. 1955), *cert. denied,* 351 U.S. 933 (1956).

144 Boggess v. Milam, 34 S.E.2d 267 (W. Va. 1945).

145 Williams & Meyers § 521.6.

146 Hassie Hunt Trust v. Proctor, 60 So. 2d 551 (Miss. 1952).

matter. Application of the apportionment principle in this situation has the important advantage of reducing the pressure upon the regulatory commission to grant exceptions to spacing rules in order to prevent confiscations. Confiscation refers to depriving an owner or lessee of a fair chance to recover the oil and gas in or under their land.[147] In general, the apportionment rule prevents confiscation and also takes away the basis for a claimed exception. Apportionment will also be applied where the operation of conservation laws rules and regulations has the effect of compulsory unitization or pooling. When compulsory unitization is not possible, the nonapportionment theory will be applied.[148]

[9] — The Duty of Fair Dealing and the Effect on Apportionment or Nonapportionment of Royalties.

Even if the nonapportionment rule is the general theory adopted by the courts of a particular state, certain benefits realized by a lessor may be apportioned among owners of nonparticipating mineral or royalty interests. The owner of these interests does not have to be necessary parties to the leasing of the premises. This is termed a duty of fair dealing.[149]

For example, in a West Virginia case, *Robinson v. Milam,*[150] after leasing a 214-acre tract the lessor (defendant) conveyed 70 acres of the surface to the plaintiff, reserving three-fourths of the minerals and the exclusive leasing power for all of the minerals. One well was drilled by the lessee on the remaining 144 acres, the portion of the 214 acres in which plaintiff had no interest. The lessor and the lessee entered into an agreement, in consideration of the payment of an agreed sum to the lessor, providing that further development would not be required of the lessee. The court held the plaintiff was not entitled to any share of the royalties accruing from one producing well, but he was entitled to a share of the sum paid in lieu of further development.[151] The court's reasoning was as follows,

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147 Williams & Meyers § 521.6.

148 *Id*.

149 *Id*. at § 521.7.

150 Robinson v. Milam, 24 S.E.2d 236 (W. Va. 1942).

151 *Id*.

> . . . Where a lessor and lessee agree, in lieu of development of a leasehold upon which a test well has been drilled, that the lessee will pay a certain sum, however measured, the owner of a portion of the minerals in a subdivision of the leasehold is entitled to a share of such payments, based upon his proportionate mineral ownership. . . .The agreement herein . . . provides that it shall be nullified by the drilling of another well on the leasehold, in which event it necessarily follows that payment of the royalties therefrom will depend upon the location thereof. We do not intend by what has been said herein to relax the rule as to apportionment of royalties . . ., but we believe that money to be paid by a lessee in lieu of further development is to be distinguished from royalties, the money so paid being a consideration for forbearance to enforce a covenant for reasonable development; while royalty is paid for a license to explore for minerals and when found to sever the same from the land . . . The defendants having contracted with reference to property and an undivided interest of a portion of such property being owned by the plaintiffs, and the defendant deriving profit by reason thereof from such agreement, we believe and so hold that the plaintiffs are entitled to a proportionate share of the money arising from the agreement in lieu of further development.[152]

[10] — The Duration of the Mineral or Royalty Grant and the Effect on Apportionment or Nonapportionment of Royalties.

The duration of a mineral or royalty grant is relevant to the intention of the parties concerning the apportionment of royalties. Even with the inclusion of an entirety clause in the lease, royalties are normally apportioned among mineral and royalty owners. Where the duration of a subsequent mineral or royalty grant is limited to the existing lease, this is strong evidence the parties did not desire apportionment.[153]

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152 *Id*. at 239-40.

153 Williams & Meyers § 521.8.

[11] — Drafting Issues and the Effect on Apportionment or Nonapportionment of Royalties.

In the majority of states where nonapportionment of royalties is the accepted rule, those purchasing minerals or royalties in a portion of a tract subject to an existing lease must be cautious to protect their interests. The buyer needs information about the applicable spacing rules and the possibilities of getting a well drilled on the portion of the tract in which they acquire mineral or royalty interests.[154]

The purchaser may not require the lessee to drill on the acreage allocated to the purchaser, if development of the lease as a whole without the well is considered adequate. This is because the later subdivisions of the lessor's interests may not increase the burdens on the lessee. If the acreage in which the acquired interest is not of such size or shape as to be entitled to a well permit, the inclusion of an apportionment clause in the instrument would be highly recommended.[155]

§12.04. Unitization Provisions.

Unitization is a term used to denominate the joint operation of all or some portion of a producing reservoir. Unitization is important where there is separate ownership of portions of the rights in common within the unit, in order that it may be economically feasible to engage in cycling, pressure maintenance or secondary recovery operations and to explore for minerals at considerable depth.[156] Maximum recovery of hydrocarbons from a reservoir may require that all tracts overlying the producing formation be unitized.[157] If a lessee, by virtue of pooling or unitization clauses in separate leases which he owns, pools or unitizes separately owned tracts, royalties from production on the pooled or unitized tract will, in accordance with the usual provisions of the leases, be apportioned among all interested parties.[158]

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154 *Id*. at § 522.

155 *Id*.

156 Williams & Meyers § 910.

157 Western Gulf Oil Co. v. Superior Oil Co., 206 P.2d 944 (Cal. App. 1949).

158 *Id*.

Sometimes, to achieve the maximum recovery of hydrocarbons the states must compel lessors to unitize their properties. There are a number of states that have compulsory unitization statutes, such as: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Kansas, Louisiana, Michigan, Mississippi, Montana, Nebraska, Nevada, New York, North Dakota, Ohio, Oklahoma, Oregon, Utah, Washington, and West Virginia.[159] The Pennsylvania compulsory unitization statute, which references unitization integration orders, applies only to deep wells.[160] Specifically § 408 (a) provides:

> When two or more separately owned tracts are embraced within a spacing unit, or when there are separately owned interests in all or a part of a spacing unit, the interested persons may integrate their tracts or interests for the development and operation of the spacing unit. In the absence of voluntary integration, the commission, upon the application of any operator having an interest in the spacing unit, shall make an order integrating all tracts or interests in the spacing unit for the development and operation thereof and for the sharing of production therefrom. The commission as part of the order establishing a spacing unit or units shall prescribe the terms and conditions upon which the royalty interests in the unit or units shall, in the absence of voluntary agreement, be deemed to be integrated without the necessity of a subsequent separate order integrating the royalty interests.

A Pennsylvania statute addresses the allocation of production and the sharing of costs in a case where a well is completed prior to forced pooling. Section 408(c) provides, "In instances where a well is completed prior to the integration of interests in a spacing unit, the sharing of production shall be from the effective date of the integration, except that, in calculating costs, credit shall be given for the value of each operator's share of any prior production from the well."[161]

159 Williams & Meyers § 912.

160 "Integration in Interests in Spacing Units," 58 Pa. Cons. Stat. Ann. § 401 (1996).

161 *Id*. at § 408 (c).

§12.05. Pooling.

Pooling is the bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules. The importance of pooling is to prevent the drilling of unnecessary and uneconomic wells, which can result in physical and economic waste. Voluntary agreements among owners of interests in small neighboring tracts to pool their interests have become increasingly common in the past few years.[162]

There are a few factors that influence this increased frequency; these factors also lead municipalities to compel pooling. The first factor is that when a tract is small, the owners of interests in neighboring small tracts are compelled to pool their interests in order to obtain a favorable lease. Also, zoning regulations, limiting drilling, and production activities in certain areas have provided an incentive to pool small adjoining tracts. Well spacing regulations also have required pooling as a useful means of obtaining leases. An applicant for a well permit must have operating rights in a tract of a specified minimum size. Owners of interests in tracts smaller than that specified in such regulations will be unable to derive benefit from the oil and gas, if any, beneath their premises unless such premises are pooled with other premises into a tract of sufficient size for a well permit.[163]

Under the authority of the "police power," municipalities have enacted compulsory pooling ordinances in order to restrict drilling within the municipal boundaries while protecting the rights of all landowners.[164] There is a specific procedure followed by most jurisdictions to institute pooling. First, a petition or application is filed with the appropriate regulatory body, setting forth the description of the proposed unit, the location of the well, the working interests and royalty interests in the tracts to be pooled, the reasons for pooling, methods proposed for the bearing of costs, and the apportionment of production. Then, notice is given to the interested parties, all those joining in the pooling agreement. The commission holds a hearing

162 Williams & Meyers § 902.

163 *Id.* § 905.

164 Marrs v. City of Oxford, 32 F.2d 134 at 135 (8th Cir. 1929), *cert. denied*, 280 U.S. 573 (929).

to determine whether or not compulsory pooling is necessary, and finally the regulatory body issues an order.[165]

§ 12.06. Estate Issues.

The different types of interests which may be affected by an estate are as follows: potentially producing, but unleased lands; leased lands; perpetual mineral interests (ownership of the minerals or an undivided interest therein apart from the surface, in fee simple absolute); term mineral interests (ownership of the minerals or an undivided interest therein apart from the surface for a term of years); royalty interests; hybrid interests; overriding royalty interest; net profits interests; production payment; or working or operating interests.[166]

A few of the interests require further explanation. Term mineral interests that include a "thereafter" clause operate to extend the term of the grant "so long thereafter" as oil, gas or other minerals are produced from the land in commercial quantities. This is also called an estate in fee simple defeasible.[167] If the term mineral interest does not include a "thereafter" clause the interest will terminate at the expiration of the granted term of years, whether or not there is then production in commercial quantities. The owner of this type of interest does not have a fee or freehold interest.[168]

A royalty interest, which has been the topic for the majority of this paper, is a share of production, if, as, and when there is production, free of the cost of production. It can be an interest in fee simple absolute or have the duration of a particular existing lease. It could also have the duration of a term of years "and so long thereafter" as there is production in commercial quantities.[169]

Hybrid interests have characteristics of mineral and royalty interests. For example, a mineral interest could be conveyed without the right to lease or develop the land. This is like a royalty interest in that the owner is not a

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165 Williams & Meyers § 905.3.
166 *Id.* § 523.
167 *Id.*
168 *Id.*
169 *Id.*

necessary party to the lease, but it is similar to a mineral interest in that the owner shares in rentals and bonuses.[170]

When determining the interests left by an estate, first decipher the nature of the interest as either realty or personalty. Then determine the character as either corporeal or incorporeal. These classifications are important for many of the governing laws that will be used to finalize the estate. Also, authorization for leasing the premises should be included in the will; otherwise court permission may be required. For example, Pennsylvania statute 20 Pa. C.S.A. § 3352, entitled "Power to Lease," provides:

> Except as otherwise provided by the will, if any, the personal representative may lease any real or personal property which he is entitled to possess. The lease may be or a term expiring not more than one year after the decedent's death unless it is terminable by the personal representative at any later time on 30 days' notice, or unless a longer term is approved by the court.[171]

§12.07. Transfer of Interest "Out of" Grantor's Interest.

The best way to describe the transfer of interest "out of" the grantor's interest is to discuss two examples. The royalty owner (R) owned the surface and an undivided 50 percent of the minerals on the land. In the first example, the royalty owner executed a general warranty deed to E, which stated, "Convey . . . an undivided one-fourth interest out of our one-half interest in the minerals in the following described land." In the second example, R executes a royalty deed to E as follows, "Convey . . . a perpetual one-sixteenth royalty out of our undivided one-half mineral interest in the following described land." Both sets of language contain the phrase "out of" and both sets should be treated alike.[172]

The case *Minchen v. Hirsch*[173] held that the words "out of" indicate the source of the title, so that the grantee takes an interest based on 100

170 *Id*.

171 20 Pa. Cons. Stat. Ann. § 3352 (West 2009).

172 Williams & Meyers § 319.

173 Minchen v. Hirsch, 295 S.W.2d 529 (Tex. Civ. App. 1956).

percent title to the land.[174] Therefore, in the first example E would receive a one-fourth mineral interest, and in the second example E would receive a one-sixteenth royalty.[175] If the first example had used the phrase, "one-fourth interest in our one-half mineral interest" then a one-eighth mineral interest would have been created. In the second example if the phrase had stated "one-sixteenth royalty interest in our one-half mineral interest" then a one-thirty-second royalty interest would have been created.[176]

The case of *Black v. Shell Oil Co.*[177] has accepted the above stated position. In *Black* the grantors conveyed, "An undivided one-half interest in and to all the oil, gas and other minerals in and under, and that may be produced from [described land.] It being intention of grantors herein to convey one-half of the minerals out of the interest owned by them in above-described tract of land."[178] The court held that the deed conveyed one-half of grantors' one-half interest, that is a one-fourth interest in the whole. The court of civil appeals then reversed and held that the instrument in question conveyed all of the grantors' one-half interest.[179]

§12.08. Life Estate/Remaindermen.

Care should be taken in determining payment of royalties on oil and gas production which is subject to a life estate. The laws of individual jurisdictions vary on the issue; however, the following principles apply in Pennsylvania as to payment of royalty subject to a life estate: The owner of a life estate in royalties receives the payment of royalty from the wells in operation at the time the life estate is created. The term is only for the life of the grantee; the interest in the royalties then passes to the remaindermen.

The general rule states, a life tenant cannot produce oil and gas without the joinder of the remaindermen; as such independent production would constitute waste.[180] The exception to the rule is, the life tenant may operate

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174 *Id.*

175 Williams & Meyers § 319.

176 *Id.*

177 Black v. Shell Oil Co., 397 S.W.2d 877 (Tex. Civ. App. 1965).

178 *Id.*

179 *Id.*

180 Cronan v. Castle Gas Co., 512 A.2d 1 (Pa. Super. Ct. 1986).

oil and gas wells, mines and quarries if they were opened before his or her life estate began.[181] This is known as the "open mines" doctrine. The reasoning behind the theory is if the life tenant continues to use the mines of the former owner, he is then merely enjoying the use of the land in the same manner in which it the previous owners enjoyed the estate.[182] This doctrine extends to payment of royalties under a lease. If the lease was a producing lease when the life estate was created, the life term would be extended to all royalties on production during the term of his life.

If the deed creating the life estate specifically reserved for the life tenant all rights under existing mineral leases together with all rights to gas rentals and royalties, the "open mines" doctrine would not apply.[183] In the case of *Doverspike v. Chambers,*[184] Donald B. Chambers and his wife, Mary E. Chambers, conveyed two tracts of land containing approximately 108 acres to their son Donald E. Chambers, and his wife, Shirley, by deed dated May 29, 1970. The deed contained the following reservations,

> "ALSO EXCEPTING AND RESERVING a life estate in the above described premises unto Donald Brooks Chambers and Mary Evelyn Chambers, his wife for and during their natural lifetime of both the said Donald Brooks Chambers and Mary Evelyn Chambers, his wife."
>
> "ALSO EXCEPTING AND RESERVING unto Donald Brooks Chambers and Mary Evelyn Chambers, his wife for and during the natural lifetime of both the said Donald Brooks Chambers and Mary Evelyn Chambers, his wife, the gas rentals and/or royalties."[185]

The deed also stated the real estate was 'UNDER AND SUBJECT to outstanding gas and oil leases.'"[186]

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181 *In re* Crozer's Estate, 9 A.2d 535 (Pa. 1939).
182 *In re* Bruner's Estate, 70 A.2d 222 (Pa. 1950).
183 Doverspike v. Chambers, 516 A.2d 392 (Pa. Super. Ct. 1986).
184 *Id.*
185 *Id.* at 394.
186 *Id.*

Donald B. Chambers died on January 14, 1971. On November 18, 1976 Mary E. Chambers executed an oil and gas lease to Doverspike. The remaindermen did not sign the lease. The lease was for the term of two years and so long thereafter as oil or gas was produced. A lease extension was entered into in 1979. Mary E. Chambers died on May 19, 1982, thus vesting title to the 108 acres in the remaindermen, Donald E. Chambers, and his wife, Shirley.[187]

The remaindermen brought suit to argue that the open mines doctrine should have prevented the life tenant from entering into the oil and gas lease. The court stated the deed creating the life estate contained precise, express provisions from which the intent of the grantors was clearly understood. The language of the deed clearly stated, when Donald B. Chambers and Mary E. Chambers transferred the real estate, they intended to preserve their rights under existing leases. Furthermore, they reserved an additional clause with the word "also," the right to gas rentals or royalties. The grantors intended to give the life tenants the power to execute leases in addition to those already existing.[188] Therefore, the "open mines" doctrine was not applied.

In regards to the distribution of the royalties as money, the Pennsylvania statute states,

> If the life estate and remainder interest are administered within a trust or an estate, and no provision has been made for the disposition of the net proceeds thereof after the payment of expenses and carrying charges on such property, one-third of the net proceeds, if received as rent or payment on a lease or as royalties, shall be deemed income, and the remaining two-thirds thereof shall be deemed principal to be invested to produce income.[189]

If the remaindermen and the life tenant wish to execute an oil and gas lease, then the life tenant may join with the remainderman in a lease permitting immediate exploration and production. However, an oil lease,

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187 *Id.*

188 *Id.* at 395.

189 Principal and Income Act, 20 Pa. Cons. Stat. Ann. § 8151 (West).

giving the lessee the right to remove all oil in place, in consideration of giving the lessor a certain percentage thereof, is in legal effect a sale of a portion of the land covered by the lease. Therefore, the proceeds of the sale of the oil produced represent the lessor's interest in the premises. If there are life tenants and remaindermen, the tenants are entitled to interest on the fund during their lives, and the corpus thereof goes to the remaindermen on the last surviving life tenant's death.[190]

§12.09. Royalty Calculation Examples.

To clarify the rules dealing with the division of royalties in an apportionment and nonapportionment jurisdiction, it is helpful to look at examples. The following calculations are for the determination of royalties as applied to a single lease well and as to unitized wells. The following explains the attached diagrams (Exhibit "A") simulating leases and unitized tracts as they pertain to apportionment and nonapportionment problems. Diagram I consists of 100 acres with a one-eighth royalty. It is made up of four tracts with well #1 on tract A and well #2 on tract D.

Diagram II is an example of a unit. Specifically, Lease II consists of 90 acres with a one-eighth royalty. Lease III consists of 60 acres with well #3 on the leasehold property and a one-eighth royalty. The 200-acre unit is comprised of 50 acres from Lease I with well #2 on tract D, 90 acres from Lease II, and 60 acres from Lease III.

Each lease contains the following unitization clause,

> Lessee may at any time unitize or pool and consolidate this lease, in whole or in part, as to any stratum or strata, with lands adjacent to or in the immediate vicinity of the premises, so as to constitute a unit or units not exceeding in area the acreage prescribed or required in any Federal or State law, order, rule or regulation for the drilling or operation of one well . . . Drilling, mining or reworking operations upon, or production of oil or gas from, or existence of a shut-in gas well on any part of such unit shall be treated for all purposes

190 *In re* Bruner's Will, 70 A.3d 222 (Pa. 1950).

hereunder as such operations upon or production from or such a shut-in gas well on the Premises, whether occurring before or after the creation of the unit. Upon production from any part of such unit, Lessor shall be entitled to royalties calculated as follows: There shall be allocated to this lease, a fractional part of all production from the unit as constituted at the time of such production in the ratio that the number of acres of this lease included in the unit bears to the total number of acres then included in the unit, and Lessor shall be entitled to royalties as provided in this lease upon such fractional part of such production, and no more . . . .[191]

[1] — Single Lease Example.

[a] — Apportionment or Entireties Clause Calculations for Well #1.

Tract A → 30/100 x 1/8 = 0.03750

Tract B → 20/100 x 1/8 = 0.02500

Tract C → 35/100 x 1/8 = 0.04375

Tract D → 15/100 x 1/8 = 0.01875

[b] — Nonapportionment Royalty Payable for Well #1.

Tract A = 1/8 or 0.125

[2]— Unitization Example

[a] — Apportionment or Entireties Clause Calculations for Wells #2 and #3.

Tract A → 30/100 x 50/200 x 1/8 = 0.0093750

Tract B → 20/100 x 50/200 x 1/8 = 0.0062500

Tract C → 35/100 x 50/200 x 1/8 = 0.0109375

Tract D → 15/100 x 50/200 x 1/8 = 0.0046875

Tract E → 90/200 x 1/8 = 0.0562500

Tract F → 60/200 x 1/8 = 0.0375000

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191 Felmont Oil Corp. v. Cavanaugh, 446 A.2d 1280 (Pa. Super. 1982).

[b] — Nonapportionment Calculations for Well #2 and #3.

Tract C → 35/200 x 1/8 = 0.021875

Tract D → 15/200 x 1/8 = 0.009375

Tract E → 90/200 x 1/8 = 0.056250

Tract F → 60/200 x 1/8 = 0.0375000

§12.10. Conclusion.

In conclusion, the task of determining the amount of royalties a landowner receives can be complicated. It does not always depend simply upon a calculation of one-eighth of production. Many factors and variables, including the laws of the particular state, must be considered before reaching a conclusion. Lessors/landowners must pay close attention to the clauses in their leases so they have an understanding of what they are giving the lessee and what they will be receiving.