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AN ANALYTICAL APPROACH TO DRAFTING ASSIGNMENTS*

by

David E. Pierce**

I. INTRODUCTION

THE most common transaction affecting title to leased minerals is the assignment of rights in an oil and gas lease. Oil and gas leases are the negotiable instruments of the oil and gas business; assignments are the documents used to transfer lease rights.¹ Although the common form of assignment may appear simple, it creates complex rights and obligations.² To properly draft an assignment attorneys must understand the substantive law regarding the property interests transferred and the resulting rights and obligations of the lessor, lessee, and transferee. Adding to this complexity are federal regulatory initiatives impacting the transfer of oil and gas interests.³ Once the substantive law is determined, the attorney must put the law into action through the drafting process. The goals of the process are easily stated: first, transfer rights in the lease from *A* to *B*, and; second, document the agreement of *A* and *B* on their respective rights and obligations created by the transfer. This Article identifies a comprehensive list of issues the attorney should analyze before drafting an assignment and examines these issues from the perspectives of the lessor, the lessee/transferor, and the transferee.

The ultimate goal of this Article is creation of a guide to drafting assign-

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1. Although there are no standard oil and gas lease forms, nearly all forms contain the same basic types of clauses. The primary term of the habendum clause may vary, but virtually all leases have a habendum clause that provides for a specified primary term followed by a secondary term defined by production. The specific fraction of royalty may vary, but almost all leases compensate the mineral owner through a share of production. The creation of such standard relationships facilitates the marketability of leasehold interests. See Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L. J. 445, 450, 457 (1987).

The motivating force for assigning an interest in a lease is usually economic. The lessee may have acquired the lease in hopes of selling it for a profit, or the lessee may not be able to raise the money to develop the lease. The lessee may place a lesser value on the lease than an assignee having more or less geological information.

2. Assignment forms are less homogeneous than lease forms. This diversity results from the greater sophistication of the parties entering into assignments.

3. E.g., Order No. 451-B, *Order Granting Rehearing in Part, Denying Rehearing in Part, Clarifying Final Rule, and Denying Stay Request*, 52 Fed. Reg. 21, 669 (1987). See *infra* text accompanying notes 149-198.

ments which combines the "why" with the "how to." If attorneys appreciate the purpose of language used in the assignment, they can better evaluate whether its presence promotes the client's interests. They also can evaluate whether it can be more effectively stated.

II. THE PROPERTY BEING TRANSFERRED

A. *Classification of the Leasehold Interest*

Although classification problems abound with oil and gas interests,⁴ proper classification is essential to determine what is required for proper transfer of such interests. Texas, for example, follows the ownership-in-place theory, which treats the owner of the land as owner of all oil and gas currently situated within the surface boundaries of the land.⁵ Texas also treats the oil and gas lease as creating an interest in real property.⁶ An assignment of an oil and gas lease should, therefore, follow the rules governing the conveyance of real property. Kansas also follows the ownership-in-place theory,⁷ but it treats the oil and gas lease as a *profit a prendre*,⁸ and classifies the lease as personal property.⁹ Regardless of the classification, however, the oil and gas lease is an interest in, or affecting, land.¹⁰ Even states which classify oil and gas leases as personal property generally have statutes and case law treating such leases similar to real property for certain purposes, such as recording.¹¹

Attorneys drafting assignments must ascertain the proper classification in their state and then determine whether oil and gas leases have been reclassified for certain purposes. For example, after researching Kansas law the attorney will discover that the lease, although classified as personal property, is treated as real property for recording purposes.¹² Beyond this discovery, however, attorneys will face drafting issues not expressly addressed by statute. For example, a spouse's consent may be required to transfer rights in homestead property.¹³ Silence in the assignment regarding warranties may give rise to implied warranties.¹⁴ Addressing these issues may require statu-

4. For an exhaustive analysis of classification problems see 1 H. WILLIAMS C. MEYERS, OIL AND GAS LAW, §§ 201 - 216.8 (1988) [hereinafter WILLIAMS AND MEYERS].

5. *Texas Co. v. Daugherty*, 107 Tex. 226, 176 S.W. 717, 721 (1915). See generally A. W. Walker, *Fee Simple Ownership of Oil and Gas in Texas*, 6 TEX. L. REV. 125 (1928) (examining Texas law regarding ownership of oil and gas).

6. *Cherokee Water Co. v. Forderhause*, 641 S.W.2d 522, 525 (Tex. 1982).

7. *Gas Co. v. Neosho County*, 75 Kan. 335, 337-38, 89 P. 750, 751-52 (1907) (ownership-in-place rule applied to oil and, in a companion case, to natural gas). See generally *Wilson v. Holm*, 164 Kan. 229, 188 P.2d 899, 905-08 (1948) (court compares Texas and Kansas law with regard to the property interest created by an oil and gas lease).

8. *Connell v. Kanwa Oil, Inc.*, 161 Kan. 649, 653, 170 P.2d 631, 634 (1946).

9. *Burden v. Gypsy Oil Co.*, 141 Kan. 147, 150, 40 P.2d 463, 466 (1935).

10. 1 H. WILLIAMS AND MEYERS, *supra* note 4, § 212. See, e.g., *Hinds v. Phillips Co.*, 591 P.2d 697, 698, 699 (Okla. 1979).

11. E.g., KAN. STAT. ANN. § 58-2221 (1983).

12. *Id.*

13. If the property interest is classified as real property, the spouse may have homestead or similar rights in the property. *Palmer v. Parish*, 61 Kan. 311, 315, 59 P. 640, 641 (1900).

14. If the oil and gas lease is classified as personal property, an assignment for a fair price

tory construction or consideration of common law concepts based upon the personal/real property status of the lease.

B. Rights Transferred in Conjunction with the Leasehold

1. Tangible Personal Property

Apart from transferring the mineral interest, the assignment may also transfer rights to tangible personal property associated with the lease such as casing, tubing, pump jacks, compressors, tanks, and oil in tanks. The parties should also consider transfer of logs, files, and abstracts associated with the lease. To ensure the proper mode of transfer the lawyer should divide the property into three categories: (1) titled personal property, such as a motor vehicle; (2) other personal property, such as oil tanks; and (3) fixtures.

Typically, general references in the lease assignment or a separate "Bill of Sale" will transfer these items. For titled property, however, the transfer may be ineffective until the appropriate registration documents are processed. Fixtures seldom present a problem since they usually constitute the personal property of the lessee as trade fixtures.¹⁵

Generally, the sale of the tangible personal property is a sale of goods under the UCC.¹⁶ Application of the UCC to the transaction often requires special attention when drafting the transfer document. For example, UCC Section 2-316 requires specific language to effectively disclaim a warranty of the transferred goods.¹⁷

2. Intangible Personal Property

Transfer of leasehold rights may also require the concurrent transfer of contract rights associated with the lease. Rights in most developed oil and gas leases are subject to contracts designed to facilitate development. The leasehold may, for example, be subject to a pooling agreement, operating agreement, gas balancing agreement, gas purchase agreement, and division orders. Even undeveloped leases will often be subject to exploration and development agreements. Each of these agreements can create lingering rights and liabilities.

In most instances the parties merely need to study the agreements to determine their impact on the value of the interest. In many cases, however, the parties must audit and allocate accrued rights. For example, there may

implies a warranty of title in the assignor. *Ratcliffe v. Paul*, 114 Kan. 506, 220 P. 279, 280-81 (1923).

15. See generally R. BROWN, *THE LAW OF PERSONAL PROPERTY*, § 144 (2d ed. 1955) (discussing trade fixtures as personal property belonging to the lessee).

16. U.C.C. § 2-105(1) (1977) provides, in part: "'Goods' means all things . . . which are movable at the time of identification to the contract for sale . . . 'Goods' also includes . . . other identified things attached to realty (Section 2-107)." U.C.C. § 2-107(2) (1977) provides, in part: "A contract for the sale apart from the land of . . . things attached to realty and capable of severance without material harm thereto . . . is a contract for the sale of goods within this Article . . ."

17. U.C.C. § 2-316 (1977) requires the "conspicuous" use of explicit language to exclude or modify the implied warranty of merchantability.

be accrued balancing rights affecting the transferred interest arising out of a gas balancing agreement. A gas purchaser may have rights to take gas from the lease to make up for gas it paid the assignor for but was unable to take prior to the assignment.¹⁸ The parties should consider these issues and address them in the appropriate transfer documents. In any event, the lessee should except such contracts from any warranty against encumbrances on the transferred leasehold.

III. FUNCTION OF THE ASSIGNMENT DOCUMENT

The assignment serves three basic functions: first, it assigns rights and delegates duties between the assignor and the assignee;¹⁹ second, it allocates liabilities between the assignor and assignee and may create obligations in addition to those imposed by the oil and gas lease;²⁰ and third, the assignment provides notice to the world that a transfer of an interest in the lease has taken place.²¹

A. Assignment of Rights and Delegation of Duties

Many assignments are purely an assignment of rights. For example, *A* assigns to *B* the right to receive 1/16th of all oil and gas produced under the oil and gas lease. *B* receives an interest in the lease, but assumes no duties. *A* has, however, created new obligations *A* must discharge with regard to *B*'s interest.²² Most assignments include both an assignment of rights and a delegation of duties. For example, *A* assigns to *B* all of *A*'s rights in an oil and gas lease. *B* obtains *A*'s rights in the lease. *B* also assumes *A*'s obligations to the lessor, and perhaps to previous assignees of the lease. The extent of this liability depends on the underlying lease, previous assignment documents, and the present assignment.²³

18. See generally 2 D. PIERCE, KANSAS OIL AND GAS HANDBOOK §§ 17.25 and 17.26 (1989) (discussing gas purchase agreements and gas balancing agreements).

19. Contract law distinguishes assignment of contract rights from the delegation of contract duties. Professor Farnsworth explains the distinction:

An obligee's transfer of a contract right is known as an *assignment* of the right. By an assignment, the obligee as *assignor* (B) transfers to an *assignee* (C) a right that the assignor (B) has against an *obligor* (A). An obligor's empowering of another to perform his duty is known as a *delegation* of the performance of that duty. By a delegation, the obligor as *party delegating* (B) empowers a *delegate* (C) to perform a duty that the party delegating (B) owes to an *obligee* (A).

E. FARNSWORTH, CONTRACTS 746 (1982).

Courts treat lease assignments more like conveyances than contracts. Even in states which classify the oil and gas lease as a contract, courts tend to apply property law conveyancing concepts to leases and lease assignments. For example, the assignee ordinarily does not execute the assignment. Instead, the parties rely upon delivery and acceptance of the assignment to bind the assignee. *E.g.*, Hansen v. Walker, 175 Kan. 121, 259 P.2d 242 (1953).

20. The assignment may impose drilling obligations on the assignee, or it may require the assignee to deliver a share of production to the assignor in the form of an overriding royalty, production payment, or net profits interest.

21. Notice is given by recording the assignment.

22. These obligations are discussed in section VII of this article. See *infra* notes 112-148 and accompanying text.

23. These matters are discussed in Section VI of this article. See *infra* notes 82-111 and accompanying text.

Frequently, the new obligations are created in conjunction with the lease assignment. For example, *A* assigns to *B* all of *A*'s rights in a lease, but retains the right to receive 1/16th of all oil and gas produced under the lease. In this situation, *B* receives the property burdened by the obligation to pay *A* 1/16th of all oil and gas produced. The assignment also includes a delegation of pre-existing duties to the lessor and previous assignees. For example, *B* must pay 1/8th of all oil and gas produced to the lessor, as well as make payment to any others entitled to a share of production carved out by earlier assignments. The scope of *B*'s obligations to *A* in this situation are discussed in Section VII of this Article. *A*'s and *B*'s obligations to the lessor and intermediate assignees are discussed in Section VI. A proper assignment should anticipate problems associated with these relationships and expressly allocate rights and duties between the parties.

B. Allocating Present and Future Liabilities

A's assignment to *B* cannot alter the rights of the original lessor or previous assignees. Unless *A* and *B* obtain the consent of the party affected, they must deal with the rights of parties as established by the oil and gas lease and any prior assignments. For example, if the oil and gas lease indicates the original lessee, *A*, will remain liable for any breach of lease covenants, *A* and *B* cannot alter *A*'s liability.²⁴ *A* and *B* can agree in the assignment, however, that *B* will indemnify *A* for any failure on *B*'s part to perform the obligations.²⁵

The allocation function of the assignment should focus on two types of liability: (1) liability for improper performance of oil and gas lease obligations; and (2) liability for improper performance of obligations under current and prior assignments. The assignment should specifically allocate existing liabilities and future obligations.²⁶ These matters are discussed in Sections VI and VII of this Article.

C. Notice a Transfer Has Occurred

Since an assignment is a transfer of an interest affecting land, notice is given through the recording system established for real estate transfers.²⁷ If the transfer is given as security, additional recording may be necessary to perfect the security interest.²⁸ Meeting the recording requirements is crucial

24. Lessees anticipating subsequent assignments generally try to address these matters in the lease. See *infra* notes 37-51 and accompanying text.

25. Since an indemnity is only as good as the indemnitor, *A* may want additional protection, such as a reversion of assigned rights in the event of *B*'s nonperformance.

26. For example, the assigned property may be subject to a gas purchaser's right to take makeup gas paid for prior to the assignment or subject to accrued rights to a disproportionate share of gas under a balancing agreement.

27. See, e.g., TEX. PROP. CODE ANN. § 13.001(a) (Vernon Supp. 1990) which provides, in part: "A conveyance of real property or an interest in real property . . . is void as to a creditor or to a subsequent purchaser for valuable consideration without notice unless the instrument has been acknowledged, sworn to, or proved and filed for record as required by law."

28. Establishing a secured position in the leasehold and all associated rights requires perfection of the lease, production, production proceeds, well equipment, fixtures, and any

because subsequent purchasers or lenders without notice can defeat the unrecorded assignment.²⁹

Often, an assignment is made but not recorded until some future event occurs. For example, *A* enters into a farmout agreement with *B*, who receives an interest in the property in exchange for drilling a well on the property. *A* doesn't want to cloud title until *B* performs the drilling obligation.³⁰ For tax purposes, however, the parties desire an up-front assignment to avoid passing the assigned interest after completion of a producing well has enhanced the value of the property.³¹ An up-front assignment in an unacknowledged, and hence unrecordable, farmout agreement addresses both problems. However, *B* assumes a substantial risk by not obtaining a recordable assignment. If *A* files a petition for bankruptcy prior to recording the assignment, the trustee will have the rights of a bona fide purchaser of real property.³² The trustee will be able to assert rights in the assigned property superior to *B*'s.³³ Although other sections of the Bankruptcy Code may provide *B* with some recourse, obtaining a recordable assignment in the first instance avoids the problem.

Recording problems can arise in a simpler fashion. For example, *B* agrees to provide *A* with funds to drill and complete a well. *A* does not want to transfer *B*'s interest until *B* has paid its share of costs. Before *A* gives *B* a recordable assignment, *A* mortgages the leasehold to *C* and conveys an interest to *D*. If *C* and *D* lack actual notice of the prior assignment to *B*, the rights of *C* and *D* will be superior to those of *B*.³⁴ The only way *B* can effectively protect its interest against the rights of subsequent transferees is to promptly record its assignment. Before an assignment can be recorded, however, it must meet certain requirements set by law.³⁵

general intangible property associated with the lease. Perfecting these interests may require local and central UCC Article 9 filings as well as a mortgage filing. *See generally* Ingram v. Ingram, 214 Kan. 415, 521 P.2d 254, 260 (1974).

29. TEX. PROP. CODE ANN. § 13.001(a) (Vernon Supp. 1990) provides, in part: "A conveyance of real property or an interest in real property . . . is void as to a creditor or to a subsequent purchaser for valuable consideration without notice unless the instrument has been acknowledged, sworn to, or proved and filed for record as required by law."

30. If *A* gives *B* a recordable assignment, *B* through subsequent assignments may complicate a reassignment in the event *B* fails to earn the assigned acreage.

31. Rev. Rul. 77-176, 1977-1 C.B. 77. *See generally* Wegher, *Taxation of Earned Interests—The Impact of Revenue Ruling 77-176*, 24 ROCKY MTN. MIN. L. INST. 521 (1978) (discussing tax consequences of farmout arrangements).

32. 11 U.S.C. § 544(a)(3).

33. *Id.*

34. *See, e.g.*, TEX. PROP. CODE ANN. § 13.001(a) (Vernon Supp. 1990).

35. *E.g.*, TEX. PROP. CODE ANN. § 12.001 (Vernon Supp. 1990) provides, in part:

(a) An instrument concerning real or personal property may be recorded if it has been acknowledged, sworn to with a proper jurat, or proved according to law.

(b) An instrument conveying real property may not be recorded unless it is signed and acknowledged or sworn to by the grantor in the presence of two or more credible subscribing witnesses or acknowledged or sworn to before and certified by an officer authorized to take acknowledgements or oaths, as applicable.

IV. RESTRICTIONS ON ASSIGNMENT

The attorney's first step in the assignment process should be a careful study of the oil and gas lease for restrictions on assignment. Absent an express limitation on assignment, the lessee can freely assign rights in the oil and gas lease.³⁶ General references in the lease, making it binding on the heirs, successors, and assigns of the parties suffice as express authority to assign.³⁷ Most modern lease forms are more explicit, providing, for example:

The rights of each party hereunder may be assigned in whole or in part, and the provisions hereof shall extend to their heirs, successors and assigns³⁸

Although restrictions on assignment come in a variety of forms³⁹ lessors often unwisely insert clauses such as the following:

(1) "This lease may be assigned only with the written consent of the lessors."⁴⁰

(2) "That the rights of the parties hereto shall not be assigned without the written consent of the other parties, which consent shall not be unreasonably withheld."⁴¹ Neither restriction will accomplish the lessor's intended goal.

Unlike other lease clauses, limitations on assignment will be strictly construed against the lessor.⁴² Some courts hold a restriction requiring the lessor's written consent for assignment void as an unlawful restraint against alienation,⁴³ when it doesn't provide for a reversion, forfeiture, or other rem-

36. *E.g.*, *Watts v. England*, 168 Ark. 213, 269 S.W. 585, 587-88 (1925). Classification of the assignment as either a conveyance of real property or as a transfer of contract rights, could impact whether rights can be assigned and duties delegated. In practice, the courts seem to treat the transaction more like a conveyance when considering whether the leasehold interest can be transferred to others. *E.g.*, *Shields v. Moffitt*, 683 P.2d 530, 1533 (Okla. 1984). Even in Kansas, where the oil and gas lease is personal property and frequently described as a contract, the lessee's associated rights and duties are freely assignable. *Matthews v. Ramsey-Loyd Oil Co.*, 121 Kan. 75, 81-82, 245 P. 1064, 1067 (1926).

Even under a strict contract analysis, the result may be the same. For example, in *Heffington v. Hellums*, 212 S.W.2d 245 (Tex. Civ. App.—San Antonio 1948, writ ref'd n.r.e.), the court held that duties could be freely delegated under a contract to operate a well, because operation of a well does not require the degree of personal skill, confidence, character, or trust that would preclude delegation. *Heffington*, 212 S.W.2d at 248.

37. *Terrell v. Munger Farm Co.*, 129 S.W.2d 407, 408 (Tex. Civ. App.—Ft. Worth 1939, writ denied).

38. E. KUNTZ, J. LOWE, O. ANDERSON, AND E. SMITH, *OIL AND GAS FORMS MANUAL* 21 (1987) (clause 8 of the AAPL Form 675 Oil and Gas Lease, Texas Form) [hereinafter *OIL AND GAS FORMS MANUAL*].

39. *E.g.*, *Moherman v. Anthony*, 103 Kan. 500, 175 P. 676, 676 (1918) ("This lease is transferable only by consent of first party [lessor]. If sold, first party to receive one-half of the consideration lease is sold for").

40. *Shields v. Moffitt*, 683 P.2d 530, 531 (Okla. 1984).

41. *Palmer v. Liles*, 677 S.W.2d 661, 663 (Tex. App.—Houston [1st Dist.] 1984, writ ref'd n.r.e.).

42. *Knight v. Chicago Corp.*, 144 Tex. 98, 103, 188 S.W.2d 564, 566 (1945).

43. *Shields*, 683 P.2d at 534 (restriction on assignment of oil and gas lease); *Outlaw v. Bowen*, 285 S.W.2d 280, 283 (Tex. Civ. App.—Amarillo 1955, writ ref'd n.r.e.) (restriction on transfer of mineral interest). *But see Reynolds v. McCullough*, 739 S.W.2d 424, 1432-433

edy.⁴⁴ The second clause offers lessors little protection unless they can demonstrate damages arising out of the contested assignment.⁴⁵ In certain situations, the second clause may impose a greater risk of liability on the lessor than the lessee. If a court finds the lessor's consent was unreasonably withheld, they may be liable to their lessee for a lost sale.

The lessor's task is to protect their economic interests without creating an unlawful restraint against alienation. The lessor's economic interests fall into five categories:

- (1) The lessor's reliance on the reputation, skill, and financial position of the original lessee;
- (2) the lessor's desire to share in any increased value of the leasehold;
- (3) the lessor's desire to prevent the creation of excessive noncost-bearing interests which may discourage development;
- (4) the lessor's desire to know the current owners of the leasehold; and
- (5) the lessor's desire to avoid a large number of recorded transactions which will increase abstracting fees for routine transactions such as secured farm loans. Proper drafting can achieve each of these goals.

A. Policing Assignments Through Continuing Liability

If the lessor is concerned the lessee might assign the lease to a fly-by-night operation, the lease should hold the lessee liable for any post-assignment nonperformance of lease covenants.⁴⁶ The lease could provide:

ASSIGNMENT BY LESSEE

LESSEE can Assign all or any part of the Lease. However, LESSEE will remain obligated for the proper performance of all express and implied Lease obligations. LESSEE's liability for the non-performance of lease obligations will be in addition to the liability of any assignee obtaining an interest through the LESSEE or any assignee obtaining an interest through LESSEE's assignee. The liability of LESSEE and all assignees transferred an interest in the Lease is joint and several.⁴⁷

(Tex. App.—San Antonio 1987) (court distinguishes the rule applied to real property interests and applies a less restrictive rule when evaluating assignment restrictions in a "ground lease.").

44. Lack of any remedy was the defect which caused the Texas and Oklahoma courts to find the restriction void as an unreasonable restraint against alienation. *Outlaw v. Bowen*, 285 S.W.2d at 283; *Shields*, 683 P.2d at 533.

45. *Palmer*, 677 S.W.2d at 665.

46. For example, in *Trafalgar House Oil & Gas v. De Hinojosa*, 773 S.W.2d 797, 799 (Tex. App.—San Antonio 1989, no writ), the lease provides: "[N]o assignment nor reassignment shall operate to relieve LESSEE or its assignees from any liability or responsibility hereunder." If this approach is followed, other clauses in the lease must be carefully reviewed and, if necessary, modified. For example, many leases have a clause similar to the following:

In the event of assignment hereof in whole or in part, liability for breach of any obligation issued hereunder shall rest exclusively upon the owner of this Lease, or portion thereof, who commits such breach.

OIL AND GAS FORMS MANUAL, *supra*, note 38.

47. The significance of the assignment/sublease distinction is discussed *infra* notes 103-111 and accompanying text. This clause contemplates definition of "Lease" and "Assign" elsewhere in the lease. "Lease" is typically defined in the granting clause, which contains a description of the leased land. "Assign" should be defined to include subleases, for example:

1. "Assign" and "Assigns" mean:

Instead of restricting transfer, the clause makes the lessee a guarantor for the performance of all subsequent assignees.⁴⁸ Since lessees have total control over assignment, they may leverage their liability by avoiding assignments, assigning to responsible operators, obtaining indemnities from assignees, or seeking a release from the lessor prior to the assignment. When the lessee requests a release of *liability*, the lessor may refuse for any reason.⁴⁹

If the lessor fails to select a responsible lessee in the first instance, continuing lessee liability will be of little value. Cumulative liability of subsequent assignees will, however, provide a pool of potential defendants. Many states attempt to obtain such a position under their plugging statutes.⁵⁰ Lease language to make subsequent assignees jointly and severally liable to the lessor could provide:

Any person or entity obtaining an Assignment of rights in the Lease:

- (1) Is deemed to have accepted liability for the non-performance of any express or implied Lease obligations accruing prior to the date of Assignment; and
- (2) Is liable for the proper performance of express and implied lease obligations from and after the date of Assignment. Liability for the non-performance of lease obligations will be in addition to the liability of LESSEE, any assignees obtaining an interest through LESSEE, or any assignees obtaining an interest through LESSEE's assignees. The liability of LESSEE and all assignees transferred an interest in the lease is joint and several.

Such a provision forces a prospective assignee to inquire about the lessee's

A written transfer of rights in the Lease, whether technically classified as an assignment or sublease.

2. "Assignment" means:

The written document used to Assign rights in the Lease.

48. Generally, if the assignment covers all of the lessee's interest, the assignee will become responsible to the lessor for performance of lease obligations. Unless the lease contains a clause relieving the lessee/assignor from further liability, the lessee will remain obligated to the lessor for performance of lease obligations. The assignee's liability will extend from the time the assigned interest is received until it is disposed of through assignment to others. *Hale v. Oil Co.*, 113 Kan. 176, 180, 213 P. 824, 826 (1923). The parties frequently adjust liability by express provisions in the lease.

49. Although a restriction on assignment may be an unlawful restraint against alienation, the cases do not suggest a burden, such as continuing lessee liability, would be open to attack. Instead, the cases seem to suggest the need for a burden to make the restraint lawful. When the lessor is merely given the right to withhold consent, the cases focus on the lack of reversion, forfeiture, or other penalty for assignment without the requisite consent. *E.g.*, *Shields*, 683 P.2d at 534 (restriction on assignment of oil and gas lease); *Outlaw*, 285 S.W.2d at 283 (restriction on transfer of mineral interest).

50. For example, KAN. STAT. ANN. § 55-179(b) (Supp. 1989) imposes liability on a chain of potential defendants when a well is improperly plugged or abandoned. Persons who may be legally responsible for improper plugging or abandonment of a well include, but are not limited to, the original operator, the current operator, or the last operator.

The current operator has primary responsibility for plugging abandoned wells. Controlling the leased premises arguably imposes primary liability for any pollution problems on the lease. Only the current operator has the right to enter and conduct operations on the lease.

If the current operator is unable to respond, prior operators can be held responsible for the current operators default. A similar concept is applied for the regulation of hazardous wastes under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) 42 U.S.C §§ 9601-9675. By imposing potential liability on any party acquiring property with a hazardous waste problem, CERCLA encourages purchasers to discover and resolve such problems prior to purchase.

performance, thereby allowing the lessor to air any complaints against the lessee. The prospective assignee can then consider settlement of the lessor's claims, possibly resulting in a corresponding adjustment to the purchase price. The cumulative liability clause proves its value by forcing a prospective assignee to bargain with the lessor at the critical pretransfer stage. Absent this legal advantage, the assignees could refer many lessor grievances back to the prior assignors.

B. Policing Assignments Through Reversion and Forfeiture

To ensure that the interest is not assigned without the lessor's consent, the lease may provide that the lease will automatically revert upon an unauthorized assignment.⁵¹ To avoid assuming a leasehold liability, such as plugging obligations, the lessor may, instead, retain the option of declaring the lease terminated. Such provisions will be subjected to close judicial scrutiny.⁵² In general, elimination of all lessor discretion in the reversion creates a stronger case. If the interest may not be assigned without the lessor's consent, courts may try to mitigate the harshness of the reversion by implying that the lessor's consent will not be unreasonably withheld.⁵³ The drafter can eliminate this problem by simply providing that the lease will terminate upon assignment. The lessor, however, must carefully define the term "assignment" to ensure all the intended types of assignment are expressly described. Absent express language including assignments of overriding royalties and loan pledges, courts will likely limit the clause to assignments of working interests in non-credit transactions.⁵⁴

C. Policing Assignments Through Special Requirements

If the lessor has a particular reason for restricting assignment, a lease clause directed to the concern at hand may function more effectively than general restrictions. If the concern is with increased abstracting fees, for example, the lease could provide:

While this lease is in effect, LESSEE agrees to pay to LESSOR all costs associated with the preparation of abstracts of title covering all or any part, or any interest in, the LESSOR's land covered by this lease. This obligation relates to any transaction which the LESSOR enters

51. Although such a provision will discourage assignment, apparently the courts do not view it as an unlawful restraint against alienation. See *Shields*, 683 P.2d at 533 (restriction on assignment of oil and gas lease); *Outlaw*, 285 S.W.2d at 283 (restriction on transfer of mineral interest).

52. See, e.g., *Knight v. Chicago Corp.*, 144 Tex. 98, 188 S.W.2d 564 (1945).

53. See, e.g., *Warmack v. Merchants Nat'l Bank*, 612 S.W.2d 733, 735 (Ark. 1981); RESTATEMENT (SECOND) OF PROPERTY (LANDLORD AND TENANT) § 15.2(2) (1977), which states:

(2) A restraint on alienation without the consent of the landlord of the tenant's interest in the leased property is valid, but the landlord's consent to an alienation by the tenant cannot be withheld unreasonably, unless a freely negotiated provision in the lease gives the landlord an absolute right to withhold consent.

See *Meng, Limitations on the Right to Transfer Mineral Leases*, 9 *Eastern Min. L. Inst.* 12-1, 12-3 to 12-5 (1988).

54. This limitation is a product of the strict interpretation rule.

into concerning the sale, lease, or other transfer of the land covered by this lease. The obligation also relates to loan transactions where the land is used as collateral. LESSOR will provide the LESSEE with a copy of the paid invoice showing the abstracting charge and a brief description of the transaction requiring the abstracting services. LESSEE will reimburse LESSOR for the expense within thirty days after receiving the invoice and LESSOR's description of the transaction.

If the lessor wants prompt notice of lease transfers, the lease could encourage notice by holding the assignor liable for all lease obligations until the lessor receives notice. The lessor might use a clause similar to the following:

Upon Assignment of all or any part of the Lease, the assignor will provide LESSOR with a certified copy of the recorded Assignment. The assignor will remain liable for the non-performance of all express and implied lease obligations occurring up to and including the date the required Assignment document is given to LESSOR.⁵⁵

To share in the increased value of the leasehold, the lessor may insert a clause similar to the one in *Moherman v. Anthony*: "If [an interest in the lease is] sold, first party [lessor] to receive one-half of the consideration lease is sold for."⁵⁶ The lessor alternatively could provide for a flat fee to be paid upon each interest assigned.⁵⁷

If the lessor wants to discourage the creation of nonoperating interests, the lease could provide that lessor will receive a cost-free share of production each time a non-operating interest is assigned out of the leasehold interest. For example, the lease might require that each time a non-operating interest is assigned to third parties the lessor will receive a 1/32nd of 8/8ths overriding royalty. The term "nonoperating interest" should be carefully defined to include overriding royalties, production payments, net profits interests, convertible interests, carried interests, and any other form of interest where the lessee must bear costs associated with the assigned interest. More workably,

55. This clause assumes the lessor was unable to negotiate the continuing liability of the lessee and all assignees. The general rule, absent a specific lease provision, is that the assignor will be responsible only for events occurring while they owned an interest in the lease. See generally R. SULLIVAN, HANDBOOK OF OIL AND GAS LAW § 129 (1955) [hereinafter referred to as SULLIVAN].

56. 103 Kan. 500, 175 P. 676 (1918).

57. The lessor in *Trafalgar House Oil & Gas v. De Hinojosa*, 773 S.W.2d 797 (Tex. App.—San Antonio 1989, no writ), had a creative approach. The lease provided, in part: The right of either party hereunder may be assigned in whole or in part In the event of assignment, LESSEE, its successors and assigns, shall give notice of the fact of such assignment and the name and address of the assignee within thirty (30) days after such assignment; and, LESSOR shall likewise be notified upon each subsequent assignment. Upon each failure of the LESSEE, its successors and assigns to comply with the foregoing 'notice of assignment', said LESSEE, his successors and assigns shall jointly and severally forfeit and pay unto the Lessor the sum of ONE THOUSAND AND NO/100 (\$1,000.00) DOLLARS as liquidated damages.

Trafalgar, 773 S.W.2d at 799. Apparently the lease had been assigned twenty times without anyone giving the lessor the required notice. The lessor brought suit seeking \$20,000 in liquidated damages. The court upheld a \$20,600.00 judgment in the lessor's favor finding the notice of assignment provision was an enforceable liquidated damages agreement.

the lease could terminate if the lessee's net revenue interest falls below a certain level, for example 75%.

If the lessee can identify the lessor's specific problems, a tailored clause can often be fashioned to address the lessor's concerns without unduly restricting the lessee's ability to assign. Reasonable restrictions on assignment, in turn, can provide the lessor with effective protection from subsequent assignees.

V. IDENTIFYING THE ASSIGNED INTEREST

This section considers problems with identifying the scope and nature of the interest assigned. Assignments create many of the same interpretive problems encountered with mineral interest conveyances. For example, interpreting an assignment of oil rights to one party, while retaining the gas and other minerals, not only requires an interpretation of "other minerals,"⁵⁸ but also requires an interpretation of "oil."⁵⁹ Defining the surface and subsurface leasehold area assigned is a more common problem.

Once the area affected by the assignment is accurately defined, the rights associated with the assignment must be described. For example, tangible and intangible property rights included with the grant should be specified. The assignment should also address the respective rights of the assignor and assignee to use the surface or segregated formations to develop their leasehold interests. After defining the bundle of rights to be conveyed, the parties must agree on the assignor's warranty. The final task addressed in this section is resolution of problems in quantifying the interest conveyed.

A. Surface and Subsurface Descriptions

1. Surface Description Problems

Assume *A* owns a lease covering all of Section 30. If *A* wants to convey to *B* all of *A*'s rights to the North 1/2 of Section 30, the description task is simple. If, however, *A* only wants to convey to *B* lease rights to the drill site associated with the Farmer 2-30 Well in the North 1/2 of Section 30, the task becomes more difficult. The drill site may be a proration unit, spacing unit, or pooled unit. The area may be defined by current production and well completions. If the existing spacing unit is 40 acres based on oil production, for example, deepening the well or discovering gas may result in spacing on a 160-acre or 320-acre basis.

Reference to the "drill site" falls short of an adequate description. In some cases, the lessee may instead simply assign a definite block of acreage associated with the well, such as the Northeast Quarter of the Northwest Quarter of Section 30. In other cases, the assignment may anticipate expansion or reduction of the drill site area by providing for a corresponding ad-

58. See, e.g., *Moser v. United States Steel Corp.*, 676 S.W.2d 99, 103 (Tex. 1984).

59. See, e.g., *Amarillo Oil Co. v. Energy-Agri Prod.*, 32 Tex. Sup. Ct. J. 252, 256 (March 8, 1989); *Raw Hide Oil & Gas v. Maxus Exploration*, 766 S.W.2d 264, 271 (Tex. App.—Amarillo 1988, writ denied).

justment to the rights assigned. Such an approach presents special problems, however, since property rights would revert and revest in response to new drilling and conservation commission actions.⁶⁰

Equally complex problems arise when the assignment is limited solely to leasehold rights associated with a specific well. Suppose *B* purchases *A*'s rights associated with the Farmer 2-30 Well. This "wellbore" or "borehole" assignment limits *B*'s rights solely to production from the Farmer 2-30. Presumably, *B* is entitled to the production allocated to the well by the conservation commission, even though *B* owns none of the leasehold acreage required for the allowable. If the well ceases to produce, however, several problems arise. First, the assignee may lack the right to enter the surface of the lease to access the well. If the assignment grants the assignee use of the surface, they may lack the right to perform the desired work, such as deepening or recompletion in a new zone. Although the assignee may be able to enter new zones within the existing well; drilling a replacement well would seem to be impermissible.⁶¹

2. Subsurface Description Problems

When dividing the leasehold by depth, commonly called a "horizontal severance," the parties are seldom certain of subsurface configurations. The area may be heavily faulted, or a producing reservoir may dip, causing the depth selected by the parties to inadvertently split rights to a single reservoir. For example, suppose *A* conveys to *B* the leasehold rights in Section 30 from the surface down to 5,000 feet below the surface, while retaining all leasehold rights to depths below 5,000 feet. If an oil and gas reservoir underlying Section 30 extends from 4,900 feet to 5,050 feet below the surface, a dispute may arise as to which party has the right to produce from the reservoir.⁶²

Similar problems arise when a specific formation is conveyed. If *A* conveys to *B* the leasehold rights to only the Dakota formation in Section 30, this conveyance avoids the split reservoir problem, but can create disputes concerning the existence and extent of the Dakota formation. For example, *A* may claim the base of the Dakota formation is at 5,000 feet while *B* may claim the Dakota extends to 5,100 feet. On the other hand, *B* might argue a producing zone at 5,500 feet is part of the Dakota formation segregated by a fault.

Such problems demonstrate the need for technical advice to devise a workable depth description. Geological studies of the area may reveal readily identifiable formations suitable for depth references; such studies can also reveal formations which may be difficult to identify. Depth limitations

60. See generally Terrell, *Limited Assignments - Who Gets What?* 35 ROCKY MTN. MIN. L. INST. 17-1 (1989) (discussing limited assignments) [hereinafter Terrell]. Professor Lowe discusses this problem in conjunction with farmout agreements in Lowe, *Analyzing Oil and Gas Farmout Agreements*, 41 SW. L. J. 759, 822-24 (1987) [hereinafter, referred to as Lowe].

61. *Id.*

62. See, e.g., *Carter Oil Co. v. McCasland*, 190 F.2d 887 (10th Cir. 1951); *Carter Oil Co. v. State*, 205 Okla. 541, 240 P.2d 787 (1951); *Palmer Oil Corp. v. Phillips Petroleum Co.*, 204 Okla. 543, 231 P.2d 997 (1951), *appeal dismissed*, 343 U.S. 390 (1952).

are often defined by referencing logs from area wells. For example, *A* wants to convey a portion of its Section 30 leasehold rights in the Dakota formation to *B*. On Section 29, the Smith 1-29 well penetrates the Dakota formation. The sonic log for the Smith 1-29 indicates the Dakota formation begins at 4,050 feet and ends at 4,100 feet. Due to surface elevation variances and the folding, dipping, or faulting of subsurface structures, the Dakota formation will not likely be encountered at the same depths in Section 30. Comparing sonic logs from a well drilled in Section 30 with those from the marker well in Section 29 will aid the parties in defining the Dakota formation. *A*'s conveyance to *B* could provide:

A assigns to *B* the oil and gas leasehold interest created by an oil and gas lease dated 31 July 1985 between Fred Farmer as lessor and *A* as lessee, recorded in Miscellaneous Book 143 at Pages 17-18 of the Eureka County, Kansas records, to the extent the lease covers *A*'s leasehold rights to the Dakota formation in Section 30, Township 36 South, Range 10 East from the Sixth Principal Meridian, Eureka County, Kansas.

For reference purposes, *A* and *B* agree the Dakota formation is identified by sonic log as beginning at 4,050 feet and ending at 4,100 feet in the Smith 1-29 Well located in the Northwest Quarter of the Northwest Quarter of Section 29, Township 36 South, Range 10 East, from the Sixth Principal Meridian, Eureka County, Kansas.

A excepts from this assignment all leasehold rights to depths and formations in Section 30 above and below the Dakota formation.

Frequently the portion of the leasehold interest assigned is to the total depth drilled by the assignee. To account for the varying depth of subsurface structures, assignments often grant down to the stratigraphic equivalent of a stated numerical depth. For example, *B* drills the Farmer 1-30 well to 3,000 feet and, pursuant to a farmout agreement with *A*, is entitled to an assignment to the total depth drilled. To ensure *B* obtains rights to the formations penetrated by its well, and to avoid splitting productive formations, the assignment could provide:

A assigns to *B* the oil and gas leasehold interest created by an oil and gas lease dated 31 July 1985 between Fred Farmer as lessor and *A* as lessee, recorded in Miscellaneous Book 143 at Pages 17-18 of the Eureka County, Kansas records, covering Section 30, Township 36 South, Range 10 East, from the Sixth Principal Meridian, Eureka County, Kansas, to the extent the lease includes *A*'s interest from the surface down to the stratigraphic equivalent of 3,000 feet beneath the surface, as measured in the bore of the Farmer 1-30 well completed in the Northwest Quarter of the Northwest Quarter of Section 30, Township 36 South, Range 10 East, from the Sixth Principal Meridian, Eureka County, Kansas.

A excepts from this assignment all leasehold rights to depths below the stratigraphic equivalent of 3,000 feet beneath the surface as measured in the bore of the Farmer 1-30 Well.

Another problem concerns whether to measure depth as true vertical depth or as measured through the drill pipe. Since the drill pipe inevitably

deviates from the vertical, the depth as measured through the drill pipe always exceeds the true vertical depth. Measurement of the drill pipe length is, nonetheless, usually the most practical approach. A related problem is choosing whether sea level, the rig floor, or the surface should be the starting point for the measurement from the surface.⁶³

B. Property Associated with the Assignment

As noted in Section II of this Article, assignments should convey the leasehold plus all tangible and intangible property rights associated with the leasehold. If the assignment is limited by depth or otherwise, the assignment should include the surface and subsurface rights necessary to develop the assigned interest. For example, if *A* conveys to *B* only the leasehold rights to the Dakota formation in Section 30, the assignment should indicate: "*B* is also conveyed, to the extent necessary to reasonably explore, develop, and operate the assigned interest, the right to enter and use the surface of the leased land and to drill and operate through formations excepted by *A* from this assignment." *A* should similarly retain the right to drill and operate through the Dakota. For example: "*A* reserves from this assignment, to the extent necessary to reasonably explore, develop, and operate *A*'s retained leasehold interest, the right to drill and operate through the interest assigned to *B*." The parties must also consider whether the increased surface use burden falls within the express or implied easement created by the oil and gas lease.⁶⁴ If the mineral and surface estate were severed before creation of the lease, the surface use issue must be determined under the implied easement/reasonable use doctrine, unless the deed severing the minerals specifically addresses the issue.⁶⁵

Assignment of the leasehold interest does not necessarily convey lease equipment and fixtures.⁶⁶ To specifically convey such items, the lease could provide: "*A* also conveys to *B* all fixtures, equipment, and other personal property located on, and used in conjunction with, the assigned interest." If a bill of sale conveys the tangible personal property, the assignment can incorporate the bill of sale for descriptive purposes. For example, the lease could provide: "*A* also conveys to *B* all fixtures, equipment, and other personal property located on, and used in conjunction with, the assigned interest, to include items listed in a Bill of Sale between the parties dated September 15, 1989." Even if the bill of sale is not recordable, the reference in the recorded assignment places third parties on notice of the assignee's rights.⁶⁷

63. Lowe, *supra* note 60, at 806, 825.

64. *Id.*

65. See generally Pierce, *Toward A Functional Mineral Jurisprudence for Kansas*, 27 WASHBURN L. J. 223, 238-40 (1987).

66. Fike v. Riddle, 677 S.W.2d 722, 727 (Tex. App.—Houston [1st Dist.] 1984, writ ref'd n.r.e.).

67. See Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 904-05 (Tex. 1982) ("inquiry notice"); MBank Abilene, N.A. v. Westwood Energy, Inc., 723 S.W.2d 246, 248 (Tex.—Eastland App. 1986, no writ).

Intangible rights associated with the assigned interest are generally listed as exceptions to the warranty. As noted in Section II of this Article, the parties may need to specifically allocate and assign related contract rights.

C. Warranties and the Assigned Interest

The assignment should clearly state whether the assignor warrants the interest. To effectively convey the lease without such warranties usually requires an express disclaimer of warranties. In states that treat the oil and gas lease as personal property, an assignment of the lease for a fair price implies a warranty of title in the assignor.⁶⁸ In states that classify the oil and gas lease as real property, the use of common words of conveyance, such as "convey" or "grant," may imply certain warranties in conjunction with the transfer.⁶⁹

An assignment of an oil and gas lease may contain a general or special warranty, state no warranty, disclaim all warranties, or quitclaim the assignor's interest. If the assignment contains a warranty, the assignor should carefully except all existing encumbrances, including operating agreements, gas purchase contracts, gas balancing contracts, and rights burdening the leasehold created by prior assignments. Assignors often offer a special warranty, which generally applies only to encumbrances and defects caused by the assignor.

Since the assignee's interest depends upon the continuing validity of the lease, the assignment sometimes addresses specific issues concerning the status of the lease. For example, the assignees' failure to properly pay delay rentals⁷⁰ or shut-in royalty⁷¹ may have terminated the lease. The lease may be subject to cancellation because the assignee has failed to operate and develop it prudently.⁷² An interruption in production during the secondary term may have terminated the lease.⁷³ Consequently, if *B* purchases an interest in *A*'s lease, *B* may require *A* to warrant that the lease is in effect, that all rental, shut-in royalty, royalty, and other payments required by the terms of the lease have been properly made, and that *A* has the right to convey the interest. The attorney representing *B* should independently investigate the

68. See *Ratcliff v. Paul*, 114 Kan. 506, 509, 220 P. 279, 281 (1923).

69. For example, TEX. PROP. CODE ANN. § 5.023 (Vernon 1984) provides:

(a) Unless the conveyance expressly provides otherwise, the use of 'grant' or 'convey' in a conveyance . . . implies only that the grantor and the grantor's heirs covenant to the grantee and the grantee's heirs or assigns:

(1) that prior to the execution of the conveyance the grantor has not conveyed the estate or any interest in the estate to a person other than the grantee; and

(2) that at the time of the execution of the conveyance the estate is free from encumbrances.

(b) An implied covenant under this section may be the basis for a lawsuit as if it had been expressed in the conveyance. TEX. PROP. CODE ANN. § 5.023 (Vernon 1984).

70. See e.g., *Young v. Jones*, 222 S.W. 691, 692 (Tex. Civ. App.—El Paso 1920, no writ) (wrong amount); *Gillespie v. Bobo*, 271 F. 641, 643 (5th Cir. 1921) (wrong address).

71. See *Greer v. Salmon*, 82 N.M. 245, 479 P.2d 294 (1970); *Gulf Oil Corp. v. Reid*, 161 Tex. 51, 337 S.W.2d 267 (1960).

72. See generally *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 274-76 (1934).

73. See *Hoyt v. Continental Oil Co.*, 606 P.2d 560 (Okla. 1980); *Samano v. Sun Oil Co.*, 621 S.W.2d 580 (Tex. 1981).

status of the lease by examining state records, delay rental receipts, shut-in royalty receipts, affidavits of production, lessor demands, surface occupancy, and any additional sources necessary to ensure the assignor's compliance with the lease.

Prior assignments should also be examined. For example, in *Riley v. Meriwether*⁷⁴ the assignment provided:

Assignee shall reassign to Assignor, all interest in the [assigned leases] . . . which are not then producing . . . if said production cessation is for longer than sixty (60) consecutive days . . .⁷⁵

The assignee completed several gas wells pursuant to its farmout agreement with the assignor, but then shut them in. Since the assignment did not provide for payment of shut-in royalty in lieu of actual production, the assignee's rights terminated automatically when the production condition was not met.⁷⁶ The assignment also provided:

Reference for all purposes is made to the oil and gas leases described in Exhibit A attached hereto and incorporated herein by this reference.⁷⁷

The court, nevertheless, held that this provision did not incorporate the lease terms, such as the shut-in royalty provisions, for purposes of determining the duration of the assigned estate.⁷⁸ In addition to ascertaining the status of the oil and gas lease, therefore, the prospective assignee must ascertain the current status of each prior assignment to ensure the assignor still possesses the rights it is purporting to convey. If the assignee fails to discover a defect in the assignor's title, the only remedy, absent fraud, misrepresentation, or mutual mistake, will be damages for breach of any warranty contained in the assignment.

D. Quantifying the Assigned Interest

Problems concerning the quantum of interest conveyed out of the leasehold usually involve the creation of nonoperating interests such as overriding royalties and production payments. The owner of the leasehold interest receives a share of production determined by subtracting the lessor's royalty interest. For example, assume the lessor's royalty is 1/8th of gross production and the lessee is entitled to the remaining 7/8ths. If *A* conveys a 1/16th overriding royalty to *B*, the conveyance document should clearly indicate the calculation of *B*'s interest. If *A* conveys to *B* 1/16th of *A*'s share of production, the interest conveyed is expressed as: "*A* conveys to *B* 1/16 of 7/8 of 8/8 of production," and *B* receives 7/128ths (1/16 of 7/8) of gross production instead of 8/128ths (1/16 of 8/8). On the other hand, if *A* assigns *B* a 1/16th share of gross production, the appropriate language is: "*A* conveys to *B* 1/16 of 8/8 of production."

74. 780 S.W.2d 919 (Tex. App.—El Paso 1989, no writ).

75. *Riley v. Meriwether*, 780 S.W.2d 919, 923 (Tex. App.—El Paso 1989, no writ).

76. *Id.* at 923.

77. *Id.* at 924.

78. *Riley*, 780 S.W.2d at 924.

References to the lessee's "working interest" or "leasehold interest" for quantity descriptions are unclear since these phrases often refer to the lessee's *share* of gross production. For example, if *A* conveys to *B* "1/16 of 7/8 of *A*'s working interest", *B* arguably receives either 7/128ths (1/16 of 7/8) of gross production or 49/1024ths (1/16 of 7/8 of 7/8) of gross production.⁷⁹

If *A* owns only an undivided 50% leasehold interest in Section 30 and conveys to *B* 1/16 of 7/8 of 8/8 of production, the express terms of the assignment will entitle *B* to 7/128ths of production as opposed to 7/256ths.⁸⁰ If *A* desires to reduce the assigned interest to reflect *A*'s 50% ownership in the leasehold, *A* can include a proportionate reduction clause in the assignment. A proportionate reduction clause reduces the assigned interest to coincide with *A*'s actual leasehold ownership, in the event *A* owns less than the entire leasehold interest. The clause should also address *B*'s interest in the event pooling or unitization reduces *A*'s share of production. A sample clause follows:

To the extent *A*'s leasehold interest in [the assigned property] covers less than 100% [8/8ths] of the mineral interest, *B*'s overriding royalty interest will be reduced in the proportion that *A*'s interest bears to 100% [8/8ths] of the mineral interest.

In the event all or part of the assigned property is pooled or unitized with other leasehold interests to form a drilling, spacing, or proration unit, or to effect fieldwide unitization, *B*'s overriding royalty interest shall be further reduced in the proportion surface acreage covered by the assigned property included within the unit bears to the total surface acreage within such unit.

Allocation of unit production on some basis other than surface acreage will require incorporation of the appropriate formula into the assignment.

To quantify *B*'s interest, the assignment must designate how *B* will share in production and production costs. Overriding royalty language usually follows the lease royalty clause language in providing that *B*'s interest will attach only to oil and gas "produced and saved from the leased premises." Typically, *A* agrees to bear drilling, production, and operating expenses from its share of production but *B* agrees to pay taxes levied against its share of production. The parties should expressly state in the assignment the costs that can be deducted from gross production before calculating the overriding royalty.⁸¹

79. See generally R. HEMINGWAY, LAW OF OIL AND GAS 484-85 (2d ed. 1983).

80. See *First Nat'l Bank v. Kinabrew*, 589 S.W.2d 137, 149 (Tex. Civ. App.—Tyler 1979, writ ref'd n.r.e.).

81. Wyoming has attempted to clarify the allocation of marketing costs between operating and nonoperating interests by statute. WYO. STAT. § 30-5-304(a)(v), (vi), and (vii) (Supp. 1989) provide:

(v) 'Overriding royalty' means a share of production, free of the costs of production, carved out of the lessee's interest under an oil and gas lease;

(vi) 'Costs of production' means all costs incurred for exploration, development, primary or enhanced recovery and abandonment operations including, but not limited to lease acquisition, drilling and completion, pumping or lifting, recycling, gathering, compressing, pressurizing, heater treating, dehydrating,

VI. OBLIGATIONS INCIDENT TO THE ASSIGNMENT

A's assignee receives not only the express rights created by the lease, but also any implied rights conferred upon the lessee. For example, in *Mai v. Youtsey*⁸² the court held that each of the lessee's partial assignees could exercise the lessee's implied right to make reasonable use of the surface to conduct operations on their portion of the assigned property.⁸³ Most disputes, however, concern the allocation of obligations between the assignee and assignor.

A. Liability to Lessor

When the assignment conveys all of the lessee's interest, the assignee becomes responsible to the lessor for performance of lease obligations.⁸⁴ The lessee, however, remains obligated to the lessor for compliance with lease covenants, unless excused by agreement of the lessor.⁸⁵ The assignee's liability extends from receipt of the assigned interest until it is disposed of through subsequent assignment.⁸⁶

The parties may, however, allocate liability through express provisions in the lease and assignment documents. For example, in an assignment by *A* to *B*, *A* might insist upon the following clause:

B assumes, and agrees to comply with, from and after the date of this assignment, the express and implied covenants created by the oil and gas lease. From and after the date of this assignment, *B* agrees to indemnify *A* against any liability, claim, demand, damage, or cost, including litigation costs and attorney fees, associated with the oil and gas lease and the interest assigned to *B*.

In this case, *B* should insist upon a reciprocal indemnity from *A*, for example: "*A* agrees to hold harmless and indemnify *B* against any claims or lia-

separating, storing or transporting the oil to the storage tanks or the gas into the market pipeline. 'Costs of production' does not include the reasonable and actual direct costs associated with transporting the oil from the storage tanks to market or the gas from the point of entry into the market pipeline or the processing of gas in a processing plant;

(vii) 'Royalty' means the mineral owner's share of production, free of the costs of production

WYO. STAT. § 30-5-305(a) (Supp. 1989) (emphasis added) which provides, in turn:

(a) Unless otherwise expressly provided by specific language in an executed written agreement, 'royalty', 'overriding royalty' . . . shall be interpreted as defined in W.S. 30-5-304. A division order may not alter or amend the terms of an oil and gas lease or other contractual agreement.

82. 231 Kan. 419, 646 P.2d 475 (1982). *Pipeline Corp. v. Dixon*, 737 S.W.2d 96, 97-98 (Tex. App.—Eastland 1987, writ denied)(lessee could assign to pipeline the right to use surface of tract of land to transport gas from unit well in which tract participated).

83. 231 Kan. at 425, 646 P.2d at 480.

84. Professor Sullivan observes in his treatise: "The liability of an assignee of the lessee is predicated upon privity of estate unless he expressly assumes the obligations of the lease in the instrument of assignment." SULLIVAN, *supra* note 55, at § 235 (1955).

85. The lessee's continuing liability would be predicated upon privity of contract with the lessor. See, e.g., *Whale v. Rice*, 173 Okla. 530, 49 P.2d 737, 738 (1935). See also SULLIVAN, *supra* note 55, at § 235.

86. E.g., *Ardizzone v. Archer*, 71 Okla. 289, 160 P. 446 (1916).

bilities for acts or omissions arising out of the [oil and gas lease] prior to the date of this Assignment."

To obtain a release of future liability from the lessor, the lessee may seek to have the assignee substituted for the lessee under the lease contract.⁸⁷ Such a novation, however, requires the consent of the lessor.⁸⁸ To avoid this issue, most oil and gas lease forms expressly terminate the lessee's liability for acts occurring on the lease *after* the assignment. For example:

In the event of assignment hereof in whole or in part, liability for breach of any obligation issued hereunder shall rest exclusively upon the owner of this Lease, or portion thereof, who commits such breach.⁸⁹ By broadening the clause, lessees could shift liability for *past* and *present* liabilities under the lease. Lessors, however, would likely object since such a broadened clause could permit the lessee to escape liability for existing breaches by assignment to a third party.

B. Impact of Assignment on Lease Obligations

The case of *Cowman v. Phillips Petroleum Co.*⁹⁰ demonstrates a common assignment problem—the "divisibility problem". In *Cowman* the lessor granted a 400 acre oil and gas lease to Harwood who subsequently assigned 80 acres to Phillips. Harwood obtained production on his retained portion of the leasehold, extending the lease into its secondary term; Phillips, however, never developed its 80-acre portion of the leased land. The lessor asserted Phillips' portion of the lease had expired for lack of production. The lease expressly permitted partial assignment, and the lease term would extend "as long . . . as the lessee produces oil and gas . . . from said land."⁹¹ The court found that "from said land" referred to the original 400 acre tract and accordingly held that Phillips' portion of the lease was extended by production.⁹²

87. See generally E. FARNSWORTH, *CONTRACTS* at 284 (1982) ("the term novation is used to describe a substituted contract that discharges a duty by adding a party who was neither the obligor nor the obligee of the duty").

88. *Id.* at 806-07.

89. A more detailed clause addressing the issue provides:

If lessee assigns all or part of this lease, lessee shall be discharged, as to the assigned portion of the lease, from further liability, whether created by express or implied covenant, relating to lease obligations and acts or omissions occurring from and after the effective date of the assignment. Lessee shall remain liable to lessor for any breach of lease obligations, or any other actionable act or omission, occurring during, and to the extent of, lessee's ownership of the lease. In the event lessee's assignment fails to bind its assignee to perform lessee's obligations under this lease, lessee's liability to lessor will continue.

See OIL AND GAS FORMS MANUAL, *supra* note 38.

90. 142 Kan. 762, 51 P.2d 988 (1935).

91. *Id.* at 766, 51 P.2d at 990.

92. *Cowman v. Phillips Petroleum Co.*, 142 Kan. 762, 768, 51 P.2d 988, 991 (1935). The court summarizes the basic rule quoting Mills-Willingham, *LAW OF OIL AND GAS*:

[W]here the lease covers several tracts of land, although they may have passed into the ownership of different parties since the execution of the lease, a producing well drilled upon any of the tracts, during the term, will extend the fixed term as to the other tracts. And this is true although the lease upon the different tracts has come to be owned by different parties and there is no privity of inter-

In *Wilson v. Texas Co.*⁹³ a quarter section of land was leased to Wakefield in October 1935. In March 1936 Wakefield assigned Texas Co. the lease to the South half of the quarter section. In April 1936 Wakefield drilled a dry hole on his retained portion of the lease. When neither Wakefield nor Texas Co. paid delay rentals in October 1936, the lessor contended that the lease terminated. The court held, however, that the dry hole clause of the lease relieved Wakefield from paying delay rentals.⁹⁴ Although the lessor contended the assignment created separate delay rental obligations, the court noted the lease permitted either party to assign and extend the lease covenants to each party's assigns.⁹⁵ The court held the dry hole clause was indivisible,⁹⁶ thereby satisfying the delay rental obligation for the entire leased acreage.⁹⁷

In *Wilson* the lease contained a common provision making the delay rental obligation divisible.⁹⁸ Divisibility of the obligation protects the partial assignee and the assignor from each other's improper payment of delay rental. For example, if no well had been drilled by Wakefield, a delay rental payment of \$160 would have been due. Absent divisibility of the delay rental clause, an \$80 payment by Wakefield would not have preserved his leasehold interest in the North half if Texas Co. failed to make the \$80 payment due for the South half.

Most oil and gas lease forms contain language to make the delay rental obligation divisible.⁹⁹ However, the common form of lease clause making the delay rental obligation divisible is of no real use where the assignment is of an interest in a specified formation or depth. Such assignments, instead, should specify the party responsible for payment of all delay rental. The clause should also address liability in the event delay rentals are improperly handled and the lease terminates.¹⁰⁰ One approach would be to provide:

A [the partial assignor] will use its best efforts to properly pay all delay rentals required to extend the entire [oil and gas lease]. However,

est between the lessee, who drilled the producing well, and the owners of the lease upon the other tracts.

Id.

93. 147 Kan. 449, 76 P.2d 779 (1938).

94. *Id.* at 782.

95. *Id.* at 783.

96. *Id.* at 783.

97. *Id.*

98. See *Cosden Oil Co. v. Scarborough*, 55 F.2d 634, (5th Cir. 1932); *Gulf Oil Corp. v. Prevost*, 538 S.W.2d 876, (Tex. Civ. App.—San Antonio 1976, no writ).

99. A common Texas lease form provides:

In the event of an assignment of this Lease as to a segregated portion of said land, the rental payable hereunder shall be apportioned as between the several leasehold owners ratably according to the surface area of each, and default in rental payment by one shall not affect the rights of other leasehold owners.

OIL AND GAS FORMS MANUAL, *supra* note 38.

100. For example, in *Huggs, Inc. v. LPC Energy, Inc.*, 889 F.2d 649 (5th Cir. 1989), the court enforces a provision in the development contract and joint operating agreement which provides that the operator will not be liable for losses relating to "mistake or oversight if any delay rental or shut-in gas royalty payment is not paid or is erroneously paid." *Huggs*, 889 F.2d at 652. See generally TERRELL, *supra* note 60, at § 17.04[2][b] (discussing responsibility for payment of delay rental in case of assignment).

A will not be liable to *B*, except for gross negligence or willful misconduct, for failure to properly make delay rental payments. *B* will reimburse *A* for *B*'s proportionate share of delay rentals which will be equal to *B*'s proportionate assigned interest in the [oil and gas lease]. Upon payment of delay rentals, *A* will provide *B* with proof of payment and a bill for reimbursement. *B* will pay *A*'s billing within thirty (30) days after the date received by *B*.

C. *Allocating Leasehold Burdens*

This section addresses the allocation of leasehold burdens among the parties to an assignment. For example, a mineral owner leases to *A* and retains a 1/8th royalty. *A* assigns a 1/16th of 8/8ths overriding royalty in the lease to *X*. *A* next assigns an undivided 1/2 interest in the lease to *Y*. *A* and *Y* may determine the allocation of *X*'s overriding royalty by agreement. Absent agreement, the allocation of *X*'s burden between *A* and *Y* will depend on *A*'s warranty and *X*'s recordation.

If *X* records the assignment creating the overriding royalty, all subsequent assignees will take subject to *X*'s interest. If *A* gave a warranty, and failed to except *X*'s interest from the warranty, *Y* could claim a breach of warranty against *A*. If the assignment to *Y* simply conveys an interest in the lease without warranty against other interests, it is not clear how the burden of *X*'s interest will be shared.¹⁰¹ The parties to the assignment should agree in advance how prior burdens will be allocated. An appropriate clause might provide:

Y agrees to bear its share of burdens created by any overriding royalty, production payment, or other third party rights to production, carved out of the lease and which were created, and properly recorded, prior to the date of this assignment [or a specified date to correspond with the assignee's examination of title]. *Y*'s share of any burden will be proportional to its working interest ownership in the oil and gas lease from which the burden was created.

Specifically identifying and allocating the burdens between the parties is the better practice when practical. Such a clause might provide, for example: "*Y* agrees to bear its proportionate share of the burden on production created by the *X* assignment." If the assignment specifies *Y*'s net revenue interest the designated fraction or percentage will govern. For example, *A* assigns *Y* an undivided 1/2 interest in the lease and the assignment states that *Y* will receive not less than 7/16ths of gross production. *A* will be re-

101. Professor Hemingway offers the following guidance:

Where the assignor merely assigns the interest in the lease, e.g. 'an undivided one-half interest in the following described oil and gas lease,' without mention of any outstanding interests, the assignor will bear the burden of such interests. . . . However, on the other hand, if the language is modified, e.g., 'an undivided one-half interest in the following described oil and gas lease, subject, however, to any outstanding overriding royalty interests or production payments,' the burden of all such interests will be borne by and subtracted from the interest of the assignee.

HEMINGWAY, *supra* note 79, at 484-85.

sponsible for payment of all burdens created by the lease and prior assignments.

D. Assignment/Sublease Problem

An assignment transfers the lessee's total interest in the leasehold; a sublease transfers something less.¹⁰² For example, if *A* owns an oil and gas lease covering Section 30, and transfers its leasehold rights in all or a separate portion of Section 30, *A* has assigned its interest.¹⁰³ If *A*'s lease is for a primary term of three years from July, 1985, and *A* transfers it to *B* for two years from July, 1985, *A* has subleased the interest.¹⁰⁴ Although courts seldom address the assignment/sublease issue, the distinction can affect the rights and obligations of the parties through the doctrine of privity.

Privity requires the parties to be related in some manner before rights and obligations become binding upon their transferees.¹⁰⁵ For example, transferee *C* can become obligated to *A* to perform obligations under an oil and gas lease between *A* as lessor and *B* as lessee, only if privity exists between *A* and *C*. Privity can be established two ways: by contractual agreement between *A* and *C* (privity of contract), or through their ownership of interests (privity of estate).¹⁰⁶ Privity of contract arises when the lessor and lessee enter into the lease. Privity of estate also arises from the lease because each hold current, mutually exclusive, interests in the leasehold.¹⁰⁷ If a lessee

102. See SULLIVAN, *supra* note 55, at § 126.

103. Robinson v. Eagle-Picher Lead Co., 132 Kan. 860, 862, 297 P. 697, 698 (1931) (transfer of rights under mining lease for a shorter duration than the original term constituted a sublease; transfer of all rights in the lease constituted an assignment).

104. *Id.*

105. See SULLIVAN, *supra* note 55, at § 126.

106. Privity concepts are illustrated by the following situations:

A (lessor) leases Section 30 to *B* (lessee): privity of contract and estate exist between *A* and *B*.

B assigns all its rights in the lease to the North Half of Section 30 to transferee *C*: *A* and *B* remain in privity of contract but are no longer in privity of estate as to the North Half of Section 30; *A* and *C* are in privity of estate as to the North Half of Section 30. If *C* fails to comply with the lease terms, *A* may sue *B* (because there remains privity of contract) and *C* (because there is privity of estate).

B assigns all its rights in the lease to transferee *C*, *C* subsequently assigns all his rights to transferee *D*: If *D* fails to comply with the lease terms, *A* may sue *B* (privity of contract) and *D* (privity of estate). However, *A* cannot sue *C* for violations of the lease which occur before or after *C*'s term of ownership because there will be no privity of estate or contract between *A* and *C*. Privity of estate between *A* and *C* terminates once *C* assigns its interest to *D*.

B assigns all its rights in the lease to transferee *C* who, in the assignment document, expressly agrees to perform all lease covenants due *A* under the lease: If *C* fails to comply with the lease terms, *A* may sue *B* (privity of contract) and *C* (privity of estate and privity of contract since *A* is a third party beneficiary of *C*'s promise to *B* to perform the lease covenants).

The lease between *A* and *B* expressly provides that if *B* assigns its rights *B* will be relieved from future liability. *B* assigns all rights in the lease to transferee *C*: If *C* fails to perform all lease covenants due *A*, *A* will not be able to sue *B* but will be permitted to sue *C* since there is privity of estate between *A* and *C*.

See, PIERCE, *supra* note 18, at § 7.12.

107. See Hale v. Oil Co., 113 Kan. 176, 213 P. 824, 825-26 (1923).

subleases some of its interest, the lessee remains in privity with the lessor.¹⁰⁸ The original lessee is, therefore, legally responsible for performance under the lease, while the sublessee has liability only to the lessee under their contract.¹⁰⁹

Distinguishing between a sublease and an assignment, however, may depend on questions still unanswered in most states. Retention of an overriding royalty, for example, may suffice to create a sublease.¹¹⁰ It is uncertain whether, and to what extent, many jurisdictions will recognize the sublease/assignment distinction.¹¹¹ This uncertainty requires the attorney to consider the possibility that retained rights will create a sublease. To protect the lessee in this event, the transfer document should require the transferee to perform all lease covenants. The document should also permit the lessee to terminate the transferred interest if the transferee fails to perform lease covenants, or otherwise endangers the transferor's rights under the lease.

VII. PROBLEMS ASSOCIATED WITH NONOPERATING INTERESTS

Nonoperating interests, such as the overriding royalty, production payment, net profits interest, and carried interest, all depend upon the continued validity of the underlying oil and gas lease.¹¹² Termination of the lease terminates the nonoperating interest.¹¹³ Nonoperating interest problems fall into three broad categories: accidental lease termination, intentional lease termination, and implied obligations of the working interest owner. Although the law is unsettled in these areas, each problem can be addressed through proper drafting.

A. Accidental Termination

Numerous mishaps can cause accidental lease termination. Fumbling a delay rental or shut-in royalty payment, for example, can cause the lease to expire. If the lease is terminated accidentally, courts generally deny recov-

108. SULLIVAN, *supra* note 55, at § 127.

109. Haynes v. Eagle-Picher Co., 295 F.2d 761, 763-64 (10th Cir. 1961), *cert. denied*, 369 U.S. 828 (1962).

110. Sunburst Oil & Ref. Co. v. Callender, 84 Mont. 178, 274 P. 834, 837 (1929) (reservation of overriding royalty was sufficient to make the transaction a sublease). *Cf.* Willis v. International Oil & Gas Corp., 541 So.2d 332 (La. Ct. App. 1989) (retention of overriding royalty created a sublease). *See also* Hartman Ranch Co. v. Associated Oil Co., 10 Cal. 2d 232, 73 P.2d 1163 (1937).

111. E. KUNTZ, J. LOWE, O. ANDERSON, AND E. SMITH, CASES AND MATERIAL ON OIL AND GAS LAW 679 n.2 (1986) states:

In jurisdictions, such as Texas, which view the oil and gas lease as a fee simple determinable, a court is unlikely to apply the distinction between assignments and [sub]leases to lease transfers, for the underlying document is not a 'lease' in the traditional common law sense.

See also Brown, *Assignments Of Interests In Oil And Gas Leases, Farm-out Agreements, Bottom Hole Letters, Reservations Of Overrides And Oil Payments*, 5th Inst. on Oil and Gas L. & Tax'n 25 (1954); Logan, *Nonproducer Speculation in Oil and Gas: Sublease and Assignment*, 4 KAN. L. REV. 396 (1956). Merrill, *The Partial Assignee - Done in Oil*, 29 TEX. L. REV. 298 (1942).

112. Keese v. Continental Pipe Line Co., 235 F.2d 386, 388 (5th Cir. 1956).

113. *Id.*

ery to a nonoperating interest owner unless liability is imposed by contract. For example, in *Davis v. Cities Service Oil Co.*,¹¹⁴ Cities, the working interest owner, failed to file an affidavit of production covering its leased land. A subsequent developer, lacking effective notice of Cities' lease, obtained a lease on the same land. Since the new lessee was a bona fide purchaser, Cities' leasehold rights in the land were extinguished, as were the rights of the nonoperating interest owners. Davis, an owner of an overriding royalty in Cities' lease, asserted Cities had a duty to protect his interest. The court held, however, that Cities had no duty to file the affidavit of production.¹¹⁵

Since mere drafting cannot prevent the working interest owner from making mistakes, the parties should specify the consequences of an accidental termination. The nonoperating interest owner should seek to impose duties on the lessee to protect their interests and provide for liability in the event the duty is not performed.

B. *Intentional Termination*

There are two distinct categories of intentional termination. First, is when the lessee, for legitimate business reasons, surrenders a lease or permits it to expire. Second, is when the lessee terminates the lease to eliminate nonoperating interests. Absent limiting language in the assignment, the lessee can usually terminate the lease for legitimate business reasons without consulting nonoperating interest owners.¹¹⁶ To avoid dispute, in the assignment the working interest owner should expressly provide for the right to surrender or terminate the lease. A nonoperating interest owner in turn could reasonably insist upon an opportunity to acquire the lease before reversion.

Absent a special provision in the assignment creating the nonoperating interest, the working interest owner is under no obligation to offer the lease to other interest owners,¹¹⁷ but a clause such as the following can protect the nonoperator's interests:

Assignor will not surrender, abandon, or otherwise permit or cause the lease to terminate without offering to reassign the lease to assignee at least 30 days prior to any action or inaction by assignor which would terminate the lease.

The lessee may insist upon amending the clause to provide protection against its negligence, such as overlooking a delay rental. The lessee should also seek to limit the measure of damages in the event the lease terminates without offering a reassignment. Absent such a provision, the loss might be measured by the value of the entire unassigned lease instead of the pre-existing nonoperating interest.¹¹⁸ Title to be provided by the lessee upon reassignment also creates an issue. A properly drawn reassignment clause can clear

114. 338 F.2d 70 (10th Cir. 1964).

115. *Id.* at 75.

116. See, e.g., *Nigh v. Haas*, 139 Kan. 307, 315, 31 P.2d 28, 32 (1934).

117. See WILLIAMS AND MEYERS, *supra* note 4, at §§ 356-356.1.

118. See *McLaughlin v. Ball*, 431 S.W.2d 305, 307 (Tex. 1968) (nonoperating interest owner entitled to damages equal to the value of the unassigned leasehold interest). See also WILLIAMS AND MEYERS, *supra* note 4, at § 428.2.

out nonoperating interests created after the initial assignment.¹¹⁹

An operator may intentionally terminate the lease and obtain a new lease on the same property in order to destroy the nonoperating interests. The assignment itself may limit use of such "washout" tactics. In *Probst v. Hughes*¹²⁰, for example, the assignment reserving the overriding royalty stated: "This reservation shall . . . apply as to all modifications, renewals of such lease or extensions that the assignee, his successors or assigns may secure."¹²¹ In *Probst* the lessee obtained a new lease on the property while the prior lease was still in effect.¹²² The Oklahoma Supreme Court held the overriding royalty burdened the new lease stating: "the new lease constitutes a renewal or extension of the original lease within the meaning of the assignment"¹²³ The court, discussing the relationship of the overriding royalty owner and the lessee,¹²⁴ held that the lessee occupied a "position of trustee" and was "duty bound to act in the utmost good faith" for the nonoperating interest owner's benefit.¹²⁵

In *Howell v. Cooperative Refining Association*¹²⁶ the assignment made the overriding royalty binding as to extensions and renewals of the lease, but the lessee obtained the new lease over a year after the prior lease terminated.¹²⁷ The Kansas Supreme Court held, nevertheless, that the overriding royalty burdened the new lease because the lessee had breached its fiduciary duty.¹²⁸ Although the court declined to find an implicit fiduciary duty between the operator and overriding royalty owner, the court held that a position of trust arose from the parties' relationship and a clause subjecting extensions or renewals of the lease to the overriding royalty.¹²⁹ Consequently, the overriding royalty would burden any new lease procured by the lessee on the property.¹³⁰

Although the Kansas and Oklahoma courts attach special significance to the extension or renewal clause as creating a relationship of trust, Texas requires more than the presence of the clause to trigger fiduciary obliga-

119. The clause should also allocate rights in the equipment necessary to continue operation of the well. This is usually done by requiring the party taking over operations to pay the salvage value of the leasehold equipment. The parties also need to allocate plugging obligations.

120. 143 Okla. 11, 286 P. 875 (1930).

121. *Probst v. Hughes*, 143 Okla. 11, 286 P. 875, 876 (1930).

122. *Probst*, 286 P. at 877.

123. *Id.* at 879.

124. The court quotes the following from *Trice v. Comstock*, 121 F. 620 (8th Cir. 1903):

'Whenever one person is placed in such a relation to another . . . that he becomes interested for him, or interested with him, in any subject of property or business, he is in such a fiduciary relation with him that he is prohibited from acquiring rights in that subject antagonistic to the persons with whose interests he has become associated.'

Probst, 286 P. at 877.

125. *Id.* at 878.

126. 176 Kan. 572, 271 P.2d 271 (1954).

127. *Howell v. Cooperative Ref. Ass'n*, 176 Kan. 572, 577, 271 P.2d 271, 275 (1954).

128. *Id.*

129. *Id.*

130. *Howell*, 176 Kan. at 576, 271 P.2d at 274.

tions.¹³¹ In *Sunac Petroleum Corp. v. Parkes*,¹³² for example, the assignment creating the overriding royalty was binding upon a "renewal or extension" of the lease.¹³³ The lessee formed a gas unit, drilled a well on acreage pooled with the leased land, and obtained an oil well. After the primary term expired, the lessee completed a producing oil well on the leased land. Later, the lessor asserted the lease had terminated because the pooling clause was limited to a gas well. The lessee purchased a new lease from the lessor, and then ceased paying the overriding royalty owner. The overriding royalty owner asserted that the renewal or extension clause encompassed the new lease.

The court first concluded that the initial lease terminated due to the ineffective pooling.¹³⁴ At the time the new lease was obtained, therefore, no lease existed between the landowner and the lessee. The court also found the new lease was not an extension¹³⁵ or a renewal¹³⁶, explaining:

. . . [T]he new lease was executed under different circumstances, for a new consideration, upon different terms, and over a year after the expiration of the old lease. . . .¹³⁷

Acknowledging the Kansas and Oklahoma cases, the court noted that the existence of a confidential relationship depends upon the facts of each case.¹³⁸ In the *Sunac* case, the assignment also contained the following provision:

There shall be no obligation, express or implied, on the part of Assignee, its successors or assigns, to keep said lease in force by payment of rentals or drilling or development operations, and Assignee shall have the right to surrender all or any part of such leased acreage without the consent of Assignor.¹³⁹

The court found that this clause relieved the lessee of any duty to develop the land or continue the lease in force.¹⁴⁰

Responding to the *Sunac* case, the extension and renewal clause can be expanded to include any lease obtained within a stated period of time after termination, for example:

The obligation to pay the overriding royalty required by this assignment will exist for the life of the oil and gas lease plus any extensions or renewals of the lease. For purposes of this Section, any leasehold interest acquired by assignee within — years following the termination, cancellation, or surrender of the oil and gas lease will be deemed an 'extension or renewal.'

131. Apparently in Texas the courts will inquire into the actual relationship between the parties. See *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 805 (Tex. 1967).

132. 416 S.W.2d 798 (Tex. 1967).

133. *Id.* at 799.

134. *Id.* at 802.

135. *Id.*

136. *Id.*

137. *Id.* at 803.

138. *Id.* at 805.

139. *Id.* at 804.

140. *Id.*

The rule against perpetuities arguably invalidates the extension and renewal clause.¹⁴¹ If the overriding royalty is an interest vesting upon the extension or renewal of the lease, the indefinite duration of an oil and gas lease creates the possibility that vesting will occur more than 21 years after assignment. Although application of the rule against perpetuities probably serves no valid purpose in this situation, courts have applied the rule mechanically in other contexts.¹⁴² To avoid this concern, the overriding royalty owner could substitute language which expressly imposes an obligation on the lessee to protect the interests of nonoperators, for example:

[Lessee] owes [overriding royalty owner] a fiduciary duty to deal with the leased property in a manner that will protect the overriding royalty owner's interests against any action or inaction by the lessee [or its successors and assigns] that could impair or terminate the overriding royalty owner's rights under this assignment.

Such a provision can establish the right to impose a constructive trust against any interest the lessee may obtain in the property which tends to defeat or diminish the nonoperator's interests. The lessee should be cautious in agreeing to such a broad clause because it could imply additional obligations, for example, to develop the property and protect against drainage.

C. Implied Covenants

If the assignment is silent regarding the lessee's obligation to develop the leased land, or protect it from drainage, the nonoperating interest owner will seek the same sort of implied covenant protection provided lessors. The Texas Supreme Court, in *Bolton v. Coats*,¹⁴³ recognized an implied covenant by the lessee to protect an overriding royalty owner against drainage. The court, acknowledging that the situations of the lessor and nonoperating interest owner are analogous, stated:

Unless the assignment provides to the contrary, the assignee of an oil and gas lease impliedly covenants to protect the premises against drainage when the assignor reserves an overriding royalty.¹⁴⁴

The extent to which the nonoperating interest owner will be equated to a lessor in defining implied covenant obligations is unclear.¹⁴⁵ For example, it can be argued since assignments typically do not mention any sort of drilling obligation, a covenant to test the property within a reasonable time could be implied.¹⁴⁶ Other courts have refused altogether to imply covenants to pro-

141. See e.g., *Cities Serv. Oil Co. v. Sohio Petroleum Co.*, 345 F.Supp. 28,30-31 (W.D. Okla. 1972)(interest held void as a violation of the rule against perpetuities).

142. See PIERCE, *supra* note 18, at § 4.13.

143. 533 S.W.2d 914 (Tex. 1976).

144. *Id.* at 916.

145. Professor Sullivan has noted: "The same reasons for implying covenants of drilling, development, protection, and marketing in favor of an oil and gas lessee apply to the owner of an overriding royalty interest." SULLIVAN, *supra* note 55, at § 241.

146. But see WILLIAMS AND MEYERS, *supra* note 4, at §§ 355-56 stating: "Certainly the weight of authority is to the effect that a covenant to drill a well is not to be implied from the severance of some nonoperating share of the working interest, e.g., an overriding royalty or oil payment." *Id.*

protect nonoperating interests.¹⁴⁷

The lessee may seek express language to negate any implied obligation to develop the property or protect nonoperating interests. Conversely, a nonoperating interest owner may seek express covenants to protect its interests. Often the nonoperating interest owner can bargain for the right to enforce the express and implied obligations created by the oil and gas lease. The lease covenants alone may not, however, fully protect the nonoperating interest owner.¹⁴⁸

VIII. ALLOCATING FEDERAL REGULATORY BURDENS

During the past few years, the Federal Energy Regulatory Commission (FERC) has restructured the natural gas regulatory regime.¹⁴⁹ In many instances, the impact of FERC's orders depends upon the terms of the gas sales contract between a producer and pipeline.¹⁵⁰ If producers could alter the impact of an order through assignment of their leases, strategic transfers might thwart FERC-created pipeline rights.¹⁵¹ To avoid this possibility, FERC Orders 451¹⁵² and 500¹⁵³ established permanent leasehold ownership dates to administer the orders. The rights of the producer and pipeline would henceforth depend upon the relationship which existed on the specified date, despite subsequent ownership changes. Although permanent ownership dates promote compliance with FERC orders, they also create pitfalls for both the leasehold assignor and assignee.

A. Order 451

The Natural Gas Decontrol Act of 1989¹⁵⁴ will gradually eliminate federal price and non-price controls over all gas.¹⁵⁵ In the meantime, Order 451 authorizes collection of an increased price for "old gas"¹⁵⁶—gas falling in Natural Gas Policy Act of 1978¹⁵⁷ ("NGPA") pricing sections 104¹⁵⁸ and

147. See e.g., *McNeil v. Peaker*, 253 Ark. 747, 488 S.W.2d 706, 707-08 (1973).

148. See Collins, *The Rights of the Overriding Royalty Owner*, 39 J. BAR. ASS'N OF KANSAS 235 (1970).

149. See generally Pierce, *Reconstituting the Natural Gas Industry from Wellhead to Burnertip*, 9 ENERGY L. J. 1 (1988).

150. See 18 C.F.R. § 270.201(a)(ii)(A) (1988) and 18 C.F.R. § 270.205 (1988).

151. Order No. 451-B, *Order Granting Rehearing in Part, Denying Rehearing in Part, Clarifying Final Rule, and Denying Stay Request*, 52 Fed. Reg. 21,669 (June 8, 1987) [hereinafter 451-B].

152. Order No. 451, *Ceiling Prices: Old Gas Pricing Structure*, 51 Fed. Reg. 22, 168 (June 18, 1986) [hereinafter Order 451]. In *Mobil Oil v. F.E.R.C.*, 885 F.2d 209 (5th Cir. 1989), cert. granted June 4, 1990, the Court of Appeals for the 5th Circuit vacated Order 451 and Order 451-A in their entirety. On June 4, 1990, the United States Supreme Court granted certiorari to review the 5th Circuit's decision. 58 U.S.L.W. 3763 (June 5, 1990).

153. Order No. 500, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 52 Fed. Reg. 30,334 (1987).

154. Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 § 157 (1989).

155. *Id.*

156. 18 C.F.R. § 271.402(a) & (c)(7) (1988).

157. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92, § 3351 (codified as amended at 15 U.S.C. §§ 3301-3432 (1982)).

158. 15 U.S.C. § 3314 (1982).

106(a).¹⁵⁹ For example, on October 1989 small producer Permian Basin gas had a maximum lawful price of \$0.817/MMBtu¹⁶⁰, as compared to Order 451's \$2.888/MMBtu alternative ceiling price.¹⁶¹

1. *The Good Faith Negotiation Process*

Although Order 451 expands the legal price range for old gas under contracts in existence on July 18, 1986,¹⁶² the actual price paid depends upon negotiation between the buyer and seller. Order 451 establishes a special procedure, the "good faith negotiation" ("GFN") process, which permits a producer to terminate the gas contract if their purchaser refuses to pay the alternative ceiling price.¹⁶³ To qualify for the GFN process, the existing contract must authorize "the first seller to collect a higher price upon the establishment by the Commission of a higher maximum lawful price."¹⁶⁴ An area rate clause, or similar indefinite price escalator clause, satisfies this requirement.¹⁶⁵ The bargaining position of the parties depends on three factors: the price of the gas under the contract, the current market price for the gas, and the alternative ceiling price. If we assume the contract covers large producer flowing gas and the GFN process commences in August 1989, the three critical numbers are:

- * NGPA maximum lawful price before GFN: \$0.579/MMBtu
- Current market value of the gas:¹⁶⁶ \$1.600/MMBtu
- * Alternative ceiling price: \$2.864/MMBtu

In this case, the gas purchaser will not pay \$2.86 when the gas can be replaced on the open market for \$1.60. The producer, on the other hand, can obtain the market price by resorting to the GFN process.¹⁶⁷

The only real limitation on the producer's freedom of choice is the reciprocal right of the purchaser to extend the GFN process to any gas "under any existing contract with the purchaser that includes the sale of any old gas, whether or not named in the first seller's request"¹⁶⁸ If the gas contracts include gas subject to the NGPA incentive price categories, the purchaser will elect to bring the high priced gas into the renegotiation.¹⁶⁹ A producer collecting the maximum lawful price of \$5.762/MMBtu for section

159. 15 U.S.C. § 3318 (1982).

160. Tables containing the current calculations of NPGA maximum lawful prices can be found at: II F.E.R.C. Stats. and Regs. #24,111 at 14,161 and 14,180 (1989) [hereinafter NGPA tables].

161. *Id.*

162. 18 C.F.R. § 271.402(a) & (c)(7) (1988).

163. 18 C.F.R. § 270.201 (1988).

164. 18 C.F.R. § 270.201(a)(ii)(A) (1988) and 18 C.F.R. § 270.205 (1988).

165. *Order No. 451-A, Order Granting Rehearing in Part, Denying Rehearing in Part, and Clarifying Final Rule*, 51 Fed. Reg. 46,762 (1986).

166. El Paso's spot price, at the Pecos receipt point in the Waha, Texas zone, as reported by Natural Gas Clearinghouse, Inc. See Foster Natural Gas Report, No. 1734, at 12 (Aug. 3, 1989).

167. The lessee's implied obligations under its oil and gas lease will compel the lessee, in many cases, to trigger the GFN process.

168. 18 C.F.R. § 270.201(b)(2) (1988).

169. *Id.*

108 gas in August 1989¹⁷⁰, for example, risks reduction to the \$1.60 spot price.

To illustrate the GFN process, assume producer *A* has four gas sales contracts with pipeline company *X* on the following terms:

- #1 Dated July 1, 1960
Covers NGPA § 104 Gas
Contains only a "definite" price escalation clause:
\$.01/year during life of contract.
- #2 Dated July 1, 1965
Covers NGPA § 104 and § 108 Gas
Contains an area rate clause.
- #3 Dated July 1, 1977
Covers NGPA § 106(a), § 103, and § 108 Gas
Contains an area rate clause.
- #4 Dated July 1, 1980
Covers NGPA § 102 and § 108 Gas

A initiates the GFN process by requesting *X* to nominate the price it is willing to pay for the section 104 and section 106(a) gas under contracts #1, #2, and #3. Contract #1, however, is ineligible for the GFN process because it does not contain the requisite authority to collect a higher price.¹⁷¹ If *X* fails to offer the alternative ceiling price for the old gas covered by contracts #2 and #3, *A* may terminate the contracts as to the section 104 and section 106(a) gas. However, *X* will request *A* to nominate the price it will accept for the section 103 and section 108 gas included in contracts #2 and #3. *X* cannot bring in the gas covered by contract #4 because it does not include "the sale of any old gas."¹⁷² If *X* does not agree to *A*'s nominated price *X* can terminate the contracts as to the section 103 and section 108 gas.¹⁷³

2. Assignment Problems Under Order 451

Expanding on the foregoing hypothetical, *A*, on August 1, 1989, assigns to *B* the leases producing section 108 gas under contracts #2 and #3. *B* also has an existing contract with *X*, contract #5, that includes section 104 and section 108 gas. On August 2, 1989, *A* initiates the GFN process with *X* for the old gas in contracts #2 and #3. This raises the issue of whether *X* can nominate a lower price for any of the section 108 gas now owned by *B*. Such issues prompted FERC to adopt Order 451-B.¹⁷⁴

Prior to Order 451-B, Order 451-A permitted the purchaser to reconstruct ownership of the gas contract as of July 18, 1986, and exercise its GFN rights as though no assignment had occurred.¹⁷⁵ Using the hypothetical

170. *NGPA Tables*, *supra* note 160, at 14,160.

171. 18 C.F.R. § 270.201(a)(ii)(A) (1988) and 18 C.F.R. § 270.402(c)(7) (1988).

172. 18 C.F.R. § 270.201(b)(2) (1988).

173. 18 C.F.R. § 270.201(c)(1) (1988).

174. *Order 451-B*, *supra* note 151.

175. *451-B Reg. Preamble*, *supra* note 151, at 30,687.

above, A's triggering of the GFN process for its retained section 104 gas would entitle the purchaser to bring the assigned section 108 gas into the process.¹⁷⁶ Concluding that only the assignee has the right to dispose of the assigned gas,¹⁷⁷ FERC changed its approach in Order 451-B by permitting producers who assign gas subject to an "existing contract" to initiate the GFN process only if the purchaser can renegotiate with regard to the assigned gas.¹⁷⁸

Assignments after June 2, 1987 are subject to the Order 451-B restrictions.¹⁷⁹ For assignments between the July 18, 1986 effective date of Order 451,¹⁸⁰ and the July 3, 1987 Order 451-B rule change, a special rule applies:

[W]hen gas in an existing contract including old gas has been assigned before the issuance of this order, the purchaser in step 2 may seek renegotiation of any multi-vintage or old gas *currently* sold by the assignor or assignee initiating good faith negotiation, *but not any other gas*. Accordingly, assigned gas shall be subject to renegotiation in step 2 only when the assignee initiates good faith negotiation for old gas in any of its contracts with the purchaser.¹⁸¹

For assignments after June 2, 1987, FERC adopted a nebulous rule permitting the purchaser to reconstruct ownership under the gas contracts as it existed on June 3, 1987, if the assignor or assignee is "eligible" to initiate the GFN process.¹⁸² The key to eligibility is preserving the purchaser's GFN rights after assignment.¹⁸³ If an assignment impairs the purchaser's GFN rights, the assignor loses its GFN rights to *all* contracts between the assignor and purchaser. The assignee loses its GFN rights as to the assigned gas only.¹⁸⁴ The only interpretation offered by Order 451-B concerning the eligibility issue is found in the regulation preamble, which suggests that an agreement between assignee and assignor to permit renegotiation of each

176. *Id.* at 30,688.

177. *Id.*

178. FERC seems to have concluded that "only the assignee has power to contract with respect to the assigned gas, just as only the assignor has power to contract with respect to the unassigned gas." *Id.*

179. *Id.*

180. *Order 451, supra* note 152.

181. *451-B Reg. Preamble, supra* note 151, at 30,689.

182. *Id.* The "eligibility" requirements are found at 18 C.F.R. § 270.201(a)(5)(i) and (ii), which provide:

(i) A first seller that validly assigns or otherwise transfers gas subject to an existing contract on or after June 3, 1987 may not request a nomination of price under the provisions of this section for any gas sold under any existing contract with that purchaser unless the purchaser's right to renegotiate, under the provisions of this section, the terms of the sale of the assigned gas are unaffected by the assignment.

(ii) A first seller to whom gas subject to an existing contract is validly assigned, or otherwise transferred, on or after June 3, 1987 may not request nomination of a price under the provisions of this section for the assigned gas, unless the purchaser's right to renegotiate, under the provisions of this section, the terms of the sale of all gas sold under any existing contract between the purchaser and the assignor on June 3, 1987 are unaffected by the assignment.

Id.

183. 18 C.F.R. §§ 270.201(a)(5)(i) and (ii) (1988).

184. *Id.*

other's gas would satisfy the eligibility requirement.¹⁸⁵

Perhaps the best way to avoid impairing the purchaser's GFN rights is to expressly provide in the assignment that the purchaser's rights under the GFN process are in no way restricted by the assignment. The parties could covenant that neither will do anything to diminish the purchaser's GFN rights or render themselves ineligible to participate in the GFN process.¹⁸⁶ Breach of the covenant could give rise to damages measured by the revenue lost by a party's inability to use the GFN process.

The regulations also address the effect of the GFN process on the eligible assigned and retained interests.¹⁸⁷ Expanding the hypothetical, *A*, after the August 1, 1989 assignment of the § 108 gas to *B*, initiates the GFN process for the § 104 and § 106(a) gas in contracts #2 and #3. *X* can request a price nomination for the section 108 gas assigned to *B*, since *A* owned this gas on June 3, 1987.¹⁸⁸ *X* cannot, however, bring in any of the gas *B* owns under contract #5.¹⁸⁹ Assume *B*, after the August 1, 1989 assignment, initiates the GFN process for the section 104 gas covered by its contract #5. Although *X* can bring in the section 102 gas covered by contract #5, *X* cannot bring in the section 108 gas assigned by *A*. *X*'s GFN rights extend only to the gas *B* owned as of June 3, 1987.¹⁹⁰ Considering another hypothetical case, *A* assigns *B* the section 104 gas under contract #2 and retains the section 108 gas. *B* triggers the GFN process as to the section 104 gas in contract #2. *X* can bring in any gas which belonged to *A* on June 3, 1987, including not only *A*'s section 108 gas under contract #2, but also *A*'s § 103 and § 108 gas under contract #3. Since *B* limited the GFN request to the assigned gas, however, *X*'s rights are likewise limited to gas owned by the assignor as of June 3, 1987.¹⁹¹

As the foregoing examples demonstrate, the acts of the assignor or assignee may draw assigned or retained gas into the GFN process. In assignments of leases affected by existing contracts covering old gas, the parties

185. The preamble reads:

The purchasers ability to renegotiate the gas which would have been subject to renegotiation in the absence of the assignment could arise, for example, through an agreement by the assignor or assignee to permit renegotiation of its gas if the other initiates good faith negotiation or through the assignment itself under state law.

451-B Reg. *Preamble*, *supra* note 151, at 30,688 to 30,689. Furthermore, the preamble continues:

[T]he assignor or assignee would be *eligible* to initiate good faith negotiation if the other agrees that the purchaser may renegotiate its gas in step 2, state law permits the purchaser to do so, or for some other reason the purchaser must be given such a right.

Id. at 30,698 n.14.

186. *Id.* at 30,689.

187. 18 C.F.R. § 270.201(b)(5) (1988).

188. 18 C.F.R. § 270.201(b)(5)(ii) (1988).

189. 18 C.F.R. § 270.201(b)(5)(ii) (1988) (covers only gas subject to an existing contract between the "purchaser and the assignor").

190. 18 C.F.R. § 270.201(b)(5)(iv) (1988).

191. 18 C.F.R. § 270.201(b)(iii) (1988).

must consider whether to expressly restrict or permit a party to trigger the GFN process.

B. Order 500

Under Order 500¹⁹² a producer may access pipeline transportation only by offering to credit transported volumes against the pipeline's take or pay liability under pre-June 23, 1987 take or pay contracts with the producer.¹⁹³ For example, if producer *A* uses pipeline *X* to ship 1,000 Mcf of gas, *X* will receive 1,000 Mcf of credit against any pre-June 23, 1987 take-or-pay contract between *A* and *X*.

The consequences of a lease assignment under Order 500 depends on two issues: first, ownership of the gas transported at June 23, 1987, and second, ownership of the take-or-pay obligation gas at June 23, 1987. If *A*, for example, has a pre-June 23, 1987 take-or-pay contract with pipeline *X*, any gas shipped from properties owned by *A* on June 23, 1987 will generate take-or-pay credits against *A* even though the current owner of the gas is *B*.¹⁹⁴ Consequently, if *A* assigns *B* leases subject to a pre-June 23, 1987 take-or-pay contract, *A* must provide pipeline *X* with an offer of credit before *B* can ship.¹⁹⁵ The offer of credit is the Order 500 ticket on to *X*'s pipeline. *A* may, however, be unwilling to provide the offer of credit because the pipeline can use the credit to offset any pre-June 23, 1987 take-or-pay obligations with *A*, not merely those relating to the assigned property.¹⁹⁶ Where *X* is the only available pipeline, *B* must insist upon *A*'s covenant to provide the necessary offers of credit. Otherwise, *B* will be unable to move gas from the leased lands.

Sometimes, *A* will need *B* to provide an offer of credit to enable *A* to ship gas from retained properties. For example, when the gas production from

192. Order 500, *supra* note 153.

193. *Id.* at 30, 780.

194. 18 C.F.R. § 284.8(f)(4) (1989) and 18 C.F.R. § 284.9(f)(4) (1989).

195. FERC has formally explained the requirement as follows:

In addition to the current working interest owners of the gas to be transported under Order No. 500, other producers may be required to provide credits to the pipeline as a result of the transportation of the gas. If so, those producers must also sign an offer of take-or-pay credits.

The only circumstances in which a producer other than the owner of the transported gas may be required to provide credits and thus sign the offer is where there has been an assignment or transfer since June 23, 1987 of either (1) the transported gas or (2) other gas which on June 23, 1987 was (a) owned by the same producer that owned the transported gas and (b) was subject to a take-or-pay contract with the pipeline. Assignments may result in other producers being required to provide credits because the pipeline is entitled to obtain credits against its take-or-pay liability under pre-June 23, 1987 contracts for gas which was owned on June 23, 1987 by the persons who on June 23, 1987, also owned the gas being transported. If there has been an assignment or transfer since June 23, 1987, and, as a result, producers other than the owners of the transported gas will be required to provide the pipeline credits, those producers must sign the offer of credits.

41 F.E.R.C. # 61,025, *Order Explaining Crediting Provisions of Order No. 500*, at 61,067 (Oct. 16, 1987) [hereinafter *Order Explaining Crediting*].

196. 18 C.F.R. § 284.8(f)(4)(ii) (1989) and 18 C.F.R. § 284.9(f)(4)(ii) (1989).

two leases is committed to the same pipeline under pre-June 23, 1987 take-or-pay contracts the pipeline may still look to both leases for offers of credit, even though one has been assigned. Consequently, *A* needs *B*'s offer of credit to obtain transportation.¹⁹⁷

The assignment of a lease affected by Order 500 should specifically state whether one or both of the parties will be obligated to provide offers of credit.¹⁹⁸

IX. PREPARING THE ASSIGNMENT

A. *The Drafting Process*

The major goal of the drafting process is to ensure the relevant law is considered and applied to achieve the client's desired result. To achieve this goal, the attorney must prepare documents which:

1. Meet the requirements of local law;
2. Address any special problems associated with the transaction; and
3. Express the transaction as briefly and clearly as possible.

The first substantive issue should be the legal requirements for a valid assignment of an oil and gas lease. To ascertain these, the attorney's first step may be reference to a treatise.¹⁹⁹ The next step is examination of state statutory law to determine the requirements for the conveyance. The statutes will provide information such as possible words of grant, consideration requirements, recording requirements, and other matters necessary to validate the document. Further defining the requirements to validate the document may require reference to case law. This validation process should determine the initial structure of the document.

After defining the basic contours of the document, the attorney must resolve the special issues raised by the transaction. For example, if the assignor intends to indemnify the assignee against any claims arising out of the assignor's ownership of the lease, the attorney must determine the requirements for an effective indemnity provision.²⁰⁰ If the lease in question in-

197. *Order Explaining Crediting*, *supra* note 195, at 61,067 (Example 1).

On June 23, 1987, Producer A was the working interest owner of Leases 1 and 2. The gas from each of the leases was committed to the pipeline under two separate contracts, both containing take-or-pay provisions. On September 1, 1987, Producer A assigned Lease 2 to Producer B. On October 1, the pipeline released half the gas from Lease 1 from the contract covering that gas.

In order for the released gas to be eligible for transportation, Producer A, as the current owner of Lease 1, must sign the offer of credits. In addition, Producer B must sign the offer, since under Order No. 500 the pipeline will be entitled to credits against its take-or-pay liability for the gas from the Lease 2, now owned by Producer B. This is because on June 23, 1987 Leases 1 and 2 were owned by the same person, Producer A.

198. Examples of offer of credit forms which satisfy the Order 500 requirements can be found at 18 C.F.R. § 284.9 (1989).

199. Consulting treatises or other secondary sources will help define such issues as whether the assignment will be governed by the law of conveyances or the law of contracts. Definition of these issues, in turn, will guide subsequent statutory and case law research to determine the requirements for an effective assignment. See *supra* text accompanying notes 4-12.

200. See *Atlantic Richfield Co. v. Petroleum Personnel, Inc.*, 768 S.W.2d 724 (Tex. 1989).

cludes wells producing old gas, the attorney must address FERC Order 451.²⁰¹ Once all the special issues have been identified, the attorney is ready to begin drafting.

Identifying the general and special drafting requirements will, in turn, define the drafting task. Unless the attorney understands the factual basis and legal requirements of the transaction, discriminating between necessary and unnecessary document language will be difficult. With the factual and legal content of the document clearly defined, the attorney's only remaining task is to apply the law in a clear and simple statement of the transaction.

The attorney should ensure the client is aware of provisions requiring special care. For example, if the assignment covers a gas well eligible for the good faith negotiation process,²⁰² the client should flag the file to ensure the gas contract is not amended without expressly preserving the producer's Order 451 rights.²⁰³

B. Assignment Checklist

This section collects, in checklist fashion, the various substantive and procedural matters discussed in this Article.

ASSIGNMENT CHECKLIST

I. PROPERTY TRANSFERRED

- [] 1. Determine whether the oil and gas lease is classified as real or personal property; note any special problems this may present.²⁰⁴
- [] 2. Identify the leasehold interests being assigned.²⁰⁵
 - [] Description of lease and land covered by the lease.²⁰⁶
 - [] Depth limitations.²⁰⁷
 - [] Limitations on substances.²⁰⁸
 - [] Surface use rights associated with the assigned and retained interests.²⁰⁹
- [] 3. Identify all tangible personal property included as part of the transfer.²¹⁰

201. *Order 451*, *supra* note 152.

202. See 18 C.F.R. § 270.201 (1988).

203. 18 C.F.R. § 270.201(a)(4) provides, in part:

(4) A party to an existing contract may not request a nomination of a price under the provisions of this section for any gas sold under the contract, if that party:

(i) And the purchaser or first seller have renegotiated the price or any other term for the sale of any old gas under the contract after July 18, 1986, without using the good faith negotiation procedures of this section, and have not agreed in writing to preserve their rights under this section

204. See *supra* text accompanying notes 4-14.

205. See *supra* text accompanying notes 79-81.

206. See *supra* text accompanying notes 60-61.

207. See *supra* text accompanying notes 62-65.

208. See *supra* text accompanying notes 58-59.

209. See *supra* text accompanying notes 64-67.

210. See *supra* text accompanying notes 16-17, 66-67.

- [] 4. Identify all intangible personal property included as part of the transfer.²¹¹

II. PARTIES TO THE TRANSFER

- [] 5. Name and address of assignor and assignee.²¹²
 [] 6. Consider special relationships such as homestead, community property, partnership, etc.²¹³

III. ASSIGNMENT LIMITATIONS

- [] 7. Review oil and gas lease to evaluate any restrictions on assignment.²¹⁴
 [] 8. Identify all interests to be excepted from the assignment.²¹⁵
 [] Partial assignment as to portion of land, undivided interest, certain depths or formations.
 [] Reservation of nonoperating interest.
 [] New covenants to drill, etc.

IV. VALIDATION ISSUES

- [] 9. Appropriate words of conveyance.²¹⁶
 [] 10. Consideration.²¹⁷
 [] 11. Signed by assignors.
 [] 12. Date.
 [] 13. Delivery.²¹⁸
 [] 14. Acceptance.²¹⁹
 [] 15. Acknowledgment.²²⁰
 [] 16. Record.

211. See *supra* text accompanying note 18.

212. See TEX. PROP. CODE ANN. § 11.003 (Vernon 1984).

213. The administration process may include ensuring recordation of documents such as powers of attorney, which demonstrate an agent's authority to act on behalf of the assignor.

214. See *supra* text accompanying notes 36-46, 74-78.

215. See *supra* text accompanying notes 59-60.

216. The words of conveyance should be appropriate for the transfer of an interest in land. The Texas statutes suggest either the word "conveys" or "grants" will be sufficient. See TEX. PROP. CODE ANN. §§ 5.022 and 5.023 (Vernon 1984).

217. Although consideration may not be required for a valid conveyance, it is often required to convey homestead rights or to derive the full benefits under the recording statutes. For example, to obtain priority over prior unrecorded conveyances of the property, the grantee must obtain their interest "for valuable consideration" without notice of the unrecorded conveyance. TEX. PROP. CODE ANN. § 13.001(a) (Vernon Supp. 1990).

218. To effectively transfer title, the assignment must be "delivered." TEX. PROP. CODE ANN. § 5.021 (Vernon 1984) provides, in part: "A conveyance . . . must be in writing and must be subscribed and delivered by the conveyor . . ." See 6A R. Powell, *Powell on Real Property* § 898(2)(a) (1988).

219. To complete delivery the assignee must accept the conveyance. When the conveyance is beneficial to the assignee, acceptance is presumed. To avoid disputes when the assignment imposes obligations on the assignee, the assignee should expressly accept the assignment in writing. For example, if the assignee is obligated to drill a well or perform the assignor's duties to a lessor, the assignment should indicate the assignee is accepting the assignment and all obligations created by the assignment. This will avoid problems when the assignee, within a short time following the assignment, purports to reject the grant. See *McAndrew v. Sowell*, 100 Kan. 47, 163 P. 653 (1917) (grantee attempted to avoid liability for encumbrance on conveyed land by asserting lack of acceptance).

220. Before an assignment can be recorded, it must meet certain statutory requirements. *E.g.*, TEX. PROP. CODE ANN. Section 12.001 (Vernon Supp. 1990) states, in part:

V. WARRANTY

- [] 17. Warranty of title.²²¹
- [] 18. Special representations concerning the lease.²²²
- [] 19. Personal property warranties.²²³
- [] 20. Exceptions to warranty.²²⁴
 - [] Special title problems.
 - [] Existing contracts.
 - [] Existing nonoperating interest burdens.

VI. ALLOCATION OF OBLIGATIONS

- [] 21. Obligations created by the oil and gas lease.²²⁵
 - [] Lease covenants.
 - [] Lease conditions - divisibility problem.
- [] 22. Obligations created by prior assignments.²²⁶
- [] 23. Indemnity.²²⁷

VII. NONOPERATING INTERESTS

- [] 24. Allocation between assignor and assignee of prior nonoperating interest burdens.²²⁸
- [] 25. Defining the nonoperating interest.²²⁹
 - [] Production subject to nonoperating interest.
 - [] Fraction problems.
 - [] Proportionate reduction.
 - [] Valuing production to determine gross value.
 - [] Deductible costs to arrive at net value.
- [] 26. Protection against lease termination.²³⁰
 - [] Duration - extensions and renewals.
 - [] Reassignment obligation.
- [] 27. Implied covenant rights.²³¹

(a) An instrument concerning real or personal property may be recorded if it has been acknowledged, sworn to with a proper jurat, or proved according to law.

(b) An instrument conveying real property may not be recorded unless it is signed and acknowledged or sworn to by the grantor in the presence of two or more credible subscribing witnesses or acknowledged or sworn to before and certified by an officer authorized to take acknowledgements or oaths, as applicable.

TEX. CIV. PRAC. & REM. CODE ANN. §§ 121.001 to 121.014 (Vernon 1986) address the requirements for proper acknowledgement of a conveyance. Section 121.008 permits the use of various short forms of acknowledgment which, when properly used, satisfy the statutory requirements for acknowledgment.

221. See *supra* text accompanying notes 68-73.

222. See *supra* text accompanying notes 70-72.

223. See *supra* text accompanying notes 16-17.

224. See *supra* text accompanying notes 16-17, 69-73.

225. See *supra* text accompanying notes 84-100.

226. See *supra* text accompanying notes 20-26.

227. See *supra* text accompanying notes 86-89.

228. See *supra* text accompanying note 101.

229. See *supra* text accompanying notes 79-80.

230. See *supra* text accompanying notes 112-142.

231. See *supra* text accompanying notes 143-148.

VIII. SPECIAL CONSIDERATIONS

- [] 28. Assignment/sublease problem.²³²
- [] 29. Federal regulatory considerations.²³³
 - [] FERC Order 451.
 - [] FERC Order 500.

C. Applying the Drafting Process

In the following example, Big Oil Company has agreed to assign to XYZ Petroleum Corporation an undivided 50% interest in an oil and gas lease Big obtained from Larry Landman. Larry Landman reserved an overriding royalty in the lease when he assigned it to Big. The lease is still in its primary term; no development has taken place but there are some well fixtures on the lease associated with prior operations. Big and XYZ have agreed that the assignment will be without warranty. Big will be responsible for seeing that delay rentals are paid, and the parties have agreed on how they will allocate responsibility among themselves for obligations created by the lease and prior assignments. The Big/XYZ assignment document could provide:

ASSIGNMENT

Big Oil Company ("Big"), for valuable consideration,²³⁴ conveys²³⁵ to XYZ Petroleum Corporation ("XYZ"), subject to the terms of this ASSIGNMENT, an UNDIVIDED 50% INTEREST in the following property:

a. Oil and Gas Lease between John Doe and Mary Doe as lessor and Larry Landman as lessee, dated September 15, 1988, recorded in Book 105, Page 152, of the Miscellaneous Records of Eureka County, Texas, covering the North Half of Section 30, Township 36 South, Range 10 East, in Eureka County, Texas ("Lease").

b. All personal property, to include fixtures, currently located on the Lease and used or useable in connection with oil and gas exploration and production activities ("Personal Property") [could itemize in assignment or incorporate an itemized list from a Bill of Sale].²³⁶

The Lease and Personal Property are collectively referred to as the "Assigned Property."

ASSIGNMENT terms:

1. NO WARRANTY. Big makes this ASSIGNMENT without any warranty, express, implied, or statutory. XYZ accepts the Personal Property AS IS, WITH ALL FAULTS.²³⁷
2. ADMINISTRATION OF DELAY RENTAL. Big will pay 100% of the delay rental necessary to keep the Lease in effect.²³⁸ If Big fails to prop-

232. See *supra* text accompanying notes 102-111.

233. See *supra* text accompanying notes 149-198.

234. See *supra* text accompanying notes 81-88 and note 217.

235. See *supra* note 216.

236. See *supra* text accompanying notes 15-17.

237. See *supra* text accompanying notes 17-18.

238. See *supra* text accompanying notes 73-100.

erly pay delay rental, thereby resulting in Lease termination, Big will pay to XYZ an amount equal to the greater of: (1) the price paid by XYZ as consideration for this ASSIGNMENT, or (2) the fair market value of XYZ's interest in the Lease as of the date immediately prior to termination.²³⁹

3. INDEMNITY. Big agrees to indemnify XYZ against any liability, claim, demand, damage, or cost arising out of a failure, prior to the date of this ASSIGNMENT, to fulfill the express or implied covenants created by the Lease. XYZ's indemnity rights include reasonable attorney fees and litigation costs necessary to defend any matter covered by Big's indemnity or to enforce Big's obligation to indemnify.²⁴⁰

4. ALLOCATING EXISTING BURDENS. In addition to lessor's royalty rights created by the Lease, production from the Lease is subject to an overriding royalty retained by Larry Landman in an assignment by Larry Landman to Big dated September 20, 1988 and filed for record in Book 106, Page 24, of the Miscellaneous Records of Eureka County, Texas ("Landman Override"). To the extent the Landman Override continues in effect, and relates to production from the Lease, XYZ agrees to share in satisfying the Landman Override up to, but not exceeding, an amount equal to 50% of 1/16th of 7/8ths of 8/8ths of production from the Lease. To the extent this is not sufficient to meet the requirements of the Landman Override, Big will pay or deliver the balance.²⁴¹

5. BINDING EFFECT. This ASSIGNMENT, and all related terms and conditions, are binding upon the successors and assigns of Big and XYZ.²⁴²

SIGNED AND DELIVERED 29 September 1989.²⁴³

Mary Smith, President
Big Oil Company
123 Mineral Lane
Oiltown, Texas 75275

SIGNED AND ACCEPTED 29 September 1989.²⁴⁴

Betty Doe, President
XYZ Petroleum Corporation
456 Gusher Street
Oiltown, Texas 66762²⁴⁵

239. See *supra* text accompanying note 118.

240. See *supra* text accompanying notes 86-89.

241. See *supra* text accompanying note 79.

242. Although the use of certain words of conveyance, such as "grants" or "conveys," may make the conveyance binding on successors and assigns, the complete wording is preferable, especially in states where real property law may not fully transfer to oil and gas leases.

243. See *supra* note 218.

244. See *supra* note 219.

245. See TEX. PROP. CODE ANN. §§ 5.021 and 11.003 (Vernon 1984).

ACKNOWLEDGMENT CERTIFICATE²⁴⁶

Eureka County, Texas

This ASSIGNMENT was acknowledged before me on __ September 1989 by Mary Smith as President of Big Oil Company, a Texas corporation, and Betty Doe as President of XYZ Petroleum Corporation, a Texas corporation.

(Seal, if any)

John Thomas, Notary Public

My commission expires: _____

246. See *supra* note 220.

