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LAND OWNERSHIP PROBLEMS and OIL DEVELOPMENT

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What is petroleum?

Chemists tell us that petroleum and natural gas are mixtures of a number of chemical compounds called "hydrocarbons," which probably originated from vegetable and animal materials in past geological eras. For many years, however, people believed that crude oil and gas were of mineral origin. The very word "petroleum" means "rock oil," being a combination of two ancient Greek and Latin words, <u>petros</u> (rock) and <u>oleum</u> (oil). The whole body of law which has grown up concerning crude oil and natural gas is based on a recognition of the general practice of referring to these resources as "minerals." Legally, then, the term "minerals," when used in a deed or lease, usually includes oil and gas, as well as coal, lignite, salt deposits, bentonite, ceramic clays, metallic ores, and other substances. 3/

What are mineral rights?

The term "mineral rights" includes a group of property rights associated with land. Because most minerals are located below the surface of the land, we frequently refer to mineral rights as "subsurface" rights to distinguish them from "surface" rights such as the rights to use the land surface for agricultural, forestry, right-of-way, recreational, and other purposes. A landowner has the following important powers, where his title includes both surface and mineral rights:

(1) He may sell and transfer all or part of the mineral rights, either with or separate from the surface rights. This is discussed later under the questions pertaining to mineral deeds, mineral reservations, and royalty assignments.

(2) He may develop the mineral resource and use or sell the products. Many North Dakota farmers, for example, mine lignite on their own land for home use and at times even sell part of the lignite. This right is seldom exercised in the case of oil and gas, however, because few landowners have sufficient capital to drill their own wells.

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3/ The courts of other States disagree on the question of whether building stone, sand and gravel are covered by a deed or lease of "minerals". Inasmuch as the North Dakota Supreme Court has not ruled on this question, we do not know whether these substances are legally "minerals" in this state.

(3) He may enter into oil and gas leases with oil companies and individuals who are in the business to drill wells and produce oil. Oil companies, which have the financial backing and technical knowhow necessary for successful drilling and petroleum production, seldom purchase the land or even the subsurface rights in the land on which they decide to drill. Instead, oil companies generally prefer to operate on land owned by others under agreements we call "oil and gas leases."

Similarly, where mineral rights have been separated from the surface title, the mineral owner may: (1) sell all or part of his rights, or (2) extract and sell mineral products, or (3) grant mineral leases to operators equipped to develop the mineral resource.

Who owns the mineral rights?

In the United States, we adhere to the legal theory that land titles include mineral rights unless such rights have been severed from the land and placed in separate ownership by the present or previous landowner. This is in marked contrast to the ownership systems found in many other countries, where subsurface rights are held by the governments. In the Prairie Provinces of Canada, for example, most mineral rights are held by the "Crown" and are administered by the provincial governments. Lands in North Dakota were formerly part of the Public Domain. The Federal Government transferred most of the lands, together with mineral rights, to private and State ownership under the various homestead acts, railroad grants, and grants to the State of North Dakota. Congress legally could have retained the mineral rights in these lands in Federal ownership, but only in relatively few cases was this done. 4/ Consequently, the mineral rights in most lands in North Dakota now are in private or State ownership, and only a small proportion is in Federal ownership. Whether mineral rights belong to the landowner or to someone else depends on the provisions of patents and deeds in the chain of title to the land.

What is an oil and gas lease?

It is an agreement by which the owner of the mineral rights grants the exclusive right to someone else to come onto the land to drill for and produce oil and gas. This agreement names the parties to the lease, gives the legal description of the land covered by the lease, and sets out the various terms and conditions of the agreement.

How are leases negotiated?

Various types of people contact landowners and other mineral-right holders to negotiate oil and gas leases. An oil company may send out its own agents (called "landmen") to contact landowners, or it may authorize an established broker to secure leases within a specified area on a commission basis. In addition, many independent dealers and "lease scouts" make a business of securing leases with the hope of selling them to oil companies at an increase in price.

4/ Congress did retain the coal and lignite rights in some of the lands thrown open to homestead entry in North Dakota.

An oil company frequently finds it necessary to be rather secretive about its future drilling plans, lest competitors and speculators take advantage of any promising oil structure it has located by geological and geophysical surveys. In such cases, the company landman or the broker who contacts the landowners will refuse to divulge the name of the company for which he is securing the leases. Instead, he negotiates the leases in his own name and subsequently assigns them to the company. After assignment of a block of leases, it is common practice for a company agent to contact each mineral owner and obtain his signature on a document known as a "ratification of oil and gas lease," the purpose of which is to ratify and confirm the lease negotiated by the landman or broker. This enables the company to assure itself that there is no misunderstanding about the lease and it lets each landowner know with which company he is actually dealing.

Each lease, assignment, and ratification generally is signed and acknowledged before a notary, and recorded and indexed in the office of the county register of deeds in much the same manner as are deeds and mortgages.

Who are the parties to an oil and gas lease?

The lessor is the landowner (or the mineral-right holder, if subsurface rights in the tract have been separated from surface rights). The lessee is the person or company who acquired various rights from the mineral-right owner, including the exclusive right to drill for oil and gas, for a limited time. In case the mineral rights in a tract are owned by two or more parties, it is advisable for each of them to sign as lessor. Generally, an oil company will not start drilling operations on such a tract until it has secured leases from each owner of mineral-rights. These owners may join in signing one lease document or, if more convenient, they may negotiate separate lease documents covering each fractional interest.

What is the owner's royalty in an oil and gas lease?

The owner's royalty is the share of production reserved by the mineral owner under an oil and gas lease. The customary royalty is one-eighth (that is, $12\frac{1}{2}$ percent) of the oil produced and marketed from the tract. The one-eighth oil royalty has become firmly fixed by custom, just as the landlord's share of the grain produced on his farm customarily is one-fourth in many North Dakota communities. Only rarely do leases provide for an oil royalty either more or less than one-eighth. Most oil and gas leases provide that the owner's royalty may be paid in kind, but, as a practical matter, it is paid as a cash equivalent, computed on the basis of the market price of crude oil in that field on each day of production.

Most leases in North Dakota provide for a gas royalty of one-eighth of all gas marketed or used off the tract, although there is considerable variation among leases in the wording of the gas-royalty clause. Some leases, for example, specifically provide that the royalty shall be paid on gas used in the manufacture of casinghead gasoline, while others do not. Some leases authorize the lessee to shut in wells producing only gas, in which case the owner is to receive a stated amount, such as $50 or $100 annually per well, during the periods no gas is produced. Many leases allow the landowner to use gas for heating and lighting in the principal residence on the tract free of charge by making his own connections with the well at his own risk and expense. In some parts of the country, a common gas royalty is a flat rate per well, but no leases of this type have been noted in North Dakota by the authors.

In case the oil and gas rights are owned by two or more owners, the royalty is divided among them in proportion to their respective interests. Thus, if a person owns half of the oil and gas rights in a tract on which there is a producing well, he will receive one-half of the royalty, which would be equivalent to one-sixteenth (6.25 percent) of the total production. If he owns one-fourth of the oil and gas rights, he will receive one-fourth of the royalty, which would be equivalent to one thirty-second (3.125 percent) of the total production.

What is the working interest?

This is the portion of production of a producing well (usually seven-eighths) which is retained by the lessee (that is, the oil company) to pay overhead, drilling costs, production costs, salaries, wages, interest on borrowed money, other costs, and dividends to stockholders.

What is a bonus?

A bonus is an initial cash payment which is sometimes paid by the lessee to the owner of the mineral rights at the time the lease is negotiated. Where paid, the bonus frequently constitutes a sizable portion of the return which the mineral owner gets from the lease. The bonus is not a part of the annual rental rate appearing in the contract, as it is paid only once, at the beginning of the lease.

What is the delay rental?

The terms "rentals" and "delay rentals" in the case of the usual oil and gas lease mean the same thing -- they refer to the annual payments made by the lessee (the oil company) to keep the lease in force. The usual type of oil and gas lease is so worded that it terminates at the end of one year unless the lessee has started to drill a well or unless the lessee pays the mineral owner the annual delay rentals stated in the lease. There are several reasons why an oil company may not want to drill a well within one year. It may already have more land under lease than it can drill during the year with available rigs; it may be unable to obtain additional rigs, equipment, casing, or other supplies; it may want to conduct more geological or geophysical work before deciding whether or not to drill on that tract at all, or it may wish to wait for better market conditions before drilling. At the same time it may wish to keep the tract under lease to prevent competitors from leasing it, at least unitl such time that it has decided the chances of finding oil on that tract are not very good.

The payment of delay rentals on or before the agreed date (called the anniversary of the lease) keeps the lease in force for another year. In a sense, delay rentals constitute a payment by the company for the privilege of delaying drilling operations. If the company neither drills nor pays delay rentals on or before the anniversary date, the lease automatically terminates. The owner, however, must accept payment if offered before this date, in which case he cannot negotiate a lease with anyone else until after the lease expires.

Under other types of lease, which are not common in North Dakota, the company does not forfeit the leasehold by failing to drill or to pay rentals, although it is legally liable for accrued rents.

What is the term of an oil and gas lease?

Most oil and gas leases are drawn for a primary term, which is usually 5 to 10 years, and as long thereafter as oil or gas is produced from the land, or as long as the lessee is engaged in drilling or reworking operations. After drilling starts, the lessee usually is not obligated to pay rentals, unless and until the drilling ends with a dry hole.

The lease cannot be extended beyond its primary term by the payment of delay rentals. If oil or gas is not produced during the primary term of the lease, either because no wells are drilled or becalus all completed wells are dry holes, and if no well is being drilled or reworking operations are being carried on, the lease terminates at the end of the primary term. A lease of this type is an annual renewable lease at the option of the lessee during the primary term. That is, the lessee (oil company) can terminate the lease at will before the expiration of the primary term, but the mineral owner cannot do so. However, if the lessee violates explicit or implied agreements of the lease, the mineral owner may file suit for cancellation of the lease.

Obviously, it would be unfair for the oil company to have its lease expire at the end of the primary term if it is actually drilling a well on that date. Consequently, most leases contain a clause which permits the company to retain the lease in force after the expiration of the primary term until it has completed any well, either as a producer or as a dry hole, which was started before the expiration date.

Is a long or short primary term more advantageous for the mineral owner?

The most common primary term for leases granted by private owners in North Dakota is 10 years, although many leases for 5- and 7- year terms have also been recorded. Where the State or a political subdivision holds the mineral rights, the leases generally are for 5-year terms.

Whether a long or short primary term is the more advantageous to the landowner (or mineral owner) depends upon the local situation. If, for example, drilling and exploratory work in the locality convinces the oil company that chances of finding oil on the tract are remote, it may choose to terminate the lease. Brokers and oil scouts estimate that the average life of 10-year leases is about 7 years. In situations of this sort, a 10-year term may be slightly more advantageous than a 5-year term to the owner, because the oil company sometimes might choose to pay delay rentals at the sixth and seventh anniversaries of a 10-year lease, whereas it would not be willing to undergo the expense of renegotiating a 5-year lease.

On the other hand, if nearby drilling and exploratory work indicates good possibilities of finding oil on the tract, the oil company probably will make greater efforts to drill those leases on which the primary terms are nearing expiration, because if it fails to drill before expiration date, it may not be able to renew the leases except by paying higher delay rentals and bonuses. In this situation, a 5-year term may be more advantageous to the owner.

What happens if the first well drilled is a dry hole?

In many cases where the first well drilled on a lease is a dry hole, the oil company allows the lease to terminate. Frequently, however, it may wish to keep the lease in force, in which case the provisions of the lease determine whether any further rentals are to be paid.

Most of the leases in North Dakota examined by the authors provide that if the first well drilled is a dry hole the lessee may keep the lease in force for the rest of the primary term, either by drilling additional wells or by payment of the delay rentals specified in the lease.

A few leases, however, provide that upon completion of dry hole the lessee may retain the lease in force for the rest of the primary term without payment of rentals or drilling additional wells. This wording is less advantageous to the owner than the more usual one mentioned above, inasmuch as it may result in his receiving less rentals.

What rentals and bonuses can the owner expect to receive?

The amount of bonuses and delay rentals which an oil company will pay depends upon many factors, the most important of which is the amount of competition for leases. Naturally, the competition is greatest where the bidders for leases have the most confidence that oil will be found. Competition also arises where one bidder tries to get a lease within an area where another bidder is trying to get a solid block of leases. In new, unexplored territory, a company may not be willing to lease at all unless it can secure a large acreage in a fairly solid block at a very low rate per acre. Prior to the discovery of oil in Williams County in April 1951, for example, large acreages had been leased by oil companies at annual delay rentals of 10 cents per acre and with little or no bonus being paid. After discovery, the lease rates offered increased very rapidly for several months, finally leveling off at $1.00 or $1.25 per acre, which seems to be about the standard rate for undeveloped lands in the older oil-producing areas of the Mid-continent and Rocky Mountain regions. The effect of increased competition after oil discovery was more noticeable in the cash bonuses offered. These increased from virtually nothing to several dollars per acre. Six months after the discovery well was brought in, the most usual bonuses offered were $10.00 to $12.50 per acre. One tract in the vicinity of the discovery well was reported to have been leased for a cash bonus of $137.00 per acre.

Except in the northwest counties, however, rentals and bonuses are not high at the present time. Through the central and eastern parts of the State, for example, owners may be offered rentals as low as 50 cents per acre, with little or no cash bonus.

How are mineral rights sold or otherwise transferred?

Mineral rights are transferred by deed and contract for deed in the same manner as other interests in real estate. All or part of the rights in all or some of the minerals may be transferred by the same deed which transfers the land. The ownership of mineral rights may be separated from the surface rights by "mineral deeds" and "mineral reservations." The owner of the mineral rights may sell the right to participate in any future royalty payments by an instrument known as a "royalty deed" or "royalty assignment."

What is a mineral deed?

A mineral deed is an instrument by which the owner transfers mineral rights to someone else. The usual mineral deed transfers all or a stated proportion (such as one-half or one-fourth) of the rights in some or all of the minerals. Usually, a mineral deed to anything less than all of the mineral rights in a tract does not transfer all rights in particular acres; instead, it transfers an undivided fractional interest in the mineral rights in all acres in the tract.

When a mineral deed covers "oil and gas rights" or "rights in all minerals", the buyer is entitled to participate in the bonuses, rents, and royalties from future oil and gas leasing. If oil is discovered and marketed from the tract, for example, the owner of the deed to one-half of the mineral rights will receive one-half of the owner's royalty, that is, one-sixeenth of the total production. If a mineral deed is issued during the existence of an oil lease, the purchaser would not share in the lease bonus (because that had been paid sometime previously), but he would receive his proportionate share of any rentals and royalties paid by the oil company thereafter.

In case the fractional mineral-right holders join in signing the same lease document, they would share the lease bonus and rentals in proportion to their respective fractional interests. On the other hand, where the oil company negotiates separate lease documents with each fractional owner, the amount of bonus and rentals paid to each owner would not necessarily be at the same rate.

Most mineral deeds expressly grant the right to enter upon the tract to explore for minerals, to dig mines, to drill wells, and to use as much of the surface area as is necessary for producing and marketing the petroleum or other minerals. Even if such rights are not set forth in a mineral deed, they pass to the buyer as an incident to ownership of the minerals.

The owner of the surface does not acquire title to the improvements or machinery placed on the tract by the mineral owner, for use in mineral operations, and the latter has the right to remove such improvements and machinery within a reasonable time after exhaustion of the minerals or abandonment of the operations. Similarly, an oil and gas lessee has the right to remove improvements and machinery at any time during the lease and within a reasonable time after the lease expries.

<u>What is the difference between a mineral deed in perpetuity and a mineral deed for a term certain?</u>

Most mineral deeds in North Dakota apparently are "in perpetuity," that is, they are so drawn that ownership of the stated share of mineral rights is transferred forever to the buyers of such deeds and their successors.

Some mineral deeds are drawn for a "term certain," that is, for specified term of years and for as long thereafter as oil or other minerals are produced. Thus, if petroleum or other mineral is not being produced at the end of the stated term, the deed expires and the mineral rights are automatically merged with the land title. On the other hand, if the minerals are being produced at the end of the stated term the deed does not expire until such time as production ceases. This type of mineral deed is being used more and more frequently in the southwestern oilfields. The most usual term is 20 years, but deeds for shorter or longer periods than this are not uncommon there. During the term period, the holder participates in lease bonuses, rents, and royalties in the same manner as does the holder of a mineral deed in perpetuity.

The advantage of the mineral deed for a term certain is that the mineral rights eventually are reunited automatically with the land title. A disadvantage of a term deed (especially if the term is only 10 or 15 years) is that it may not sell for as much as perpetual mineral deed.

<u>What is a royalty deed?</u>

For all practical purposes the terms "royalty deed," "royalty conveyance," and "royalty assignment" mean the same thing. This type of instrument, in effect, transfers from the owner of the minerals to the purchaser the right to receive a stated share of the owner's royalty, if and when oil or gas is produced and marketed from the tract. 5/

There are two important differences between a royalty deed and a mineral deed. The first of these is that a mineral deed transfers ownership of mineral rights, including the right to lease, while a royalty deed transfers a stated portion of the total production, payable as a royalty. This means that the holder of a royalty deed does not participate in the negotiation of oil and gas leases nor share in the lease bonuses and delay rentals, as does the owner of a mineral interest. The second difference is that the holder of a royalty deed cannot lease nor require the leasing for development of the minerals, whereas the owner of the minerals can lease his interest for that purpose.

There are three kinds of royalty deeds, as far as the length of term is concerned: (1) A royalty deed may be so worded that it runs no longer than the existing oil and gas lease on the tract. This means that if the oil company allows the lease to expire because of failure to drill or to pay delay rentals at an anniversary date, the royalty deed also expires. (2) A royalty deed may be drawn for a specified term of years and as long thereafter as oil or gas is produced in paying quantities. A deed of this type expires at the end of the specified term--say, 20 years--if oil or gas is not being produced. On the other hand, if oil or gas is being produced at the end of the specified term, the deed does not expire until production ceases. (3) Royalty deeds may be perpetual, in which case the buyer of the deed (or his successors) participate in all future royalties, regardless of when oil or gas is found.

<u>What are mineral reservations and exceptions?</u>

A mineral reservation occurs when the seller retains all or some stated portion of the mineral rights when he sells a tract of land. This is usually accomplished by a clause in the deed excepting and reserving the mineral interest which is retained. From the words "excepting and reserving," we find the common usage of the terms "mineral exception" and "mineral reservation." Although there is a technical distinction between "excepting" something from the conveyance and "reserving"

5/ Formerly, many royalty deeds actually were worded in terms of a fraction or percentage of the mineral owner's royalty. Such deeds generally included a clause by which the sellers agreed to refrain from entering into oil and gas leases on the described lands which did not provide for an owner's royalty of at least the usual one-eighth of the production. Inasmuch as the owner's royalty is a fraction of total production, the question sometimes arose as to whether the fraction being conveyed by a particular deed was a fraction of the owner's royalty or a fraction of the total production. Nowadays, the more common practice is to word royalty deeds in terms of a fraction of the total production, to be payable from the owner's royalty. This eliminates the confusion which may stem from the use of the double fraction and also eliminates the question of the minimum royalty that the seller of the royalty deed must provide in subsequent oil and gas leases.

something from it, the words are frequently used interchangeably and the technical distinction has become relatively unimportant as a practical matter.

As in the case of mineral deeds, a mineral interest may be reserved perpetually or for a term of years. The holder of mineral rights by way of reservation has the same rights as the holder of a similar interest by way of mineral deed. That is, he participates in the negotiation of oil and gas leases; he receives his proportionate share of bonuses, delay rentals, and royalties; and he may transfer all or part of his mineral rights by mineral deed or royalty assignment.

Mineral reservations and exceptions have been included in many conveyances of farm land in North Dakota. The statutes require all agencies of the State of North Dakota to reserve at least 50 percent of the mineral rights in any State lands they sell. Several corporations (including the Northern Pacific Railroad, the Federal Land Bank, and some insurance companies) years ago adopted the policy of reserving part of the mineral rights in land they sold. Few individuals, however, have followed this practice, although it is expected that more will do so in the future.

In the past, the amount of mineral rights sold with the land seems to have had little or no effect on the selling prices of land. Buyers and sellers apparently felt that mineral rights had only a nominal value. From now on, however, the amount of mineral rights transferred with the land frequently will have a strong influence on selling prices.

There has been much confusion in the use of mineral exceptions and reservations. A well-known oil authority has stated that "there are more problems arising from mistakes made in exceptions and reservations than in any other phase of oil and gas conveyances with the consequent result that the intentions of the parties in many cases are not carried out." In order to avoid possible mistakes and the resulting disagreements and lawsuits, buyers and sellers should secure competent legal service in the drafting of deeds involving mineral exceptions and reservations.

What is group leasing or block leasing?

Mineral-right owners sometimes can increase the attractiveness of their holdings for oil and gas leasing by joining together and offering all their mineral acreage for lease as a unit. Oil companies may prefer taking a large area under lease at one time, thus saving them the trouble of assembling the block and relieving them of considerable time and money which otherwise would have to be spent in negotiating with each individual owner.

A common procedure for creating a group lease or block is for the mineral owners to set up some type of formal or informal organization, which takes a lease option on all available mineral acreage owned by the members. The representatives of the group negotiate with a broker or oil company, and when lease rates, bonuses, and other terms are agreed upon, the group assigns the lease options to the broker or company.

Such a group lease is generally more attractive to an oil company if it is in a solid block, with no inside tracts omitted from the lease. Omitted inside tracts are a source of annoyance, or even danger, to the oil company. Most companies feel that they can achieve orderly development--and thus lower drilling costs--only if they own the lease on every acre in the block.

The principal advantage to owners of group leasing is that collective bargaining and the creation of virtually solid lease blocks usually result in higher average bonuses and rentals being paid. Moreover, oil companies frequently will make other concessions in order to get a desirable block of leases. Some owners, however, may feel that a group lease is a disadvantage. They think they might get a higher bonus or more favorable terms if they stayed out of the block and conducted their own negotiations with brokers or oil companies.

Experience in other States has shown that there are serious dangers for owners in group leasing. In some cases, landowners have been victimized by unscrupulous promoters who made exaggerated claims regarding the value of their services and the prospects for future profit. The expected profits never materialized because the promoters obtained a "cut" or commission far out of proportion to their contributions to the group lease.

What is meant by pooling of royalties?

Sometimes a group of mineral owners will form an organization or "pool" to which they will assign a uniform portion (such as 25 or 50 percent) of their royalty rights in all minerals they own in return for shares in the pool. If oil is produced on any tract included in the arrangement, all participants get a share of the royalties through dividends on their shares in the pool. The principal advantage of a royalty pool is that it provides greater chances of each participant getting something out of the oil development. Of course, those owners on whose land oil is found won't get as much royalty as they would if they had stayed out of the pool. It is like an insurance policy in reverse—the participants in a royalty pool share the chance to benefit, while the individuals in an insurance program share the hazard of loss.

Organizations for pooling royalties have sometimes been used by promoters in older oil-producing States as a means of defrauding landowners. In typical situations of this kind, the promoters appropriated valuable royalty rights, leaving little return for the landowners.

One disadvantage with royalty pools, which are honestly created and justly operated, is the great amount of promotional and legal work required to organize them. It is not easy to so organize a pool that all participants will be treated fairly. In North Dakota, royalty pools must meet certain legal requirements and practical standards established by the State Securities Commission in an attempt to prevent fraud.

What is meant by well spacing?

Well spacing refers to the distance between wells in terms of acres. Ten-acre spacing means that only one well may be drilled on each 10-acre tract, and 40-acre spacing means only one well per 40-acre tract.

North Dakota statutes provide that oil and gas wells may be drilled only in accordance with rules and regulations established by the North Dakota Industrial Commission. Well spacing is only one of the many subjects covered by these rules. In the fall of 1951, the Commission established 40-acre spacing for the Beaver Lodge-Madison field in Williams County, each well to be drilled as near as practicable in the center of the 40-acre subdivision of the section. Several months later, the Commission denied the petition of oil companies to increase the spacing to 80 acres, even on a temporary basis. Wildcat drilling outside of the Beaver Lodge field and the activities of speculators and brokers all seem predicated on the assumption that 40-acre spacing will be established in other areas if oil is discovered. It should be remembered, however, that the Industrial Commission has the power to establish different spacing patterns in particular areas and, under certain conditions, to change the spacing pattern in any oilfield after public hearing on the matter.

What are offset rights?

When a well penetrates the porous rock which comprises an oil reservoir, the natural pressure or "reservoir energy" drives the oil through the reservoir rock to the well and towards the surface. Oil is thus "drained" from a considerable area around the well.

An offset is a well which is drilled to prevent drainage across ownership boundaries toward a producing well. In the usual case, the offset, would be drilled directly opposite the producing well and the same distance from the property line.

Generally, the lessor's right to compel offset drilling is a matter of contract, unless there is a State statute on this subject. Some leases stipulate the lessee's obligations regarding offsets in great detail. Most of the leases in North Dakota, however, contain little or nothing with respect to offset drilling, leaving the lessee's obligation to be determined under general rules of law which may be established.

In many of the older oil producing States, the courts have held that if a lease does not contain an express requirement for offset drilling, the lessee is bound by an implied agreement to drill offset wells in accordance with the established practice of good operation in each field, at least in circumstances where failure to drill would result in loss to the mineral owner and drilling would not result in an operating loss to the lessee.

At present, there is no statute in North Dakota governing offset drilling, nor has the Supreme Court had any occasion to rule on this matter. In the absence of any law in North Dakota regarding offsets, oil companies are following a number of rules, developed by oil-field practice and the courts of other States, in an effort to treat all owners of oil rights as fairly as possible. These rules, which possibly may be modified later by the legislature or the courts, are briefly as follows:

(1) With 40-acre spacing, the offset wells of course must be drilled in the center of adjoining 40-acre tracts. Although some authorities have questioned the necessity of drilling offsets on the diagonal forties, most oil companies in North Dakota at present are following the general practice of drilling diagonal offsets as well as the direct offsets.

(2) Ownerships which are separated from the tract containing the producing well by intervening forties are not entitled to offset wells. For example, if a well is located in any of the inside forties of a section in a single ownership, no offsets would be required.

(3) If the land entitled to offset rights is under oil and gas lease, the lessee (whether or not this be the company operating the producing well) may either: (a) start drilling the offset well within a "reasonable time" after the producing well is completed; 6/ or (b) pay compensating royalties to the owner of the oil rights, generally based on the amount of drainage to the producing well. The latter represents an additional expense to the lessee and usually the company will prefer to drill the offset rather than pay the compensation.

(4) If the tract entitled to an offset well is not under lease, the owner of the oil rights cannot claim damages. In order to protect his interests in the underlying oil, he must either drill the well himself or put the land under lease with someone who is willing to put down a well.

6/ "Reasonable time" is generally interpreted as being 60 or 90 days.

What should the owner look for in an oil and gas lease?

Each owner must decide for himself whether he will sign any lease offered him by a broker or lease scout. Naturally, he will want to receive just as high a bonus and delay rentals as possible. If his holdings are not in an area where there is considerable competition, however, his opportunity to bargain for higher bonuses and rentals is likely to be rather limited.

So far as known, all lease forms being used by brokers and oil companies in North Dakota are of the "Producers 88" type. There are, however, dozens of variations of this type, some of which are more advantageous for the owners than others. Generally, each broker and oil company has a definite preference for a certain lease form and does not like to make any changes in it. Nevertheless, they are sometimes willing to make reasonable changes in their lease forms, especially if there is considerable competition for leases in the area.

Here are a few things that the mineral owner might well bear in mind, some of which are discussed in more detail in preceding sections:

(1) A royalty clause providing for one-eighth royalty, not only on oil but also on natural gas and casinghead gasoline produced and marketed from the tract, is usually more advantageous for the owner than a clause which permits the company to pay an annual flat rate per well if only gas is produced.

(2) A "shut-in" clause, which allows the lessee to shut in wells which produce only gas is generally considered reasonable and proper in new areas where there is a lack of pipelines and other facilities for marketing gas. This clause should include provision for payment of shut-in royalties to the lessor on a per-well basis.

(3) If the tract is located in an area of known production possibilities, a short primary term (5 years) is generally more advantageous to the owner, while if the tract is located in an area of unknown possibilities, a long term (10 years) generally is more advantageous.

(4) A "dry-hole" clause which provides that if the first well drilled is a dry hole, the lessee can retain the lease in force for the rest of the primary term without payment of rentals or conducting additional drilling, is undesirable from the lessor's viewpoint. It may result in less delay rentals being paid during the life of the lease than would be the case under the more common provision which requires the lessee to either forfeit the lease or to drill or to pay delay rentals after completion of a dry hole.

(5) Most lease forms used in North Dakota include provisions which give some protection to the surface owner, such as a clause to the effect that the lessee will not drill a well within a stated distance from any house or barn on the tract; a clause requiring the lessee, when so requested by the landowner, to bury all pipelines below plow depth; and a clause providing that the lessee will pay for damages to growing crops (or to growing crops and improvements) caused by the lessee's operations. The mineral owner, especially if he is also the owner of the land, should assure himself that the lease contains these provisions.

These are only a few of the many little things in a lease which sometimes may make considerable difference in the amount the owner will receive. Consequently, the wise owner discusses any proposed oil and gas lease with his attorney before he signs it. Chances are that the landman or broker who is attempting to secure the lease is in a great hurry to get all tracts in his block signed up, but the owner should not letthis interfere with his right to seek legal advice. Some brokers and companies encourage each prospective lessor to discuss the proposed lease with his attorney before signing--they believe that if the owner fully understands the meaning of each lease provision at the outset, the relations between the oil company and the owner will be more amicable.

How are recorded leases canceled at lease termination?

An unreleased oil and gas lease, even though it may appear to be terminated by its own provisions, creates some doubt as to the validity of any subsequent drilling lease on the tract. Consequently, it is to the best interests of both mineral owners and the oil industry generally that each lease be promptly canceled after termination.

The usual procedure at termination is for the oil company to execute an instrument by which it relinquishes all rights it may have had in the lease. This document is known variously as a release of lease, termination notice, surrender of lease, and lease cancelation. In the past, most oil companies apparently sent these releases to the mineral owners at lease termination. In some cases, the owners put them on record, but in others they merely filed them away or destroyed them. Subsequently, when other companies or brokers attempted to get leases on these tracts for which no cancelation of the previous leases had been recorded, the former lessee would be called upon to search his files and execute another release. Because this frequently meant some expense and trouble, several oil companies adopted the practice of recording the surrender documents in the office of the county register of deeds.

The 1951 session of the North Dakota Legislature made this the mandatory procedure, by making it the duty of each mineral or oil lessee to execute and record the release document at lease termination. 7/ If a lessee fails to do this within 60 days after lease termination, various

7/ Laws of 1951, ch. 233.

procedures are specified by which the lessor may obtain and record a termination document. If lessees follow the mandates of the 1951 statute and if lessors exercise their statutory rights under this act, the problem created by unreleased, though expired, leases will greatly diminish in the future.

But what about such leases which are of record from the 1930's and early 1940's? There are various ways of canceling these. The simplest procedure, of course, is to obtain a lease surrender from the lessee, if this party still exists and can be found. Where the primary term of such lease has expired, some oil companies will accept a new lease, if it is accompanied by affidavits from neighboring landowners to the effect that no well has been drilled on the tract. For situations in which old leases cannot be canceled by these methods, resort can be made to procedures provided by the 1951 Act, including judicial action to obtain release of expired leases.

Should the landowner sell his mineral rights?

This is a difficult question which each landowner must decide for himself. The usual reason for landowners selling mineral rights is to obtain immediate cash. Sale of mineral rights, however, has several disadvantages for the landowner, which he should evaluate in relation to the offered price before he makes his decision. The situation is different for each landowner and is continually changing with changing conditions. Hence, only a few general guides can be suggested to help the landowner to decide whether to sell, the proportion to sell, and the price to accept.

(1) If you decide to sell, try to sell rights to specific minerals, such as "rights to oil and gas," rather than "rights to all minerals" or "rights to oil, gas and other minerals." By selling only oil and gas rights you may be able to keep rights to lignite and other minerals which are, or may become, valuable to you as a landowner. Many North Dakota farmers, for example, have home-use lignite mines on their property. In several instances where such farmers sold a portion of the rights in all minerals, the purchasers later demanded a royalty on the lignite mined by the landowners. Some mineral deeds are so drawn as to cover a stated portion of the "rights in all minerals except lignite," or "rights in all minerals, except lignite, sand, gravel, and gold." From the landowner's viewpoint, this may be more advantageous than selling rights in all minerals, although less desirable than selling rights to definitely specified minerals. Inasmuch as fewer rights are transferred by deeds to specified minerals than are transferred by deeds to all minerals, they may not be able to command as high a price.

(2) Investigate the possibility of selling oil and gas rights by royalty assignment rather than by mineral deed. If the sale is by royalty assignment, you will retain the power to negotiate drilling leases with oil companies in the future and to receive all bonus and rental payments. As indicated previously, the division of legal control over mineral rights among several parties may make it more difficult for oil companies to secure leases. Because the purchaser of a royalty assignment does not obtain the right to participate in bonus and rental payments, royalty assignments

generally do not sell for as high a price per acre as do mineral deeds. In fact, brokers report that the present market for royalty assignments is very poor, except in the vicinity of existing oil fields.

(3) Avoid selling all your oil and gas rights. In most cases, landowners probably will find it to their advantage to sell not more than half of their oil and gas rights, although under some conditions they may find it advantageous to sell as much as three-fourths of them. Reasons why landowners retain part of their oil and gas rights include the desire to receive part of any future lease and royalty payments and to participate in negotiations for any oil and gas leases to the end that they may be able to get provisions in leases which protect their surface rights.

Another possible reason for retaining part of the oil and gas rights is the maintenance of the loan-security status of the land. Studies in Oklahoma and Texas point out that most credit agencies operating in those States, as a result of experience with the problem, require at least 50 percent of the mineral rights to stay with the surface rights in order to qualify for a maximum loan. Whether this requirement will be adopted by credit agencies in North Dakota remains to be seen.

It is especially dangerous for the landowner to sell his rights in all minerals, or his rights in coal and lignite, without making adequate provision for protection of the surface, and for compensation for use of the surface or for damages thereto. It is equally dangerous to purchase land where rights in coal, lignite, or all minerals have been severed from the surface without such provisions being made. Recent research in utilization of lignite indicates a great expansion of lignite mining ultimately will be possible in North Dakota. Present strip-mining methods destroy practically all of the agricultural value of the land. If the landowner does not own the coal and lignite rights -- as would be the case if he sells rights in all minerals -- some mining company may acquire these rights and start stripping operations, or threaten to do so. In that event, the rights and remedies available to the landowner would depend to a large degree on the provisions of the grant or reservation which severed the mineral rights from the surface rights.

(4) Don't sell your oil and gas rights for a lesser amount than a reasonable estimate of the future costs and disadvantages you can expect to experience as a result of the sale. One disadvantage of selling oil and gas rights is that you would lose at least part of any bonuses, rentals, and royalties which might be paid by lessees in the future. The probable amount of these future payments you will forego depends upon the proportion of the mineral rights sold, the wording of the deed conveying these rights, the amount of drilling activity in the area, whether oil or gas is actually found, the future leasing policy of oil companies in the areas, and other factors.

Secondly, you will incur a risk of increased costs for bringing your abstract up to date, should you wish to sell or mortgage the land in the future. Many of those who are buying mineral rights in North Dakota are reselling part of what they buy in numerous small parcels. In some cases, these parcels are as small as one-eighth of 1 percent of the total mineral rights in a tract. Thus, resales by mineral buyers may result in anywhere from two or three to over 100 separate chains of title to various interests in the total ownership of the tract. Under present procedures, all of the recorded instruments in each chain of title to mineral rights are included in the landowner's abstract of title, the cost of which is directly proportional to the number of recorded instruments. Although speculation in mineral rights is relatively new in North Dakota, landowners already are beginning to complain of the increased abstracting and title-examination fees resulting from fractionalization of mineral rights.

Thirdly, if you sell part of your mineral rights by mineral deed, you risk the possibility that subsequent fractionalization of the part you sell may proceed to the point where it would be so expensive for an oil company to negotiate with the many scattered owners that it would refuse to lease the tract. This would impair the income value of the mineral rights retained by you. Such situations are not uncommon in the older oil-producing States and they may be expected to occur in North Dakota.

In order to offset the loss of future income from drilling leases and to fully protect himself against all possible risks, the landowner would have to receive at least as much per mineral acre for the oil and gas rights as the long-time or "normal" agricultural value of the land per surface acre. Many landowners will not adhere strictly to this rule, because of other considerations discussed in the next paragraph. But this rule does provide a good basing point from which the landowner can figure what price he will accept for his mineral rights. It calls attention to the fact that the risks assumed by the landowner in selling mineral rights are greater with high quality farm land than with low value land.

(5) Give consideration to the amount of your indebtedness and need for ready cash in deciding the minimum price you will accept for your oil and gas rights. Some farmers, for example, have found it advantageous to sell part of their minerals at moderate prices in order to obtain funds with which to pay off mortgages, to fix up their homes, or to buy additional farm equipment. In their judgment, the immediate savings in interest costs or the advantages of having adequate working capital for farm operations offset to some extent the risks, discussed above, of future costs and inconveniences associated with selling mineral rights. The heavily encumbered landowner can ill afford to take the risks inherent in holding out for high mineral prices. The debt-free farmer, on the other hand, is in position to consider holding for higher prices than those currently offered in his locality. If he does decide to hold for higher prices, however, he should recognize the speculative risks he is assuming.

(6) Hedge during drilling operations on your land or on an adjoining tract. During the several weeks' period that a well is being drilled, the market price for oil and gas rights on that tract and adjoining tracts usually rises rapidly, often as high as 10 to 20 times the agricultural value of the land. The landowner who wishes to get as much as possible out of his mineral rights under all contingencies will watch the local market very carefully during the drilling period and attempt to time the sale of part of his oil and gas rights when competition has forced the price to high levels. If the well proves to be a dry hole, the market for minerals in that locality, even at low prices, may almost disappear. Selling part of the oil and gas rights at these high prices is a hedge against a dry hole being drilled. If the well comes in as a producer and the landowner has held back half of the mineral rights, he may still receive a nice royalty income.

(7) Finally, always consult your attorney before signing away any of your rights. An attorney's fee is small compared with the possible savings in dollars and the avoidance of trouble his services can mean to you.

Some instances have been reported of landowners signing deeds to mineral rights under the mistaken impression they were signing oil and gas leases. Frequently, the price received was only a small fraction of current market values. If these owners had followed the practice of obtaining competent legal advice before signing any instrument affecting their land titles, these costly mistakes might have been avoided.

Similarly, if you are about to buy land, consult your lawyer regarding mineral rights which might be reserved or excepted and which might be exercised in such a manner as to cause you loss or damage.

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