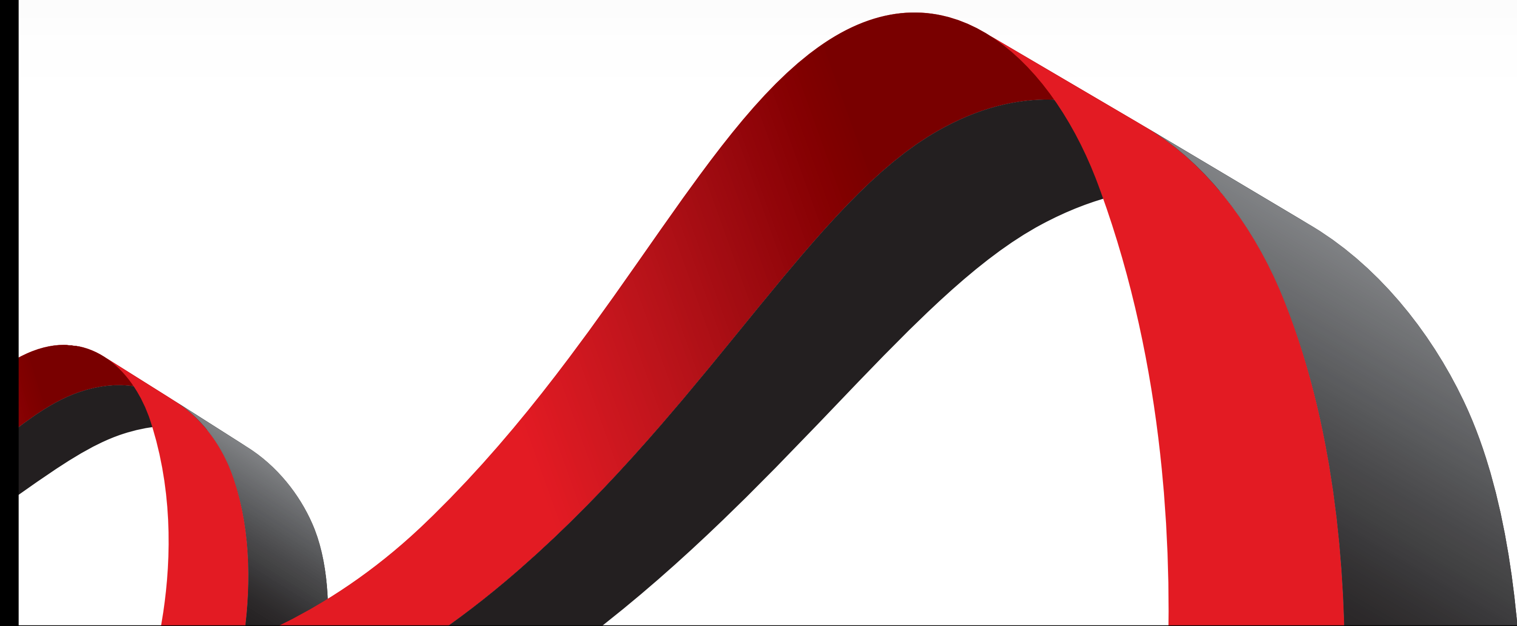
Oil & Gas Law Report

Blog series: Common Oil and Gas Lease Conundrums



A relationship of a different stripe.

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Porter Wright Resources

Porter Wright's Oil & Gas practice group includes more than 40 attorneys with extensive experience in all aspects of doing business in the Marcellus and Utica shale plays. These attorneys include:

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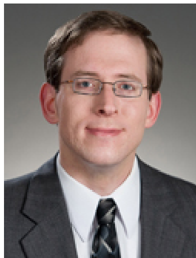

Eric Gallon counsels on subjects including Clean Air Act compliance and defense, public utilities law, government relations, contract disputes and damages actions under the Ohio Consumer Sales Practices Act and federal Telephone Consumer Protection Act.

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Production in “Paying Quantities”

August 1, 2012 | Porter Wright

The Point: Oil and gas leases are specialized instruments of real estate and contract law. The very existence of the lease can turn on court opinions over 100 years old (with little between now and then) and the court's interpretation of something as ephemeral as "good faith" can be determinative. Curative documents, a royalty check endorsement, division orders and the like may clarify ambiguities when a lot of money is at stake.

Discussion: The relationship between the owner of minerals (which may be different from the owner of the surface, the subject of a future blog) and the oil company is typically defined in and oil and gas lease where the Owner, in a contract, grants to Lessee defined rights to the property in exchange for promises and money. The length of the lease, the term, is addressed in one of the most important provisions the lease — the "habendum" or term clause, which usually appears near the beginning of the lease. The term clause in an oil and gas lease is the product of long development and experience. It attempts to reconcile the competing interests of the parties. Owner wants a well and its royalty payments quickly (a short term) while Lessee wants flexibility and as much time as possible (a long term). Given the new interest in oil and gas production in Ohio, it is crucial to understand the term clause for both old/existing leases and new ones.

There are many variations and the addition or deletion of a word or a phrase can have dramatic consequences. An example of a typical provision:

> "This lease is for a primary term of 12 months, and as long thereafter as oil or gas is produced."

As the so-called "thereafter" clause can extend the lease indefinitely, it often is the source of controversy. It may extend the fixed or primary term so long as oil or gas, "is produced from said land."

Other variations include:

- "is or can be produced"
- "is or can be produced in Lessee's judgment"
- "is produced from said land or the premises are being developed or operated"
- "is produced in paying quantities"
- "is produced from said land or land with which the land is pooled hereunder"
- "is produced from said land by Lessee, or drilling operations are continued, as hereinafter provided."

A recent case decided by the Supreme Court in Pennsylvania illustrates the controversy. *T.W. Phillips Gas and Oil Co. and PC Exploration, Inc. v. Ann Jedlicka*, decided March 26, 2012. The land owner, Jedlicka, sought to have an old lease terminated for the failure to produce "in paying quantities."

First, the court reviewed the respective interests of the parties to a lease. The interest granted in an oil and gas lease is inchoate. That is, it is an interest that is likely to vest but has not yet actually done so. Vesting is dependent on the occurrence of an event. Here, if development during the agreed upon primary term is unsuccessful, no estate vests in the lessee. If, however, oil or gas is produced, an interest in the property is created in the lessee, and the lessee's right to extract the oil or gas becomes vested.

The interest created in the lessee is a "fee simple" meaning that it may last forever in the lessee and his heirs and assigns, the duration depending upon the concurrence of an event, here the termination of production. Since the fee can end, the interest is a "fee simple determinable." It automatically reverts to the grantor upon the occurrence of the event. The interest held by the grantor after such a conveyance is termed "a possibility of reverter."

The lease is also a contract. As the court points out, it must be construed in accordance with the terms of the agreement as manifestly expressed, and the accepted and plain meaning of the language used, rather than the silent intentions of the contracting parties, determines the construction to be given the agreement. Further, a party seeking to terminate a lease bears the burden of proof.

In short, Jedlicka argued that the lease had suffered a loss in 1959 and was therefore terminated and that "lessees should not be allowed to hold land indefinitely for purely speculative purposes." Lessee argued that the lease remained valid; that the wells on the property have produced gas in paying quantities because they have continued to pay a profit over operating expenses; and that they have operated the wells in good faith to make a profit.

What's a "paying quantity?" Jedlicka argued that it is simple math — an objective test — using a computation of production receipts minus royalty minus expenses including marketing, labor, trucking, repair, taxes, fees and other expenses. Rejecting that approach and reaffirming an 1899 decision, the court held that consideration should be given to a lessee's good faith judgment (that is, a subjective test) when determining whether oil was produced in paying quantities.

Jedlicka argued that, "if only a subjective standard is used to determine paying quantities, oil and gas companies may choose to hold onto otherwise unprofitable wells for merely speculative, as opposed to productive, purposes."

The court disagreed, "a lessor will be protected from such acts because, if the well fails to pay a profit over operating expenses, and the evidence establishes that the lessee was not operating the wells

for profit in good faith, the lease will terminate. Consideration of the operator's good faith judgment in determining whether a well has produced in paying quantities, however, also protects a lessee from lessors who, by exploiting a brief period when a well has not produced a profit, seek to invalidate a lease with the hope of making a more profitable leasing arrangement.

The Ohio Supreme Court considered a similar case in 1955. *Hanna v. Shorts*. There, lessee's argument that "lessee's good faith judgment that production is paying must prevail" in determining whether there is production in paying quantities did not survive the fact that there had been no production at all. (It took the Supreme Court to figure that out? It just goes to show that when there is a lot of money at stake, controversy and litigation abound.)

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Lawsuits Over "Fraudulent" Oil & Gas Leases Often Lack Merit

December 13, 2012 | Chris Baronzzi

The Ohio shale boom started slowly when a few small companies quietly began acquiring mineral leases for as little as $25 per acre. This soon gave way to a full blown land rush in the fall of 2010. But as lease prices skyrocketed through the Fall of 2011, disillusioned lessors who signed before the peak of the market were the ones rushing — to the courthouse to file lawsuits to cancel their leases.

In order to gain leverage and legitimize their lawsuit, lessors frequently allege that their lease is "unconscionable" or they were fraudulently induced to sign it. "Exhibit A" to these lawsuits is often a technical error in the lease signing or a "fraudulent" statement made by a landman. There are exceptions, but many of these kinds of lawsuits have no legal basis.

Technical Notary Errors Do Not Void a Lease

A favorite technical error alleged by lessors is improper notarization of the lease. ORC §5301.01 does indeed require documents like mortgages, deeds and leases to be signed and notarized. That statute and related case law may lend some support to an argument to cancel a lease that completely omits a signature, notary acknowledgment, or name of the lessor. However, Ohio law does not allow a lessor to cancel a lease because of a technical error by the notary. "[A] defectively executed conveyance of an interest in land is valid as between the parties thereto, in the absence of fraud." *Citizens Nat. Bank in Zanesville v. Denison* (1956), 165 Ohio St. 89, 95. This principle, which is also reflected in ORC §2719.01, expresses the law's refusal to nitpick technical errors in contracts to undermine the intent of parties.

In *Swallie v. Rousenberg*, 2010-Ohio-4573, ¶35 (Seventh Dist.) the court upheld the validity of a deed as to the parties to the transaction even though the grantee improperly acted as the notary. In *Logan Gas Co. v. Keith* (1927), 117 Ohio St. 206, 208 the Court held that even though one of the lessor's signatures was impermissibly acknowledged by telephone, the oil and gas

lease remained valid. Finally, ORC § 5301.071 provides that even if a notary fails to seal the acknowledgment, the validity of the agreement is unaffected.

Calling attention to a notary error may get a notary's license revoked, or cause a consternation for a county recorder, but it is not grounds to disregard contractual obligations between parties.

Fraud or the Hard Truth?
Lessors often complain that a landman told them to sign immediately or "they would miss their chance" or "the company would just take their minerals anyway" or some similar statement. These kinds of statements, even if they were made, probably do not amount to fraud.

First, predictions of future events typically do not constitute fraud. "It is clear in Ohio that fraud cannot be predicated upon promises or representations relating to future actions or conduct." *Crase v. Shasta Beverages, Inc.*, 2012-Ohio-326, ¶42 (Tenth Dist.). Further, such statements have proven to be true in many circumstances.

Next, Ohio oil and gas law does not require an operator limit production to within the boundary of a leased parcel. Ohio follows the doctrine of "correlative rights," which preserves each landowner's opportunity to draw from a common resource. ORC §1509.01(I). Under this doctrine, so long as there is no waste or reservoir damage, each landowner has the right to take as much oil and gas as his or her wells will produce, although the minerals may be drained from the land of others. *Williams & Meyers*, Abridged Fourth Edition, §203.2.

There are a number of scenarios that would allow a lessee to drill a well on one parcel and draw oil and gas out from beneath adjacent, unleased, parcels in Ohio. Drilling a well to intersect large natural fractures, for example, is one scenario that may allow a lessee to produce from beneath an adjacent parcel regardless of whether it is leased. In that scenario, a landman's statement that a lessee could take minerals from beneath an unleased parcel is accurate.

Next, statements by landmen that landowners should sign a lease quickly, before they "miss their chance" or that the offer was "for a limited time" seemed disingenuous in the early months of the landrush. But when the landrush subsided in early 2012 some landowners saw lease offers of nearly $6,000 per acre withdrawn literally overnight. This fluctuation in lease prices was dictated by unpredictable market forces, including competition among various lessees, the amount of land left to lease, the price of natural gas, and production from exploratory wells. Landmen who urged landowners to seize the opportunity to lease were not committing fraud. In many cases they were actually giving good advice.

Bad Timing Does Not Make a Contract Unconscionable
In order to prove that a lease is unconscionable, a lessor must produce clear and convincing evidence that the lease contains commercially unfair or unreasonable terms, that no voluntary meeting of the minds was possible, and there was an absence of meaningful choice for the lessors. *Featherstone v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 2004-Ohio-5953, ¶13 (Ninth Dist.).

The legal theory of unconscionability is not yet well developed as it relates to modern leases focused on horizontal drilling. What is "commercially reasonable" for this relatively new industry will undoubtedly challenge Ohio courts for years to come.

Likewise, most claims of unconscionability will probably fail because of the voluntary nature of the lease arrangement. If a lessor tries to void a lease as unconscionable, the lessor will have to show that they had no choice but to sign a lease. This will be a difficult task. In most cases, lessors made a deliberate decision to lease with whatever information they chose to gather, and they would have been thrilled if they timed the market perfectly. But, a lessor's failure to time the market does not equate to fraud or render a lease unconscionable. As explained in my prior blog on the subject, courts do not and should not decide what price is "enough" for a particular transaction.

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A Bonus Payment Is Not Relevant to the Validity of an Oil and Gas Lease Law

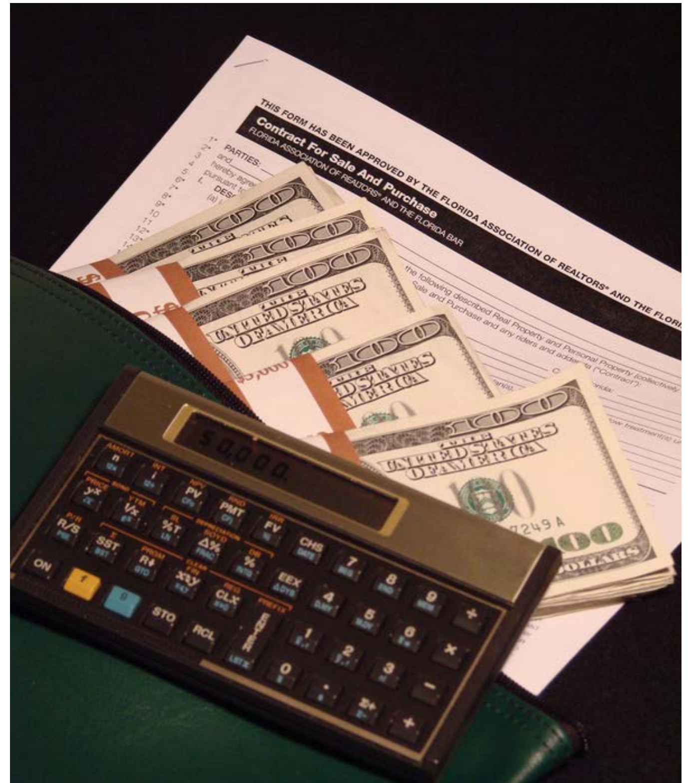
August 1, 2012 | Chris Baronzzi

In Eastern Ohio before 2010, a customary signing bonus for an oil and gas lease was usually less than $25 per acre, as it had been for years. By the fall of 2011, after the shale boom hit, lease bonus prices had risen in leaps and bounds to their peak (so far) of about $6,000 per acre before pulling back significantly in the spring of 2012.

Naturally, everyone who did not have the foresight or nerve to hold out for $6,000 per acre was left feeling more than a little miffed. After all, a typical bonus check on a 100 acre parcel in 2009 or early 2010 would have been $2,500 but that bonus may have swelled to $600,000 in less than two years!

Courts Do Not Decide What is "Enough"
Fortunately for our economy and legal system, a party to a contract cannot later adjust the contract price when they finally realize the value of a transaction. In fact, it is the imbalance of information, risk tolerance, and vision among different people that is the driving force of business in the United States.

But even reasonable lessors were overwhelmed by the incredible disparity between lease bonuses paid during the shale boom. That disparity, combined with the belief that the oil and gas companies have bottomless bank accounts, spawned lawsuits by lessors to try to break leases with the hope of signing for more.



Of course, breaking contracts requires more than just a lot of hard feelings about not getting paid enough. "It is axiomatic that courts, as a general rule, will not inquire into the adequacy of consideration once consideration is said to exist." *Rogers v. Runfola & Assoc. Inc.* (1991), 57 Ohio St.3d 5, 7. In other words, as long as some valuable consideration was paid for a lease, the *amount* of that consideration is not relevant to the validity of the lease.

Oil and Gas Leases Are Different
Courts should be even more reluctant to pass judgment about the initial consideration given for oil and gas leases

than the consideration given for conventional contracts.

Unlike conventional contracts for sale of an asset at a determinable price, an important part of the consideration given for an oil and gas lease is the lessee's promise to pay future royalties on production. The bonus payment is only part — and possibly a small part — of the total consideration that will be realized from an oil and gas lease.

If the total consideration (including bonus and royalties) for an oil and gas lease is calculated, the average difference in value realized by different lessors over the life of their leases will be much less distinct than the disparity in bonus payments they may have received.

For example, our hypothetical landowner with a 100 acre parcel who signed a lease for $2,500 may have only received .42% of the maximum bonus that would have paid at the peak of the market. But taking royalties into account, the total value of that same lease is discounted merely 11.94%, assuming royalty income of $5 million over the life of the lease.

Furthermore, even with a narrow focus on only the bonus payment, it is incredible for a lessor to allege that he or she would have received a much larger bonus if a landman or lessee had been more forthcoming. Market forces caused bonus payments to fluctuate wildly during the shale boom and no one could predict when the market would peak or when it would collapse.

Consequently, landowners and courts should not be tempted to judge oil and gas leases from a narrow and short sighted analysis of only the disparity in bonus payments. Likewise, no one should be convinced by the perfect perspective of hindsight that a landowner would have timed the market better if further information was known.

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My Sister is a Fractivist and Won't Sign an Oil and Gas Lease. What Can We Do?

August 17, 2012 | Christen Blend

When something is owned by more than one person at the same time, there can be problems.

Background (and we mean far back!)
Since the Statute of Westminster II, c. 22 (1285), a co-tenant has been subject to the law of waste. This rule of liability is found in the law of all states in one form or another. Therefore, as a general proposition, a cotenant may not remove minerals from concurrently owned land without the consent of the other cotenants. Williams and Meyers, Oil and Gas Law, § 502.

But waste goes both ways. Given the fugitive nature of oil, which may be drained from the land by a well on adjoining property, if the cotenant owning a small interest in the land was required to give his consent before the others could produce the oil, he could arbitrarily destroy the valuable quality of the land.

Most states, therefore, strike a balance and allow "unilateral" production by a cotenant subject to an accounting to the other cotenant, i.e., a sharing of net proceeds.

Hypothetical
Assume that three siblings, A, B, and C, inherited the minerals on a 160-acre parcel of land. Oil Company proposes to drill a 40-acre well on the property and all three siblings sign a lease providing for a 1/8 royalty in exchange for Oil Company's paying the expenses. If production is realized, the proceeds will be divided as follows:

Owner	Fraction	Decimal
A	1/3 x 1/8	0.0416666 RI
B	1/3 x 1/8	0.0416667 RI
C	1/3 x 1/8	0.0416667 RI
Lessee	7/8	0.8750000 WI
Total	8/8	1.0000000

Now assume C won't sign a lease.

Ohio Law
Under Ohio law, a tenant-in-common generally may transfer, devise, or encumber his interest in the property without the consent of his co-tenant. *Koster v. Bodreaux*, 11 Ohio App.3d 1, 5 (1982), citing 4 Thompson on Real Property,

Separate and Concurrent Ownership, Section 1793, at 136-137 (1979).

Ohio courts have not decided the more specific issue of whether one tenant-in-common may make a valid lease of his mineral rights without the consent of his cotenant, and courts in other states that have considered this issue have not ruled consistently. While some courts have held that one tenant-in-common may lease his oil rights without the consent of his cotenant, others have held to the contrary. Still other courts permit a tenant-in-common to exploit underground deposits, but require him to account to a cotenant for any profit that is realized.

Ohio law states generally that "[o]ne tenant-in-common … may recover from another tenant-in-common … his share of rents and profits received by such tenant-in-common … from the estate, according to the justice and equity of the case." Ohio Revised Code 5307.21. Ohio courts have not considered this requirement in the context of underground mineral rights. But, given this statute and since oil and gas resources are finite and transitory, Ohio courts may be receptive to the argument that one cotenant should be allowed to produce minerals from the property without the other cotenant's consent.

With that background, A, B, and Oil Company may elect to proceed without C, but such unilateral development is risky for Oil Company. In such a case, Oil Company becomes a tenant-in-common with C as to the rights granted by the lease, i.e., the right to explore for and produce the minerals. How are the proceeds divided? As there is no lease providing for a 1/8 royalty and an allocation of expenses for C, a possible outcome is:

Owner	Fraction	Decimal
A	1/3 x 1/8	0.0416667 RI
B	1/3 x 1/8	0.0416667 RI
C	1/3	0.3333333 MI
Lessee	2/3 x 7/8	0.5833333 WI
Total	8/8	1.0000000

Since C has benefitted from Oil Company's work and they are cotenants, absent any agreement, Oil Company may be able to deduct from C's share of the production C's share of the expenses. So, even though A and B may be able to lease and Oil Company can produce, Oil Company's interest in production from the well is merely 58.3% (as opposed to 87.5% if all three siblings agreed to lease).

Alternatives

Although Ohio case law offers no clear answers when one or more cotenants are holdouts, the Ohio Revised Code gives operators options.

I. Mandatory Pooling

If the minimum acreage needed to drill a well cannot be obtained voluntarily, the Ohio Revised Code provides for "mandatory pooling" — a procedure to force an uncooperative owner to participate in a drilling unit in certain situations. ORC § 1509.27. Mandatory pooling is process designed to protect correlative rights and to effectively develop the mineral resources.

The procedure also anticipates the situation where the recalcitrant cotenant of a mineral estate will not sign a lease. In such a case, the Mandatory Pooling Order

from ODNR would likely provide that mandatorily pooled parties are granted a pro rata share of production from the well and the standard 1/8th royalty interest upon production of the well. However, such an Order would also require the parties to share all reasonable costs and expenses of drilling and operating the well as follows:

- If the owner elects to participate (working interest owner), then the Mandatory Pooling Order must specify the basis upon which each owner of a tract pooled by the order shall share in these expenses.
- A non-participating owner will not receive any share of production, exclusive of his/her share of the royalty interest, until their share of such costs are recovered by the Oil Company, plus an additional risk penalty. The costs and penalty cannot exceed 200% of the non-participating owner's proportionate costs of the well for high financial risk and horizontal wells, or 150% for other wells. ORC § 1509.27.

Thus, continuing the hypothetical, if C becomes a non-participating owner, the allocation is:

Until costs and penalties are paid:

Owner	Fraction	Decimal
A	1/3 x 1/8	0.0416667 RI
B	1/3 x 1/8	0.0416667 RI
C	1/3 x 1/8	0.0416667 RI
C	1/3 x 7/8	0.2916666 WI*
Lessee	2/3 x 7/8	0.5833333 WI
Total	8/8	1.0000000

**Paid to working interest to recover costs and penalties.*

After costs and penalties are paid:

Owner	Fraction	Decimal
A	1/3 x 1/8	0.0416667 RI
B	1/3 x 1/8	0.0416667 RI
C	1/3	0.3333333 MI
Lessee	2/3 x 7/8	0.5833333 WI
Total	8/8	1.0000000

In this scenario, the Oil Company (and all other working interests) benefit from the penalty imposed upon the recalcitrant cotenant until the well has paid out but the Oil Company's interest in the production is still merely 58.3%.

The scenarios above assume that the entire unit is located on ABC property. However, if ABC property comprises only a small portion of the drilling unit, say 2 acres out of a 640 unit, the economics are far more favorable. In that situation, C's interest, even after cost and penalties are deducted, is 1/3 x 2/640 or 0.0010417 (0.104%). Even if it were 2 acres out of a 40-acre drilling unit, it would be 1.67%.

These figures illustrate the importance of strategizing to determine where to locate the well so as to minimize the recalcitrant's share or, the importance of striking a deal.

II. Partition

The age-old method of ending a cotenancy is partition, and in Ohio this remedy is provided for by statute. Ohio Revised Code section 5707.01 states: Tenants in common, survivorship tenants, and coparceners, of any estate in lands, tenements, or hereditaments within the state, may be compelled to make or suffer partition thereof as provided in sections 5307.01 to 5307.25 of the Revised Code.

The code sections that follow outline a procedure for filing a petition, obtaining an order of partition from the court of common pleas, the appointment of one to three commissioner(s) to make the partition, etc. If it cannot be partitioned "without loss of value," the commissioner establishes a value and one cotenant pays the other or there is a sale by the sheriff or at public auction.

In the context of Ohio shale resources, a Court would likely struggle with the speculative nature of the value of the mineral interests and whether physically dividing the property would devalue the property, especially when a recalcitrant owner would own one of the contiguous parcels. Given these problems, a court may very well order a sale of the property, which amounts to a roll of the dice for all owners. Instead of assuming this risk, all cotenants would probably be better off to negotiate a price and find a way to settle the dispute without a sale. Recognize, however, that emotions, distrust, and speculation about a possible bonanza always make settling partition actions difficult.

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When Is an Assignment of a Lease not an Assignment of Obligations?

February 26, 2013 | Porter Wright

When oil companies transfer oil property among themselves, they frequently do so by an assignment of lease rights. Sometimes they assign all their interest under a lease, but they often assign just a portion of the lease, or reserve some interest in the property. In the event of multiple assignments — such as when party A assigns to party B, who assigns to party C, and so on — there can be confusion about what was assigned, and who is obligated to do what.

This kind of controversy set the stage for the recent decision by the North Dakota Supreme Court captioned *Golden v. SM Energy Co.*, 2013 ND 17, Feb. 1, 2013. The *Golden* decision presents an interesting discussion about royalty payments, division orders and assigned obligations. Does this case portend what can happen in Ohio? Only for companies that do not learn from mistakes made in other states.

The Facts

Golden owned oil and gas leases covering property in McKenzie County, N.D. In 1970, Golden sold his "entire interest in the leases" to "B" "subject to my retention of four percent (4%) overriding royalty."

Golden also designated a "joint area of interest" ("JAI") in which the parties had further rights and obligations. Specifically, the parties agreed that if Golden purchased additional property in the JAI, he would sell it to B at cost, subject to a 4% overriding royalty. On the other hand, if B acquired additional property in the JAI, it

would assign a 4% overriding royalty to Golden at no cost. Finally, the agreement between Golden and B provided that, "any assignment of this Agreement made by [B] shall recite that same is made pursuant and subject to the terms and conditions of this Agreement."

B did, in fact, acquire new leases in the JAI and assigned the override to Golden. Then in 1993, B assigned its interest in the leases and lands covered by the 1970 agreement to C. The assignment included a provision that B was assigning "all right, title and interest of Assignor in and to … all operating agreements, joint venture agreements, partnership agreements, and other contracts, to the extent that they relate to any of the Assets." (emphasis added)

C also subsequently acquired additional leases in the JAI before assigning everything to D. The assignment from C to D provided that D "assumes all of Assignor's duties, liabilities and obligations relating to the Assets to which Assignor was a party or by which it was bound on and after the date hereof." D ultimately merged into Defendant, SM Energy ("SM").

All relevant documents in this case were duly recorded.

The dispute arose when, beginning in 2009, SM recognized and paid Golden's 4% overriding royalty on production from a well located in the JAI, but refused to pay the 4% overriding royalty for earlier periods. The overriding royalty was apparently erroneously overlooked by the parties before 2009. Making matters difficult for Golden, the royalty payments made by SM before 2009 were in conformance with division orders executed by Golden.

The Court's Analysis of the Assignments

Golden filed a declaratory judgment action to determine the parties' rights, to quiet title to interests in the land, and for an accounting.

SM argued the lower court erred in granting summary judgment in favor of Golden because, as a matter of law, neither SM nor its predecessors in interest assumed the JAI clause in the 1970 agreement. Specifically, SM argued that the AMI clause did not relate to properties B had previously acquired and assigned to C, but only to properties B might acquire in the future. On the other hand, Golden argued that the assignments leading to SM unambiguously established that SM assumed the AMI clause because the assignments were subject to the terms of "other contracts" that related to the conveyed leases.

The North Dakota Supreme Court began its analysis of the agreement by observing:

> The "joint area of interest" clause in the 1970 letter agreement is commonly referred to in the oil and gas industry as an area of mutual interest (AMI) agreement, which has been defined as an "agreement by which the parties attempt to describe a geographical area within which they agree to share certain additional leases or other interests acquired by any of them in the future." [Citation omitted] The parties in this case agree that the AMI clause is not a covenant that runs with the land, but is a personal covenant that is enforceable only between the original parties to the agreement.

After analyzing general hornbook law on assignments of contracts, the court noted that the same principles apply to AMI clauses:

> If an assignee takes an interest in oil and gas leases and the document of conveyance states that it is specifically subject to the terms of a contract wherein the area of mutual interest was created, and the assignee operates under the agreement or attempts to use or enforce the terms of that contract, it is submitted that the assignee has assumed the obligations of the area of mutual interest and it is enforceable against him. Whether or not these obligations were assumed by a party acquiring oil and gas leases subject to an area of mutual interest clause is a question of intent, and all the surrounding circumstances must be evaluated to determine that intent. [Citation omitted]

The Supreme Court concluded that the contested provisions of the 1993 assignment were ambiguous and that a trial would be necessary to discern the intent of the parties. In support of this holding, the court observed that one of

the hallmarks of an ambiguous contractual provision is that, as was the case in Golden, each opposing party was able to articulate a rational argument to support its position.

The court also held that even though the agreement between Golden and B was duly recorded and, therefore, gave C constructive notice of its terms, notice to B was not equivalent to an agreement by B to be bound by the terms of the agreement. Of course, if the agreement was deemed to run with the land, the court may have reached a different conclusion.

The Court's Analysis of the Overriding Royalty

With regard to the override, SM did not contest its obligation to pay Golden royalties on the disputed well, nor did SM deny that Golden was previously underpaid. Rather, SM argued, citing North Dakota precedent, that a well operator is not required to compensate a royalty owner for underpayments if the payments were based on division orders executed by the royalty owner.

The court disagreed and distinguished prior case law by noting that in previous cases the well operator paid out 100% of the proceeds from the well. In prior cases some payees were overpaid and others were underpaid but the well operator realized no benefit from the mistake and was not unjustly enriched, which is different than the present case wherein the operator would benefit from the error. The court instructed:

> "Generally, the underpaid royalty owners, however, have a remedy: they can recover from the overpaid royalty owners. … The basis for recovery is unjust enrichment. …
>
> [Prior case law] does not hold that a well operator is automatically insulated from liability for underpayment of royalties simply because the incorrect payments were made in accordance with an executed division order. * * * Here, it is undisputed that SM is the well operator that prepared the division order and SM is also the overpaid working interest owner. Because Golden was underpaid during the relevant time period and SM was overpaid, Golden has suffered harm and SM has been unjustly enriched by retaining the benefits of the erroneous division order and receiving the payments to which Golden was entitled."

The Supreme Court concluded that SM was unjustly enriched and owed Golden retroactive overriding royalty payments regardless of whether the erroneous payments were based on a division order signed by Golden.

Lessons Learned

1. Consider whether an obligation in a contract can be made to "run with the land" so as to obligate future owners who acquire an interest in the land.
2. Take care to make your contractual obligations and assignment provisions clear. A carefully drafted contract is still priceless.
3. Don't count on division orders to cure all payment errors.

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