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Oil and Gas Leases on Federal Lands

*ROSS L. MALONE, JR.

The State of Wyoming had its first discovery of oil in 1881, and by 1884 had bored—not drilled—fourteen producing wells. Its neighboring State of Montana experienced its first discovery of oil in commercial quantities in 1913, and by 1920, when the Cat Creek oil field was brought in, at least two-thirds of which is on federal lands, the oil industry was well developed. By comparison the first discovery of oil in commercial quantities in my native state of New Mexico did not occur until the year 1922.

The states of the west have a great deal in common in the importance of the public lands within their respective boundaries. It is true in New Mexico, as it is in Wyoming and Montana, that a very large amount of the production of oil and gas is from lands falling within the category of the public domain of the United States. In addition to the lands as to which fee simple title remains vested in the United States of America, the hundreds of thousands of acres of land which have been patented to private individuals by patents reserving title to the underlying minerals under the various applicable acts of Congress, contribute additional importance to the public domain and the oil and gas deposits which it contains.

At the outset I should delineate the scope of this paper. It will be limited to oil and gas leases issued by the United States of America embracing lands in the public domain, including underlying mineral deposits which have been reserved to the United States of America. I shall mention the subject of leases on acquired lands but my subject does not include Indian lands of any character. The subject of unitization is beyond the scope of this paper.

The records of the Department of the Interior indicate that today there are approximately 9,500 wells producing oil or gas in commercial quantities from deposits belonging to the United States of America which are administered by the Department of

the Interior as a part of the public domain. Production from these lands has increased to the point that it is a very considerable factor in our domestic production of petroleum. In addition to the lands theretofore administered by the Department of the Interior, Congress in 1947 placed under the jurisdiction of the Department of the Interior the so-called acquired lands, title to which had been acquired by the United States of America principally through the various governmental activities incidental to World War II. The Department of the Interior has administered the great majority of the lands in the United States of America insofar as the development, exploration and production of oil and gas is concerned since the passing of the so-called Mineral Leasing Act of 1920.² It is to that Act as amended by subsequent Acts of Congress, and to the regulations promulgated by the Secretary of the Interior under it, that we address our attention today in considering the subject of oil and gas leases on federal lands.

At the outset, it should be kept in mind that we are dealing here with leases issued by a federal government to its citizens. Particularly during the past two decades that government has evidenced an ever increasing sense of responsibility for the welfare of its citizens—political, economic and social. It is not surprising that this paternal interest of the sovereign is apparent in the oil and gas lease which it issues to its citizens and in the regulations which it promulgates governing such leases. Neither is it surprising that in an industry famous for its initiative and its rugged individualists this paternal interest is tolerated but not particularly appreciated.

It must be recognized that the lessee of the government will of necessity be dealing with government employees and that government employees in groups constitute bureaus and some of them personify bureaucrats. This somewhat undesirable aspect of federal lease ownership is in no ways minimized by the fact that the lessee of the government is also subject to the vicissitudes of congressional action. This is true even though in almost every instance congressional enactments have been more favorable to the industry than acceptable to the federal agencies charged with their administration.

It is true in New Mexico, and I have no doubt that operators in Wyoming and Montana may share the view, that of the three types of leases—private, state and federal—the federal lease is

¹Act of August 7, 1947 (Public Law 382 of 80th Congress), B.L.M. Circ. 1668 app'd 12-15-47.
third in terms of desirability and ease of operation and handling. Nonetheless, it must be said that even though operations under a federal oil and gas lease may be considered somewhat less desirable than operations under other types of leases, operators have been in no wise deterred from drilling and producing oil under leases issued by the Secretary of the Interior. Apparently the oil operator is looking for oil and if he thinks that it may be found at a particular location the identity of the lessor and any attendant irritations are of minor consequence so long as he can get the lease that he seeks.

The lease form now in use by the United States, the regulations under which the leases are issued and the rights of the lessee are the product of Congressional and administrative evolution since 1920. It is essential, therefore, before we consider the lease now issued by the United States that we examine the development of legislation under which private individuals have been permitted to acquire rights in oil and gas deposits belonging to the federal government.

**Legislative History**

Prior to 1920 persons desiring to obtain rights in potential oil deposits in the public domain proceeded under the so-called Placer Mining Law. There was no lease and no leasehold estate. The government had no control over the creation of rights in these lands by a private individual so long as they had the qualifications fixed by the Act. The proposed claimants merely staked their claim and recorded notice thereof in the appropriate county offices. The government was not notified of the existence of these claims until the claimant had made a discovery, had done the necessary development work, and wished to secure a patent for the land including the underlying mineral deposit from which his discovery had been made. He then paid the government $2.50 per acre if and when the patent was issued and received title to the land embraced in his location notice. The patent issued on the basis of such a discovery was not limited to the underlying minerals but vested a fee simple title in the patentee.

About 1910, because of the unsatisfactory operation of the Placer Mining Act as applied to oil and gas, numerous lands potentially valuable for oil and gas and related minerals were withdrawn from entry by the Department of the Interior which recommended to Congress that legislation be enacted to make possible the leasing and orderly development of deposits of coal,
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oil, gas, phosphate, potash and oil shale belonging to the federal government*. 

The Mineral Leasing Act of 1920 resulted and was the first legislation authorizing the leasing of lands of the United States of America for oil and gas development. This Act has been amended, modified and extended by Congress a number of times but it remains the basic authority for the issuance of oil and gas lease upon deposits in the public domain.

The 1920 Act however did not provide for the issuance of oil and gas leases as we now know them. It provided for the issuance of oil and gas prospecting permits embracing not to exceed 2,560 acres of land in a reasonably compact form. It was required that the lands be in approximately a square or rectangular tract, the length of which could not in any event exceed two and one-half times its width.º

The basic distinction between lands upon a known geological structure of a producing field and lands the petroleum content of which was problematical first appeared in this Act. It has been included in all subsequent legislation as a matter of basic policy. The Act of February 25, 1920 made provision for the sale by competitive bidding of leases not exceeding 640 acres each upon lands within known geologic structures of producing oil and gas fields.² With very minor changes this provision of the law has continued in effect since the original enactment of the leasing act of 1920. As to other lands, then as now, the first qualified applicant was awarded the permit.

The qualifications required of an applicant for an oil and gas prospecting permit under the original 1920 act³ were substantially identical with the qualifications required today of an applicant for a noncompetitive lease upon federal land.⁴ He must have been a citizen by birth or naturalization. He was required to show that he was qualified within the acreage limitations in that he was not the holder of more than two other subsisting permits in the state in which the application was filed nor of any other permit upon the same geologic structure.⁵

Under the terms of the permit the permittee was granted the right for a period of two years to explore for valuable deposits

²Act of February 25, 1920, supra, Sec. 13.
³Ibid. Sec. 17.
⁴Ibid. Sec. 13.
⁵43 C.F.R. 192.42.
⁶Act of February 25, 1920, supra, Sec. 13 et seq.
of oil and gas on the lands embraced in the permit. He was re-
quired to spud a well within six months from issuance of the
permit, to drill it to a depth of 500 feet within one year, and an
aggregate of not less than 2,000 feet within two years of the date
of the permit unless production was obtained at a lesser depth.\textsuperscript{10}
The Secretary of the Interior, however, was authorized to grant
extensions of time if he should find that the permittee with the
exercise of due diligence had been unable to drill as required.\textsuperscript{11}
Such extensions were generally granted upon request and on
conditions that varied from time to time until Congress in the
1935 amendment yielded to pressure from operators and granted
a blanket two year extension of all permits in good standing to
December 31, 1937.\textsuperscript{12}

If, during the life of the permit, the permittee or persons
claiming under him discovered valuable deposits of oil or gas he
was entitled to apply for and receive a lease from the United
States of America embracing one-fourth of the area covered by
the permit with a minimum of 160 acres. The royalty payable
to the United States on production under this lease was to be
five per cent.\textsuperscript{13} The lease was issued for a primary term of twenty
years with successive rights of renewal of ten years each. This
lease was generally referred to as the "A" lease or "preferred"
lease because of the more favorable royalty rate which it carried.
The permittee, as a further reward for his discovery, was
given the preference right to apply for and receive a lease on the
remaining three-fourths of the land embraced in the permit at a
royalty to the United States on a sliding scale basis ranging from
12\(\frac{1}{2}\)\% to 33\(\frac{1}{3}\)\% of production, depending upon the average
daily production of the wells for each calendar month and the
gravity of the oil produced.\textsuperscript{14} This lease was generally known as
the "B" lease or "secondary" lease.

The 5\% royalty provision of the "A" lease was and is, sub-
stantially less than the royalty payable under private leases with
which we are familiar today. In exploring the background for
this royalty rate I learned that the United States Geological Sur-
vey was charged with making recommendations as to the royalty
rate which should be included in the 1920 Leasing Act. A na-
tionwide survey of royalty rates in the oil and gas industry was
made and available information indicated that the average royal-

\textsuperscript{10}\textit{Ibid.}
\textsuperscript{11}\textit{Ibid.}
\textsuperscript{12}\textit{Act of August 21, 1935.}
\textsuperscript{13}\textit{Act of February 25, 1920, Sec. 14.}
\textsuperscript{14}\textit{Ibid.}
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ty then being paid by lease operators was approximately 16\%\%.
It was felt, however, that development of the oil and gas deposits
of the public domain had fallen behind and it was intended that
the 5\% royalty rate included in the leasing act should provide
some inducement to oil operators to explore for, and develop,
oil deposits on the public domain.

It is interesting to note that acreage limitations, one of the
principal characteristics of federal leases throughout the history
of such leases, were included in the original leasing act of 1920. It
Changes have been made, however, in the amount of acreage that
a single individual was permitted to hold under federal lease on
the public domain. Section 27 of the Act of 1920 limited each
person, association or corporation to the ownership of not more
than three oil or gas leases in any one state and not more than
one lease within the geological structure of the same producing
oil or gas field. This act, however, contained no limitation in
terms of the number of acres. Under its provision on lessee or
permittee who owned three permits or leases each embracing only
160 acres would be limited to a total of 480 acres in a given state
whereas another permittee whose permits each embraced the full
four sections or 2,560 acres of land which might be included in
such a permit would have a total of 7,680 acres within a given
state.

The penalty for violation of this provision which was in-
cluded in original Section 27 of the leasing act was couched in
much stronger language than the comparable provision of Section
27 as it exists today after several amendments. Under the pro-
vision as it was originally written, the act provided: "Any inter-
ests held in violation of this act shall be forfeited to the United
States by appropriate proceedings instituted by the Attorney
General for that purpose in the United States District Court for
the district in which the property or some part thereof is lo-
cated. * * *")

The foregoing provision may be compared to the present pro-
vision of Section 27 which is as follows: "If any interest in any
lease is owned or controlled directly or indirectly, by means of
stock or otherwise, in violation of any of the provisions of this
act, the lease may be cancelled or the interest so owned may be
forfeited or the person owning or controlling the interest may be
compelled to dispose of the interest in any appropriate proceed-
ing instituted by the Attorney General."

Two changes in the congressional policy governing excess

15Ibid. Sec. 27.
16Act of August 8, 1946, Sec. 6.
acreage are immediately apparent from a comparison of these two statutes. The first is that in the 1920 act the provision for forfeiture by suit was mandatory, the provision being that any interest so held in violation "shall be forfeited to the United States by appropriate proceedings." The present forfeiture provision is permissive, "may be forfeited," and the further alternative is provided that the person so holding the interest in violation "may be compelled to dispose of the interest" not, necessarily, to forfeit it to the United States.

In spite of these changes, which may or may not be of major significance, it is apparent that from the original enactment of the 1920 Mineral Leasing Act down to the present, it has been the policy of Congress to prevent monopoly by limiting the numbers of acres of federal leases which may be held or controlled by a single individual or company.

The first amendment to the 1920 leasing act occurred in 1926 when the acreage limitation was changed in terms from permits to acres." Thereafter each individual was limited to a maximum of 7,560 acres in each state and 2,560 acres on a structure.

In administering limitations on acreage under the 1926 amendment, the Department of the Interior had held that an oil and gas prospecting permit created no vested rights and therefore an operating agreement embracing the rights under a permit did not constitute an interest in federal acreage chargeable against the acreage limitation provisions of the act. The practice then became widespread of taking operating agreements from permittees preparatory to exploration on the public domain, rather than assignments of the permit. Thus operators were enabled to control large blocks of acreage which, though contrary to the spirit of the Congressional Act, was far more realistic from the point of view of an active operator.

The customary operating agreement sublet all rights of the permittee to the operator and in case of discovery normally provided that the permittee should receive an overriding royalty of 7½% of production from the land which thereafter should be embraced in the "preferred" or "A" lease on which the royalty to the government would be 5%. In some instances provision was also made for an overriding royalty less than that allowed on the "A" lease to be applicable to the "B" acreage. Such overrides were out of the ordinary in New Mexico, however.

After a discovery, application for a lease was made in the name of the permittee or the record owner of the permit; royalty

12 Act of April 30, 1926.
13 In re: Producers and Refiners Corporation, 54 L.D. 371.
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accrued at an increased rate after discovery until lease applications were filed. On issuance of the leases the operator who had made the discovery either continued his operations under the provisions of the operating agreement or took an assignment of the lease from the lessee with appropriate reservations of the overriding royalty provided for by the operating agreement.

These discovery leases were issued for a term of twenty years with the right to successive renewals for periods of ten years each, "upon such reasonable terms and conditions as may be prescribed by the lessor unless otherwise provided by law at the time of the expiration of such periods." Such "reasonable terms" have never included a continuation of the five per cent royalty to the government on renewal of an "A" lease. The minimum royalty in all such renewal leases has always been 12\(\frac{1}{2}\)%.

The significance of these renewal provisions has become quite apparent to New Mexico operators within the past few years. Discovery leases issued in the years immediately following the first production of oil in Lea County in 1926 have come up for renewal during the years since 1946. The operator who had been paying a royalty of 5% to the United States and 7\(\frac{1}{2}\)% as an overriding royalty or a total of 12\(\frac{1}{2}\)% royalty on production from the lands in an "A" lease found himself faced with an increase of at least 7\(\frac{1}{2}\)%. He would be required to pay a minimum of 20% royalty on production which accrued on his renewal ten year lease. Frequently this additional royalty burden became payable at a time when production under the lease was beginning to decline and the royalty burden was a substantial factor in his operations.

The lease owner applying for a renewal encounters further trouble under present regulations providing that no renewal lease will be issued by the Director of the Bureau of Land Management if he concludes that the existing overriding royalty and oil payments in excess of 5% constitute a burden prejudicial to the United States. The Director so concludes in all cases unless there is an agreement with the overriding royalty holder that the total of such payments will be scaled down to 5% when the average daily production of the wells on the lease is 15 barrels of oil or 500,000 cubic feet of gas or less.

No such limitation was in contemplation when these twenty year old overriding royalties were created and no provision was made in operating agreements or assignments for scaling down

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19Act of February 25, 1920, Sec. 17.
20Act of August 8, 1946, Sec. 4. 43 C.F.R. 192.61.
2143 C.F.R. 192.62.

https://scholarship.law.umt.edu/mlr/vol14/iss1/2
the overrides. The lessee seeking renewal thus finds himself today at the mercy of the overriding royalty owner. His only weapon in seeking to reach an agreement with his overriding royalty owner is the fact that unless they agree to an appropriate modification of their royalty, the interest of both the lessee and the royalty owners alike will be destroyed by the refusal of the government to issue a renewal lease at all. Some operators have experienced substantial difficulty in dealing with overriding royalty owners in this situation.

An interesting and often disregarded sidelight of these ten year renewals of twenty year discovery leases is that the right to renewal is not dependent upon continued production. Even though production has been exhausted the lessee is titled to a ten year renewal lease. This provision may well make it inadvisable to exchange such a lease for a five year, and as long thereafter, lease as authorized by the act of August 8, 1946.

Let us now return to the oil and gas prospecting permittee who had obtained no production under his permit. If he had met certain minimum requirements as to expenditures on the lease, and in some instances if he had submitted for approval unit agreements embracing his acreage, the permit had been extended first by the Secretary of the Interior and thereafter by acts of Congress to December 31, 1937. The Act of Congress of August 21, 1935 which was the first major amendment of the Mineral Leasing Act of 1920, authorized the issuance of so-called "exchange leases" embracing the land in prospecting permits which were in good standing and under which production had not been obtained. The leases authorized were for a primary term of five years and as long thereafter as oil or gas is produced in paying quantities. They provided for payment of a sliding scale royalty to the United States of America ranging from 12½% to 32% determined by the average daily production and gravity. This act provided that under no circumstances should any oil or gas prospecting permit be extended after December 31, 1938. The permittee thus had to take advantage of the right to convert to an exchange lease or he lost all rights in the lands embraced in his permit.

Companies holding operating agreements on permits were immediately faced with the problem of continuing their operating rights to include the exchange lease. The operating agreement had been taken at a time when federal legislation did not contemplate a lease other than on the basis of production obtained

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*Act of August 21, 1935 (49 Stat. 674, 30 U.S.C. 221).*
under the permit. It provided for an overriding royalty of 7½% upon the acreage included in a subsequent lease which carried a 5% royalty to the United States. The royalty specified by the exchange lease was a minimum of 12½% upon all of the land. Thus, it was immediately apparent that the express terms of the operating agreement could not be applied to the exchange lease. The question was then presented whether or not the owner of the exchange lease was bound by the operating agreement at all insofar as his exchange lease was concerned. The fact that the provision for overriding royalties could not be applied to the exchange lease without modification required a supplemental agreement between the lessee and the operator. Such agreements soon became commonplace.

In most instances, the operator considered a 7½% overriding royalty in addition to the sliding scale royalty specified by the exchange lease to be burdensome and he approached the lessee with a proposal that he “spread the override” over the entire four sections included in the lease. Many hours were spent by company representatives in an effort to convince permittees that they would be as well or better off with a 1¼% or 2% overriding royalty on all four sections as they would have been with a 7½% override on one section. Frequently the lessee replied that “whoever heard of all four sections of a federal lease producing—I had rather have a larger override on the good part of the lease.” Obviously, prior to production, it was not possible to determine what part of the lease fell in that category and the matter was usually compromised at a 2% to 2½% override on the entire leased acreage.

By 1942 the exchange leases on which no production had been obtained were beginning to expire. The country was at war; steel pipe was practically unobtainable. Congress gave a new lease on life to the holders of nonproducing leases by the Act of July 29, 1942. It provided, in effect, that the record title holder of any non-competitive lease issued under the 1935 act should have a preference right to a new lease embracing the same land which might be exercised by making application therefor at any time within the last ninety days of an existing lease which was in good standing. This lease was referred to generally as a “preference right lease.” It was for a primary term of five years and as long thereafter as oil or gas might be produced. In accordance with the established policy as to the issuance of leases upon a known geologic structure of a producing oil or gas field, the act

*56 Stat. 726 (1942), 30 U.S.C. 226 b (1940).*
provided that no such preference right lease should be issued as to lands so situated at the time of the expiration of the previous lease.

The provisions of the act of July 29, 1942 authorizing preference right leases were carried forward into the amendment of August 8, 1946 as to all leases issued prior to the effective date of that act. The last opportunity to obtain preference right leases was vested in owners of noncompetitive leases which expired on August 7, 1951. Thus, preference right leases are fast becoming of only historical significance.

The Bureau of Land Management held in a rather recent decision that in order to be entitled to a preference right lease, the pre-existing lease must have been in good standing at the time of its expiration and that a lease on which the fifth year rentals had not been paid was not in good standing. Presumably the same rule would be applied to the five year extension authorized under the act of August 8, 1946. It is then incumbent upon a lease owner seeking a five year extension to be certain that all rentals are paid prior to the time his application is filed.

The amendment to the leasing act which became effective on December 24, 1942, should be noted in passing as it presented a nice Christmas present to operators. It reduced the royalties payable to the United States under certain circumstances. The act provided that any lessee who, during the period of the national emergency proclaimed in 1941, should make a discovery of a new oil or gas field or deposit would pay a flat royalty of 12 1/2% for the next succeeding ten years on all lands in the lease on which the discovery was made. This royalty rate was in lieu of the graduated royalty based on production which was specified by existing leases. It was the first step toward the establishment of a flat 12 1/2% lease royalty on federal leases comparable to the basic royalty normally paid on a fee lease.

The Amendment of August 8, 1946

The latest amendment to the mineral leasing act became effective on August 8, 1946. It made the most extensive changes in the leasing act since its original adoption. The 1946 amendment was brought about primarily by agitation in the industry which resulted from two causes. The first was the desire of operators to reduce the royalties to the government to a flat 12 1/2% conforming to the royalty rate usually payable to fee and state
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lessors. The second cause was the decision of the Department of the Interior in the year 1938 that operating agreements executed by lessees of the United States would be considered as direct acreage holdings of the operators chargeable against his acreage limitation just as if he were the record owner of the lease. Thus, all operating agreements held by companies and individuals became chargeable against the 7,680 acres permitted to be held by an operator in a single state.

This decision was an apparent reversal of the departmental policy of many years standing. Inasmuch as the average lease embraced 2,560 acres, the maximum of three leases permitted in any one state was wholly inadequate to meet the requirements of an active operator. While the apparent intention of Congress to prevent control of large areas of the public domain by a single company or individual had been largely frustrated by the former policy as to operating agreements, it had been governmental policy for a number of years. The 1938 decision had many and immediate repercussions.

One effect of this decision was to curtail interest in federal leases on the part of operators where other acreage was available. But oil still remained to be found under federal lands and the ingenuity of the legal profession in behalf of its clients produced the plan of taking options from oil and gas lessees upon federal lands, rather than assignments or operating agreements. The theory was that an option to acquire an oil and gas lease, during the term of which an opportunity was afforded to conduct geophysical and geological exploration upon the lands, was not an interest in real estate. It therefore was thought that it would not be charged against the optionee as acreage in determining his holdings under the leasing act.

No official expression from the Department of the Interior on this question was forthcoming but it was thought that the options would not be chargeable prior to exercise if they did not extend for a major portion of the life of the lease. Reports were heard from time to time, however, that certain officials in the Department were of the opinion that options should be charged just as operating agreements and interests of lessees were charged in computing the acreage held under the act. Such reports were disturbing as many operators held options on thousands of acres of federal land embraced in existing leases and lease applications in public land states. Millions of dollars have been invested in such options which generally granted the operator the right to

\textsuperscript{20}Decision of Com'\textsuperscript{r}. G.L.O. in case of Leroy H. Hines, April 19, 1938.
go upon the land, to conduct geological and geophysical exploration, and on exercise of the option to acquire by assignment the title to the lease. Usually provision was made for the payment of an additional cash consideration and the reservation of an overriding royalty in the event that an assignment was taken in exercise of the option.

In hearings conducted by the Committee on Public Lands and Surveys of the Senate and of the House of Representatives, the industry sought to liberalize the acreage limitations and to reduce the government royalty to a flat 1/8th. These proposals had the general support of the industry but did not have the approval of some of the officials of the Department of the Interior. Other modifications of the leasing act were sought by the industry, particularly a provision which would alleviate the royalty problems, which I discussed earlier, which arose when the owner of a twenty year discovery lease applied for a renewal. In this latter respect the industry was unsuccessful but the provisions which were incorporated in the act of August 8, 1946 substantially liberalized the provisions of the Mineral Leasing Act.

The acreage limitation was increased to 15,360 acres, amounting to four full leases in any state and the 2,560 acre limitation upon a geologic structure was entirely abolished. The efforts of the industry to obtain recognition and approval of the option practice which had grown up were partially successful. The 1946 act authorizes a single individual or corporation to own 100,000 acres of nonrenewable two year options within a state in addition to the direct holding of 15,360 acres authorized by the act. The effect of the 1946 act as implemented by the regulations promulgated thereunder is that "acreage held under a nonrenewable option valid only for two years or such longer period as may be authorized by the Secretary, for the purpose of geological or geophysical exploration, shall not be chargeable under the acreage limitation section but no individual may hold options at any one time for more than 100,000 acres in any one state." At the time it was thought that this liberalization of the acreage limitation provisions of the act was as much as could be hoped for. However, in a conversation in Washington about two weeks ago with an attorney who devotes most of his time to practicing before the Bureau of Land Management, he advised me that had the industry sought to do so, it was his opinion that the Department...
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of the Interior would not have actively opposed a complete elimination of the acreage limitation provisions of the act. Whether or not that would have been the case, I do not know. Neither can we say that even if the Department of the Interior had consented to the elimination of acreage limitations, Congress would have consented to such limitations being eliminated.

The other principal liberalization which was accomplished in the 1946 act was with reference to royalty rates on federal leases. As I have stated earlier, there has been an almost continuous effort on the part of operators to have the royalty rate on federal leases scaled down to the usual 1/8th which is provided for in most fee and state leases. The 1946 act provides that the royalty to the United States on all noncompetitive leases issued under the act in the future will be 12 1/2%. It further provides as to existing leases, other than competitive leases, that a royalty of 12 1/2% will be payable to the United States on all production:

(a) From lands determined by the Director of the United States Geological Survey not to have been within the productive limits of any oil or gas deposit on August 8, 1946, and,

(b) On oil or gas deposits discovered after May 27, 1941 which are determined by the Director of the Geological Survey to be new deposits, and,

(c) Similarly as to new deposits discovered under unit agreements embracing such lease.

An interesting effect of this provision was demonstrated recently in a case in Eddy County, New Mexico, where old "A" leases embraced in a unit agreement which had been producing from shallow formations for twenty or thirty years were to be explored for deeper formations. The question was presented as to the royalty rate that would be applicable as to new production which might be obtained from the deeper horizons. Would it be the five per cent royalty specified in the existing leases, which was being paid on the shallow production or would it be the 12 1/2% rate specified by the 1946 act as to all new discoveries? It was the opinion of the Supervisor of the Geological Survey at Roswell that the government would give the operators the benefit of the lowest royalty rate possibly applicable to these leases and that any such new discoveries would pay royalty to the government on the basis of 5%.

A new provision of the 1946 amendment entitled the holder

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^a^ Act of August 8, 1946, supra, Sec. 12.

^b^ Act of August 8, 1946, supra, Sec. 3.
of a noncompetitive lease issued thereafter, the primary term of which was expiring, to a single extension of the lease for an additional five-year period and as long thereafter as oil or gas is produced in paying quantities. The provision applies only to lands not on a known geologic structure at the time of the expiration of the lease. To obtain the benefit of this provision, holders of leases in effect when the act was passed were required to file an election to have their leases governed by the provisions of the 1946 act. Most lease owners, however, whose leases were in effect at the time the 1946 act was passed, elected not to come under the provisions of the 1946 act inasmuch as they had a right to a five year preference right lease which was originally provided for under the 1942 act. This preference right lease in turn having been issued after the 1946 act would be entitled to the five year extension provided for in the act. Thus, the lease owner could obtain two five year extensions by not electing to come under the act.

Interest in this situation is only academic now inasmuch as the last date on which an expiring lease owner was entitled to apply for and receive a preference right lease was August 7, 1951. At the present time the holder of a noncompetitive lease expiring by reason of nonproduction is entitled only to the five year extension provided for in the 1946 act.

In order to obtain the five year extension, the lessee is required to file an application therefor within ninety days preceding the termination date of his lease. It has been held that an application filed more than ninety days prior to the termination of the lease is premature and ineffectual. It has likewise been held that a failure to file such an application until after expiration of the ninety day period is fatal to the right of the lessee, regardless of what excuse he may offer for not having filed the application until after the expiration of his lease. In years past the Bureau of Land Management has been inclined to recognize equities and not to stand strictly on the wording of its regulations in instances where the facts seemed to justify an exception. Under the new statute and regulations, however, the Bureau has uniformly held that it is without power to extend a lease where the application for the extension was filed subsequent to the expiration date of the primary term of the lease. I referred earlier to the fact that the lease must be in good standing in all respects at the time the application is filed.

43 C.F.R. 192.130.
43 C.F.R. 192.120.
5B.L.M. Decision of November 9, 1949 in re Julia R. Keinath, Las Cruces Serial No. 069472.
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No extension will be granted as to lands which, on the expiration date of the lease, are within the limits of a known geologic structure of a producing oil or gas field. Neither is an extension authorized as to lands which have been withdrawn from leasing during the primary term of the existing lease.

Where only a part of the lands in an expiring lease has been determined by the United States Geological Survey to be within a known geologic structure of a producing oil or gas field, the lessee is entitled to the five year extension as to the lands not within the boundaries of such structure. As to the lands which are on structure, all rights will terminate on the expiration date of the lease unless a well is drilling on some portion of the land included upon the structure on that date. If the lessee has a well in process of drilling on the expiration date, the primary term of the lease will continue in effect for a period of two years from the normal expiration date while drilling operations are diligently being prosecuted and upon discovery for so long thereafter as oil or gas is produced in paying quantities.

The situation just mentioned is the only one in which the federal oil and gas lease becomes a "commence form" lease. Under all other conditions the lease terminates in the absence of production during the primary term.

In granting the five year extension provided for by the act, the Bureau of Land Management does not issue to the lessee a new lease as was the case with preference right leases. The extension is recognized by a letter or decision of the Bureau to the lessee and by an appropriate notation on the serial record of the lease but no further action is taken by the Department.

After enactment of the 1946 amendment, the Bureau of Land Management completely revised its rules and regulations relating to oil and gas leases. The new regulations were originally effective October 28, 1946 as revised Title 43 of the Code of Federal Regulations, Parts 191 and 192. These regulations with the modifications made since that date govern the issuance of oil and gas leases on federal lands and the rights of lessees at the present time. Regulations governing operations under federal leases are found in Title 30, Part 221 of the Code of Federal Regulations.

Land Office Practice

In the post-war reorganization of the Department of the Interior, the Bureau of Land Management was charged with the responsibility for the issuance and administration of leases on fed-

43 C.F.R. 192.120, et seq.
Ibid.
eral lands. Operations under such leases are under the supervision of the United States Geological Survey. The Manager of each District Land and Survey Office is authorized to issue and sign oil and gas leases on behalf of the government as well as to approve assignments of oil and gas leases. All instruments filed in connection with the leases themselves are filed in the district office having jurisdiction of the land in question.

Prior to January 28, 1951 an informal application for an oil and gas lease on federal lands was authorized. On January 28, 1951 new regulations became effective providing for an "Offer to Lease" which constituted both an application for the lease on the part of the applicant and the lease itself when signed by the Bureau of Land Management. Under the present regulations, it is mandatory to use this form, which may be obtained from the District Land Office, or an identical facsimile thereof.

The application must be filed in quintuplicate in the District Land Office, or in states where no District Land Office exists, in the Bureau of Land Management in Washington. Detailed instructions for completing the application are appended to the form. There is no occasion to restate them here. When completed the offer to lease will contain the name and address of the applicant, his citizenship, a description of the land applied for, a statement of the amount of filing fee and of the first year's rental transmitted therewith. It will also contain a statement that the applicant's other interest, direct and indirect in oil and gas leases and applications in the same date, do not exceed 15,360 chargeable acres.

A corporate applicant must meet additional requirements which are clearly set out in the regulations.

At the time of the filing of the Offer to Lease, which may be by mail or "over the counter" in the District Office, the filing fee of $10.00, plus the entire first year rental of 50¢ per acre, must be paid. Rentals for the second and third year are waived at present but there are two bills pending in Congress which would terminate this waiver. Rentals for the fourth and fifth lease years are 25¢ per acre. For the sixth and subsequent years the rentals increase to 50¢ per acre. After production is obtained, or the lands are included within a known structure by the U.S.G.S., rentals, or a minimum royalty of $1.00 per acre per year are payable.

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43 C.F.R. 192.42, et seq.
43 C.F.R. 192.42 (f).
43 C.F.R. 192.80.

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For many years it was only necessary to pay the filing fee at the time of the filing of the application. Payment of the rentals for the first year was not required until issuance of the lease. Applicants took advantage of this delay in many cases by including in their application lands already subject to an application or lease with the result that an "overlap" occurred. In such instances it was the practice of the Department not to adjudicate the right of the applicant to a lease until the conflict had been adjudicated. The result was that applications remained pending for three, five and even more years during all of which time the applicant had the land tied up but had invested only a $10.00 filing fee. This obvious abuse has been eliminated by the present practice under which, if any portion of the land applied for is in conflict with another application, the lease is issued immediately as to the land not in conflict and a supplemental lease or amendment is issued as to the remaining land when, as and if the conflicting interests have been adjudicated. 2

The issuance of leases has been very materially expedited under the new system and it is now possible to apply for and receive a lease on federal lands in a matter of days, an unheard of situation under the former practice.

All assignments of interest in a federal oil and gas lease, whether of the record title of an interest therein, or an operating agreement, royalty interest, sublease, or other type interest, must be filed for approval within ninety days from the date of final execution and must contain all of the terms and conditions agreed upon by the parties, together with a statement over the transferee's signature with respect to his citizenship and interests held similar to that required of an applicant for a noncompetitive lease. 3 The assignment, together with the application for its approval on the part of the assignee, operator, sublessee or other transferee, must be filed in the District Land Office, if such an office is maintained in the district in question. If not filed within ninety days of the date of execution or, in case of an escrow, if properly substantiated, within ninety days of the delivery out of escrow, the instrument will not be approved. A filing fee of $10.00 must accompany each assignment and application for approval. The assignment, if it is of an interest in the record title to the lease, must be filed in triplicate, each copy being executed as an original. 4 If the assignment is of an overriding royalty interest only, a single copy may be filed. Assignments of a 1%
overriding royalty or less will be approved only upon a specific request and then only after a discovery on the lease out of which the assignment is made. The regulations provide that any assignment of 1%, or less, overriding royalty, if filed of record, will be deemed to be valid, whether formally approved or not.¹⁴

Last year the Bureau of Land Management promulgated a suggested form for use in assigning the title to an oil and gas lease. The use of this form is not required. It has not gained general favor in New Mexico because of several respects in which it is deficient. In the first place, the form does not indicate the marital status of the assignor which is necessary in a title examination in New Mexico. The form is unsatisfactory for a further reason which came to my attention recently. On one line of the very brief assignment form, a blank is left to indicate the interest of the assignor in the described land. The following line is "extent of such interest conveyed to assignee." In a recent case assignments were valueless and had to be re-executed because of the fact that the assignor owned a one-half interest in the lease and was assigning a one-fourth interest in the lease; however, when he filled out the second blank with the fraction "one-fourth," it had the effect of transferring one-fourth of the one-half and not one-fourth of the whole. The typewritten assignment of a federal oil and gas lease or interest therein, or of an overriding royalty out of such a lease, which was in use prior to the promulgation of these suggested forms, is still in general use in New Mexico and we consider them to be preferable to the forms suggested by the bureau.

Each assignment out of an existing lease creates, in effect, a new lease composed of the acreage so assigned.¹⁵ The assignment, when approved, will be given a new serial number and a new serial record in the name of the assignee will be set up in the records of the District Land and Survey Office. With one or two minor exceptions, this tract in all respects is treated as a separate lease, unrelated to the basic lease out of which it is assigned. The first of the exceptions to which I refer occurs in the event that production is obtained from lands included in the basic lease after such an assignment has been made. In that case, the lease on the assigned tract will remain in effect for the remainder of the primary term of the basic lease or for two years after the discovery on the basic lease, whichever is longer.¹⁶

¹⁴ 43 C.F.R. 192.145.
¹⁵ 43 C.F.R. 192.141 (2)
¹⁶ 43 C.F.R. 192.143.
A second exception to this complete divorcement occurs when an assignment of acreage is made out of a lease which is being held by production in its extended term. In that case, the lease on the assigned tract remains in effect for a period of two years from the date of the assignment and then terminates unless in the meantime production has been obtained on some portion of the assigned tracts.

For many years the federal government took no interest in the overriding royalty or oil payment that might be reserved between the parties in the assignment of a federal lease or under the terms of an operating agreement upon such a lease. In 1942, however, the regulations were amended to provide: "No assignment of any kind will be recognized as valid which, exclusive of the royalty payable to the United States, shall create overriding royalty interests in the lease aggregating in excess of 5%. Furthermore, no assignments providing for other payments out of production which constitute a burden upon lease operations, prejudicial to the interest of the United States, will be approved."  

The regulations were amended likewise to require the filing of assignments, operating agreements, and other instruments affecting the title to a federal lease, within ninety days from the date of their execution, upon penalty that the instrument would not be approved if not so filed. The two provisions created consternation in the industry and many protests were registered in Washington. As a result of numerous conferences between representatives of the industry and representatives of the Department of the Interior, the provision was subsequently modified so that there would be no limit upon the overriding royalty so long as the average daily production of the wells on any lease, or on any separate zone thereof, is in excess of fifteen barrels of oil per day. In the event that such average production falls below fifteen barrels per day, it is required that the overriding royalty in excess of 5% be suspended. Approximately three years ago the regulations were amended to add gas and to make a similar provision applicable to gas wells from which the production dropped below 500,000 cubic feet of gas per well per day. It is now required that this so-called suspension provision be incorporated in all assignments and operating agreements which reserve an overriding royalty in excess of 5%.

43 C.F.R. 192.144(b).
43 C.F.R. 192.141(a), (1) and (2).
43 C.F.R. 192.83.

-43 C.F.R. 192.141(a), (1) and (2).
I pointed out earlier that the first qualified applicant is entitled to receive the noncompetitive lease applied for. In some instances two or more persons may file simultaneously for a particular lease and in that case the regulations of the Bureau of Land Management provide for a drawing to determine the successful applicant. Under the existing regulations, simultaneous filings are defined as two filings for the same lease received in the same mail or received simultaneously over the counter in the land office. Applications filed prior to the availability of the land for leasing are ineffective. A particular tract of land becomes open for leasing at the time the cancellation or termination of the prior lease is noted in the tract book in the District Land Office. For that reason the filing of simultaneous applications is the rule rather than the exception. The drawings which result in the case of simultaneous filings have attracted wide attention. That is particularly true of the drawing which occurred in Santa Fe, New Mexico, in November of 1951 in which there were in excess of 28,000 simultaneous applicants for 87 tracts in Lea and Eddy Counties, New Mexico.

These tracts had been withdrawn from leasing for a great many years because of the fact that they were within an area in which potash deposits existed and it was thought that development of the two would be incompatible. When the determination was made that the leases would be offered it was anticipated that a large number of applications would be received. The order of the Secretary of the Interior provided that all applications filed during the period from October 16, 1951 to November 16, 1951 would be considered as simultaneous filings and would be entitled to participate in the drawing. No applicant was permitted to apply for in excess of 15,360 acres in the drawing on the theory that he might be drawn number one on each lease he applied for and hence might receive leases in excess of the acreage permitted for one individual in a single state. The applicant was required to accompany his application by two checks, one for $10.00 to cover the filing fee on each application, and another to cover the first year's rental in the sum of 50¢ per acre for each acre applied for. When the land office was so deluged with applications, it was decided that checks for advance rental would not be cashed except the checks of the person who was the successful applicant.

543 C.F.R. 191.10.
543 C.F.R. 192.43.
"Secretary of the Interior, Order of October 16, 1951. F.R. Doc. 51-12547; filed October 18, 1951."
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Thus, each person participating in the government sponsored lottery took a chance on a lease for the sum of $10.00.

In one instance, which came to my attention, the successful applicant sold his lease for a cash payment of $50,000.00, plus a 5% overriding royalty within two weeks after the drawing. In this situation there was a $50,000.00 return on a $510.00 investment. The lottery attracted nationwide attention and was criticized by Drew Pearson and other columnists. Senator Clinton P. Anderson introduced amendatory legislation in Congress to prevent the holding of such lotteries in the future. The same legislation would eliminate the suspension of rentals during the second and third lease years of federal leases. To date I believe that it has not gotten out of committee in the Senate.

Another lottery in which 830 applications were filed was held in New Mexico in 1947 involving acreage in a lease which had been cancelled. The acreage had a then existing market value of forty to fifty thousand dollars. Unfortunately, the successful applicant immediately became involved in litigation with the number 2 applicant and with the former owners of the lease. The lease was issued to him but had been involved in three different controversies, either administrative or judicial, as a result of his success in this government lottery. The result has been that his title has not been merchantable, and he has been unable to develop his lease, even though the time is running on the primary term of the lease.

The unfavorable publicity incident to the "Santa Fe Sweepstakes" probably will prevent any repetition of drawings on such a large scale. While the government received $280,000.00 in forfeited filing fees, it did not receive the market value of the leases which it sold and in fact only received a small fraction of the market value.

Some Legal Problems Incident to Federal Leases

Earlier in this paper I mentioned the provision of the Act of August 8, 1946 which authorized a single individual to own nonrenewable two year options on not exceeding 100,000 acres in any state, in addition to the 15,360 acres of leases authorized to be held in a single state. The handling of these options and the questions of interpretation as to exactly the interests which might be held thereunder has been the subject of a great deal of discussion in the public lands states. The first problem which was presented was the question of whether or not, if an individual

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Act of August 8, 1946, supra, Sec. 6.
or a company had held an option for a period of two years on a federal lease, and that option expired without being exercised, did the act or the regulation prevent the company from purchasing a new option upon the same acreage? On the one hand it could be argued that it was the policy of the act that a particular operator should not control a given tract of land for more than two years under option; that the approval of the Secretary of the Interior is required before an option for more than two years can be taken. On the other hand, it was and is equally true that the act only prohibits a "renewable" option. If no provision appears in the option itself for its renewal, it can be argued that it is not a renewable option, and hence that if the option is limited to a two year term, it meets the requirements of the act.

A decision of the Bureau of Land Management shed some light on the attitude of the Department of the Interior on this question. While the statement is dicta, in the decision of January 30, 1950, in the case of Walter E. Armstrong and the Mule Creek Oil Company, relating to Billings' Serial Number 023158, the Associate Director said as follows:

"There is no objection seen to the Mule Creek Oil Company securing a new option from the lesseeholder provided that at the time of the acquisition it does not hold options on oil and gas leases or applications therefor, in excess of allowable acreage in the same state."

The question arose in this instance after expiration on one option. Apparently the Department feels that there is no question as to the validity of a subsequent option.

A more troublesome question is presented when the holder of an existing option on a federal lease goes back to the lessee prior to the expiration of the existing option and negotiates for a new two year option to begin at the expiration of the existing option. Whether or not such an arrangement is in violation of either the spirit or the letter of the regulations again is a difficult and controversial question. Certainly it may be said that neither of the options is a renewable option and each meets the requirement of the statute, that the option be "nonrenewable." The fact that the first is succeeded by a later option would not seem to change the character of the original option or the second one. In view of the decision in the Mule Creek Oil Company case, it appears likely that there would be no objection to this practice if the rights under the two options are not dependent upon each other, but each transaction is negotiated independently and at arms length, between the parties.

There is a suit pending in the United States District Court
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in New Mexico, for specific performance, involving these questions. A lessee refused to execute an assignment when the option held by the company was exercised, basing his refusal on the fact that it was the third option which the company has held on this acreage and that hence the option was a violation of public policy and not enforceable in a court of equity. In all probability this case will go to the Tenth Circuit Court of Appeals before the question is finally decided.

One other aspect of this problem should be pointed out. That is the fact that under the regulations, the penalty for taking an option which does not conform to these requirements is that it will be charged as owned acreage. It is arguable, therefore, that if the optionee has not used his entire 15,360 acres in a given state, the fact that he may hold an option which does not meet the two year nonrenewable requirement, only results in the addition of the acreage in the option to his leaseholdings in the state. It is also quite possible that a court would hold that the acreage limitation provisions of the act are for the benefit of the United States alone and that the parties to a private contract cannot use them as an excuse for avoiding the performance of their obligations.

Another problem that has arisen in connection with federal leases has grown out of the practice of individuals who keep a close watch on the records in the District Land Office and who, having exhausted their own acreage limitation, file their friends, relatives, and employees and anyone else available, on open federal acreage, in many instances paying the filing fee and rental themselves. Various agreements are made, some in writing and some oral as to the participation of the applicant and the party making the filing in any profits that may result from the arrangement. In the case of Antonio DiRocco et al., Utah Serial 01975, the decision of the Bureau of Land Management, dated January 5, 1952, sheds some light on this situation. In that case a geologist and his associate had entered into the wholesale business of filing applications on federal leases. The geologist selected the land on which the application would be filed and a power of attorney, giving absolute right to handle the leases, was taken from the eleven persons who filed some twenty-three applications under the arrangement. In this instance the applicant paid the filing fees and advance rentals and signed blank applications which were subsequently filled in by the parties to the arrangement. The parties making the filing participated in a small portion of the profits. The director held:

"The facts show that the ostensible applicants had no
control over their lease applications, and any leases which might issue thereunder, other than the right to relinquish the application and be reimbursed for the advance rentals, and a right to one-half of a one per cent royalty. The dummy applicants had no authority to enter into option agreements, assignments or operating agreements, nor in fact could they exercise any control over their lease application or lease.

The director construed the arrangement as giving the parties making the filing a 99\% interest in each lease and lease application. It was held that the arrangement constituted a conspiracy to evade the acreage limitation embodied in the Mineral Leasing Act and, by reason thereof, that the entire device was void. The opinion further says:

"If the facts had not come to the attention of the Bureau, it might well have resulted in one person holding a 99\% controlling interest in oil and gas leases having an acreage in excess of 37,000 acres in violation of the statutory limitation.

"The above described arrangement may properly be deemed to be a conspiracy to defraud the government in contravention of the provisions of the United States statutes."

All of the applications were denied and all existing leases under the arrangement were cancelled by the opinion. Undoubtedly, a number of persons have re-examined their dealings in federal leases in the light of this opinion.

There have been very few adjudicated cases in the courts relating to rights under federal oil and gas leases. While the act provides that a producing lease can only be cancelled by the government through a suit filed in the Federal District Court, no such suit has been filed in New Mexico to my knowledge since oil was first discovered there. Litigation in the courts between applicants and lessees on one hand and the government on the other has been extremely rare. Most controversies have been disposed of administratively in the Department of the Interior. There have been several significant cases relating to the rights of private individuals in federal leases, overriding royalties carved out of them, and operating agreements.

All of these cases are cited in the recent decision of the Supreme Court of New Mexico in the case of Kutz Canon Oil & Gas Company v. Feasel, et al, No. 5,330, opinion filed April 16, 1952 (Unreported as yet). In that case the New Mexico Supreme Court held that an operating agreement executed upon an oil and
gas prospecting permit held over and bound the exchange lease thereafter issued on the basis of the permit. In reply to the argument that the operating agreement contemplated a 7 1/2% overriding royalty, which was not permissible under present regulations of the Department, and further that this royalty was to be payable out of acreage on which the royalty to the government was 5% and no such acreage is included in the present leases, the operator tendered an override of 7 1/2% on 640 acres selected by it. It offered geologic testimony that this was the best one-fourth of the lands embraced in the lease. In spite of the contentions of the lessee that the court was rewriting his contract and requiring him to accept something which he never agreed to accept, the District Court held that the operating agreement bound the exchange lease and that the lessee would be required to accept the offer to do equity. The case was sustained by the Supreme Court of New Mexico in a decision which reviews most of the existing case law in this field. At the outset of this paper I referred to the "acquired lands" of the United States. Since 1947 these lands have been under the jurisdiction of the Department of the Interior for leasing. The regulations governing leases upon acquired lands and the operations thereunder are similar to, and in most respects identical with, the regulations governing leases on the public domain. The principal distinction is that application for lease on acquired land must be filed in the Bureau of Land Management in Washington, rather than in the District Land Office."

Should you be interested in expanding your library to include the available source material on federal leases, I can suggest only two sources. The first is the *Oil & Gas Lease Service*, published by F. H. Gower of Denver, Colorado. The service is known as *Gower Federal Service* and the address of the publisher is First National Bank Building, Denver, Colorado. The service provides copies of all statutes and regulations relating to federal oil and gas leases and keeps them up to date. It also furnishes you weekly with copies of all decisions of the Bureau of Land Management and of the Secretary of the Interior relating to oil and gas leases on the public domain. The only text book available on the subject is a volume published by Gower entitled *Oil and Gas Leasing on the Public Domain* by Lewis Edwin Hoffman. Mr. Hoffman is the chief of the Minerals Branch of the Bureau of Land Management and prepared his manuscript as a manual

*Revised regulations governing leases on acquired lands have been distributed but were not in effect on August 1, 1952. They will be found as 43 C.F.R. 200 et seq. when effective.*
for the use of adjudicators and other employees of the Bureau of Land Management. While its contents clearly indicate that it was prepared with that in mind, it does contain complete information as to the processing of lease applications and assignments and other information which is valuable to attorneys dealing in such leases.

The latest available information indicates that approximately 5% of the domestic production of oil is from lands of the United States of America, administered under the Mineral Leasing Act of 1920. There are many reasons to believe that this fraction will increase substantially during the next ten years. Accordingly, attorneys practicing in the public land states will want to be familiar with the statutes and regulations relating to federal oil and gas leases.
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