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FACT SHEET

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REALESTATEMENT: THE LANDOWNER'S GUIDE TO LIGNITE LEASING IN TEXAS

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Texas landowners who have coal and lignite face a complex situation when considering leasing arrangements, as the following case illustrates. After 25 years of barely making a living, an East Texas farmer thought he had discovered his fortune at last. A land broker or "land man" from a national energy development company had asked to lease the rights to mine the coal and lignite on and under his property. However, there was just one small catch. Ten years ago, the farmer had sold the rights to the "oil, gas, and other minerals" on his property to a speculator who now claimed that he owned the coal and lignite on the farmer's land. The farmer went to his attorney to find out who owned these rights.

"Probably you do" was the best answer that his lawyer could give him in light of the present state of the law in Texas.

Determining Lignite Ownership

Court Rulings

Whether the owner of the surface estate (landowner) or the owner of the mineral estate (speculator) has legal rights to the coal and lignite under a piece of land has not been decided finally by the Supreme Court of Texas. The first major case on this issue, *Acker v. Guinn* in 1971, involved iron ore rights on a particular piece of land. The Texas Supreme Court decided that the owner of the surface estate owned the iron ore and established the test that if a substance is located so near the surface that it must be mined by methods that would destroy or substantially impair the surface, a grant or lease of "oil, gas and other minerals" would not be deemed to include the surface materials. The court reasoned that the owner of the surface estate would not have given away his rights to use the surface or allow it to be destroyed without specifically stating this in the lease.

The next and latest case involving lignite rights was *Reed v. Wylie*, decided in 1977. The Texas Supreme Court applied the rule of *Acker v. Guinn* and held that a substance is not a mineral (in terms of an "oil, gas and other minerals" grant) if substantial quantities of it lie at or near the surface or are so closely related to the surface that production will strip away and substantially destroy the surface. The court held that the lignite under these circumstances would belong to the surface owner. Yet to be answered by the court, however, are the questions of what "at or near the surface" means and whether or not the courts are legally bound to examine the most reasonable method of mining that existed when the lease was signed to determine if that method would have destroyed the surface. The best interpretation at this time is that lignite will be deemed to belong to the owner of the surface estate in most instances.

Assurance of legal rights, however, is only the first step; the landowner still should consult an attorney about the terms and conditions of a typical coal and lignite lease.

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Examining the Lease

There is no standard form of lease in the coal and lignite industry such as the Producers 88 in the oil and gas industry. Each coal company (lessee) has a preferred form which the landowner (lessor) will be asked to sign; however, the landowner should remember that many, if not most, of the provisions of these leases are negotiable to some degree.

Mining Provisions

Unless otherwise agreed to in writing, a typical coal and lignite lease will allow the coal company to mine the lignite by any means available, not just by surface mining methods. At this time, however, surface mining is the only economically profitable method. If surface mining is used, the coal company must comply with the Texas Surface Mining and Reclamation Act of 1977 and obtain a surface mining operations permit from the Railroad Commission of Texas.

First, when negotiating the terms of the lease, the landowner will want to consider how long the lease will be in effect. Coal and lignite mining requires a very long period of time for the operation to be set up and to start production. Most coal companies will want a 40- or 50-year lease, while most landowners will want as short a term as possible. A common compromise is to grant an initial primary term of 10 to 15 years with the option to renew the lease for another 15 to 25 years. All leases will provide also that the lease terms and conditions will continue in full force and effect even after the scheduled termination of the lease "for so long thereafter as mining operations are being conducted."

Financial Arrangements

Another primary consideration, of course, is the amount of economic benefits to the landowner. Before he signs a lease, the landowner should be familiar with the financial terms of the lease.

Bonus or Advanced Royalties. Basically, a bonus is a payment made by the coal company to induce the landowner to sign a lease. It is not recovered later out of production royalties. If there is one long primary term, a typical bonus might be $25 to $35 an acre. If there is a short primary term with an option, the initial bonus might be $15 to $25 an acre with a second bonus of $25 to $35 an acre paid when the option is exercised.

Rather than pay a bonus, however, some coal companies will pay an advanced royalty to get the landowner to sign the lease. This payment is similar to a bonus, except that it is recovered or paid back to the company from future royalties as production begins. If paid as advance royalties, these payments may be slightly higher than if paid as a bonus. The landowner should be careful to insert a clause in the lease stipulating that these advance royalties may be taken from only 40 or 50 percent of the landowner's share once production begins. This will assure him of some income on a continuing basis even when the advance royalties are being recovered by the coal company.

Annual Rentals. Annual rentals are payments by the coal company to keep the lease in effect for the entire term of the lease. These payments are usually $1 or $2 per acre paid annually.

Royalties. Royalties are payments to the landowner for his share of production. In coal and lignite leases one of three common types of royalty payment clauses will be included. The royalty may be based on a per ton figure. That is, the landowner may be paid a specific amount, for example $.20 per ton of mined coal. This method of royalty payment is the easiest to understand and check.

A second method of payment is more difficult to understand and verify. The landowner may be paid by the acre-foot, for example, $500 per acre-foot. An acre-foot is a thickness of one foot of coal underlying one acre of land.

A third method of royalty payment is to base the royalty on a percentage of the market or proceeds price at the minehead, commonly five percent. If the price is to be determined at a place other than the minehead, the transportation costs should be deducted and the percentage should be taken of the net proceeds. The landowner must be careful, however, to determine where the coal is being shipped and who the buyer is. If the coal buyer and the coal company are financially related companies (parent, subsidiary), it may be unfair to the landowner to deduct transportation costs.

Because the lease may be for a number of years, the landowner may want to protect himself and insist on a clause providing for an increase in the royalty payments if the inflationary trend of the economy continues. An index considered by most to be fair to both landowners and coal companies is the *Monthly Index of Wholesale Prices: Basic Commodities and Thirteen Raw Materials,* as computed by the Bureau of Economic Analysis, United States Department of Commerce.

Surface Damages. In addition, the landowner should receive payment for surface damages. This includes payment for the loss of the use of the surface during mining operations; the amount of the payment depends on the productivity of the land prior to mining, but several hundred dollars per acre is not uncommon. The landowner also will be paid for the damages to the surface estate prior to production. This includes payment for the loss of structures, roads, tanks, crops, fences or similar effects. Before

signing the lease, a fair market value should be placed on any of these items that will be totally or partially destroyed. A landowner may insist also that the coal company build a new fence, tank, water well or similar structure as part of the consideration for the lease.

Pooling Clause. A unitization or pooling clause may or may not be included in a coal and lignite lease. Some coal companies insist on it, while others do not. Most landowners oppose it. Basically, it provides that the owner's land may be pooled by the coal company with the other land leased in the area to form a mining unit, possibly of 5,000 to 10,000 acres. The advantage to the landowner is that he will receive some income long before his land is mined if the coal company starts mining at the far end of the unit. The disadvantage is that the quantity and quality of the coal on his land may be superior to the other land in the unit, and his payments might be less than if his land were mined separately.

As mentioned previously, the Texas Surface Mining and Reclamation Act requires the coal company to do certain things, one of which is to reclaim any surface-mined lands, that is, to restore them to their original or substantially beneficial condition. There are heavy penalties, both civil and criminal, if the coal company violates any order of the Railroad Commission with regard to reclamation. Furthermore, the coal company is required to post a bond large enough to pay for the costs of reclamation should it be necessary for a third party to complete it. As additional protection, however, the landowner should insist on a clause in the lease which states that the coal company will comply with all federal and state laws and regulations in the mining operation. This assures that the landowner would have the right to sue the coal company for a breach of its promise to restore the land after mining.

Another important consideration for the landowner is the reservation of the right to mine or produce other minerals, especially oil and gas, if they are discovered on his property after the lignite lease is signed. The production of oil and gas is more lucrative than coal production, and since the coal lease will be in effect for such a long period of time, the landowner will want to reserve the right to develop other minerals if he gets the chance. The coal company will object strenuously to this idea because such activities might interfere with its operations. It is a difficult problem which may require legislation to resolve.

All leases also will include a "force majeure" clause which provides that if the production is stopped because of an act of God (tornado, flood, earthquake or similar natural disaster) or because of an act of the government (labor strike, materials shortage) or other act outside of the control of the coal company, the lease will not terminate and the primary term of the lease will be extended by the same period of time that production was halted.

Warranty Clause. One clause to examine very closely is a warranty clause whereby the landowner warrants or promises the coal company that he has a good and marketable title to his property. The landowner should have no reservations about warranting the title to the surface of his land. However, if the surface estate and mineral estate previously have been divided (see "Real Ownership of Heaven and Earth," *Tierra Grande*, First Quarter 1978), he should avoid warranting title to the coal or lignite which is or will be mined because of the uncertain state of the issue of lignite ownership in Texas. If the owner of the mineral estate were to successfully establish in a lawsuit that he, not the landowner, owned the lignite, then the coal company certainly would sue the landowner to recover all of the prior payments made to him.

The landowner should insist also on a clause whereby the coal company will pay the taxes on any improvements or equipment it places on the owner's land.

Surrender Clause. Every lease will include a release or surrender clause which allows the coal company to terminate the lease with regard to all or any portion of the leased lands. The coal company would have to pay any financial obligations then due and owing at that time, but it would be relieved of any future obligations. To protect himself, the landowner might want to insist on a clause that provides a minimum annual rental payment regardless of how many acres may be released.

Taking Final Precautions

When a landowner leases his land for lignite mining operations, he will be losing his rights to use the land for long periods of time and will have substantial amounts of it totally destroyed. Reclamation procedures, if properly followed, ultimately should restore the land to its original or substantially beneficial condition. To give up his rights, the owner must receive adequate financial incentives. The coal and lignite lease is the legal instrument by which he must protect himself and provide for compensation. Before he signs a lease, he should clearly understand what the lease will mean to him over its entire duration. Consulting with a tax specialist is recommended. He should remember that any advance royalties will be taken out of his share of production at a later date. Finally, he should realize that many, if not most, terms of the lease are negotiable. A landowner should not be afraid to ask for or insist on certain clauses or requirements. Because of the technical and legal aspects of a coal and lignite lease, he should consult an attorney prior to negotiating and signing a lease.

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