



University of Arkansas at Little Rock Law Review

Volume 10 | Issue 1

Article 2

1987

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Susan Webber Wright

University of Arkansas at Little Rock William H. Bowen School of Law

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Recommended Citation

Susan Webber Wright, *The Arkansas Law of Oil and Gas: Chapter IV*, 10 U. ARK. LITTLE ROCK L. REV. 5 (1987).

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UNIVERSITY OF ARKANSAS AT LITTLE ROCK
LAW JOURNAL

VOLUME 10

1987-88

NUMBER 1

THE ARKANSAS LAW OF OIL AND GAS*

*Susan Webber Wright***

Following is Chapter IV of a multichapter short treatise on the Arkansas law of oil and gas. Other chapters appear in Volumes 9 and 10 of *UALR Law Journal*.*** This treatise is not intended as an in-depth analysis, but rather as a description of the current state law which, the author hopes, will be helpful to those not regularly engaged in the oil and gas law practice.

CHAPTER IV
THE OIL AND GAS LEASE

An oil and gas lease in Arkansas conveys to the lessee the right of exploration and development of these minerals.¹ The lessee's interest is generally referred to as the "working interest."² The lessor receives consideration in the form of bonus, delay rentals, and royalty, as provided in the lease. Many other provisions in the lease may determine the rights and liabilities of the parties.

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** Professor of Law, University of Arkansas at Little Rock School of Law. The author acknowledges and thanks Paula Williams, class of 1987, who helped in the research for this project.

*** Chapters I and II concern the Nature of Oil and Gas Interests and Multiple Ownership of Oil and Gas Interests and appear at 9 UALR L.J. 223 (1986-87). Chapter III is on Conveyances of Oil and Gas Interests by Deed and appears at 9 UALR L.J. 467 (1986-87).

1. See the discussion in Wright, *The Arkansas Law of Oil and Gas (Chapter I)*, 9 UALR L.J. 223, 224-25 (1986-87), which notes that the Arkansas Supreme Court decision in *Hillard v. Stephens*, 276 Ark. 545, 637 S.W.2d 581 (1982) characterized a lease of oil and gas as a sale.

2. See, e.g., *Schnitt v. McKellar*, 244 Ark. 377, 380, 427 S.W.2d 202, 207 (1968).

The first topic of this chapter is the right of the lessee to the use of the surface. The next section covers the lessor's proceeds from the lease and the lease clauses governing these proceeds. Finally, this chapter covers some Arkansas cases on specific lease clauses and summarizes the various means by which a lease may terminate. Implied lease covenants are the subject of the following chapter. This chapter is not a description of the lease generally. For this, see one of several good references.³

Lessee's Liability For Surface Damages

The owner of a mineral interest, or that owner's lessee, has an easement of reasonable use of the surface for the purpose of developing the minerals.⁴ If the mineral owner or lessee has made an unreasonable use of the surface, he is liable to the surface owner for damages.

Arkansas has several cases involving surface damage by mineral owners or their lessees.⁵ In *Diamond Shamrock Corp. v. Phillips*⁶ the surface owner sued for damages because the defendant had located a well on the owner's proposed homesite, even though one of the defendant's employees had represented to the plaintiff that a well would not be located there after the plaintiff protested that he did not want a well on that site. Evidence showed that other locations would have been suitable and that the well was located 160 feet south of the location selected by the defendant and certified to the Oil and Gas Commission. The defendant offered no explanation of why the well was in fact drilled on the plaintiff's proposed homesite. A jury awarded actual damages based upon the difference in value of the property before and after the well was drilled. Because the plaintiff failed to prove wanton or willful misconduct on the part of the defendant, the jury award of punitive damages was reversed. This decision indicates that the standard of reasonableness requires that the right of surface use be

3. *E.g.*, R. HEMINGWAY, THE LAW OF OIL AND GAS ch. 6 (2nd ed. 1983); 3 H. WILLIAMS, OIL AND GAS LAW §§ 601-02 (1986).

4. *E.g.*, *Reimer v. Gulf Oil Corp.*, 281 Ark. 377, 664 S.W.2d 456 (1984); *Diamond Shamrock Corp. v. Phillips*, 256 Ark. 886, 511 S.W.2d 160 (1974); *Arkansas Louisiana Gas Co. v. Wood*, 240 Ark. 948, 403 S.W.2d 54 (1966); *Wood v. Haye*, 206 Ark. 892, 895, 175 S.W.2d 189, 190 (1943).

5. The Arkansas cases discussed in this treatise involve operations for development of oil and gas. However, Arkansas has a number of decisions involving surface damages resulting from the mining of hard minerals. *See, e.g.*, *Benton v. U.S. Manganese Corp.*, 229 Ark. 181, 313 S.W.2d 839 (1958); *Paris Purity Coal Co. v. Pendergrass*, 193 Ark. 1031, 104 S.W.2d 455 (1937).

6. 256 Ark. 886, 511 S.W.2d 160 (1974).

exercised in a manner "least injurious" to the surface owner.⁷

The "before and after" measure is not always the appropriate formula for determining surface damages. In *Arkansas Western Gas Co. v. Foster*,⁸ the jury was instructed, without objection, to measure damages by ascertaining the rental value of improved pasture land upon which the defendant had drilled and plugged a well, left a slush pit, and built a road. The rental period was from the time of the damage to the time the land was restored to the same condition prior to the damage. In addition, the jury was told to award the surface owner the costs of reseeding and otherwise restoring the pasture to its prior condition. The Arkansas Supreme Court reversed and remanded a verdict for the plaintiff on grounds that there was no evidence in the record on rental value. One disturbing aspect of this case is that the jury instructions, which were not the issue on appeal, did not acknowledge that at least some damage should result from the reasonable use of the surface by a mineral owner or lessee, and there should be liability only for damages resulting from unreasonable use.

The 1984 decision in *Reimer v. Gulf Oil Corp.*⁹ held that the lessee's use of the surface was not unreasonable when the lessee built a road across the plaintiff's tract to transfer a drilling rig to adjacent land which was in the same drilling unit as the tract in question. The lease expressly gave the lessee this right, so the court did not find it necessary to rely upon any implied easement of reasonable use. This decision, whether or not it is based upon an express lease clause, certainly reaches the result necessary for efficient production from drilling units. If the surface owner in *Reimer* had also been a royalty owner of the tract, he probably would not have objected to the road across his land.

Water is part of the surface estate, and some Arkansas decisions concern a lessee's damage to the surface owner's water. A 1966 decision, *Arkansas Louisiana Gas Co. v. Wood*,¹⁰ held that the following

7. *Id.* at 891, 511 S.W.2d at 163 (quoting from *Martin v. Dale*, 180 Ark. 321, 21 S.W.2d 428 (1929)). *Martin* involved use of the lessor's private road by the lessee, who was drilling for oil on the lessor's property. The court approved the lessee's use of the private road on grounds that use of this road was necessary, as it provided the lessee's only access. The *Phillips* decision perhaps represents an adoption of the "accommodation" doctrine enunciated by the Supreme Court of Texas in *Getty Oil Co. v. Jones*, 470 S.W.2d 618, 623 (Tex. 1971), without the requirement that the lessor's use of the surface be an *existing* use. See E. KUNTZ, J. LOWE, O. ANDERSON, & E. SMITH, CASES AND MATERIALS ON OIL AND GAS LAW 119-20 (1986) [hereinafter KUNTZ CASES AND MATERIALS].

8. 254 Ark. 14, 491 S.W.2d 380 (1973).

9. 281 Ark. 377, 664 S.W.2d 456 (1984).

10. 240 Ark. 948, 403 S.W.2d 54 (1966).

lease clause did not give the lessee the right to use water from the lessor's artificial stock pond: "Lessee shall have free use of oil, gas and water from said land, except water from Lessor's wells, for all operations hereunder."¹¹ The court affirmed a judgment for the lessor for damages to his land and for use of water from the stock pond.

In 1967 the supreme court decided *O'Brien v. Primm*,¹² upholding a verdict for damage to well water resulting from a sandfracturing operation at the defendant's oil well. The majority of the court was satisfied that there was sufficient evidence of the defendant's negligence, but a strong dissent by Justice Fogleman, in which Justice Brown joined, took the position that the plaintiffs did not prove negligence or causation. This case did not concern the right of reasonable use of the surface, for the plaintiff and defendant were not surface owner and mineral owner in the same tract. However, this decision might set a precedent for finding a mineral owner negligent in a sandfracturing operation which results in damage to the surface owner's water well.

There are two Arkansas decisions involving liability for damage to water wells resulting from the use of seismographic tests in the exploration for oil and gas. These tests employ explosives underground. In *Western Geophysical Co. v. Mason*¹³ the plaintiffs alleged that the tests caused their well water to be muddy and unfit. The Arkansas Supreme Court affirmed a jury verdict based upon the difference in the before and after values of the plaintiff's property. The court noted that there was substantial evidence to justify the jury's finding of negligence, but that a finding of negligence was not necessary because explosives were used.¹⁴ This decision shows that the court is willing to apply strict liability in tort for damages resulting from the use of explosives in geophysical exploration.¹⁵

In the 1967 case of *Continental Geophysical Co. v. Adair*,¹⁶ the plaintiffs claimed that the defendant's seismograph operations caused their wells to run dry. The court reversed and remanded on grounds

11. *Id.* at 949, 403 S.W.2d at 55.

12. 243 Ark. 186, 419 S.W.2d 323 (1967).

13. 240 Ark. 767, 402 S.W.2d 657 (1966).

14. *Id.* at 769, 402 S.W.2d at 658. The court quoted from 4 W. SUMMERS, OIL AND GAS § 661 (1962).

15. The opinion does not mention any Arkansas cases on liability for the use of explosives. In an earlier case involving damage from explosives used to mine gravel, the Arkansas Supreme Court recognized the rule that a finding of negligence is not essential to liability, but did not adopt that rule because there was sufficient evidence of negligence to sustain the jury's award. *Benton Gravel Co. v. Wright*, 206 Ark. 930, 175 S.W.2d 208 (1943).

16. 243 Ark. 589, 420 S.W.2d 836 (1967).

that the plaintiffs failed to show causation. There had been a period of drought preceding the failure of the plaintiff's wells. The court distinguished the holding in *Western Geophysical Co. v. Mason*, in which there was more evidence that the plaintiff's muddy well water was caused by the defendant's operations. This holding and the dissenting opinion in *O'Brien v. Primm* illustrate that causation might be a difficult element of proof for a plaintiff suing for damage to well water.

The Arkansas legislature perceived the problem of surface damages as deserving of special treatment, and by Act 902 of 1983¹⁷ required an operator to give written notice of exploration or drilling to the surface owner before entering upon the site and to file proof of financial responsibility with the Oil and Gas Commission as a prerequisite to the issuance of a drilling permit. The act further provides that any surface owner "damaged or threatened with damage by the neglect of the operator" has a lien on the operator's equipment and fixtures. Depending upon interpretation of the awkward wording of the Act, the lien might extend to production run to the credit of the operator.¹⁸

The provisions of Act 902 of 1983 were amended by Act 559 of 1985.¹⁹ The amendment requires a surface owner seeking damages through the proof of financial responsibility to file a claim within one year of the date of issuance of the drilling permit.

Act 44 of 1987 requires any operator who is to drive heavy oil and gas equipment on county roads or municipal streets to file a bond to cover anticipated damages to streets and roads. The amount of the bond is determined by the county road foreman and supervisor or by the municipal street department and must be "sufficient to repair damage caused to the roads or streets by operating such equipment

17. This act is codified as ARK. STAT. ANN. §§ 53-216 to -219 (Supp. 1985).

18. The Honorable Alex Sanderson has addressed problems with this act. Sanderson, *Recent Arkansas Legislation and Cases Affecting the Oil & Gas Industry*, 23 ARK. NAT. RESOURCES L. INST. (1984). ARK. STAT. ANN. § 53-219 (Supp. 1985) reads as follows:

Any surface owner that is damaged or threatened with damage by the neglect of the operator, will have a lien upon the fixtures or equipment owned by the operator, with all oil, gas and other hydrocarbons produced therefrom which may be run to the credit of the operator to secure payment for all damages that can be lawfully recovered under the terms of the oil and gas lease or leases covering the particular property and under which drilling operations are being undertaken by [the] operator; and further, the lien to secure payment for any other damages that the surface owner would be entitled to recover from the operator under the laws of the State of Arkansas.

19. ARK. STAT. ANN. § 53-220 (Supp. 1985).

thereon."²⁰

In 1986 a majority of the Arkansas Supreme Court, in *Bonds v. Sanchez-O'Brien Oil & Gas Co.*²¹ held that "the duty to restore the surface, as nearly as practicable, to the same condition as it was before drilling is implied in the lease agreement."²² The defendant lessee, after the lease had terminated, left "water pits, concrete slabs, dams, and winrock stone on the surface."²³ Recognizing that commentators are divided on this issue,²⁴ the majority reasoned that to hold otherwise would allow the lessee, after termination of the lease, to continue to occupy the premises and that such would be unreasonable surface use.²⁵ The dissent, written by Justice Newbern in which Justices Smith and Purtle joined, pointed out that no other jurisdiction has found an implied duty on the part of the lessee to restore the surface in absence of legislation.²⁶

Lease Proceeds

The lessor's consideration for the lease generally includes a bonus, delay rentals, and royalty. The bonus is paid upon execution of the lease. Delay rentals are generally payable during the primary term of the lease to permit the lessee to postpone development yet keep the lease in effect during the primary term.²⁷ However, in a "paid up" lease, delay rentals are paid with the bonus payment upon execution of the lease. Royalty is reserved by the lessor and is payable out of production. Although the traditional lessor's royalty in Arkansas was an eighth of production free of expenses,²⁸ greater fractions

20. Act 44 of 1987 is not codified at this writing.

21. 289 Ark. 582, 715 S.W.2d 444 (1986).

22. *Id.* at 585, 715 S.W.2d at 446.

23. *Id.* at 583, 715 S.W.2d at 445.

24. *Id.*

25. *Id.* at 585, 715 S.W.2d at 446.

26. *Id.* at 586, 715 S.W.2d at 446 (Newbern, J., dissenting). Justice Purtle wrote a separate dissent and would have found for the lessee on grounds that the plaintiff, who was not the original lessor, purchased the property in question with knowledge of the structures left by the defendant. *Id.* at 585, 715 S.W.2d at 447 (Purtle, J., dissenting).

27. For example, a lease might provide that it is to last for "three years and as long thereafter as oil and/or gas are produced." The primary term is for three years. Yet the delay rental clause may provide as follows: "This lease shall terminate one year from this date unless operations are commenced or unless lessee pays or tenders to lessor, or to lessor's credit at the — Bank, the sum of — dollars." Thus, payment of delay rentals may keep the lease alive during the primary term.

28. For example, this is the fraction deemed royalty for purposes of integrating unleased mineral interests. ARK. STAT. ANN. § 53-115A-2 (Supp. 1985) (amended by Act 94 of 1987, but not as to this royalty provision).

have been reserved in recent years at times when the price of oil was high.

Arkansas decisions concerning division of bonus, delay rentals, and royalties among concurrent or successive owners are discussed in Chapter II.²⁹

a. Improper Payment of Delay Rentals

Commentators divide delay rental clauses into two categories: the "unless" clause and the "or" clause.³⁰ Generally leases in Arkansas are of the "unless" variety, as they provide that the lease will terminate before expiration of the primary term *unless* the lessee commences a well or pays delay rentals periodically.³¹ If a lessee has not commenced a well, failure to pay delay rentals on or before the due date in the specified manner to the proper party results in termination of the lease. According to the rule adopted by most jurisdictions, the "unless" type of delay rental clause creates a limitation to the lease and thus failure to pay the rental properly results in automatic termination of the lease under its own terms.³² Logically this would require a court to eliminate consideration of the equities in favor of the lessee, for the court is not declaring a forfeiture, but is instead recognizing that the lease has terminated under its own terms. However, from time to time courts have considered equitable principles, such as estoppel and waiver, to bar a lessor's suit to terminate a lease.³³ More commonly, courts excuse improper delay rental payments when the lessee has not been at fault, when the improper payment has been accepted by the payee, or where the transfer of the ownership by the lessor has caused uncertainty concerning the identity of parties entitled to receive rental payments.³⁴

The Arkansas Supreme Court has generally recognized the ma-

29. Wright, *The Arkansas Law of Oil and Gas (Chapter II)*, 9 UALR L.J. 241, 245 (1986-87).

30. For a discussion of authority on the "or" as opposed to the "unless" clause, see 3 E. KUNTZ, OIL AND GAS ch. 29 (1967).

31. The "unless" lease is contrasted with the "or" variety of lease, in which the lessee promises to drill or to pay rentals or to surrender the lease during the primary term. In the event that the lessee of an "or" lease does not pay delay rentals, the lessor might sue for payment (if there has been no surrender), while the "unless" lease terminates under its own terms if the lessee fails to pay rentals or commence a well. See, e.g., *Girolami v. Peoples Natural Gas Co.*, 365 Pa. 455, 76 A.2d 375 (1950) ("or" lease).

32. For citations to authority on the "unless" lease, see 3 E. KUNTZ, *supra* note 30, at § 29.2.

33. E.g., *Ledford v. Atkins*, 413 S.W.2d 68 (Ky. 1967).

34. E.g., *Armstrong v. McGough*, 157 Ark. 173, 247 S.W.2d 790 (1923) (Lease preserved by rental payment received by bank on due date but credited to lessor after due date when

jority rule in cases concerning improper delay rental payments.³⁵ However, in two cases involving late payment of rentals, the court characterized the lease contract, with the delay rental clause, as an agreement in which time is of the essence.³⁶ The court could have reached the same result by characterizing the delay rental clause as a special limitation to the lease. In one of these cases, *Harrell v. Saline Oil & Gas Co.*,³⁷ the court held that notice of the intent of the lessor to declare a forfeiture is unnecessary for termination of the lease. In this respect the court seemed to recognize that the lease had terminated on its own terms, as a property interest subject to a special limitation can terminate.

Arkansas has recognized that the lessee must tender the delay rental payment to the proper party. In *Vaughan v. Doss*³⁸ the lease required that rentals be paid to the First National Bank of Magnolia and deposited to the lessor's credit. By mistake the lessee paid the rentals to the First National Bank of El Dorado, which did not notice the error and which negotiated the check and deposited it to the lessor's credit. The mistake was not discovered until after the rental payment date specified in the lease had passed. The lessor demanded that the lessee cancel the lease and filed suit when it refused to do so. The chancellor found for the lessor and the supreme court affirmed, pointing out that lessees must strictly comply with lease provisions and citing the Arkansas decisions holding that time is of the essence in this kind of contract. The court pointed out that the Arkansas legislature had recognized this rule in enacting Act 170 of 1923.³⁹

b. Computation of Royalty

Royalty is defined as: "(1) The landowner's share of production, free of expenses of production. (2) A share of production, free of ex-

lease provided that bank was lessor's agent). See also KUNTZ CASES AND MATERIALS, *supra* note 7, at 139-40.

35. *E.g.*, *Harrell v. Saline Oil & Gas Co.*, 153 Ark. 104, 239 S.W. 731 (1922); *Epperson v. Helbron*, 145 Ark. 566, 225 S.W. 345 (1920).

36. *Harrell v. Saline Oil & Gas Co.*, 153 Ark. 104, 108, 239 S.W. 731, 732 (1922); *Epperson v. Helbron*, 145 Ark. 566, 225 S.W. 345 (1920).

37. 153 Ark. 104, 239 S.W. 731 (1922).

38. 219 Ark. 963, 245 S.W.2d 826 (1952).

39. ARK. STAT. ANN. § 53-314 (1971). In the event a lease terminates as a result of rentals not being paid in accordance with the terms of the lease, the act allows the owner of the fee to indorse on the margin of the record of the original lease a statement to the effect that rental has not been paid and that the lease is forfeited. The owner must sign the statement, which must be attested by the recorder. The statement is notice to subsequent purchasers of the lease and is prima facie evidence of the termination of the lease.

penses of production. . . ."⁴⁰ Although the expenses of production are not deductible, other expenses, such as transportation and treatment expenses, generally may be deducted from the royalty owner's share.⁴¹ Sometimes questions arise whether certain expenditures are non-deductible production expenses or are deductible expenses not attributable to production.⁴²

Arkansas has had occasion to determine the issue of the deductibility of transportation costs in computing royalty. In *Clear Creek Oil & Gas Co. v. Bushmaier*⁴³ the lease provided for royalty based upon "market price of royalty gas at the well." There was no market for the gas at the well, but the lessee transported the gas to Fort Smith and Van Buren, where it was sold for 10 cents per thousand cubic feet. The court found that the lessee's transportation and distribution costs were 3 1/2 cents per thousand cubic feet, resulting in a market price at the well of 6 1/2 cents per thousand cubic feet.⁴⁴

In *Parnell, Inc. v. Giller*⁴⁵ the leases provided for royalty to be based upon the "market value at the well" for brine sold or used off the premises but upon the "amount realized" for brine sold at the wells.⁴⁶ The brine was not sold at the well but was piped to a chemical company. The contract between the lessee, Parnell, and the chemical company required the lessee to deliver the raw brine to the chemical company, where bromine was extracted, and to dispose of the spent brine. Following *Bushmaier*, the court held that the transportation costs were deductible in calculating the market value of the brine.⁴⁷ A majority of the court held that the expenses of disposal of spent brine were also deductible on grounds that, like the transportation expenses, disposal costs "are services that are essential to and peculiar to the marketing of the product itself" which might well have been assumed by the purchaser and which the purchaser takes into account

40. H. WILLIAMS & C. MYERS, *MANUAL OF OIL AND GAS TERMS* 770 (6th ed. 1984).

41. *Id.*

42. Eugene Kuntz takes the position that the lessee should bear any costs prior to obtaining a marketable product. But if the product is of a marketable quality, he would require the lessor to share in the transportation expenses if the product is "unmarketable" merely because there is no pipeline. 3 E. KUNTZ, *supra* note 30, § 40.5, at 322-33. On the other hand, Howard Williams has taken the position in his treatise that the "[e]xpenses of treatment required to make the mineral product salable, e.g., expenses of dehydration," should be shared by the lessor. 3 H. WILLIAMS, *supra* note 3, § 645.2, at 602.

43. 165 Ark. 303, 264 S.W. 830 (1924).

44. *Id.* at 307, 264 S.W. at 832.

45. 237 Ark. 267, 372 S.W.2d 627 (1963).

46. *Id.* at 268, 372 S.W.2d at 628.

47. *Id.* at 269, 372 S.W.2d at 628.

in determining the purchase price.⁴⁸ Justice McFaddin dissented on allowing the deduction of disposal expenses, contending that such expenses are business expenses to be borne by the lessee, "just like advertising, salaries, telephone, and such other items are business expenses and not to be charged against the royalty interest."⁴⁹

Perhaps the expense of disposing of spent brine could be characterized as a marketing expense on grounds that the lessee would not have been able to sell the brine without agreeing to dispose of it after the extraction of bromides. If this is the case, one could argue that the lessee alone should bear the expense because it is part of the implied duty to market the product.⁵⁰ On the other hand, one might argue that the expense should be shared by both the lessee and the lessor because the brine is of unmarketable quality at the well and to require the lessee to absorb all the expenses of making the product marketable would bestow a windfall upon the lessor.⁵¹ Of course, the preferred solution to this problem is for the lease to provide explicitly for the calculation of the royalty.

c. Computation of Royalty—Statutory Provisions

The Arkansas legislature sought to protect the royalty owner from unfairness and collusion of producers and purchasers when it passed Act 222 of 1929.⁵² The Act prevents the producer and the purchaser from contracting in such a manner as to deprive the royalty owner of the benefits enjoyed by the producer under the contract. The penalty for a lessee's or operator's (producer's) violation of these provisions is forfeiture of the lease; the penalty for violation by a pipeline company or other purchaser is treble value of the amount of oil or gas wrongfully taken from the royalty interest.⁵³

Only two Arkansas Supreme Court cases have interpreted these provisions. The first, *Dobson v. Arkansas Oil & Gas Comm'n*,⁵⁴ held that the penalty provision (section 6 of the Act) would not apply to a purchaser which had taken the plaintiffs' minerals under the mistaken assumption that the plaintiffs' interests were validly unitized. The court pointed out that there was no indication of a conspiracy be-

48. *Id.*

49. *Id.* at 270, 372 S.W.2d at 629 (McFaddin, J., dissenting).

50. *See supra* note 42.

51. *Id.*

52. ARK. STAT. ANN. §§ 53-509 to -514 (1971).

53. ARK. STAT. ANN. § 53-514 (1971).

54. 218 Ark. 160, 235 S.W.2d 33 (1950).

tween the producer and the purchaser.⁵⁵

The second Arkansas Supreme Court decision concerning this act is *Hillard v. Stephens*,⁵⁶ in which the court interpreted § 3, which reads as follows:

It shall be the duty of both the lessee, or his assignee, and any pipe line company, corporation or individual contracting for the purchase of oil or gas under any oil, gas or mineral lease to protect the royalty or lessors [sic] interest by paying to such lessor or his assignees the same price including such premiums, steaming charges, and bonuses of whatsoever name, for royalty oil or gas that is paid such operator or lessee under such lease for the working interest thereunder.⁵⁷

Hillard had executed several leases to Stephens, some of which contained a clause fixing royalty as follows:

The Lessee shall pay Lessor as royalty for gas the equal one-eighth (1/8) of the value of such gas calculated at the rate of five seven (7) cents per thousand cubic feet while the same is being sold or used off the premises, measured according to the Standard Measurement Law of the State in which the above described land lays [sic].⁵⁸

Hillard contended that the statute converted the fixed royalty clause into a "proceeds" lease provision, requiring Arkla pay as royalty one-eighth of the amount it received from the sale of the gas, which would be in excess of 7 cents per thousand cubic feet.⁵⁹ Alternatively, Hillard contended that under the penalty section of the Act Stephens had forfeited the lease.⁶⁰ The court found for Stephens, reasoning that the legislature did not intend for the statute to convert all fixed price leases into proceeds leases, pointing out that such would not be favorable to lessors with high fixed price leases.⁶¹ In a later federal diversity case, both the federal district court and the Court of Appeals for the Eighth Circuit followed the *Hillard* decision on this point.⁶²

55. *Id.* at 168, 235 S.W.2d at 37.

56. 276 Ark. 545, 637 S.W.2d 581 (1982).

57. ARK. STAT. ANN. § 53-511 (1971).

58. 276 Ark. at 547, 637 S.W.2d at 582.

59. On December 1, 1981, Stephens was receiving \$0.3390 per thousand cubic feet for the gas. *Id.* at 550, 637 S.W.2d at 585.

60. *Id.* at 549, 637 S.W.2d at 583.

61. *Id.* at 554, 637 S.W.2d at 585-86.

62. *Taylor v. Arkansas Louisiana Gas Co.*, 604 F. Supp. 779, 785 (W.D. Ark. 1985), *aff'd*, 793 F.2d 189, 193 (8th Cir. 1986).

From the decisions in *Hillard* and *Dobson* one can conclude that the Arkansas Supreme Court will apply Act 222 of 1929 only in cases of conspiracy or fraud on the part of the purchaser and producer against the royalty owner. This is the only possible conclusion, for a literal interpretation of the statute would require a judgment for *Hillard*.

d. Market Value Royalty

The nature of the natural gas market is such that gas contracts are long term. In the 1970's the price of gas rose dramatically, and in some instances the market price of gas far exceeded the price which purchasers were paying under long-term contracts.⁶³ This led to the "market value royalty" issue, wherein lessors claimed a right to royalty based upon the market value of the gas instead of the proceeds received from the sale.⁶⁴ These lessors based their claims on leases reserving royalty based upon "market value" or "market price." The following royalty clause is typical:

Lessee shall monthly pay lessor as royalty owned gas, including casing head gas, and other gaseous substance produced from said land and sold or used off the premises, or for the extraction of gasoline or other products therefrom, the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells, the royalty shall be one-eighth of the amount realized from such sale.⁶⁵

The origins of this type of clause are unclear, but probably it developed from the lessee's (or producer's) desire to recoup transportation and treatment charges the lessee had to bear when the gas was delivered to the purchaser at some distance from the well.⁶⁶ Thus, when the lessee was required to build pipelines to connect to the purchaser's pipelines, the sale is "off the premises" and the lessee could recoup the pipeline costs prior to computation of the lessor's royalty,

63. See Wright, *Market Value Royalty: Hillard and Beyond*, 24 ARK. NAT. RESOURCES L. INST. (1985).

64. An additional reason for the "market value" problem stems from the discrepancy between the prices of gas sold in interstate commerce, which was regulated, and the unregulated price of intrastate gas. *Id.*

65. *Diamond Shamrock Corp. v. Harris*, 284 Ark. 270, 272, 681 S.W.2d 317, 319 (1985).

66. Wiese, *Valuation of Gas for Royalty Purposes*, 45 TEX. B.J. 1033, 1034 (Sept. 1982), quoted in Wright, *supra* note 63. In two cases which pre-date the market value royalty problem, the Arkansas Supreme Court recognized that the parties to the lease intended for some costs to be deducted before calculating royalty based upon market value. *Parnell, Inc. v. Giller*, 237 Ark. 267, 372 S.W.2d 627 (1963); *Clear Creek Oil & Gas Co. v. Bushmaier*, 165 Ark. 303, 264 S.W. 830 (1924). Both cases are discussed above.

which is based on "market value."⁶⁷ On the other hand, if the purchaser's pipeline connects to the wellhead, the lessee has no costs to recoup and the lessor's royalty is based upon "the amount realized from such sale," or the proceeds.⁶⁸

The Fifth Circuit Court of Appeals offered a similar explanation of this type of royalty clause in the 1984 case of *Piney Woods Country Life School v. Shell Oil Co.*⁶⁹

The royalty compensates the lessor for the value of the gas at the well: that is, the value of the gas after the lessee fulfills its obligation under the lease to produce gas at the surface, but before the lessee adds to the value of this gas by processing or transporting it. When the gas is sold at the well, the parties to the lease accept a good-faith sale price as the measure of value at the well. But when the gas is sold for a price that reflects value added to the gas after production, the sale price will not necessarily reflect the market value of the gas at the well. Accordingly, the lease bases royalty for this gas not on actual proceeds but on market value.⁷⁰

At the heart of the "market value" litigation is the method of determining market value. One method is to determine the value in the unregulated free market at the time of production and delivery.⁷¹ As a rule this value is much greater than the contract price under long-term gas sale contracts and is therefore the measure sought by the lessor. This approach has been adopted by courts in Texas,⁷² Kansas,⁷³ Montana,⁷⁴ and Mississippi.⁷⁵ Another method of deter-

67. Wiese, *supra* note 66, at 1034.

68. *Id.*

69. 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985).

70. *Id.* at 231.

71. If this is to be the measure of "market value," the factors to be considered can include comparable sales. *Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225, 238-39 (1984), *cert. denied*, 471 U.S. 1005 (1985). Comparable sales have included sales from the well in question, *Diamond Shamrock Corp. v. Harris*, 284 Ark. 270, 273, 681 S.W.2d 317, 319 (1984), and sales from a large geographic area of many square miles, *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981). The Texas Supreme Court would not permit consideration of unregulated intrastate sales in *First Nat'l Bank in Weatherford v. Exxon Corp.*, 622 S.W.2d 80 (Tex. 1981), but the Kansas Supreme Court held otherwise in *Lightcap v. Mobil Oil Corp.*, 221 Kan. 449, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977).

72. *E.g.*, *Foster v. Atlantic Refining Co.*, 329 F.2d 485 (5th Cir. 1964); *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968).

73. *Matzen v. Cities Service Oil Co.*, 233 Kan. 846, 667 P.2d 337 (1983), *cert. dismissed*, 472 U.S. 1023 (1985); *Lightcap v. Mobil Oil Co.*, 221 Kan. 448, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977).

74. *Montana Power Co. v. Kravik*, 179 Mont. 87, 586 P.2d 298 (1978).

75. *Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985).

mining "market value" is the price or proceeds received from the sale of the gas in question. Oklahoma⁷⁶ and Louisiana⁷⁷ adopted this approach, as did Arkansas in the 1982 decision in *Hillard v. Stephens*.⁷⁸ However, Arkansas did not follow *Hillard* in the 1984 decision in *Diamond Shamrock Corp. v. Harris*.⁷⁹ A discussion of these decisions follows.

e. Arkansas Decisions on "Market Value" Royalty

The first decision in Arkansas on the "market value" royalty issue was the 1982 case of *Hillard v. Stephens*.⁸⁰ Beginning in 1957, Hillard executed seven leases to Stephens, the lessee. Five⁸¹ of the leases provided for royalty at the "Prevailing Market Price at Well . . . for gas" being sold or used off the premises."⁸² There was gas production from the wells, and Stephens sold the gas to Arkla under long-term purchase contracts. Stephens paid the plaintiffs⁸³ royalty based on the proceeds of the sale, and the plaintiffs accepted this royalty until they filed this suit in June, 1979, alleging that the royalties were underpaid, as the royalty clause provided for royalty based on "prevailing market price at the well." The trial court held that the royalty clause required payment on the basis of " 'current sales' of the gas on a daily basis through November 8, 1978, and thereafter by reference to section 105 of the Natural Gas Policy Act . . . which fixes the maximum price for such gas at the price specified in the existing contracts under which Ark-La purchased the gas from Stephens."⁸⁴

The Arkansas Supreme Court held for Stephens: the plaintiffs were entitled to receive royalty based upon proceeds of the sales under the long-term contracts. The court reasoned that the "prevailing market price at well" was the price received under the contracts because "a lease constitutes a present sale of all of the gas in place at the time such lease is executed; and as the gas leaves the well head, the

76. *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981).

77. *Henry v. Ballard & Cordell Corp.*, 418 So. 2d 1334 (La. 1982).

78. 276 Ark. 545, 637 S.W.2d 581 (1982), *discussed in Note*, *Hillard v. Stephens: Interpretation of Market Price Royalty Provisions in Natural Gas Leases*, 36 ARK. L. REV. 312 (1982).

79. 284 Ark. 270, 681 S.W.2d 317 (1984).

80. 276 Ark. 545, 637 S.W.2d 581 (1982).

81. The other two leases provided for a fixed royalty of 7 cents per MCF. The court's decision upholding this clause is discussed in the section on Computation of Royalty Statutory Provisions, *supra* notes 52-62 and accompanying text.

82. 276 Ark. at 547, 637 S.W.2d at 582.

83. The plaintiffs were the heirs of Hillard.

84. *Id.* at 548, 637 S.W.2d at 583.

entire ownership thereof is in the lessee, none being reserved in the lessor.”⁸⁵ Quoting the decision of the Oklahoma Supreme Court in *Tara Petroleum Corp. v. Hughey*,⁸⁶ the court held that to calculate royalties on the basis of current market value would be unfair to Stephens and would be contrary to the expectations of the lessors.⁸⁷ The contract price of \$0.339 per MCF (thousand cubic feet) was much lower than the current market price of \$2.40 per MCF. To base royalty on the latter price would award the plaintiffs a royalty of \$0.30, leaving Stephens only \$0.039 per MCF.⁸⁸ The court noted that the long-term contract of sale was executed in good faith and the contract price was fair and reasonable at the time.⁸⁹ If such were not the case, the court would hold otherwise on grounds that the lessee had not fulfilled its duty to protect the interests of the lessors by marketing “the gas efficiently and effectively.”⁹⁰

Justice Darrell Hickman dissented to this holding, quoting the trial court which decided that the words “market price” have a “common and ordinary meaning” and “refer to what the commodity will bring when placed on the market. And, . . . the word ‘prevailing’ refers to the conditions in existence at any given time and are changeable from day-to-day or at other given periods.”⁹¹ Justice Hickman reasoned that Stephens knew the difference between a proceeds lease and a market value lease and that there was evidence that Hillard would have refused to lease to Stephens and would have leased to a competitor had the lease not contained the “market value” clause favorable to the lessor. However, Justice Hickman stated that the trial court was correct in looking to the plain meaning of the lease instead of to other evidence of the parties’ intent.

The majority of the *Hillard* court could have reached the same result without stating the questionable conclusion that an Arkansas mineral lease constitutes a sale of the minerals in place. For example, it could have reasoned that the royalty clause providing for market price or market value for gas sold or used off the premises is to insure

85. *Id.* at 550, 637 S.W.2d at 583. The holding that a lease constitutes a present sale of the minerals in place is contrary to previous Arkansas law. See Wright, *supra* note 1, at 224-25.

86. 630 P.2d 1269 (Okla. 1981).

87. *Hillard v. Stephens*, 276 Ark. at 551, 637 S.W.2d at 584.

88. *Id.* at 550-51, 637 S.W.2d at 584.

89. *Id.* at 552-53, 637 S.W.2d at 585.

90. *Id.* at 552, 637 S.W.2d at 585. The requirement of a good faith, arms-length bargain was required by the *Tara* decision in Oklahoma, as noted by the court. *Id.* at 551, 637 S.W.2d at 584.

91. 276 Ark. at 556, 637 S.W.2d at 586-87 (Hickman, J., dissenting).

that the lessor receive *no more* than one-eighth of the proceeds which would have been realized by a sale at the well.⁹² This reasoning would have permitted a royalty based upon net proceeds when the "sale" takes place upon delivery of the gas to the purchaser. The court might also have found for the lessee on grounds that the public interest requires royalty based upon proceeds, as royalties are costs included in the rate base of public utilities and are paid in part by the consumer of natural gas. However, this reasoning would have no direct application to the facts in *Hillard* because the purchaser, Arkla, was not subject to the "market value" royalty provision and was paying a contract price unaffected by the royalty Stephens was paying its lessors.⁹³

The next decision on the market value royalty problem was *Diamond Shamrock Corp. v. Harris*.⁹⁴ In this 1984 decision the Arkansas Supreme Court was faced with a lease clause providing for royalty based upon "the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells, the royalty shall be one-eighth of the amount realized from such sale."⁹⁵ Harris, the lessor, executed the lease to Diamond Shamrock in 1977. At that time Diamond Shamrock had executed a long-term gas sale contract with Arkansas Louisiana Gas Corporation (Arkla) which included land in the county in which the Harris property was located. The contract had been filed with the county but did not appear in Harris' chain of title. Harris contended that he was entitled to royalty based on market value, not upon the proceeds from the gas purchase contract, or alternatively, to cancellation of the lease for failure of Diamond Shamrock to give him notice of the contract at the time he executed the lease. The trial court refused to cancel the lease but awarded Harris royalty based upon market value as determined by the amount other participants in the same well were paid.⁹⁶

The Arkansas Supreme Court affirmed, without mentioning the decision in *Hillard* that royalty should be based upon proceeds. The *Harris* court reasoned that Harris had no knowledge of the purchase contract with Arkla even though he had specifically asked the lessee's

92. See J. LOWE, OIL AND GAS LAW IN A NUTSHELL 254-65 (1983).

93. This public policy argument would not persuade the Supreme Court of Kansas. Noting that the Federal Power Commission (FPC) had no jurisdiction to regulate the payment of royalties, the court held that royalty payments would be determined by the contract provisions and would be considered by the FPC in setting rates. *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, cert. denied, 434 U.S. 876 (1977).

94. 284 Ark. 270, 681 S.W.2d 317 (1984).

95. *Id.* at 272, 681 S.W.2d at 319.

96. *Id.* at 273, 681 S.W.2d at 319.

representative about the terms of the lease before he executed it, that the filing of the contract was not notice to Harris because it was outside his chain of title, and that Diamond Shamrock should have informed Harris if it was relying on the contract with Arkla to set the basis for royalty.⁹⁷ The court said that “[t]o hold otherwise would place Harris in the unfair position of being compensated for the gas produced from his property by a contract to which he was not a party nor had any notice of when negotiating his lease with Diamond Shamrock.”⁹⁸ The court concluded that any uncertainty as to the meaning of market value should be resolved in favor of the lessor and against the lessee, the drafter of the instrument.⁹⁹

Chief Justice Webb Hubbell dissented on grounds that Harris had constructive knowledge of the contract filed of record with the county. The dissenting opinion points out a more persuasive reason for reversing the lower court: the lease provided for royalty based on proceeds for gas sold at the well, and this gas was sold at the well.¹⁰⁰

The value of the *Harris* decision as precedent is questionable, as the court's holding for the lessor was apparently based upon the fact that Harris had no notice or knowledge of the existing long-term purchase contract through which his gas was to be sold. Therefore, one might conclude that *Harris* sets a narrow precedent. This was the conclusion of the federal courts in *Taylor v. Arkansas Louisiana Gas Co.*¹⁰¹ However, *Harris* is difficult to reconcile with *Hillard* in one significant respect. The *Harris* court indicated that the meaning of “market value” is uncertain and thus interpreted that term in favor of the lessor, while the *Hillard* decision held that “market price at well” means proceeds received from the sale under the terms of a long-term purchase contract executed in good faith for a price reasonable at the time of execution. Perhaps a later decision will help resolve the question whether “market value” and “market price” are ambiguous terms in a lease royalty clause.¹⁰²

97. *Id.* at 275-76, 681 S.W.2d at 320-21.

98. *Id.* at 276, 681 S.W.2d at 321.

99. *Id.* For the rule that the instrument should be construed against the drafter, the court cited *Bradley v. Arkansas Louisiana Gas Co.*, 280 Ark. 492, 659 S.W.2d 180 (1983); *Schulte v. Benton Sav. & Loan Ass'n*, 279 Ark. 275, 651 S.W.2d 71 (1983); *Gibson v. Pickett*, 256 Ark. 1035, 512 S.W.2d 532 (1974).

100. 284 Ark. at 270, 681 S.W.2d at 321 (Hubbell, C.J., dissenting).

101. 604 F. Supp. 779 (W.D. Ark. 1985), *aff'd*, 793 F.2d 189 (8th Cir. 1986).

102. Neither *Hillard* nor *Harris*, in either the majority or dissenting opinions, distinguishes between market price and market value. Perhaps the two should be distinguished. See *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1 (Fromme, J., concurring and dissenting), *cert. denied*, 434 U.S. 876 (1977).

The United States District Court for the Western District of Arkansas and the Court of Appeals for the Eighth Circuit followed *Hillard* in *Taylor v. Arkansas Louisiana Gas Co.*¹⁰³ The facts in *Taylor* differed from those in *Hillard* in one significant respect: the lessee's interest was jointly owned by Stephens (the lessee in *Hillard*) and by Arkla (the purchaser in *Hillard*), which means that Arkla, as lessee, was not bound as a seller to a long-term purchase contract as was Stephens in the *Hillard* case. Arkla did have, however, a long-term contract to purchase the gas owned by Stephens. The Eighth Circuit reasoned that the *Hillard* rule on market value royalty should still apply, for there was nothing in the lease to indicate that a different royalty should be paid "on the same production under the same terms set out in the same leases."¹⁰⁴

f. Payment of Royalty

In *Schaffer v. Tenneco Oil Co.*¹⁰⁵ the Arkansas Supreme Court followed the general rule that nonpayment of royalties is not grounds for forfeiture of the lease unless the lease provides otherwise. The reason for this rule is that the lessor has an adequate remedy at law for damages.¹⁰⁶

The Arkansas legislature has responded to the problem of nonpayment or delayed payment of royalties and other lease proceeds payable from the sale of production.¹⁰⁷ By Act 269 of 1981,¹⁰⁸ the legislature required proceeds from the sale of oil or gas to be paid "no later than six (6) months after the date of first sale, and thereafter no

103. 793 F.2d 189 (8th Cir. 1986), *aff'g* *Taylor v. Arkansas Louisiana Gas Co.*, 604 F. Supp. 779 (W.D. Ark. 1985).

104. 793 F.2d at 192. The court listed other reasons for affirmance of the district court's summary judgment for the lessees, including the *Hillard* decision's reasoning that a lease constitutes a present sale of the gas in place. *Hillard v. Stephens*, 276 Ark. 545, 550, 637 S.W.2d 581, 583 (1982). As pointed out in an earlier chapter, Arkansas had never before recognized the lease as a sale of the minerals in place but had instead consistently held that the lease constitutes a conveyance of an easement in the land. Wright, *supra* note 1, at 224.

105. 278 Ark. 511, 647 S.W.2d 446 (1983).

106. *Id.* at 513, 647 S.W.2d at 447.

107. Proceeds other than royalty derived from the sale of production would include oil payments or production payments and overriding royalties. Generally these are payable not to the landowner or lessor, who receives royalty, but to others with an interest in the well.

108. ARK. STAT. ANN. § 53-525 (Supp. 1985), *amended by* Act 94 of 1987. The 1987 amendment apparently does not apply to the oil production in south Arkansas, as Act 94 provides:

Section 4. Limitations. The terms of this Act shall not be applicable to any producing unit or well that produces liquid hydrocarbons only, or liquid hydrocarbons associated with the production of gas or gas produced associated with the production of liquid hydrocarbons.

later than sixty (60) days after the end of the calendar month within which subsequent production is sold.”¹⁰⁹ “First purchaser” means “the first commercial purchaser after completion of the well and shall not include purchasers of oil or gas during initial testing prior to completion.”¹¹⁰ If payment is withheld because of title problems, payment must still be made to those whose title is marketable.¹¹¹ Penalties for failure to pay include payment of 12% interest,¹¹² and, if payments are withheld willfully, 14% interest.¹¹³ The prevailing party in a suit brought under this statute is entitled to costs and to prescribed attorneys’ fees.¹¹⁴ If the owner of the right to drill willfully breaches the obligation to pay royalties, a court may decree cancellation of the lease.¹¹⁵ If he fails to pay royalties to the mineral owner within 180 days of the marketing of production, the mineral owner is entitled to 12% interest on unpaid royalties.¹¹⁶

Two Arkansas Supreme Court decisions have interpreted this Act. The first, *TXO Production Corp. v. Page Farms, Inc.*,¹¹⁷ was an action brought by Page Farms to recover unpaid royalties and interest. Mr. and Mrs. Page executed a lease and later conveyed the leased property to their corporation, Page Farms, Inc. The corporation conveyed the property to a limited partnership, Page Farms, for tax purposes, but the deed, recorded a few weeks before trial, contained a property description which was void on its face. TXO acquired the lease and completed a producing gas well in February, 1982. In September, 1982, TXO received a title opinion that the record owner was the corporation, and in March, 1983, TXO sent a division order to the Page Farms, Inc., which was not signed or returned. TXO did not pay royalties and contended that it was excused because title was unmarketable, the division order was not signed and returned, and the Pages had not notified TXO of the conveyance to the corporation, as required by the lease. The court held that title was marketable and was in the corporation, as found by TXO’s counsel in the title opin-

109. ARK. STAT. ANN. § 53-525(A) (Supp. 1985). There is a proviso that proceeds may be paid annually if the aggregate of twelve months’ proceeds is less than \$25. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. ARK. STAT. ANN. § 53-525(B) (Supp. 1985) amended by Act 94 of 1987.

114. ARK. STAT. ANN. § 53-525(C) (Supp. 1985) amended by Act 94 of 1987.

115. ARK. STAT. ANN. § 53-525(D) (Supp. 1985).

116. *Id.* There is a proviso that royalties may be remitted annually when the aggregate of twelve months’ royalty is \$25 or less. *Id.*

117. 287 Ark. 304, 698 S.W.2d 791 (1985).

ion.¹¹⁸ Failure of Page Farms to sign a division order did not excuse payment of royalties, according to the court, when the division order contained provisions unauthorized by the lease and when there was no proof that the Pages knew that the custom in the industry is to require execution of division orders as a condition to payment of royalties.¹¹⁹ The court found that failure of the lessors to notify the lessee of the transfer of ownership was not a material breach of the lease, for TXO had notice by its title examination of the transfer.¹²⁰ The lower court's award of unpaid royalties, plus statutory interest and attorney's fees, was affirmed.

Justice Newbern, in a dissenting opinion in which Chief Justice Holt joined,¹²¹ would excuse delayed payment (but not payment itself) because of the lessors' failure to notify TXO of the change in ownership. The dissent notes that this failure, coupled with the failure to sign the division order, resulted in confusion as to the identity of the lessor. The dissent also points out that TXO had no duty to examine title, although it had done so.¹²²

The second case interpreting section 53-525 was *TXO Production Corp. v. First Nat'l Bank of Russellville*,¹²³ an action to recover penalties and attorney's fees for late payment of royalties. TXO started producing gas from the well in question in 1982. Some of the gas was sold to Arkla and some to Columbia Gas Transmission Service. Although Arkla started taking the gas in May, 1982, TXO and Arkla did not enter into a purchase agreement until August, 1983. TXO began to receive payment from Arkla in October, 1983, and paid royalties to the bank in November, 1983. TXO contended that it paid royalties within six months of the "date of first sale," as required by the statute. But the bank contended that the date of first sale should be measured from the time Arkla first took the gas from the well.¹²⁴ The court held for the bank:

118. *Id.* at 306, 698 S.W.2d at 792.

119. *Id.* at 306, 698 S.W.2d at 792.

120. *Id.* at 307, 698 S.W.2d at 793. The court cited the RESTATEMENT (SECOND) OF CONTRACTS § 241 (1981) to the effect that materiality of a breach is determined in part by the injured party's loss of a substantial benefit. The court reasoned that TXO gained its expected benefits under the lease. The court pointed out that this defense was apparently an afterthought. 287 Ark. at 308, 698 S.W.2d at 793.

121. 287 Ark. at 309, 698 S.W.2d at 794 (Newbern, J., dissenting).

122. *Id.*

123. 288 Ark. 338, 705 S.W.2d 423 (1986).

124. *Id.* at 340, 705 S.W.2d at 424. The trial court found that the first sale occurred in February, 1982, when Columbia first took gas under its contract with TXO. *Id.* at 341, 705 S.W.2d at 425. The opinion does not state when TXO paid royalties due under this contract.

We don't think the General Assembly intended, in passing this clearly remedial legislation, to put it in the power of a gas producer to circumvent the statute's impact by the form and timing of his sales agreements with third parties.¹²⁵

The court also held that the bank had no duty to notify TXO that it intended to file suit, pointing out that such notice was not required by the statute, although the parties could agree otherwise by contract.¹²⁶ This decision and the holding in *Page Farms* indicate that the Arkansas Supreme Court is likely to interpret section 53-525 in favor of the lessor or other party entitled to receive lease proceeds from a purchaser or producer.

g. Apportionment of Royalties

When a landowner who has leased his oil and gas subsequently conveys part of his leased land, or when the land is otherwise divided into separately owned tracts, a question arises concerning entitlement to royalties when production is from fewer than all of the individually owned tracts. One view is to apportion royalties among the owners of the several tracts in proportion to their ownership of the minerals in the entire leasehold.¹²⁷ This approach is called the "apportionment theory" and is followed by a minority of jurisdictions which have decided the question.¹²⁸ A majority of jurisdictions follow the "nonapportionment theory," under which the royalty is paid only to the owners of the tract or tracts where producing wells are located.¹²⁹ Arkansas followed this rule in the 1912 decision in *Osborn v. Arkansas Territorial Oil & Gas Co.*¹³⁰

Despite the "nonapportionment" rule, royalties are apportioned in a great majority of Arkansas leases. Apportionment can result from agreement of the parties through an "entireties" clause in the lease. A typical entireties clause reads as follows:

If the leased premises are now or hereafter owned in severalty or in separate tracts, the premises, nevertheless, shall be developed and operated as an entirety, and royalties shall be paid to each separate owner in the proportion that the acreage owned by him bears to the entire leased acreage.

125. *Id.* at 340-41, 705 S.W.2d at 424.

126. *Id.* at 341, 705 S.W.2d at 425. Notice is now required. ARK. STAT. ANN. § 53-525(c) (Supp. 1985) amended by Act 94 of 1987.

127. See 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 520 (1986).

128. *Id.*

129. *Id.*

130. 103 Ark. 175, 146 S.W. 122 (1912).

Compulsory or voluntary pooling¹³¹ may also defeat the nonapportionment rule. Compulsory pooling, or integration, is effected through the Oil and Gas Commission upon petition of an owner in an established drilling unit.¹³² Voluntary pooling results from agreement of the parties, most commonly effected through a pooling clause in the lease. The effect of pooling is that the individual royalty or mineral interests are included with other acreage for purposes of drilling a well, and royalties are paid according to each owner's proportionate interest in the pooled acreage, without respect to ownership of the well site.

Specific Lease Clauses

In addition to the clauses on bonus, royalty, and delay rentals, the oil and gas lease might contain numerous other types of standard clauses, some of which have been the focus of litigation in Arkansas.

a. Habendum Clause

The habendum clause of an oil and gas lease ordinarily provides that the lease will remain in effect for a certain period (the primary term) "and as long thereafter as oil or gas is produced." Several issues have arisen with respect to this clause.

1. "Paying quantities"

In order to keep the lease alive pursuant to the habendum clause, "production" means "production in paying quantities," the meaning of which has been litigated numerous times in other jurisdictions.¹³³ In the 1986 decision in *Turner v. Reynolds Metal Co.*¹³⁴ the Arkansas Supreme Court interpreted "paying quantities" as meaning production profitable to the lessee.¹³⁵ The lease in question had one gas well, which was one of ten wells operated by the lessee in the field. In

131. Pooling is the subject of a subsequent chapter.

132. ARK. STAT. ANN. § 53-115A-1(b) (1971). However, exploratory units are now permitted by Act 881 of 1985, codified in ARK. STAT. ANN. § 53-114 (Supp. 1985). This section permits establishment of exploratory drilling units when owners of at least a 50% undivided interest "in the right to drill and produce" agree. Whether the owner of a non-operating interest may petition for integration has not been specifically addressed by the Arkansas Supreme Court.

133. *E.g.*, Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959). One Arkansas case has held that paying quantities means "commercial quantities, and not merely a sufficient quantity for domestic use of the lessor." McLeon v. Wells, 207 Ark. 303, 305, 180 S.W.2d 325, 326 (1944).

134. 290 Ark. 481, 721 S.W.2d 626 (1986).

135. *Id.* at 483, 721 S.W.2d at 627.

determining whether a well was profitable to the lessee, the court ascertained the expenses of the well in question by prorating what the lessee paid to a contract pumper to service all ten wells.¹³⁶ The court determined that the lessee, Reynolds, had lost money on the well every year of the secondary term of the lease. Thus, the lease terminated for failure of production in paying quantities and the termination dated from the end of the primary term.¹³⁷

In *Turner* the court left unanswered numerous questions concerning determination of "paying quantities" for purposes of sustaining the lease under the habendum clause. Among these questions are whether drilling and depreciation expenses, as opposed to maintenance and lifting expenses, must be included in determining a well's profitability.¹³⁸

2. Cessation of production

Because the habendum clause requires that the lease continue "as long thereafter as there is production," it follows that a cessation of production would cause the lease to terminate under its own terms. However, the courts have not been so harsh, as a cessation of production might be temporary and can result from forces outside the control of the lessee or operator, such as equipment failure, act of God, or some other circumstance. In *Reynolds v. McNeill*¹³⁹ the Arkansas Supreme Court, noting the lessee's large expenditure of funds in obtaining production, held that "[i]t would be harsh and inequitable to say that upon a temporary stoppage of production the lessor can declare a forfeiture and take over the property himself. Hence most authorities allow the lessee a reasonable time within which to reinstate paying production."¹⁴⁰ In *Reynolds* the lease was for a primary term of six months and there was production within the primary term. But pumping was discontinued near the end of the primary term because of problems with salt water and, it was believed, sand in the casing. The lessee continued with diligence to rework the well, and when the lessor sought to have the court declare the lease forfeited, the chancel-

136. *Id.* at 484, 721 S.W.2d at 627.

137. *Id.* at 484, 721 S.W.2d at 628.

138. In *Turner* the court was able to determine that the well was unprofitable by considering only maintenance expenses. Arguably, drilling expenses should not be included as an expense in determining profitability for purposes of the habendum clause if the operator can recoup some of his costs through production, even if he will never be able to make a profit on the overall operation. See *Garcia v. King*, 139 Tex. 578, 164 S.W.2d 509 (1942).

139. 218 Ark. 453, 236 S.W.2d 723 (1951).

140. *Id.* at 456, 236 S.W.2d at 725.

lor gave the lessee sixty days in which to rework the well. The Arkansas Supreme Court affirmed.

In another decision, *Saulsberry v. Siegel*,¹⁴¹ the Arkansas Supreme Court held that the lease had not terminated when production ceased in 1930 as a result of a derrick fire, even though production was not resumed until 1934. However, weighing in favor of the lessee was the fact that the lessors did not object to rebuilding the derrick and resumption of production until 1951, when the lessors sought to terminate part of the lease.

From the *Reynolds* and *Saulsberry* decisions one can conclude that in Arkansas, once there is production and a cessation of production in the secondary term, the lease is not forfeited automatically but can continue for a reasonable time following cessation of production in order to give the lessee an opportunity to restore paying production. Furthermore, the Arkansas Supreme Court appears to have recognized estoppel in *Saulsberry*, as the holding seems to be based on the lessor's permitting the lessee to restore production and his failure to declare the lease forfeited after four years' cessation.¹⁴²

In *Reynolds* and *Saulsberry* the lease made no specific provision for temporary cessation of production, and therefore the court was free to allow the lessee a reasonable time to resume production. If a lease provides that the lessee must resume production within a specified period of time, a court will enforce that provision.¹⁴³

3. Modification of Habendum Clause by Continuous Operations Clause

In the event the lessee has begun operations but has not obtained production by the end of the primary term, the lease might terminate on its own terms, as the typical habendum clause requires production

141. 221 Ark. 152, 252 S.W.2d 834 (1952).

142. The Supreme Court of Texas has held that cessation of production brings about an automatic termination of the lease, and that therefore, the lessor cannot be estopped for his actions after the automatic termination. *Watson v. Rochmill*, 137 Tex. 565, 155 S.W.2d 783 (1941).

143. For example, in *Wilson v. Talbert*, 259 Ark. 535, 535 S.W.2d 807 (1976), Haltom, a lessor of an undivided interest, signed a lease which did not include any provision on temporary cessation of production. Talbert, the owner of another undivided interest in the same land executed a lease which provided that the lessee had to commence operations within 60 days of cessation of production. The lower court held that the lessee was bound by the lease provisions as to Talbert's lease but had a reasonable time to commence operations under the Haltom lease. There was no appeal as to the Haltom lease and the Supreme Court affirmed the chancellor as to the Talbert lease but found the clause inapplicable. 259 Ark. at 539, 541, 535 S.W.2d at 809-10.

in the primary term. However, many leases contain provisions which propel the lease into the secondary term by commencement of operations only. Of course, there can be much debate about what constitutes "operations" for this purpose. In one Arkansas case, *Haddock v. McClendon*,¹⁴⁴ the lessors sought cancellation of the lease when the lessee had built a road and had drilled to a depth of only thirty feet by the end of the three year primary term. The lease contained the following clause:

Notwithstanding anything in this lease contained to the contrary, it is expressly agreed and covenanted that if the lessee, his heirs, successors or assigns, shall *commence drilling operations* at any time while this lease is in force, this lease shall remain in force and effect, and the term and life shall continue as to the entire acreage described herein, *so long as such operations are prosecuted*, and if production results from such operations, then as long thereafter as such production continues.¹⁴⁵

The court noted that this was a "commencement" form lease as opposed to a "completion" one which would require production within the primary term.¹⁴⁶ The court found that good faith and diligence were required of the lessees, but held that the evidence did not indicate a lack of good faith when the lease permitted the lessees to commence operations near the end of the primary term. The court pointed out that the lessees were bound to exercise diligence once they had started operations, but that they were excused from continuing their efforts after the lessor notified them that the lessor considered the lease terminated.¹⁴⁷

Some clauses designed to keep the lease alive by commencement of operations are narrowly construed to permit only completion of the well or wells being worked at the end of the primary term. If that well or those wells are productive, then the lease continues.¹⁴⁸ But if they are dry or unproductive, the lease terminates and the lessee may

144. 223 Ark. 396, 266 S.W.2d 74 (1954).

145. *Id.* at 397, 266 S.W.2d at 75 (emphasis supplied by the court).

146. *Id.* at 401, 266 S.W.2d at 77.

147. *Id.* at 402-03, 266 S.W.2d at 78.

148. *E.g.*, *Tate v. Stanolind Oil & Gas Co.*, 172 Kan. 351, 240 P.2d 465 (1952). The clause in *Tate* read as follows:

If the lessee shall commence to drill a well within the term of this lease or any extension thereof, the lessee shall have the right to drill such well to completion with reasonable diligence and dispatch, and if oil or gas, or either of them, be found in paying quantities, this lease shall continue and be in force with the like effect as if well had been completed within the term of years herein first mentioned.

Id. at 355, 240 P.2d at 467.

not commence operations on a new well following the end of the primary term.¹⁴⁹

4. Modification of Habendum Clause by "Commencement" Delay Rental Clause

As pointed out above, delay rentals are paid during the primary term to keep the lease alive in absence of production. Frequently a delay rental clause forgives payment of the rental if the lessee has begun operations on the premises, even if there has been no production. Typically such a clause reads in pertinent part as follows:

If operations for the drilling of a well for oil or gas are not commenced on said land on or before one year from the date hereof, this Lease shall terminate as to both parties, unless the Lessee shall on or before that date pay or tender to the Lessor [delay rentals]. . . .

Under this type of clause it is clear that the lessee need not pay or tender the delay rentals if operations are begun by a rental due date. However, the clause does not address the issue whether commencement of operations alone, without production, is sufficient to keep the lease alive beyond the primary term. As noted above, the habendum clause permits the lease to continue into the secondary term for as long as there is production. Yet some courts have interpreted this type of delay rental clause to propel a lease into the secondary term by commencement of operations.¹⁵⁰ Arkansas has no cases on this issue.

b. *Force Majeure* Clause

The wording of this type of clause takes many forms, but its purpose is to keep the lease alive despite cessation of operations or production and despite breach of the lease covenants as a result of factors listed in the clause. Such factors may include acts of God and governmental regulation.

In *Wilson v. Talbert*¹⁵¹ the Arkansas Supreme Court had before it the interesting question of whether to apply a continuous operations clause or a *force majeure* clause. The latter read as follows:

All express and implied covenants of this lease shall be subject to all applicable laws, government orders, rules and regulations. This lease shall not be terminated in whole or in part, nor lessee held

149. *E.g.*, *Skelly Oil Co. v. Wickham*, 202 F.2d 442 (10th Cir. 1953).

150. *See* R. HEMINGWAY, *supra* note 3, § 6.6 for a discussion on the split of authority on this point.

151. 259 Ark. 535, 535 S.W.2d 807 (1976).

liable in damages because of a temporary cessation of production or of drilling operations due to breakdown of equipment or due to the repairing of a well or wells, or because of failure to comply with any of the express or implied covenants of this lease if such failure is the result of the exercise of governmental authority, war, lack of market, act of God, strike, fire, explosion, flood or any other cause reasonably beyond the control of lessee.¹⁵²

The continuous operations clause required the lessee to commence operations within sixty days of cessation of production in the secondary term. Production ceased in March, 1974 (after expiration of the primary term) because of a leak in an oil storage tank. The lessee attempted to enter the premises to repair the tank in July, 1974 (outside the time limit permitted by the "sixty day" clause) and was refused entry by a lessor, Talbert. The court held that the *force majeure* clause applied to the situation at hand, not the so-called "sixty day" clause, as the latter applied to "cessation of production because of depletion or threatened depletion of the well or wells rather than a temporary cessation because of such things as temporary lack of storage facilities."¹⁵³ Because the *force majeure* clause did not have a time limitation within which production had to be resumed, the lessee had a reasonable time. However, the court held that the lessee had not resumed production within a reasonable time because the lessee had available another storage tank, adjacent to the leaky one, which could have easily been used.¹⁵⁴

c. Free Gas Clause

This clause is designed to permit the lessor to take gas for domestic use from a well producing under the lease. As with other types of clauses, there are many variants of this one. Two Arkansas decisions exemplify the importance of careful drafting of this clause.

In *Post v. Tenneco Oil Co.*¹⁵⁵ the plaintiff, a lessor, contended that the free gas clause permitted him to take gas from a well that was not on his property but was in a unit which included his property. The supreme court found for the lessor, reversing the lower court. The free gas provisions were part of the royalty clause and read as follows:

To pay Lessor for gas from each well where gas only is found, the equal one-eight [sic](1/8) of the gross proceeds at the prevailing

152. *Id.* at 537-38, 535 S.W.2d at 808.

153. *Id.* at 540, 535 S.W.2d at 809.

154. *Id.* at 540-41, 535 S.W.2d at 810.

155. 278 Ark. 527, 648 S.W.2d 42 (1983).

market-rate, for all gas used off the premises, said payments to be made monthly if \$10.00 or more and Lessor to have gas free of cost from any such well for all stoves and inside lights in the principal dwelling house on said land during the same time by making his own connections with the well at his own risk and expense.¹⁵⁶

The court reasoned that any ambiguity in the lease should be construed against the party preparing it, the lessee.¹⁵⁷ Further, the opinion says that the lessee's interpretation of the lease was "strained and forced," and inconsistent with lessee's payment of royalties to the lessor because his land was in the producing unit.¹⁵⁸

An earlier Arkansas decision, *Cranston v. Miller*,¹⁵⁹ denied the lessor free gas from a well producing oil, but not gas, commercially. The lease clause provided:

To pay lessor one-eighth part of the gas from each well where gas only is found, while the same is being used off the premises, and lessor to have gas free from any such well for all stove and inside lights in the principal dwelling house on said land during the same time by making his own connections with the wells at his own risk and expense.¹⁶⁰

The court reasoned that two conditions attached to the lessor's right to free gas, neither of which was met: "1st, it must come from a well where gas only is found, and 2nd, the gas so found in a gas well only must be used off the premises."¹⁶¹

d. Express Drilling Covenants

Occasionally (but not usually) a lessee promises in a lease to drill a well or wells. If this drilling covenant is breached, an interesting question arises concerning the lessor's remedies.

At least two decisions from Arkansas have dealt with the problem. In *Harvey v. Marr*¹⁶² a contract between Marr, the owner of an undivided one-half mineral interest, and the operator required the operator to drill a second well in the event that a first well produced in excess of 100 barrels of oil per day. The first well met that requirement, but the operator, who also had purchased the other one-half mineral interest, assigned its interest to the defendant, Harvey, who

156. *Id.* at 528, 648 S.W.2d at 43.

157. *Id.* at 529, 648 S.W.2d at 44.

158. *Id.* at 530, 648 S.W.2d at 44.

159. 208 Ark. 156, 185 S.W.2d 920 (1945).

160. *Id.* at 157-58, 185 S.W.2d at 920.

161. *Id.* at 159, 185 S.W.2d at 921.

162. 173 Ark. 880, 293 S.W. 1005 (1927).

did not drill the second well. The plaintiff, Marr, obtained a court-appointed receiver, who contracted with another party to drill a second well. In a partition action between Marr and Harvey, Harvey was charged the entire cost of drilling the second well.¹⁶³ Because the well in question was almost certain to be a producer and because the plaintiff actually drilled the well which the defendant had covenanted to drill, the cost of drilling the well was undoubtedly the appropriate measure of damages. However, if the well had never been drilled, the cost of drilling it *might* be an inappropriate measure of damages, particularly if events subsequent to the contract indicate that a well would likely be unprofitable.¹⁶⁴

A 1922 federal diversity case from Arkansas, *Sanzenbacher v. Howard-Clay Oil Co.*,¹⁶⁵ rejected the view that the proper measure of damages is always the cost of drilling a well. An oil company agreed that in exchange for a lease to plaintiffs' land, it would commence drilling a well within sixty days. The company failed to drill, and the plaintiffs sought recovery on the company's performance bond, contending that the failure of the company to drill the well resulted in the plaintiffs' losing the ability to sell land surrounding the well site to speculators. The plaintiffs introduced evidence showing that the drilling of a well would have enhanced the value of surrounding land. The lower court granted nominal damages only on grounds that the plaintiffs had introduced no evidence on the cost of drilling a well, which the lower court held to be the proper measure of damages, pointing out that the plaintiffs could have enhanced the value of surrounding land by drilling a well themselves. But the Court of Appeals for the Eighth Circuit ruled that the plaintiffs had no such obligation and had proven a "clear, clean-cut loss, caused by default on the contract."¹⁶⁶ The court enunciated, in somewhat awkward language, what should be the rule in each case involving breach of an express drilling covenant:

[T]he measure of damages is, in each separate case, such loss as actually resulted from that character of losses which could have

163. *Id.* at 885, 293 S.W. at 1007.

164. For a discussion of the various measures that may be appropriate, see 5 H. WILLIAMS & C. MEYERS, *supra* note 127, §§ 885.1-885.5. When the covenant to drill a well is not part of a lease but instead is in a contract of assignment of the lessee's interest, the lessee frequently reserves a production payment or overriding royalty. If the lease terminates from failure of the assignee to drill, the assignor's loss might be measured by the value of the interest he lost as a result of the assignee's failure to drill. *See, e.g., Denman v. Aspen Drilling Co.*, 214 Kan. 402, 520 P.2d 1303 (1974).

165. 283 F. 13 (8th Cir. 1922).

166. *Id.* at 15.

fairly been foreseen and therefore must be held to have been within the contemplation of the parties at the time the contract was made.¹⁶⁷

Termination of an Oil and Gas Lease

From the foregoing it is clear that an oil and gas lease may terminate for failure of production or for failure to commence operations at the end of the primary term. Similarly, the lease may terminate under an "unless" type of delay rental clause for improper or untimely payment of rentals. Likewise, after there is production, a cessation of production in the secondary term may result in termination of the lease if production is not resumed within a reasonable time. The next chapter, which concerns implied lease covenants, shows that a court of equity may cancel a lease for breach of implied covenants.

a. Abandonment

But there is one other means a lease may terminate which deserves mention: by the lessee's abandonment. This is consistent with the characterization of the lease as an easement.¹⁶⁸ Arkansas has recognized that a mineral lease may be terminated in this fashion. In *Zappia v. Garner*,¹⁶⁹ the lessee had sunk a mining shaft in 1953 or 1954, had carried off a few carloads of iron at that time, and in 1956 or 1957 had taken some limestone samples from the land. This was the extent of the lessee's activity, and the plaintiffs brought suit to have the lease canceled for breach of an implied warranty to search and develop. In holding for the plaintiff, the Arkansas Supreme Court held that the lessee had breached his obligation " 'to proceed with the search and also with the development of the land, with reasonable diligence' . . . 'and may thereafter be treated as having abandoned his contract'"¹⁷⁰ Similarly, other cases finding abandonment of the lease have sounded in breach of the lessee's obligation, which may be express or implied, to develop the lease.¹⁷¹ The Arkansas cases thus seem to be based upon breach of covenants instead of abandonment. It would seem that breach of covenant is a preferable basis for these decisions, as abandonment ordinarily re-

167. *Id.*

168. See Wright, *supra* note 1, at 224.

169. 259 Ark. 794, 536 S.W.2d 714 (1976).

170. *Id.* at 795-96, 536 S.W.2d at 715 (quoting *Millar v. Mauney*, 150 Ark. 161, 169, 234 S.W. 498, 501 (1921)).

171. *E.g.*, *Millar v. Mauney*, 150 Ark. 161, 234 S.W. 498 (1921); *Mansfield Gas Co. v. Alexander*, 97 Ark. 167, 133 S.W. 837 (1911).

quires an intent to abandon,¹⁷² an element that could be difficult to prove with respect to mineral leases.

b. Statutory Provisions on Lease Termination

By Act 192 of 1921¹⁷³ Arkansas requires that upon forfeiture of a lease, a lessee must cancel or release the lease in the official record.¹⁷⁴ If a lessee fails to so release or cancel after thirty days' notice by the owner of the land, the lessee can be liable for double damages plus attorneys' fees and costs.¹⁷⁵

The Arkansas Supreme Court has held that the double damages provision is penal and must be strictly construed.¹⁷⁶ Thus, if the lessee in good faith contends that the lease has not been forfeited and has reasonable grounds to support that contention, the provision on double damages will not be enforced.¹⁷⁷

172. See R. BROWN, *THE LAW OF PERSONAL PROPERTY* 8-9 (W. Raushenbush 3rd ed. 1975). In *Millar v. Mauney*, 150 Ark. 161, 175, 234 S.W. 498, 503 (1921), the court said that abandonment is "a mixed question of law and fact."

173. ARK. STAT. ANN. §§ 53-312 to -313 (1971).

174. *Id.* § 53-312 (1971).

175. *Id.* § 53-313 (1971). This section provides that the damages are to be "not less than two annual rentals as fixed by the original lease and all costs, including a reasonable attorney's fee to be fixed by the court."

176. *Prewitt v. Chambers*, 209 Ark. 807, 194 S.W.2d 186 (1946).

177. *Hill v. Larcon Co.*, 131 F. Supp. 469 (W.D. Ark. 1955); *Prewitt v. Chambers*, 209 Ark. 807, 194 S.W.2d 186 (1946).

