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The Good Faith Mineral Trespasser's Reasonable Cost of Production

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The Good Faith Mineral Trespasser's Reasonable Cost of Production

Introduction

One of the special hazards involved in mineral production is the risk that the producer may have to account to owners unforeseen[1] at the commencement of production. This is the result when the producer extracts minerals to which he has no claim; under these circumstances he is a trespasser in the eyes of the law.[2] The same uncertainty is present when the producer extracts minerals in which there are additional latent ownership interests at the time production begins; in this case the producer becomes a cotenant with such interests.[3]

Discovery of the extraction frequently results in a civil suit in which the producing trespasser or joint tenant is a defendant.[4] The plea in such suits is that the producer account to the nonconsenting owner for the minerals appropriated.[5]

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[1] Although it is also possible that the producer will have to account to parties which were foreseen to him at the time his production began, an assumption for this Note is that the producer is acting in good faith. Good faith on the part of the producer is a requirement for the issues addressed by this Note; therefore the producer must not foresee the possibility of accounting for his production, for this would bring into question his good faith.

[2] *See, e.g.*, Swiss Oil Corp. v. Hupp, 69 S.W.2d 1037 (Ky. 1934).

[3] *See, e.g.*, *infra* notes 25-30 and accompanying text.

[4] The theory of damages in such cases is restitution. The owner is to be compensated for his appropriated minerals, the value of the minerals being their value in place. Johns Run Coal Co. v. Little Fork Coal Co., 3 S.W.2d 623, 624 (Ky. 1928).

[5] *See generally id.*

When the producer has acted willfully[6] a harsh rule of damages is applied.[7] This rule denies the defendant credit for any costs incurred in producing the mineral.[8] If the defendant acted innocently, he may reduce the amount received for the sale of the mineral by some of his costs of production.[9]

When the producer is allowed to deduct the expenses of production, a frequently litigated issue is which of the expenses will be allowed and which will not.[10] It is difficult, if not impossible, to answer this question in the absence of litigation because the courts who have previously addressed these questions have typically provided little or no rationale for their decisions.[11] The resulting uncertainty hinders the development of valuable mineral estates[12] and promotes the use of less desirable methods of computing damages[13] due to an unnecessarily undeveloped area of the law.[14]

This Note will examine the reported decisions in this area to determine the types of expenses which have been allowed by some courts. Although the analysis will focus on Kentucky law, cases from other jurisdictions will be discussed for their persuasive value. As a general solution to the uncertainty as to whether costs are deductible, this Note will propose that the general rule

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[6] For an excellent discussion of the determination of when a producer has acted wilfully or innocently *see* Stigger, *The Mineral Trespasser: Innocent v. Willful*, 12 ANNUAL MIN. L. SEMINAR 10-B (Oct. 2-3, 1987).

[7] *See, e.g.*, Houston Production Co. v. Mecom Oil Co., 62 S.W.2d 75, 77 (Tex. Civ. App. 1933).

[8] *Id.*

[9] Swiss Oil Corp. v. Hupp, 69 S.W.2d 1037, 1044 (Ky. 1934).

[10] *See infra* text accompanying notes 46-90.

[11] *See e.g. infra* text accompanying notes 86-90.

[12] *See* Smith, *Methods for Facilitating the Development of Oil and Gas Lands Burdened With Outstanding Mineral Interests*, 43 TEX. L. REV. 129, 131 (1964-65).

[13] *See* Trustees of Proprietors of Kingston v. Lehigh Valley Coal Co., 88 A. 768, 769 (Pa. 1913) (adopting the "royalty method" of computing damages due to the uncertainty of the computations of value based on the proceeds less the cost of production); *accord*, Reeves, *Liability for Mining on a Void Claim*, 16 ROCKY MTN. MIN. L. FOUND., Vol. 6 AMERICAN LAW OF MINING, 2d ed. § 203.01(2)(b) at 203-07 (2d ed. 1987). The "royalty method" is criticized because it allows the defendant no less than he would have recovered had he bargained with the owner, and because it fails to compensate the owner for the value of his minerals in some situations. Hughett v. Caldwell County, 230 S.W.2d 92, 95 (Ky. 1950).

[14] Avenues of analysis do exist in this area; *see, e.g.*, notes 91-96 and accompanying text.

as to the deductibility of production costs in such cases of trespass should be that the defendant may deduct only costs which the plaintiff would have incurred. The amount of this deduction should be ascertained by an examination of the plaintiff's costs for mining similar sites. Where this information is unavailable, the defendant's deduction should be based on customary costs of mining near the locality of the trespass. As an extension of this thesis, the Note will comment on the recent trend of the Kentucky courts and explain why this trend should be reversed.

II. ANALYSIS OF PRIOR CASES

A. Trespassers, Cotenants and the Law

One of the most frequently cited cases in the area of the trespassing mineral producer is the Kentucky case, *Swiss Oil v. Hupp.*[15] This litigation involved a producer, Hupp, who had drilled under color of title from a defective "top lease"[16] on land which was validly leased to another.[17] Because the plaintiff, Swiss Oil, was a lessee, the court viewed this claim differently from the claim of an owner.[18] Had Swiss Oil been the owner of the land, the measure of damages would have been the customary royalty.[19] Because Swiss Oil was a lessee, the court felt that it was entitled to the "market value less the cost of extracting and marketing. . . ."[20] In so holding, the court was forced to distinguish the situation of the oil and gas trespasser from the coal trespasser and from situations in which the plaintiff was the owner of the appropriated oil and gas and not merely a

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[15] 69 S.W.2d 1037 (1934).

[16] A "top lease" is "[a] subsequent oil and gas lease which covers one or more mineral interests that are subject to a valid, subsisting prior lease." BLACK'S LAW DICTIONARY 1335 (5th ed. 1979).

[17] 69 S.W.2d at 1039.

[18] *Id.* at 1043.

[19] "*We regard [the royalty rule] sound, for royalty is all that . . . an owner would* have received for what he had under the usual and customary lease or conveyance." *Id.* at 1044.

[20] *Id.*

lessee.[21] In these cases, the measure of damages remained undisturbed as "the usual and customary royalty."[22]

The holding in *Swiss Oil* brought to Kentucky law the question of which expenses would be allowed to a producing trespasser.[23] As part of its analysis, the court relied on another Kentucky case, *New Domain Oil and Gas Co. v. McKinney*,[24] which had addressed the same question fourteen years earlier in a situation involving cotenants.[25] In *New Domain*, the producer had begun production and was subsequently declared to be a cotenant of the oil and gas he was producing.[26] The court compared the producing cotenant to the innocent trespasser, cited a lengthy number of precedents outside Kentucky which granted the plaintiff the "value in situ"[27] of the converted property, and reaffirmed the use of that method.[28] The court adopted for the measure of the "value in situ" a method which can be summarized as the gross proceeds less expenses of the operation.[29] It should be observed that this court's analysis was based on a theory of restoring the plaintiff to his original position rather than preventing the unjust enrichment of the defendant. Therefore, the remedy was not a suit for money had and received by the defendant, but rather was an attempt to restore the value of the coal to the plaintiff. The *measure* of that value is the proceeds less the expenses of the operation.[30]

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[21] *Id.* at 1044.

[22] 69 S.W.2d at 1044.

[23] *See supra* note 21 and accompanying text.

[24] 221 S.W. 245 (Ky. 1920).

[25] *Id.* at 251.

[26] *Id.* at 246.

[27] Although the court was secure that the general rule was the "valu in situ" or value in place basis for recovery, the court noted that there was a discrepancy in the method which different jurisdictions used to compute the value in place. *Id.* at 250. Some jurisdictions, the court noted, compute the value by deducting "from the value of the mineral at the mouth of the mine the expense of extracting it, and the difference is taken as its value as it lay in the earth." *Id.* Pennsylvania was referenced as computing the value of the mineral as "the universal and customary royalty paid for the right of mining the particular substance in the locality. . . ." *Id.*

[28] *Id.*

[29] *Id.* at 251-52. It should be emphasized that these suits are not based on the fact that the defendant has money to which he is not entitled; the legal theory is that the law is seeking to restore the plaintiff for coal which he has lost. *See supra* note 5.

[30] *See supra* note 29.

The third Kentucky case to refine the measure of damages using the "value in situ" based on the gross proceeds less cost of production method of computing damages was the 1950 case, *Hughett v. Caldwell County*.[31] The *Hughett* court held that the royalty method[32] would be used when the owner "could not extract the minerals himself in any practical or feasible way, or where he [was] merely holding his property for development in the unforeseeable future. . . ."[33] This case more notably held that when the owner is able to produce the mineral himself[34] a different rule would apply; the measure of damages would be the same as those in the case of the injured lessee and the nonproducing cotenant. This measure would be the "reasonable market value . . . less the reasonable cost incurred . . . in mining."[35]

These three cases and their progeny illustrate situations in which it will be necessary to determine the reasonable costs of production.[36] They also provide examples of costs which have

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[31] 230 S.W.2d 92 (Ky. 1950). This case is actually one of a series of appeals growing out of a much litigated contest over the ownership of a roadbed containing fluorspar. Cases related to this litigation are: Caldwell County v. Hughett, 248 S.W.2d 338 (Ky. 1952) (court analyzes the reasonableness of certain items of cost claimed deductible by defendant); Morgan v. Hughett, 192 S.W.2d 197 (Ky. 1946) (a quitclaim deed obtained by Hughett was found not to have been obtained by fraud); Caldwell County v. Hughett, 192 S.W.2d 194 (Ky. 1946) (Caldwell County's motion for new trial is denied); Hollowell v. Caldwell County, 155 S.W.2d 481 (Ky. 1941) (title to the disputed property is adjudged to be in Hughett).

[32] *See supra* note 27 (explanation of the "royalty method").

[33] 230 S.W.2d at 96.

[34] *Id.* at 97. *See also* Stigger, *supra* note 6, at R-18 (discussing Rudy v. Ellis, 236 S.W.2d 466 (Ky. 1951) as holding a similar measure of damages to be applicable).

[35] 230 S.W.2d at 97. Interestingly, this case involves a plaintiff in a suit for recovery of the value of appropriated fluorspar, a hard mineral like coal. It was coal which *Swiss Oil* had explicitly held to still fall under the royalty method. Obviously, the holding in *Hughett* modifies the recovery in the coal scenario when the owner is able to produce.

[36] Another case which *may* have an impact on the question of when this measure of damages might be available is a Kentucky tax case: Commonwealth Dep't of Revenue v. Majestic Collieries Co., 594 S.W.2d 877 (Ky. 1980). This case holds that, for purposes of taxation, a person is "severing coal" when he owns the coal and uses a contract miner to take the coal from the earth. *Id.* at 878. Arguably, anyone who owns coal is able to mine that coal through a contract miner and, therefore, entitled to the measure of damages of one able and intending to mine the coal. It should be remembered, however, that the test formulated in *Hughett* for the royalty method was a disjunctive test, the second prong of which focuses on the *purpose* for which the owner holds his

been allowed. They do little, however, to provide useful rules for determining which costs are reasonable.[37] The resulting uncertainty provides an impediment to the development of mineral estates in which the producer may have to account for his production.[38] This same lack of certainty has been used in Pennsylvania as a justification for strict application of the much criticized royalty method of computing damages.[39] Because of the problems this uncertainty creates, Kentucky courts should seize the opportunity to develop this area of the law.

Two Kentucky cases which have attempted to provide some guidelines for the deductibility of costs have failed to focus on the restitutionary nature of the remedy for a mineral trespass.[40] These two cases are *Joyce v. Zachary*[41] and *Howard v. Kingmont Oil*,[42] both of which focus on the question of whether the trespasser thought his expenditures would be beneficial to the plaintiff. If the trespasser so believed then the expenditures of the defendant are deductible. These cases have also focused on the *expenditures* of the defendant rather than the benefit derived by the plaintiff.[43] Clearly the Kentucky courts have lost sight of the restitutionary nature of the remedy as enunciated in *Hughett v. Caldwell County*.[44] As the Kentucky courts receive the opportunity to develop this area of the law, they should remedy the digressions they have made from the goal of restitution. This should be done by ignoring the question of whether costs were "reasonably calculated to be beneficial" and by focusing on a

property. 230 S.W.2d at 96. In order to qualify out of the royalty measure of value under the test set forth in *Hughett*, the plaintiff must have both ability and intent to develop. *Commonwealth Dep't of Revenue v. Majestic Collieries* may reflect on ability but it cannot reflect on intent.

[37] *See* Smith *supra* note 12 at 131. *See also*, Reeves, *Liability for Mining on a Void Claim*, 16 ROCKY MTN. MIN. L. FOUND., *supra* note 13 § 203.01(2)(b); Schwinn, *Tort Liability Resulting from Mining Operations*, 8 ROCKY MTN. MIN. L. INST. 461, 483 (1963).

[38] *See supra* note 12.

[39] *See supra* note 13.

[40] *See supra* notes 4, 29 and accompanying text.

[41] 434 S.W.2d 659 (Ky. 1968).

[42] 729 S.W.2d 183 (Ky. Ct. App. 1987).

[43] 434 S.W.2d at 661; 729 S.W.2d at 183.

[44] *See supra* notes 31-35 and accompanying text.

restitutionary measure of damages rather than the expenditures of the defendant.[45]

B. *General Principles of Deductibility*

Although the reported cases provide little analysis, they do provide examples of deductible costs. Unfortunately, there is little uniformity among decisions; therefore, any analysis is limited to the facts of the case and the jurisdiction in which it was decided. Because one goal of this Note is to provide guidance as to the costs which Kentucky courts might allow, it begins by examining reported cases from all jurisdictions for general themes of deductibility.

1. Direct Costs of Extraction

Almost all jurisdictions allow the deduction of "direct costs"[46] of extraction.[47] Although early decisions disallowed the costs incurred in severing the mineral from the earth,[48] these cases have since been misinterpreted as allowing the deductibility of such expenses[49] where the expenses were direct and reasonable.[50] In a California case[51] which allowed the direct costs of extraction, the court was careful to note that "overhead costs . . . and all other items that do not fall *strictly* under the classification of 'mining and milling' should not be deducted."[52] The wording of this decision suggests strict construction of the term "direct costs." In California, the direct costs of mining and milling may be deducted, but one should note that overhead, even variable overhead, might not be deductible as part of the direct costs.[53]

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[45] *See infra* notes 55-58 and accompanying text.

[46] "Direct costs" are the costs "of direct material and labor, and variable overhead incurred in producing a product." BLACK'S LAW DICTIONARY 413 (5th ed. 1979).

[47] *See, e.g.*, Daly v. Smith, 33 Cal. Rptr. 920, 926 (Cal. Dist. Ct. App. 1963); McGuire v. Boyd Coal & Coke Co., 86 N.E. 174, 175 (Ill. 1908).

[48] Reeves, *supra* note 37 at 523.

[49] *Id.*

[50] *See supra* note 47 and accompanying text.

[51] Daly v. Smith, 33 Cal. Reptr. 920 (Cal. Dist. Ct. App. 1963).

[52] *Id.* at 926 (emphasis added).

[53] *Id. See also*, Clarke-Montana Realty Co. v. Butte & Superior Copper Co., 233 F. 547, 577 (D. Mont. 1916), *aff'd*, 248 F. 609 (9th Cir. 1918).

As with all costs, direct costs of production are limited by the requirement that they be "reasonable."[54] Such a requirement does little to provide guidance, for to label a cost as "reasonable" is to first answer the question, "Is the cost deductible?" Although no case has posited useable guidelines as to reasonableness, a West Virginia case, *Spruce River Coal Co. v. Valvo Coal Co.*,[55] does provide an example from which important observations can be made.

In *Spruce River* the producing defendant had experienced a labor strike which had caused actual costs of production to be inordinately high during the period the defendant was appropriating the plaintiff's coal.[56] In arriving at the cost allowable to the defendant, the West Virginia Supreme Court upheld a jury verdict which ignored the defendant's actual costs and based the deduction on evidence of what it would have cost the *plaintiff* to produce the coal.[57]

This case is important in an analysis of "reasonableness" for two reasons. First, it disallows increased costs due to strikes and—arguably—other factors unique to the defendant. Secondly, it allows the reasonable cost of production to be based on the *plaintiff's* costs of mining similar properties in the vicinity.[58] Therefore, this case supports the assertion that "reasonable" is a ceiling based on the amount for which the plaintiff

[54] Hughett v. Caldwell County, 230 S.W. 2d 92, 97 (Ky. 1950); Caldwell County v. Hughett, 248 S.W.2d 338, 340 (Ky. 1951).

[55] 120 S.E. 302 (W. Va. 1923).

[56] 120 S.E. at 303.

[57] *Id.* The logic behind this decision is intuitively appealing and reconcilable with other cases on the issue. Consider the holding in *Hughett*: there the court stated that when a plaintiff is in a position to mine and intends to do so, his coal has a different value than one who is holding his coal with no view of mining. *See supra* notes 31-35 and accompanying text. This same logic would support the *Spruce River* holding because a plaintiff who is holding his coal for mining is damaged in the amount of any costs which the appropriator incurs which exceed the costs the plaintiff would have experienced. This same concept appears in Bates v. Smith, 54 Cal. Reptr. 624 (Cal. Ct. App. 1966), where the court noted that, "[t]he owner . . . should be entitled to the value of the property. . . . This value should not be diminished by a reckless and unskillful operation. . . . The measure of damages . . . is the amount that will fully compensate the plaintiff for all the detriment proximately caused by the trespass." *Id.* at 626.

[58] 120 S.E. at 304. *See also*, Clark-Montana Realty Co. v. Butte & Superior Copper Co., 233 F. 547 (D. Mont. 1916), where evidence of plaintiff's efficiency seems to have entered into the court's decision. *Id.* at 577.

could have produced the mineral but for the defendant's appropriation.[59] Such a measure is also completely consistent with a restitutionary measure of damages, for it more accurately reflects the value of the coal to the plaintiff.

2. Overhead

Even though overhead may not be deductible as part of a strict construction of "direct costs,"[60] most jurisdictions allow overhead to be deducted separately.[61] The majority rule allows such deductions based on allocations rather than upon an examination of whether or not additional costs were incurred as a result of the operations on plaintiff's property.[62] Kentucky courts follow this latter view.[63]

3. Compensation for Services

In this category alone a distinction might be necessary between a producing trespasser and a producing cotenant. While the producing cotenant is generally not allowed a deduction for his services,[64] a producing trespasser may be allowed such compensation.[65]

4. Income Taxes Paid by the Defendant on Profits From the Appropriated Minerals

This is a cost for which there seems to be a developing general rule of nondeductibility.[66] This rule is found in cases as

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[59] *See supra* notes 57-58 and accompanying text.

[60] *See supra* notes 46-53 and accompanying text.

[61] Greer v. Stanolind Oil & Gas Co., 200 F.2d 920, 923 (10th Cir. 1952); Swiss Oil v. Hupp, 69 S.W.2d 1037, 1045 (1934); Spruce River Coal Co. v. Valvco Coal Co., 120 S.E. 302, 304 (W. Va. 1923); New Domain Oil & Gas Co. v. McKinney, 221 S.W. 245, 251 (1920).

[62] Daley v. Smith, 33 Cal. Reptr. 920, 926 (Cal. Dist. Ct. App. 1963); Clarke-Montana Realty Co. v. Butte & Superior Copper Co., 233 F. 547, 577 (D. Mont. 1916), *aff'd*, 248 F. 609 (9th Cir. 1918).

[63] 69 S.W.2d at 1045.

[64] Wolfe v. Childs, 94 Pac. 292, 294 (Colo. 1908); Annotation, 51 A.L.R.2D, 474 (1957); Annotation, 5 A.L.R.2D, 1379 (1949).

[65] Caldwell County v. Hughett, 248 S.W.2d 338, 340 (Ky. 1951).

[66] 69 S.W.2d at 1045; *but see* United States v. Standard Oil Co. of California, 21 F. Supp. 645 (S.D. Cal. 1937), *aff'd*, 107 F.2d 403 (9th Cir. 1939) (which seems to state a general rule of deductibility for income taxes). *Id.* at 655.

early as *Swiss Oil*, where the court correctly stated that "[i]ncome tax can hardly be regarded as entering into the cost of production. Its very nature repudiates the idea."[67] Another example is *United States v. Standard Oil Co. of California*,[68] where the court decided that it was bound by the guidelines of a California statute[69] stating that costs were to include taxes.[70] Rather than analyze whether "taxes" is a word intended to include income taxes, the court justified its deduction by analogizing the case of mineral trespass to cases involving patent infringement and utility ratemaking cases. Some of these cases had allowed the deduction of income taxes.[71] Quoting a patent infringement case, the trial court stated that "allowance is made for taxes paid, in order to leave the infringer accountable for '*only the profits of which it actually has had the benefit*.' "[72] This statement indicates that the trial court had lost sight of the goal of reimbursing the plaintiff and instead was focusing on the profits made by the defendant. In addition to reliance on what it saw as precedent and the terms of the statute, the court was also impressed by the fact that the plaintiff was the United States government, the entity to which the taxes had been originally paid.[73] This latter fact is the one upon which the Ninth Circuit correctly upheld the allowance. As part of the holding, the appellate court expressed its doubt as to whether income taxes were contemplated by the statute or whether they were "generally [classified] as an expense of production."[74]

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[67] 69 S.W.2d at 1045. In addition to recognizing a general rule of nondeductibility, the court was also impressed with the fact that the defendant had already applied for a refund.

[68] 21 F. Supp. 645 (S.D. Cal. 1937), *aff'd*, 107 F.2d 403 (9th Cir. 1939).

[69] CAL. CIV. PROC. CODE § 349 3/4 (West 1982).

[70] 21 F. Supp. at 655.

[71] *Id.*

[72] *Id.* (quoting Stromberg Motor Devices Co. v. Zenith-Detroit Corporation, 73 F.2d 62 (2d Cir. 1934) at 65). The court cited as authority for the general rule of deductibility of taxes the U.S. Supreme Court case of L. P. Larson, Jr., Co. v. Wm. Wrigley, Jr., Co., 277 U.S. 97 (1928). Interestingly, the cited case had actually *denied* the deduction of taxes where the plaintiff would have to pay taxes on his recovery. *Id.* at 98.

[73] 21 F. Supp. at 655.

[74] Standard Oil of California v. United States, 107 F.2d 402, 419 (9th Cir. 1939).

5. Improvements to the Plaintiff's Land

One area in which there is some uniformity is the issue of improvements to the plaintiff's land. Most jurisdictions allow the defendant to deduct the cost of improvements[75] but do not allow personal judgment suits against the plaintiff.[76]

More difficult questions arise when the plaintiff takes over the improvement before it has produced enough to pay for its cost.[77] It would be inequitable to allow the improvement to accrue to the plaintiff's benefit but to disallow a set-off for its cost.[78] In recognition of this possible inequity, a general rule has developed which allows the defendant to recover the costs of the improvement from the production, if any, or to go unpaid.[79] At least one Kentucky court has followed this common law rule.[80]

In addition, there is statutory protection for the good faith trespasser.[81] A Kentucky statute provides that the good faith trespasser who makes improvements is to be paid "the value of his improvements" *before* the court orders him to deliver possession to the plaintiff.[82] This provides greater protection to the defendant than the common law rule because it gives him a right to payment rather than a mere lien on future production. A possible limitation on this assertion is the use of the "value" of the improvement in the statute's computation of the amount due the trespasser. Arguably, the "value" of the improvement is so closely tied to the resulting future production that it cannot be accurately computed without knowing the resulting production. Clearly such an argument must fall to the legislature's require-

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[75] Mastin v. Mastin's Administrator, 50 S.W.2d 77, 79 (Ky. 1932); 20 AM. JUR. 2D *Cotenancy and Joint Ownership* § 52 (1965).

[76] Mastin v. Mastin's Administrator, 243 Ky. 830, 50 S.W.2d 77, 79 (Ky. 1932); 20 AM. JUR. 2D *Cotenancy and Joint Ownership* § 63.

[77] For a discussion of the problem and its resolution see 1 E. KUNTZ, OIL AND GAS § 11.6 (1987).

[78] "[H]e who seeks equity must do equity. . . ." *Id.* at 321.

[79] Lawrence Oil Corporation v. Metcalfe, 100 S.W.2d 217, 222-23 (Ky. 1936). *See also* Fox v. Buckingham, 14 S.W.2d 421 (Ky. 1928).

[80] *See* Kuntz *supra* note 77 for a discussion of the general rule (citing Joyce v. Zachary, 434 S.W.2d 659 (Ky. 1968)).

[81] KY. REV. STAT. ANN. § 381.460 (Bobbs-Merrill 1972) [hereinafter KRS].

[82] *Id.*

ment that the payment be ordered *before* delivery of the property to the plaintiff.[83]

6. Secondary Recovery Expenses

Few cases have addressed the question of whether secondary or heroic recovery techniques are deductible. In the case of *Joyce v. Zachary*[84] the expenditures of water flooding and the associated engineering fees were allowed where there was evidence that the water flooding kept production from decreasing.[85]

One case which may be mistaken as adjudicating the deductibility of secondary recovery techniques is *Caldwell County v. Hughett*.[86] The issue in *Hughett* was whether the defendant should be allowed to deduct the amount which he was "out"[87] in getting another company to sink a new shaft on an adjacent tract of land, divert a stream, and keep the water pumped out of the mine.[88] After the "payment" had been made, the payee never actually did the work.[89] Naturally the court disallowed these costs, but the basis for the holding was the defendant's own imprudence rather than the fact that these expenses were comparable to secondary recovery expenditures.[90]

III. ISSUES TO BE RESOLVED IN ADJUDICATING THE DEDUCTIBILITY OF COSTS OF PRODUCTION

As the foregoing sections indicate, there are currently no clear guidelines as to the costs that are deductible by a good faith producer in an accounting by a mineral trespasser or a

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[83] *Id.*

[84] 434 S.W.2d 659 (Ky. 1968).

[85] *Id.* at 661-62.

[86] 248 S.W.2d 338 (Ky. 1951). Note that this is not the previously analyzed case of *Hughett* but a second appeal in which the issue before the court was the deductibility of certain costs. *See* discussion at *supra* note 31.

[87] The defendant had not made an actual expenditure here but had transferred part of his interest in the lease which was the subject of dispute. 248 S.W.2d 339, 340.

[88] *Id.* at 339.

[89] *Id.*

[90] *Id.* Perhaps a finding implicit in disallowing these costs was that they were of no benefit to the plaintiff. *See* the discussion of the importance of a benefit to the plaintiff at *infra* notes 102-10.

producing cotenant.[91] This uncertainty has resulted in a hesitancy to develop reserves[92] and, in Pennsylvania, is used as justification for use of the "royalty method" of computing damages.[93] In addition, this lack of guidelines has generated notable inconsistency among jurisdictions.[94] Therefore, courts should seize the opportunity to establish thoughtful precedent and flush out this neglected area of the law.

As the following suggestions indicate, the issues to be resolved for each expenditure are complex and the problem does not lend itself to an easy rubric.[95] Instead, several questions must be answered to resolve the one ultimate question: "Are these expenditures for which the defendant's liability is to be reduced?" A discussion of each of the suggested questions follows:[96]

1. Has an expense actually been incurred for which the defendant will receive no remuneration or refund?

In most cases, the answer to this question will be in the affirmative. When the answer is in the negative, however, the basis for the court's holding that the expense is not allowed should be clarified. The analysis applied to the deductibility of income taxes in *Swiss Oil v. Huff*[97] illustrates the importance of this question.

In *Swiss Oil* the court was asked if the defendant could deduct income taxes paid on profits from sales of the plaintiff's mineral.[98] The court stated that "[i]ncome tax can hardly be

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[91] *See supra* text accompanying notes 46-90.

[92] *See supra* note 13.

[93] *See supra* text accompanying note 13 for criticism of the royalty method.

[94] It should be noted that one case did attempt to formulate a rule for the deductibility of costs. In Joyce v. Zachary, 434 S.W.2d 659, 661 (Ky. 1968) the court stated, "[W]e think the test of allowability should be whether the expenses were *reasonably calculated* to be beneficial and productive." (emphasis in original). *See also* Howard v. Kingmont Oil Co., 729 S.W.2d 183 (Ky. Ct. App. 1987) (citing *Joyce* in ascertaining deductible production costs).

[95] The length of time in which courts have been analyzing these issues and the failure during that time to formulate a standard lends much support to this assertion.

[96] Before the presentation of the question is made, the author offers a caveat: these questions are only important when the plaintiff has acted in good faith. In some situations, the plaintiff's behavior will give rise to estoppel or avoidable consequences issues. *See* KUNTZ, *supra* note 77, § 11.3 at 310.

[97] 69 S.W.2d 1037 (Ky. 1934).

[98] *Id.* at 1045.

regarded as entering into the cost of production. Its very nature repudiates the idea. Moreover, [defendants] have already filed a claim with the government for a refund . . . and . . . they have a fair chance to recover."[99] The court disallowed the deduction but the grounds for the disallowance are unclear. The case might stand for the proposition that income taxes are not deductible, or for the proposition that no expenditure is to be allowed when it can be, or has been, recovered elsewhere.

Naturally, a defendant should not be given credit for expenditures which he has not incurred, or for which he will be compensated by one other than the plaintiff[100] (the collateral source rule[101] excepted). Although such situations should not arise frequently, when they do, clearly labelling the reason for disallowance will avoid confusion by those who study the case as a statement of law.

2. Was the expenditure of benefit to the plaintiff or a cost which he would have incurred had he performed the extraction himself?

In suits of this nature "the object of the law is to compensate the owner for his loss without unduly enriching him by giving him the advantage of the trespasser's efforts."[102] The amount of this loss is measured by an amount which is sometimes comparable to the plaintiff's lost profits.[103] Failing to allow the defendant a deduction for costs which the plaintiff would have had to pay[104] and for expenditures which benefited the plaintiff would not serve the law's compensatory goal. A necessary result

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[99] *Id.* at 1045. In addition to the two reasons appearing here, the court also stated that plaintiffs "will have to render a tax accounting upon the recovery. . . ." *Id.* This is a third possible reason for disallowance.

[100] *See* Silver King Coalition Mines Co. v. Conkling Mining Co., 255 F. 740 (8th Cir. 1919), where the costs of extending and driving a tunnel were disallowed where the revenue from the tunnel exceeded its cost, and the tunnel's purpose was not directly related to the ore's discovery.

[101] Under the collateral source rule, if an injured person is compensated for his injuries from a source independent of the tortfeasor, the payment should not be deducted from money he would collect from the tortfeasor. The purpose of the rule is to prevent the torfeasor from benefitting from payment to the plaintiff from other sources. *See* BLACK'S LAW DICTIONARY 238 (5th ed. 1979).

[102] KUNTZ, *supra* note 77, § 11.3 at 308.

[103] Hughett v. Caldwell County, 230 S.W.2d 92, 97.

[104] St. Clair v. Cash Gold Mining & Milling Co., 47 P. 466 (Colo. App. 1896).

of the compensatory nature of the damage computation method used in these cases is the requirement that an expenditure must benefit the plaintiff in order to be deductible. To state the condition for allowability is to state a problem of proof for the defendant:[105] the expenditure must be proven to have benefited the plaintiff in order to justify having his recovery reduced.[106]

Most of the normal operating costs of production will satisfy this requirement without strained analysis. The question will serve its greatest function in deciding harder questions such as whether the costs of dry holes or secondary recovery techniques are deductible.[107] An inquiry as to whether such cost conferred a benefit upon the plaintiff gives the courts flexibility to make factual determinations that such expenditures did or did not benefit the plaintiff's interest.[108] For example, courts have found such benefit in the form of increased geographic knowledge of the area when no other benefits were proven.[109] The burden of proof that the expenditure provided a benefit to the plaintiff falls upon the defendant.[110] When the finding of a benefit involves a strained factual analysis, the limits of deductibility are approached.

3. Will the defendant's deduction exceed the proceeds of production?

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[105] "The burden of showing that the [cost] conferred a benefit is upon the trespasser." KUNTZ, *supra* note 77, § 11.6 at 322 (citing Greer v. Stanolind Oil Co., 200 F.2d 920 (10th Cir. 1952)).

[106] KUNTZ, *supra* note 77, § 11.6 at 321-22. *Cf.* Joyce v. Zachary, 434 S.W.2d 659, 661 (Ky. 1968). (This case seems to only require that the defendant "reasonably calculated" the costs to be beneficial to the plaintiff's interest in the minerals.).

[107] Caldwell County v. Hughett, 248 S.W.2d 338 (Ky. 1951). *See supra* notes 86-90 and accompanying text.

[108] *See* 434 S.W.2d at 661-62 and 664 (water flooding and dry hole costs were found to be beneficial). For examples of costs not found to be of benefit *see* Caldwell County v. Hughett, 248 S.W.2d 338 (Ky. 1951) (discussed at *supra* text accompanying notes 75-90); Pan American Petroleum Corporation v. Candelaria, 403 F.2d 351 (10th Cir. 1968); Carter Oil Co. v. McCasland, 207 F.2d 728 (10th Cir. 1953) (which held that well which was actually producing was of no benefit when the owner already had enough wells to produce the oil under the lease in question); Greer v. Stanolind Oil & Gas Co., 200 F.2d 920 (10th Cir. 1952).

[109] Edwards v. Lachman, 567 P.2d 73, 77 (Ok. 1977).

[110] *See* KUNTZ, *supra* note 77. *See also*, Carter Oil Co.v. McCasland, 207 F.2d 728 (10th Cir. 1953).

An elementary principle is that the defendant can recover nothing in excess of the production resulting from his efforts.[111] A refinement of this principle, which must be decided before damages are computed, is whether this limitation is to apply on a "per-well basis" or "on the basis of the expenditures . . . and receipts from the entire . . . premises."[112] If the "per-well basis" method is applied, the cost of each well is recoverable only from the production from that well;[113] if the entire property is treated as a unit, then the operator can deduct the expenses of his efforts from proceeds of the entire property.[114] Williams and Meyers, authors of an oil and gas treatise,[115] have made an intuitively appealing argument, well based in policy, for adopting the method which treats the entire property as a unit.[116] The argument is based on a policy of encouraging development: by allowing the dry hole costs as a charge on total production from a field, a producer will not be saddled with the dry hole costs and he will be encouraged to explore because of the reduced risk.[117] This same policy basis would support the allowance of secondary recovery expenditures, but it would be grounded in a policy of encouraging production rather than exploration.

Another related issue is how this limitation will be applied when the plaintiff takes over the property before the defendant has recovered his costs. This question will most likely appear in relationship to improvements which the defendant has made to the plaintiff's property and equipment located on the property when the plaintiff takes over.[118] The defendant will be allowed to remove from the premises all that can be removed without injury to the operation,[119] but he ordinarily has no claim to

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[111] Lawrence Oil Corp. v. Metcalfe, 100 S.W.2d 217, 222-23 (Ky. 1936).

[112] 2 H. WILLIAMS AND C. MEYERS, OIL AND GAS [hereinafter OIL AND GAS LAW] § 504.3 at 586.1-586.2 (1986).

[113] *Id.*

[114] *Id.*

[115] *Id.*

[116] *Id.* Note that such a finding is a prerequisite to allowing dry-hole costs. Therefore any case which allows dry-hole costs has adopted the entire property method of applying the limitation. *Id.*

[117] *Id.*

[118] *See supra* notes 77-80 and accompanying text.

[119] Gillespie v. Fulton Oil & Gas Co., 288 N.E. 192, 193-94 (Ill. 1909); 58 C.J.S. *Mines & Minerals* § 222 at 598 (1948).

future production.[120] In order to receive payment for unrecovered costs and equipment not removed, the producer must base his recovery on a theory of property improvement.[121] The measure of this recovery will be based on improvement to the property—not cost to the producer.[122]

4. Are the benefits to the plaintiff of such a nature that cost to the defendant is not a valid measure of the reasonable cost of production?

"Compensation is always the aim of the law. It is 'the bottom principle of the law of damages. To restore the party injured . . . to his former position is the purpose of allowing a money equivalent of his property. . . .' "[123] Since the emphasis is on compensation, it is possible that the defendant's costs may not be a proper basis for computing the amount upon which to base his credit.[124] This possibility is best illustrated by example:

> Whiteacre and Blackacre are two tracts of land of equal size and share a common border. Oilman is the owner of Blackacre and good faith trespasser to Whiteacre who builds a road on the common border of the two tracts so that half of the road is on each tract. Whiteacre and Blackacre produce equal amounts of oil because of Oilman's efforts and his use of the road. The road benefits both fields equally.

A hypothetical court which finds that the owner of Whiteacre is entitled to the value of the oil less the "reasonable cost" of production and that "reasonable cost" is always based on actual cost is presented with a problem. If the court allows Oilman credit for the entire cost of the road, he is benefited by virtue of his cost-free use of the road in securing production from Blackacre; if the court denies credit to Oilman for the cost of the road, then the owner of Whiteacre will receive the value of

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[120] Kuntz, *supra* note 77, § 11.6 at 323.

[121] *Id.* at 322.

[122] *Id.* at 321. *See also* Pan American Petroleum Corporation v. Candelaria, 403 F.2d 351, 356 (10th Cir. 1968); Greer v. Stanolind Oil & Gas Co., 200 F.2d 920, 923 (10th Cir. 1952).

[123] Hughett v. Caldwell County, 230 S.W.2d 92, 96 (Ky. 1950).

[124] Courts have the flexibility to ignore the defendant's costs. The court "[is] not dealing . . . with strict legal rights but with *equitable* principles." Joyce v. Zachary, 434 S.W.2d 659, 661 (Ky. 1968).

the oil without having shared the cost of production attributable to the road. Clearly, a tool is needed to temper the results of either alternative. This tool is found in the requirement that the limitation on the recovery is the amount by which the plaintiff benefited—not the amount of the cost to the trespasser.[125] Applying this to our example, the amount by which the plaintiff benefits from the road's presence is the amount by which the road improves his property plus the value of the use of the portion of the road which lies upon Blackacre.

This is an area in which the Kentucky courts have digressed from the compensatory nature of the law.[126] In *Joyce v. Zachary*, the court stated that "the test of allowability should be whether the expenses were *reasonably calculated* to be beneficial and productive."[127] This test seems to have lost focus of the limitation that the cost be of benefit to the plaintiff. It is a test which focuses on the subjective perception of the trespassing defendant rather than the objective benefit to the plantiff. Under this test, it appears that if the defendant reasonably believed that an expenditure was proper, then it is allowed regardless of whether there was actual benefit to the plaintiff. Clearly this is not in line with a remedy based in restitution. A further deviation from the compensatory aim results from the language of *Howard v. Kingmont Oil Co.*[128] In *Howard*, the court stated that the defendant "should be allowed to deduct its . . . costs . . . reasonably *expended*" (emphasis added).[129] This test seems to focus entirely on the expenditure, but the court provided itself with room for salvation by stating that "[s]uch costs may be allowed or disallowed according to principles of fairness and equity under the circumstances."[130]

In a situation where the total benefit to the plaintiff and defendant exceeds the cost of the improvements, unjust enrich-

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[125] Pan American Petroleum Corporation v. Candelaria, 403 F.2d 351, 356 (10th Cir. 1968); Greer v. Stanolind Oil & Gas Co., 200 F.2d 920, 923 (10th Cir. 1952); *cf.* Joyce, 434 S.W.2d at 661, wherein the court stated that "the test of allowability should be whether the expenses were *reasonably calculated* to be beneficial and productive."

[126] *See supra* notes 5 and 29.

[127] 434 S.W.2d at 661.

[128] 729 S.W.2d 183 (Ky. 1987).

[129] *Id.* at 187.

[130] *Id.* citing 434 S.W.2d at 661.

ment would limit the amount of the defendant's recovery to the proportionate cost of the plaintiff's benefits.[131] This is illustrated by reference to the example, with the additional fact that the value of the road to the plaintiff and defendant exceeds the cost. To allow the defendant credit for the value of the improvement to the plaintiff which exceeds the proportionate cost of the plaintiff's benefits from the road is to enrich the defendant by the excess amount. This enrichment results because the defendant's negligence has placed him in a position in which he can foist upon the plaintiff the majority of the cost of an item in which he equally shared the benefit.

5. Could the plaintiff have produced the mineral at a lower cost?

Arguably, this question is a continuation of the "benefit to the plaintiff" analysis of the previous section.[132] This question is nonetheless important for two reasons: first, it is a conceptually easier theory of analysis than a purely theoretical "benefit to the plaintiff" analysis;[133] and, second, it is an analysis which provides a more tangible base of proof than does a "benefit to the plaintiff" analysis.[134]

This can be illustrated by returning to the previous example and adding additional facts. In addition to the facts of the original example, assume that the defendant built the road at a cost of $10,000 and that the plaintiff, an expert road builder and mineral producer, proves he could have completed the road at a cost of $5,000. If we allow the defendant a set-off based on his $10,000 cost we have rewarded him for his own inefficiency while failing to compensate the plaintiff for the lost value

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[131] KUNTZ, *supra* note 77, at 319. *See, e.g.*, Silver King Coalition Mines Co. v. Conkling Mining Co., 255 F. 740 (8th Cir. 1919).

[132] If the plaintiff can do for 75¢ what the defendant has accomplished for $1.00 then the amount by which the plaintiff has benfited is only the 75¢ he would otherwise had to expend, not the $1.00 that the defendant spent.

[133] Clearly, it is easier to conceptualize a comparision of the cost for which the plaintiff could have accomplished a task than to speculate as to the amount of benefit he derived from its performance.

[134] The "benefit to the plaintiff" analysis would most likely involve historical financial data; the "lower cost" analysis would involve expert testimony based on estimates.

of his oil.[135] If, however, we treat the benefit to the plaintiff as the amount which he now does not have to spend because of the defendant's efforts, we have forced the defendant to bear the costs of his own inefficiency and compensated the plaintiff by the amount which the appropriated mineral represented to him.[136] In situations where the Kentucky statute[137] is being applied, the plaintiff would argue that the value of the road to him is no more than the amount for which he could have built it on his own.[138]

6. If the defendant is allowed the deduction, will the plaintiff's interest in the mineral be reduced twice?

The need for this analysis is illustrated by hypothesizing a case in which income taxes are allowed as a deduction:

> Oilman is a trespasser to Whiteacre and produces oil therefrom which he sells for $1,000. Oilman has a tax rate of fifty percent and the owner of Whiteacre has a tax rate of twenty-five percent. The statute of limitations for a suit for a tax refund has run before the owner sues Oilman.

The first problem with allowing Oilman to deduct his taxes from the sale proceeds is that this would saddle the owner of Whiteacre with Oilman's higher tax rate and deny him the benefit of his own lower rate. This is not the main problem with allowing the deduction. The greater problem is that the owner of Whiteacre will have paid two levels of tax in a situation where, without the defendant's appropriation, he would have paid one. Here the owner would recover $500 from Oilman if Oilman is allowed to deduct the taxes he paid. The owner would pay his own tax of $125 upon this amount leaving him with $375. Had the appropriation not occurred, he could have sold

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[135] The Kentucky case law discussed at *supra* notes 124-128 might allow this result if $10,000 was an amount which the defendant reasonably believed would be beneficial and productive.

[136] Hughett v. Caldwell County, 230 S.W.2d 92 (Ky. 1950); Spruce River Coal Co. v. Valco Coal, 120 S.E. 302 (W. Va. 1923).

[137] KRS § 381.460 (Bobbs-Merrill 1972).

[138] *See supra* text accompanying notes 81-83.

the oil for $1,000 and paid taxes of $250, leaving him with $750.[139]

Arguably, we have a good-faith defendant who has paid $500 for which he has received nothing, but "[t]he suit is for compensation to plaintiff, not to defendant. . . ."[140] From this one may conclude that *any* cost which the plaintiff must duplicate or would not have incurred should not be allowed as a deduction unless an improvement theory supports its allowance.

7. Will the defendant profit from his activities?

In order to answer the question of whether the defendant will be allowed to retain any profits made on the converted minerals after the plaintiff has been compensated, two competing policy goals should be reconciled. The two goals are: (1) a policy of discouraging trespass which would deny all profits to the defendant; and, (2) a policy of encouraging development which would allow the defendant to retain his profits.[141]

Many cases herein analyzed have favored the plaintiff's position by disallowing costs of overhead,[142] construing dry hole expenditures as falling entirely on the defendant,[143] using the potential for defendant's profit as a reason for rejecting the royalty method,[144] or simply stating that the defendant is not to be allowed a profit from his trespass.[145]

Arguably, cases which deny the defendant his profit after he has compensated the plaintiff for his losses are based on a policy of discouraging trespass to land. What these cases fail to recognize is that such a deterrent already exists in the measure of bad faith trespass to mineral lands.[146] In the case of a bad faith

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[139] There is one situation where taxes are deductible. That is the situation in which the taxing authority to whom the taxes were paid is the plaintiff owner. *See* United States v. Standard Oil Co. of California, 21 F. Supp. 645, 655-56 (S.D. Cal. 1937), *aff'd*, 107 F.2d 403, 419 (9th Cir. 1939).

[140] Clark-Montana Realty Co. v. Butte & Superior Copper Co., 233 F. 547, 577 (D. Mont. 1916).

[141] *See supra* notes 112-15 and accompanying text.

[142] Daly v. Smith, 33 Cal. Reptr. 920 (Cal. Dist. Ct. App. 1963); Clarke-Montana Realty Co. v. Butte & Superior Copper Co., 233 F.547, 577 (D. Mont. 1916), *aff'd*, 248 F. 609 (9th Cir. 1918).

[143] Greer v. Stanolind Oil & Gas Company, 200 F. 2d 920, 923 (10th Cir. 1952).

[144] Dinwiddie Construction Co. v. Campbell, 406 P.2d 294, 298 (Nev. 1965).

[145] Swiss Oil Corp. v. Hupp, 69 S.W.2d 1037, 1039 (Ky. 1934) (referring to Boleman Mortuary Association v. Fairchild, 68 S.W.2d 756 (Ky. 1934)).

[146] 69 S.W.2d at 1039.

trespasser, no deductions are allowed; the plaintiff recovers the entire proceeds from the appropriated minerals.[147] Additionally, the burden is on the defendant to establish his good faith once a trespass is proven.[148] These protections clearly discourage trespass. Since this discouragement of willful trespass is in place, the law need not punish the innocent trespasser by stripping him of the profits which he made as a result of his own efficiencies. Since the punitive damages against the willful trespasser serve to discourage willful trespass, the needed deterrents are already in place; denying profits to those who develop mineral lands in good faith will only discourage development.

Mineral producers can be guaranteed clear title in relatively few situations.[149] Placing them at risk not only for a compensatory measure of damages but also for any profits they may make will clearly deter development. Because of the desirability of encouraging the development of mineral estates, innocent trespassers who make a profit after paying compensation to the owner of the appropriated minerals should be allowed to retain those profits. This is consistent with a restitutionary measure of damages, for once the plaintiff has received the value of his minerals, he can ask for no more.

SUMMARY

Although the measure of damages in the mineral trespass scenario is often stated, it is rarely applied analytically. Because of the lack of analysis in prior decisions, confusion exists as to which costs are deductible by a good faith mineral trespasser. This uncertainty is a hindrance to mineral development and a source of confusion in the law. Because of this confusion, courts should pay special attention to the analysis given in mineral trespass damage cases. The focus of the analysis should be computing damages to compensate the owner without enriching him at the expense of the defendant. In such an analysis, the measure of the expenses allowed to the defendant should be

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[147] *Id.*

[148] Kentucky Harlan Coal Co. v. Harlan Gas Coal Co., 53 S.W.2d 538, 542 (Ky. 1932).

[149] Stigger, *supra* note 6, at R-20.

based on the objective benefit conferred on the plaintiff, not the subjective perception of the defendant. If the measure of damages leaves the defendant with a profit, it should be allowed to him since his economy gave rise to the profit.

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