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Agricultural Law Update

VOLUME ONE, NUMBER TWO, WHOLE NUMBER TWO NOVEMBER 1983

A publication of the American Agricultural Law Association

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"If we desire respect for the law, we must first make the law respectable."

— *Louis D. Brandeis*

No cash renting during installment payment of federal estate tax

A recent private letter ruling, *Ltr. Rul. 8339023, June 24, 1983,* has confirmed that cash rent leasing of farmland during the period of installment payment of federal estate tax constitutes a disposition and could terminate installment payment. The statute contemplates continuation of a "closely held business" and cash renting falls short of "business" status.

The ruling adds another item to the lengthening list of reasons why cash renting should be approached with care and caution.

— *Neil E. Harl*

2032A recaptures to the unwary

Since January 1, 1977 several farm estates have elected federal tax use valuation for farm real property under IRC Section 2032A. A 1982 Ohio study of 99 estates where use valuation was elected revealed an average savings of just over $60,000. Savings in an estate can range from very little up to $375,000. A recapture of all or a portion of the taxes saved is a concern for the heirs who are holding 2032A valued property.

For estates electing use valuation prior to January 1, 1982, the potential recapture runs for 15 years and for estates electing after December 31, 1981, the basic recapture period is 10 years with up to two more years if the property was not immediately placed in a qualified use after the decedent's death.

Recapture triggering events include: (1) disposition of the property to someone other than a family member, (like kind exchanges and involuntary conversations are permitted if the replacement property meets the qualified use test), (2) failure of a qualified heir to have the property in a qualified use (each qualified heir must meet the qualified use test), and (3) lack of material participation by a family member (three years of material participation can be missed in each 8 year period ending after the date of decedent's death.)

Private letter rulings are establishing guidelines for determining events that trigger a recapture: a sale lease back of use valued property triggered a recapture, *Ltr. Rul. 7934007;* a net least of use valued property by a qualified heir to a family member triggered a recapture, *Ltr. Rul. 8240015;* crop share rental with a cousin was cessation of qualified use and triggered recapture, *Ltr. Rul. 8330016* and the signing of an oil and gas lease was stated not to cause a recapture, however, actual well drilling would cause a partial recapture, *Ltr. Rul. 8318070.*

Unanswered questions which could cause recapture include: mortgaging 2032A valued property and investing the loan proceeds in a non-farm activity; granting of an easement especially if the surface use of the property is diverted from farming; assignment of a PIK contract; and a trustee exercising discretionary rights to distribute principal from a trust holding 2032A valued property to other family members especially if the recipient has a form of guaranteed payment.

Inadvertent recapture events may not be known until the recapture period ends. The first recapture period ends in 1992, 15 years after the first date 2032A became available, January 1, 1977; and 10 years after January, 1982, the date when the recapture period was shortened. There is a possibility that IRS in 1992 and thereafter will require a tax form to be completed by the agent designated in the 2032A election. That form could be used to determine if any unreported recapture events occured. The check list on that form could be patterned after the triggering events which have been identified. It is possible that the release of the tax lien could be dependent upon successful completion of such a form.

— *Paul L. Wright*

IRS responds to cooperatives' protests

In response to a substantial number of protests from cooperatives, the Internal Revenue Service has temporarily withdrawn assessments based on "tracing" patronage refunds from regional cooperatives to local cooperatives. The IRS has left at least five cases pending which involve other issues. The Service has also indicated it may seek dismissal of the Kingfisher, Oklahoma, test case although the cooperative community had hoped this case would go forward to a final adjudication of the "tracing" issue which was reported in more detail in the previous newsletter.

— *James B. Dean*

Farmers Comprehensive Personal Liability Insurance Somewhat Less Than "Comprehensive"

Early this year, in Bankert v. Threshermen's Mutual Insurance Co., — Wis. 2d —, 329 N.W. 2d 150 (1983), aff'g 105 Wis. 2d 438, 313 N.W.2d 854 (Ct. App. 1981), the Wisconsin Supreme Court held that a farmowners liability insurance policy did not require the insurer to defend or to indemnify its insureds against claims for damages alleged to have been caused by their negligent entrustment of a motorcycle to their minor son and the negligent failure to control their son's use of the motorcycle away from the farm premises and adjoining ways.

The Bankert result is consistent with the applicable policy language and with earlier authority, and the court's opinion breaks no new theoretical ground. Nevertheless, the decision is of interest as a reminder of an important and perhaps unexpected way in which the "Farmers Comprehensive Personal Liability" insurance coverage can prove something less than "comprehensive," and of the difficulties of improvising rationales to avoid that result.

"Farmers Comprehensive Personal Liability" (FCPL) coverage is an attempt to adapt the "Comprehensive Personal Liability" (CPL) coverage to the special needs of those engaged in farming activities. The CPL coverage sometimes is marketed as a separate policy, but usually it is sold as part of the familiar homeowners package policies. In either form it is unsuited for those engaged in farming because it does not apply "to bodily injury or property damage arising out of business pursuits of any insured . . ." The FCPL, which also may be marketed as a separate policy or as part of a "Farmowners-Ranchowners" policy packaging liability coverage with property insurance coverages on the farm dwelling and farm personal property and buildings, makes this exclusion inapplicable to farming activities.

Thus, the CPL exclusion of "losses arising out of. . . business pursuits" is modified in the FCPL so that the business pursuits exclusion does not apply to "(i) activities . . . ordinarily incident to the non-business pursuits and (ii) farming." (Curiously, when packaged as part of a Farmowners-Ranchowners policy, the exemption from the exclusion is framed to provide coverage for "activities . . . ordinarily incident to non-business pursuits or farming.") This change is the chief reason for the development of the FCPL, and its effects seem well understood.

Less well recognized is a second change. The CPL excludes from coverage bodily injury or property damage arising out of the ownership, maintenance, operation, use, loading or unloading of . . . any motor vehicle owned operated by, or rented or loaned to any insured; but this subdivision . . . does not apply to bodily injury or property damaged oecuring on the residence premises if the motor vehicle is not subject to motor vehicle registration because it is used exclusively on the residence premises or kept in dead storage on the residence premises; . . .

The FCPL instead excludes from coverage liability claims arising out of "the ownership, operation, maintenance or use, including loading or unloading of (1) automobiles while away from the premises or the ways immediately adjoining." The effect of this change is two-fold. It brings within coverage liability claims arising out of use of automobiles on the premises or adjoining ways, without regard to whether the automobile is immune from motor vehicle licensing or is being used in the farming operations; and it excludes from coverage the use of automobiles away from the premises and adjoining ways, again without regard to whether the automobile is subject to licensing requirements or the use to which the automobile is being put. It thus makes the place of the occurrence a prime determinant of the insurer's obligation to defend and indemnify in the event of liability claims.

It was this "premises and adjoining ways" limitation that prevented insurer liability in Bankert. The insureds' fifteen year old son was driving an unlicensed motorcycle on the streets of a municipality when he struck a parked car and injured the plaintiff, a passenger on the motorcycle. Plaintiff sued the insureds on the theories that they "negligently entrusted" the motorcycle to their son and that they "negligently supervised" him on the night of the accident.

The appellate courts rejected the contention that these claims were within the coverage of the FCPL policy because the negligent acts — negligent entrustment and negligent supervision — occurred on the farm premises. The insurer had agreed to defend and indemnify "only when the insured incurs liability for personal injury or property damage caused by an 'occurrence.' An occurrence is defined as an accident. This is what is insured against — not theories of liability." — Wis. 2d at —, 329 N.W.2d at 155. Indeed, the court noted, under the argument that the place of the negligent act should control, "all negligence which was attributable to conduct at the farm home would be covered. Acceptance of this theory would convert the farmowners liability policy into an automobile policy." Id. at —, 329 N.W.2d at 154.

Probably most observers will find the Bankert result both proper and predictable. After all, the policy language clearly makes liability of the insurer depend upon the location of the occurrence, rather than the loeation of the operative cause of the occurrence, and insurance law routinely indulges policy limitations incorporating that distinction. The "premises" limitation seems destined to be treated as a coverage provision, and thus immune from statutory requirements that the breach be material in order to provide a defense; besides, the risk of a liability-causing occurrence doubtless was increased once the motorcycle ventured off the farm premises.

Finally, the Bankert facts are not that compelling. Motor vehicle liability insurance could have been obtained for the motorcycle if it was to be ridden on public streets, and at the time of the accident it was being used for recreational rather than farm purposes. In such circumstances, the limitation seems neither surprising nor unduly harsh. In other settings, however, the discovery that FCPL coverage does not extend to motor vehicle accidents away from the insured premises may be more difficult to swallow.

Consider, for example, the circumstances provoking litigation in Farm Bureau Mutual Insurance Co. v. Sandbulte, 302 N.W.2d 104 (Iowa 1981). There the liability accident occurred on a public road as the insured's son drove a pickup from one tract of insured's farm to another in order to get a tractor needed to continue plowing. On these facts, the insured's hopes of either satisfying or escaping the "premises and adjoining ways" restriction might seem more likely to be realized. The pickup was being used in farming operations, and it was proceeding by the most direct route from one portion of the insured premises to another.

Moreover, Iowa has been something of a bastion of the "doctrine of reasonable expectations" which counsels ignoring policy

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Editor . Bruce H. Herz

AALA Editorial Liaison .. Philip E. Harris, University of Colorado

Contributing Editors: Dale C. Dahl, University of Minnesota; James B. Dean, Attorney, Judon Fambrough, Texas A&M University; Neil E. Harl, Iowa State University; Robert G. Works, University of Nebraska, Paul L. Wright, Ohio State University

For AALA membership information contact Margaret R. Grossman, University of Illinois, 151 Bevier Hall, 905 S Goodwin, Urbana, IL 61801 (217) 333-1829

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Division orders and royalty checks: Insufficient analysis when negotiating mineral leases can mean losses for the land owner

by Judon Fambrough

Frequently mineral owners (or their attorneys) fail to properly address the treatment of division orders and royalty checks when negotiating an oil and gas lease. If overlooked, the landowner stands to lose not only money but also many beneficial lease terms acquired during the negotiation process.

Not all mineral owners may be familiar with division orders because they are not issued until production commences. Division orders are revocable sales contracts entered between the parties owning an interest in the oil and gas produced and the person or entity purchasing the production. The sale becomes effective only after the oil or gas comes into the purchaser's possession. It does not operate as a sale of the oil or gas in place.

In addition to being a sales contract, division orders also insure that the proper parties (or owners) are paid and in the right amounts. Division orders state or "declare" the fraction of production each party is to receive. The precise figure is contained in a fraction carried out to the eighth decimal point. The specified interest is derived from a title opinion rendered by an attorney working for either the purchaser or lessee (producer). Each interest owner will be asked to sign (or execute) the division order in advance of the first royalty check.

Division orders may do more than just state each party's interest. Additional provisions may be included which may or may not comply with the original lease terms.

Here is the dilemma faced by the mineral owner when sent a division order for execution. If he or she signs the division order containing terms contrary to the original lease, will the division order amend or supplant the lease? Is the execution of the division order a prerequisite for receiving the first royalty check? Is it necessary for *all* parties named in the division order to sign before *any* party gets paid?

Apart from any specific statutory law or case law that a particular state might have, the answers to these questions are as follows.

First, it is generally held that a division order can never *permanently* amend or supplant the lease. However, should the terms of the executed division order differ from the lease, the division order controls until revoked by the mineral owner. The mineral owner has no recourse against the purchaser or lessee for any variances during the interim.

Secondly, it is generally held that the execution of the division order is not a prerequisite for receiving the first royalty check. However, for their own protection, most purchasers or lessees will refuse to issue a royalty check until the division orders have been signed.

And lastly, it is generally held that all parties need not sign the division order before any party is paid. But again, this matter lies within the sole discretion of the purchaser or lessee.

The mineral owner may encounter other questions and problems apart from the terms of the division order. For instance, how soon after production commences will the first royalty check be issued? After the first royalty check is received, how frequently will subsequent checks be tendered to the lessor? If a royalty check is delinquent or withheld, will the mineral owner receive interest on the unpaid balance due?

The answers to these questions will vary among the states depending on their statutory and case law. However, to insure the mineral owner's interest is fairly and equitably treated, these issues should be addressed when negotiating the lease. Here are a few alternatives the mineral owner may strive to include. The mineral owner's success in having these alternatives incorporated in the lease agreement depends largely upon negotiating power.

A. Recommended lease provision dealing with division orders

The following contains the essence, not the precise language, of suggested clauses pertaining to division orders.

1.) A division order tendered to the mineral owner shall be used solely to ascertain the lessor's interest in a particular well unit. Any further provisions may be stricken or disregarded.

2.) The execution of any division order containing provisions contrary to the lease terms will not temporarily nor permanently alter or amend the original lease terms. All such contrary terms shall be deemed null and void. (Some minerals simply state the division order need not be executed as a prerequisite for royalty payments. The problem of contradictory terms is thereby averted.)

3.) Acceptance of any royalty payment pursuant to the division order shall not constitute a full or final settlement for any past royalties and interest payments that may be due the mineral owner.

4.) The division order shall be cancellable or revocable at all times.

5.) The mineral owner shall be paid upon the execution of the division order (if the execution requirement is not stricken.) He or she need not wait for all parties specified in the division order to sign before being paid.

6.) The mineral owner shall not give any warranty of title in the division order beyond that contained in the lease.

7.) The division order shall not constitute a ratification of any oil or gas contract (whether revocable or not) or any other contract or agreement covering the leased premises or products produced therefrom.

(continued on next page)

8.) The terms of the original lease contract cannot be altered or amended except by a separate written instrument clearly denominating its purpose and effect. The written agreement shall describe the specific terms or provisions being altered and the proposed change or modification thereto. It must be executed by the party against whom the amendment or alteration is sought to be enforced. Any memoranda or legends attached to a royalty check shall be null and void and without legal significance for the purpose of altering the original lease contract.

B. Recommended lease provisions dealing with royalty checks

The following contains the essence, not the precise language, or suggested clauses pertaining to royalty checks.

1.) The first royalty check shall be tendered the mineral owner within ninety (90) days after the first production leaves the leased premises. (Generally it takes 90 to 120 days for the title opinion to be secured by the purchaser or lessee. Sometimes it takes longer depending upon the magnitude of production in the area.)

2.) If the first royalty check is not tendered within ninety (90) days, interest shall accrue on the unpaid royalty at the highest rate allowed by state law. (Some mineral owners tie the interest to the prime rate but never less than 15%, if it is not usurious.) The first royalty check shall contain all accrued interest.

3.) Once royalty checks have commenced being tendered, the mineral owner will be paid within sixty (60) days after the end of the month the production leaves the leased premises. If the payments are not forthcoming within the designated period, interest will again accrue on the unpaid balance. If six months transpire between royalty payments, the lease shall expire except where the delay was caused by title problems. (Such provisions determine the frequency of royalty payments and the penalty for any delinquency.)

4.) The mineral owner's royalty shall bear no costs or expenses (direct or indirect) encountered by the lessee or purchaser subsequent to production. This rule is to apply regardless of where the royalty is fixed in the lease or division order.

5.) The lessee and/or purchaser assumes all risk of loss for the oil or gas once it leaves the leased premises.

If the lessee utterly refuses to include any of the suggested provisions in the lease, or if the lessor is presented a division order for execution without having addressed these issues in the lease, the lessor may want to proceed in the following manner.

1.) Alter the division order so that it conforms to the original lease terms. This can be done by striking all contradictory or questionable language and then initialing the margins where the deletions and changes occur.

2.) Attach an addendum to the division order incorporating the suggested alternatives enumerated in Sections A and B. The addendum would begin with phraseology similar to the following: "Notwithstanding anything to the contrary contained in the attached division order rendered by the XYZ Company, the following terms and provisions control. . ."

Naturally, it would rest with the purchaser or lessee whether to issue royalty checks based on such a revised or amended division order. However, it is a possible means by which the mineral owner can receive royalty payments yet preserve the rights stated or negotiated in the original lease form.

Conclusion

The successful negotiation of an oil and gas lease requires knowledge of the lease terms, common sense, foresight and diplomacy. Even with a knowledge of the lease provisions, a mineral owner can easily overlook the problems associated with division orders and royalty checks. Therefore, the treatment of division orders and royalty checks should be on the agenda of every oil and gas leasing transaction.

Judon Fambrough is a lecturer and attorney at law in the Agricultural Economics Department at Texas A&M University. He received his B.S. degree from the University of Arkansas and his M.S. degree from the University of Missouri both in agricultural economics. He received his J.D. degree from the University of Missouri also. He currently teaches a course in oil and gas law and does research work for the Texas Real Estate Research Center.

CONTINUED FROM PAGE 2

language when necessary to vindicate the insured's reasonable expectations concerning the scope of coverage. With insureds encouraged to forgo separate motor vehicle liability insurance on vehicles not expected to leave the farm by the FCPL expansion of eoverage to even motor vehicles subject to licensing requirements while on the premises, and with even professional insurance publications describing the FCPL coverage as one which "includes farm operations," perhaps an insured might be forgiven a failure to understand and act on the "premises and adjoining ways" restriction.

The Iowa court in Sandbulte brought such musings to an abrupt halt. Only physically contiguous "ways" satisfy the policy requirement, according to a long line of authority involving "premises" restrictions in many kinds of insurance, and the court discovered no reason to disturb that requirement or its usual interpretation. That insureds might in fact expect to be covered while moving from one insured premise to another on farming business was not enough to outweigh the important coverage-allocating functions of the provision. As a matter of law, the "provision was not 'bizarre or oppressive,' nor did it eviscerate any terms agreed to or eliminate the dominant purpose of the transaction so as to give rise to the reasonable expectation doctrine." Id. at 114 (applying Restatement (Second) of Contracts sec. 211).

In Sandbulte, the pickup was covered by automobile liability insurance, so that the FCPL coverage was invoked only in an effort to find excess coverage. The Sandbulte court made nothing of that, however, and other courts consistently have refused to find coverage under the FCPL even where no other insurance was available and the departure from insured premises was minor. See, e.g., Scherschligt v. Empire Fire & Marine Insurance Co., 662 F.2d 470 (8th Cir. 1981); Foremost Insurance Co. v. Travelers Insurance Co., 54 App. Div. 2d 150, 338 N.Y.S.2d 402 (1976); Connolly v. Standard Casualty Co., 73 N.W.2d 119 (S.D. 1955).

For now, the lesson seems clear: any relaxation of the tension between what insureds in fact may expect their FCPL policies to cover and the "premises and adjoining ways" limitation of the FCPL must await improved insured understanding of the realities of the coverage; judicial relief from the "premises and adjoining ways" limitation does not seem likely.

— *Robert Works*

Ground water depletion

In 1965, after losing in court, IRS began allowing cost depletion to taxpayers in the Southern High Plains area for draw down in ground water. IRS now recognizes that ground water in areas of the Ogallala Formation in addition to the Southern High Plains, is being depleted. As a consequence, IRS has ruled (Rev. Rul. 82-214, I.R.B. 1982-50, 9) that cost depletion will be allowed elsewhere in the Ogallala Formation where it can be demonstrated that the ground water is being depleted and "that the rate of recharge is so low that, once extracted, the ground water would be lost to the taxpayer and immediately succeeding generations."

IRS points out that the income tax basis in the ground water must be adjusted for cost depletion deduetions allowed. However, taxpayers in the Ogallala Formation outside the Southern High Plains area will not be required to reduce their basis in ground water by eost depletion that was allowable but not claimed for tax years ending before December 13, 1982.

— *Neil E. Harl*

Some clarification on PIK

In the article, "PIK Brings About Tax Changes" in the October, 1983, *AGRICULTURAL LAW UPDATE,* the discussion on page 2 focused upon the income tax consequences of giving up a commodity in storage to create the farmer's PIK amount. If the farmer initiates the process at the local ASC office to receive the PIK commodity in 1983, the amount given up would be income in 1983 if the farmer had previously treated CCC loans as loans and not as income. If the farmer waits until 1984 to initiate the process to receive the PIK amount, income from the commodity given up would be income in 1984.

For farmers who are "qualified taxpayers," the PIK commodities received are treated as though the commodity was raised and would be taxable when sold. To be a qualified taxpayer, the farmer must receive PIK commodities in exchange for idling land under the 1983 PIK program.

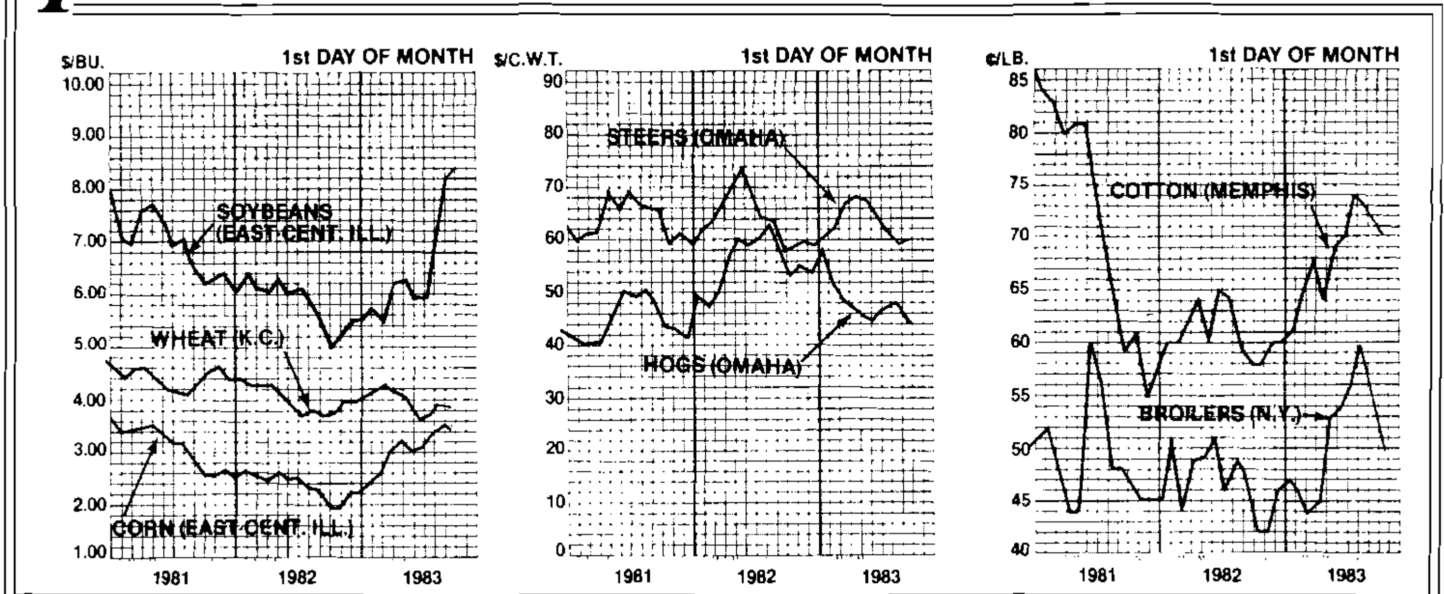
— *Neil E. Harl*

Deducting interest on deferred federal estate tax

For several years, there has been concern whether the interest on deferred federal estate tax could be deducted by the heirs for income tax purposes if the estate was closed. In a letter ruling, *Ltr. Rul. 8334025, May 20, 1983,* IRS has indicated that interest on deferred federal estate tax paid by a beneficiary after distribution of assets from the estate was deductible for income tax purposes. In the facts of that ruling, the surviving spouse was the beneficiary.

— *Neil E. Harl*

TRENDS



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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

Annual meeting report

Nearly 200 extension educators, law school teachers, practitioners, students and guests attended the American Agricultural Law Association's Fourth Annual Meeting and Educational Conference Oct. 13-14. Conducted in conjunction with the Third Annual Agricultural Law Institute, University of Arkansas School of Law Agricultural Law Committee, Arkansas Bar Association, this year's event was held at the Excelsior Hotel in Little Rock Arkansas.

Harold Breimyer, Professor, University of Missouri, Department of Agricultural Economics set the stage for this year's meeting as he addressed "Agriculture at the Crossroads: Agricultural Policy Issues Beyond the Eighties." A variety of speakers from academia and private practice addressed such topics as water and natural resource issues, legal issues with regard to government programs, bankruptcy, marketing and land ownership.

Starting new terms as administrators for the American Agricultural Law Association include President-Elect Keith Meyer, professor of law, University of Kansas School of Law and Board Members Karin Littlejohn, attorney, Eakes & Littlejohn and Laurence Kurland, attorney, Laurence B. Kurland Associates. Outgoing board members include Paul Wright, extension economist, agricultural law, Ohio State University, James B. Dean, attorney, and Past-President Donald L. Uchtmann, associate professor of agricultural law, University of Illinois.

The Association would like to thank these people for their tireless efforts. In addition we thank Dale C. Dahl, professor-agricultural economics and law, University of Minnesota, outgoing president for his direction and dedicated service to the Association. And we express our best wishes and pledge our support to our new president J.W. (Jake) Looney, dean and director of the agricultural law program, School of Law University of Arkansas.

Next year's meeting will be held October 25-26, 1984 at the Brown Palace Hotel in Denver. Mark your calendar now, for two days of education and information.

AALA requests nominees

The AALA Nominating Committee requests your candidate suggestions and selection comments for the 1984-85 Office of the President-Elect and *two* new members of the Board of Directors for the three-year term of 1984-87. Please communicate your nominee and ideas to:

Dr. Dale C. Dahl, 217 Classroom Office Building, University of Minnesota, St. Paul, MN 55108.