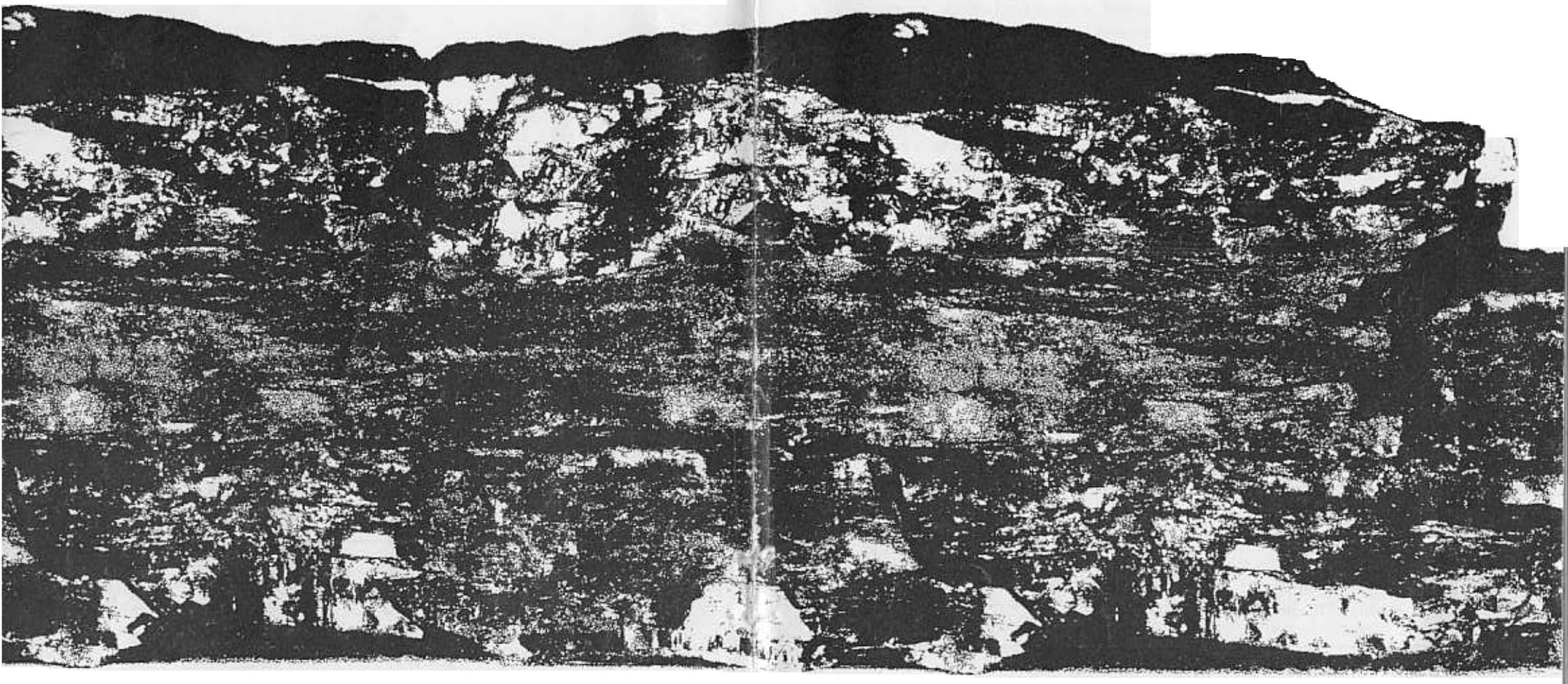


Legal Aspects of Coal Leasing in Illinois

Circular 1121



University of Illinois at Urbana-Champaign
College of Agriculture • Cooperative Extension Service

Introduction

GENERALLY, A LANDOWNER IS ENTITLED to the surface of his property and all that lies beneath it. A deed to land without reservations or exceptions will include the mineral estate unless earlier severed by a conveyance. Severance can occur by selling only the surface estate and reserving a part or all of the minerals. It is also lawful to sever the two estates by selling the minerals separately from the surface.

An "interest" in coal can also be transferred to another by a lease giving the right to remove and dispose of the mineral property. The lease usually gives the lessee only the right to find and extract coal. The title remains in the landowner as long as the minerals are in the land, the title passing to the lessee upon removal of the coal and payment of rent or royalty.

A lease grants to the lessee the right to possession for a limited time. A mineral deed, on the other hand, transfers the entire mineral estate to a buyer with no interest left in the seller. In some states, courts have held that where a lease includes all of the coal, or the lessee is given the right to mine the coal to exhaustion, a sale rather than a lease has taken place. Illinois law, however, seems to be that a coal mining lease will not be treated as a sale of the coal if the document contains such words as "lease, rent, royalty, etc."

Both the sale of coal and the leasing of land for coal development are common practices in Illinois. The mineral estate may be sold to a developer, or he may be given an option to buy. Options are also used for the lease of minerals. When the presence of workable quantities of coal is unknown, and drilling or other forms of prospecting are required, options are useful. An option is a binding agreement, and caution should be exercised to insure that it does not provide for the purchase of coal when only a lease is intended. The sale of the mineral estate and the leasing of land for development are two separate transactions, each entailing quite different legal consequences. This publication is concerned primarily with the legal aspects of coal leasing.

The Mineral Lease

A lease is an interest in land, and if the term of the lease is longer than one year, it must be in writing to be enforceable. Mineral leases are often very long and contain numerous clauses. Some of the more important clauses and covenants are discussed below.

Coal leases involve contract and mineral law, as well as taxes and environmental considerations. For this reason, it is important for a landowner to have his or her attorney review any lease offered by a coal company or broker. Although most printed leases clearly state the economic benefits agreed upon, they are usually prepared by or for the coal companies, and tend to favor the interests of these companies. Even a few minor changes in a lease may greatly benefit the landowner. This short circular is designed primarily for the use of landowners, but we hope that it will prove helpful to all those concerned with the legal aspects of coal leasing in Illinois.

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Granting Clauses

Clause: The Lessor, in consideration of the sum of \$1.00 to him in hand paid by the Lessee, the receipt whereof is hereby acknowledged, plus such rents and royalties as are hereinafter provided, and the covenants and conditions hereinafter contained, does hereby grant, demise, lease, and let unto the Lessee, for the purposes hereinafter set forth:

All of the coal contained in and lying under the surface of the following described real estate situated in _____ County, State of _____, containing _____ acres more or less. . . .

The above granting clause, taken from an actual Illinois lease, serves the purpose of transferring rights in property and defining the nature of these rights. It includes the legal description of the surface and mineral estate that are leased. The mineral estate should be only that which is within the contemplation of the parties — that is, “coal and the integral minerals of it.” A lease of “minerals” or “coal and other materials” without further words of limitation may include all minerals, including oil and gas, whether known to exist or not, thereby allowing the lessee to extract minerals in addition to coal. In those parts of the state where there is more than one seam of coal, it is in the best interest of the landowner to specify a certain seam or seams of coal that are being leased to prevent misunderstanding later when other coal is determined to be minable.

The granting clause also recites the developer’s mining rights and privileges. In modern practice, these are stated in broad general terms, and usually include all of the rights “fairly necessary to the enjoyment of the mineral estate.” In some cases, the landowner may wish to define these rights more narrowly. Some examples are given below.

Clause: The Lessor does hereby give and grant to the Lessee . . . the exclusive right to mine, extract, and remove all of the said coal and other minerals for the exclusive benefit and use of the Lessee, and to conduct such mining operations by such methods as the Lessee shall determine, including the strip-mining method.

Special attention should be given to the method of mining intended. The above clause specifically includes the right to strip-mine, but there are divergent views as to whether a generally phrased right confers the right to shaft or strip-mine, or both. To insure obtaining the limitations desired, the coal lease should specifically set forth these matters in detail.

Clause: The unrestricted right to have and use the free and uninterrupted right of way into, over, under, across, and upon said leased coal and the surface and subsurface overlying the same, at such points and in such manner . . . as may be necessary or convenient to the removal, processing, and marketing of said leased coal. . . .

Clause: The right to construct, maintain, and operate such drains and drainageways as may be necessary or convenient to the operation, production, and marketing of said leased coal. . . .

Clause: The right to deposit anywhere upon the said surface, subsurface, or in the space remaining after the removal of any of said coal, such earth, rock, stones, slate, and “gob” material as may be produced in connection with the operations.

These rights involve the use of the surface of the leased premises in connection with the mining operations. In the absence of such provisions, the lessee would be able to use only as much of the surface as reasonably necessary for operations. The above clauses are stated quite broadly, however, giving an unrestricted use of the surface that may be disadvantageous to the landowner.

In mining operations, roads for haulage and other purposes are generally necessary, and it is only reasonable for the lessee to use the surface. However, the lessor may also have an interest in using the surface during operations, and it may be advisable to limit the number or location of such roads, as well as drains and waste deposits. Provisions regarding fencing and the responsibility for the operator’s use of the surface are also desirable for the benefit of the lessor. Since these rights directly interfere with the landowner’s use of the surface during mining operations, the landowner may want to require payment for rental of the surface used, in addition to royalties based upon coal production.

Clause: The right to construct, maintain, and operate such pipe lines, telephone lines, power lines, tanks, buildings, shops, tipples, picking tables, washing and other machinery, tools, equipment, and supplies upon said lands, as may be necessary or convenient to the operation, production, and marketing of said leased coal.

The above clause could directly interfere with the landowner’s future use of the surface after termination of the lease. Therefore, it is advisable for the lease to provide for ownership or removal of structures. In the absence of any provision, the lessee has the right to remove personal property placed on the premises within a reasonable period of time after

termination of the lease. To avoid interpreting what is reasonable, the parties should make provisions for the orderly removal of structures.

Clause: The Lessor does hereby waive, release, and surrender any and all claims for damages, and also liability by reason of damages either to persons or property which may in any way be caused or occasioned at any time hereafter, directly or indirectly, by the mining and removing of coal or other minerals from said premises, or by the enjoyment of any of the rights and privileges hereby granted.

The above damage clause is much too broad for the landowner's interest. Some damages are foreseeable (compaction from heavy machinery, interference from surface installations, danger of livestock escaping because of removal of additional fencing for access, etc.), and it is reasonable to provide for such detailed items in the lease. Other damages may be beyond the initial contemplation of the parties or occur during mining operations or after the lease has been terminated (injury to livestock, subsidence, etc.), and should therefore not be waived, now or for the future. However, a waiver of damages is not unreasonable if the landowner knows specifically what is waived and receives compensation for it, or the lessee's obligation to compensate at a later time when damages are incurred is specifically stated in the lease.

Term of Lease (Habendum) Clause

Clause: The term of this lease is for such a period of time as may be necessary to mine and remove all of the practically and commercially minable seam of coal above described and hereby leased, or until this lease is sooner terminated under the provisions hereof, but not exceeding, in any event, a period of _____ years from the date hereof.

The above clause allows the parties to set a maximum term for the lease, but provides for an earlier termination if the minable coal is fully recovered. It takes into account the landowner's interest in having the lease limited to a maximum number of years to provide flexibility for future negotiations, and protects the lessee's interest by limiting his obligation to pay royalty if the coal becomes prematurely exhausted.

Other kinds of habendum clauses provide for a maximum term of years, with the lessee having an option to renew or extend the lease, or even purchase the mineral estate. These clauses are usually adverse to

the landowner's interest if the original lease is based upon unfavorable terms, or if the market value of the mineral greatly increases.

Compensation Clause

Compensation to the landowner is usually in the form of rent or royalty for the use of the premises or product mined, plus compensation for damages. Although rent and royalty are similar, they differ with respect to the tax consequences. Rent is compensation for the right to use property that is usually certain in amount and payable periodically over a fixed term, regardless of the extent of use of the property or production of the mine. Royalty, however, is compensation based upon production, and is a share of production or profits.

Compensation from coal leases is often made in advance of actual production of the mine, and is generally classified as "rentals" or "advance royalties." If not applicable to future production, these payments are rentals. If the payments are made to defer the development of the minerals to a later time, they are often classified as "delay rentals." Compensation considered to be rentals are taxed as ordinary income in the year of receipt, and are not subject to depletion or capital gain treatment.

Unlike rentals, advance royalties are applicable against future royalties. The lessee or operator is entitled to recover the amount advanced out of the earned royalties that would otherwise be paid to the landowner according to production. The landowner may elect to treat earned or advanced royalties as ordinary income subject to a depletion allowance, or as capital gains without an allowance for depletion.¹

Several methods are used in computing royalty for each ton of coal mined, removed, and sold: (1) a fixed sum of money; (2) a fixed percentage of the gross realization or market value; (3) a graduated percentage; and (4) a combination of any two of the above.

A fixed sum per ton provision is often used, but it is not usually advantageous to the landowner because it does not allow for increases in the market value of the coal. A royalty based upon a percentage of the gross realization is generally preferable, and is in the best interest of the landowner. A compromise position is often used, whereby the landowner receives a percentage of the market value, but his royalty cannot exceed a fixed sum of money per ton.

¹ Generally, capital gain under section 1231 of the Internal Revenue Code is used in computing income tax. For a discussion of this election, see I.R.S. letter sent to Tax Practitioners from the Springfield, Illinois office dated February, 1975.

Diligent Operation Clause

Clause: The Lessee, with all reasonable dispatch and as soon as practicable hereafter, and in any event not later than _____, 19____, shall enter upon the leased premises and begin and continue operations thereon and take such steps as may be necessary for the active mining and marketing of said coal, it being the purpose and spirit of this lease to secure the prompt development and continuous operation, mining, and removing of said coal, and to secure as full, complete, and speedy operation thereof as can be done practicably and economically. . . .

The above clause can be inserted to benefit the landowner, whose primary concern is to secure a maximum return on the property by the removal and sale of the coal. This clause has two purposes: (1) to insure production of the coal as rapidly as possible, given the lessee's mining capabilities; and (2) to require that all minable and merchantable coal be recovered. If the lessee unjustifiably fails to satisfy this covenant, the landowner has a legal action for breach of contract, or he may be permitted termination of the lease.

Reclamation Clause

If the method of coal mining contemplated is strip mining, the surface of the land will usually be greatly altered. Stripping privileges do not inherently impose any duty to restore the surface.

The Environmental Protection Act² prohibits any person from causing air or water pollution, and the operator may have to take measures to meet these requirements. This Act does not, however, impose any further affirmative duty on the lessee to restore the land beyond the point of abating air and water pollution.

A more demanding law on mine operators is the Illinois Surface-Mined Land Conservation and Reclamation Act.³ This Act is designed to require the operator of surface mines to restore affected lands to their optimum future productive use. To obtain a mining permit, the operator must have a conservation and reclamation plan approved by the Illinois Department of Mines and Minerals that will designate how the land will be reclaimed for forest, pasture, crop, recreational purposes, etc. Consistent with this plan, the operator is required to grade the mined surface, impound runoff waters, prevent erosion, properly dispose of mining wastes,

² I.R.S. 1975, Ch. 111½, section 1001 et. seq.

³ I.R.S. 1975, Ch. 93, section 201 et. seq.

and replant the surface with the necessary vegetative cover. A bond by the operator is required to insure compliance with the Act.

Failure to comply with the Illinois Surface-Mined Land Conservation and Reclamation Act forfeits the bond to the state, but the Act does not provide for compensation to the surface owner. For this reason, the landowner should insist that the lease contain a covenant providing how the surface will be cleaned up and restored, or that "the lessee shall comply with all applicable laws, rules, and regulations of the State of Illinois and United States government relating to the conducting of such mining operations." The landowner may also be liable for violations of the Environmental Protection Act, and he should make sure that the lease agreement provides for indemnification by the lessee. He may want a separate bond or security to reinforce this duty of the lessee.

Default and Termination Clauses

The default clause is usually inserted in a lease to provide that either party can terminate the lease upon the breach of certain covenants or promises. Each party is required to notify the other of any breach, and a period of grace is usually given to allow for corrective action. In the absence of a default clause, a court may determine that certain breaches are insufficient to terminate the lease.

A termination clause is often inserted to state certain conditions whereby a party (usually the lessee) can terminate the lease without breaching the agreement. Exhaustion of the minable coal or the economic infeasibility of continued operation are two usual conditions. An unqualified termination clause can be adverse to the landowner's interest. The lessor has no assurance that any coal mining will take place, since the lessee can avoid his obligation at any time.

Implied Covenants

Although covenants are usually set forth expressly in the lease, a covenant may be implied from the intention of the parties. One covenant almost universally implied is the lessee's duty to provide support for the surface when shaft mining is used. Subjacent support is the support of the surface of land by the underlying layers of the earth. This right to support is a "natural right," which remains with the surface, and is not presumed to have been given up by a conveyance of mining rights unless there are express words or a strong implication that such rights are waived. In general, there is a duty to provide support, and it is not a defense that the mining was done with great care or in accordance with the most approved system of mining.

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Addendum to Circular 1121.

This document was published in 1976. Page 8 references the Illinois Surface Mined Land Conservation and Reclamation Act. Since that time the Surface Coal Mining Land Conservation and Reclamation Act was passed in 1980 in response to federal legislation. Reclamation standards for surface and underground mines have changed as a result. In addition, subsidence mitigation for land undermined after February 1, 1983 is also regulated. The Department maintains citizen guides to explain the laws and regulations.