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# The Oil and Gas Lease in California: Still A Landlord-Tenant Relationship?

The modern oil and gas lease is designed to bridge the gap between the landowner<sup>1</sup> and the oil and gas producer in order to develop oil and gas resources.<sup>2</sup> In California the landowner has the right to explore for oil and gas and produce whatever lies under his property.<sup>3</sup> Usually, however, the landowner does not have the specialized knowledge or technological and capital resources required to conduct a modern oil and gas operation and is, therefore, mainly interested in obtaining royalties.<sup>4</sup> The oil and gas producer, on the other hand, has refined the complex technology designed to find and produce oil and gas. Although the producer is experienced in solving the immense financing problems associated with oil and gas resource development, he does not generally desire to purchase land where oil and gas might be found. Because the chances of finding commercial quantities at any given location may be slim, many thousands of acres of land must be explored to improve the chances of discovery. Purchasing land outright would quickly deplete a producer's capital resources needed for costly exploration operations.<sup>5</sup>

The oil and gas lease, then, is designed to serve the needs of both parties. The landowner-lessor conveys the rights to explore, develop, and produce oil and gas to the producer-lessee.<sup>6</sup> In return, the lessor receives a cash bonus for signing the lease<sup>7</sup> and a royalty, i.e., a negoti-

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1. Recognizing that an oil and gas mineral interest is severable from the surface estate in California, this comment will, nevertheless, refer to the owner of the mineral interest as the "landowner" or "lessor." See generally 1 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §209 (1980) [hereinafter cited as 1 WILLIAMS & MEYERS].

2. For a description of the oil and gas lease in California see Blake, *The Oil and Gas Lease, Part I*, 13 S. CAL. L. REV. 304 (1940); Blake, *The Oil and Gas Lease, Part II*, 13 S. CAL. L. REV. 393 (1940); Hightower, *The Oil and Gas Lease in California*, 3 U.C.L.A. L. REV. 424 (1956).

3. See *Atlantic Oil Co. v. County of Los Angeles*, 69 Cal. 2d 585, 594, 446 P.2d 1006, 1011, 72 Cal. Rptr. 886, 891 (1968); *Gerhard v. Stephens*, 68 Cal. 2d 864, 879, 442 P.2d 692, 705, 69 Cal. Rptr. 612, 625 (1968); *Dabney-Johnston Oil Corp. v. Walden*, 4 Cal. 2d 637, 649, 52 P.2d 237, 243 (1935).

4. See 3 H. WILLIAMS, OIL AND GAS LAW §601, at 2 (1980) [hereinafter cited as 3 WILLIAMS].

5. See 3 WILLIAMS, *supra* note 4, §601.

6. See 3 WILLIAMS, *supra* note 4, §601.

7. Bonus is the cash consideration paid by the lessee for the execution of an oil and gas lease

ated fraction of the oil and gas actually produced.<sup>8</sup> Additionally, the lessor retains a reversionary interest.<sup>9</sup> In these respects, most oil and gas leases are similar.<sup>10</sup>

An oil and gas lease typically does more than exchange the rights to explore, develop, and produce for royalty; it usually contains various covenants which address the particular needs of each party.<sup>11</sup> Whether covenants are included in a lease to protect and promote the lessor's and lessee's rights under the lease depends upon the parties' needs, foresight, and their respective negotiating power. To the extent these elements vary in individual leasing situations, oil and gas leases can be expected to be different.

Despite the tailoring of the agreement to reach a mutual objective, California courts have tended at times to view the agreement as merely another ordinary lease of land,<sup>12</sup> analogizing the relationship created as one of landlord and tenant. When the California courts make this analogy a basis for applying the law of landlord and tenant to an oil and gas lease, problems arise for both the lessor and the lessee.<sup>13</sup> These applications of landlord and tenant law to oil and gas leases are traps for the unwary<sup>14</sup> who do not realize that the agreement to lease land for oil and gas development might be viewed by the courts as creating a landlord and tenant relationship.<sup>15</sup> The unfortunate result is that a lessor might be unable to enforce rights he thought he had against a sublessee,<sup>16</sup> and a lessee may discover that he has lost his lease for reasons

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by a landowner, and is to be distinguished from delay rentals and royalty. 1 WILLIAMS & MEYERS, *supra* note 1, §301, at 434-36.

8. A share of the oil or gas produced by the lessee reserved to the owner. The royalty may be taken in kind or may be paid for from the proceeds the lessee receives from sale. 1 WILLIAMS & MEYERS, *supra* note 1, §301, at 436-37.

9. See 1 WILLIAMS & MEYERS, *supra* note 1, §301, at 437.

10. See 3 WILLIAMS, *supra* note 4, §601, at 2.

11. See *Montana-Fresno Oil & Gas Co. v. Powell*, 219 Cal. App. 2d 653, 659, 33 Cal. Rptr. 401, 404 (1963).

12. See generally *Renner v. Huntington-Hawthorne Oil and Gas Co.*, 39 Cal. 2d 93, 244 P.2d 895 (1952); *Hancock Oil Co. v. Hopkins*, 24 Cal. 2d 497, 150 P.2d 463 (1944); *Hartman Ranch Co. v. Associated Oil Co.*, 10 Cal. 2d 232, 73 P.2d 1163 (1937); *Kern Sunset Oil Co. v. Good Roads Oil Co.*, 214 Cal. 435, 6 P.2d 71 (1931); *Kline v. Guaranty Oil Co.*, 167 Cal. 476, 140 P. 41 (1913); *Baldwin v. Kubetz*, 148 Cal. App. 2d 937, 307 P.2d 1005 (1957); *Taylor v. Continental Southern Corp.*, 131 Cal. App. 2d 267, 280 P.2d 514 (1955); *Chase v. Trimble*, 69 Cal. App. 2d 44, 158 P.2d 247 (1945). But see *Graciosa Oil Co. v. County of Santa Barbara*, 155 Cal. 140, 99 P. 483 (1909); *Stone v. City of Los Angeles*, 114 Cal. App. 192 (1931).

13. See 1 WILLIAMS & MEYERS, *supra* note 1, §202.1, at 21 n.2.

14. See *Hutchinson, The Sublease Trap*, 3 NAT. RESOURCE L. 548, 548 (1970) [hereinafter cited as *Hutchinson*].

15. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES §178, at — (2d ed. 1940) [hereinafter cited as MERRILL]; Logan, *Nonproducer Speculation in Oil and Gas: Sublease and Assignment*, 4 KAN. L. REV. 396 (1956) [hereinafter cited as Logan].

16. See *Hartman Ranch Co. v. Associated Oil Co.*, 10 Cal. 2d 232, 242-43, 73 P.2d 1163, 1168 (1937).

not contemplated by the parties when they executed the lease.<sup>17</sup>

Applications of landlord and tenant law to oil and gas leases exist not only as traps for the unwary but also as precedent for further application of landlord and tenant doctrines to the law of oil and gas. Consequently, even one familiar with California law cannot be certain when a court will view the oil and gas leasing agreement through old spectacles of common law property notions rather than considering the intent of the parties in light of the customs of the oil and gas business.

This comment will argue that California courts should *not* apply landlord and tenant doctrines to determine the rights and duties created under an oil and gas lease. Ancient common law doctrines designed to meet the needs of an agricultural society are not suited to provide just and predictable results consistent with energy needs. Instead, the lease should be recognized as a complex instrument expressing the intent of the parties to create a specialized relationship designed to promote the development of oil and gas resources to their mutual profit.

The following sections of this comment will illustrate how California has extended landlord and tenant doctrines and remedies to the field of oil and gas leases. This comment will show that the oil and gas lease should *not* be viewed as creating a landlord-tenant relationship through an examination of the adverse impact on oil and gas leasing arrangements resulting from the use of the common law distinction between assignments and subleases,<sup>18</sup> and from an analogy of royalty to rent to support the extension of the California holdover tenant statute,<sup>19</sup> and from the potential extension of the unlawful detainer statute.<sup>20</sup> Following the discussion of these issues, this comment will present recommendations designed to correct identified inequities.<sup>21</sup>

The assignment-sublease distinction was developed to resolve problems which arise in a context that is significantly dissimilar to the oil and gas business. Analogizing the relationship of the mineral lessor and lessee to that of the landlord and tenant can result in ignoring the expressed intent of the parties to an oil and gas lease. Consequently, a realistic analysis of the problems the lease agreement attempts to resolve is sacrificed in favor of a mechanical application of archaic common law doctrines. The assignment and sublease distinction extended to the oil and gas lease is one example of this shortsighted analysis.

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17. See *Martin v. Pacific Southwest Royalties, Inc.*, 41 Cal. App. 2d 161, 168, 106 P.2d 443, 447 (1940).

18. See notes 22-108 and accompanying text *infra*.

19. See notes 125-158 and accompanying text *infra*.

20. See notes 159-178 and accompanying text *infra*.

21. See notes 179-206 and accompanying text *infra*.

THE ASSIGNMENT-SUBLEASE DISTINCTION EXTENDED TO  
OIL AND GAS LEASES IN CALIFORNIA

When an oil and gas lessee transfers his lease interest to a third party, the question arises whether the transfer operates as an assignment of the lease or creates a sublease. At common law, different legal consequences attach to a transfer by the lessee of his lease interest depending on whether the transfer is classified as an assignment or a sublease.<sup>22</sup> If the transfer is an *assignment*, the transferee is in privity of estate with the lessor and, therefore, liable to him on all covenants in the original lease<sup>23</sup> that run with the land.<sup>24</sup> If, on the other hand, the transfer is classified as a *sublease*, a new tenancy is created between the lessee and the sublessee.<sup>25</sup> There is no privity of estate between the lessor and the sublessee, thereby precluding sublessee liability to the lessor on the covenants in the original lease.<sup>26</sup> Because the transferee is not a party to the original lease, privity of contract can not stand as a basis of liability, absent an express assumption.<sup>27</sup> Since a lessor might be precluded from holding a sublessee directly for damages resulting from a breach of covenant, the characterization of the transfer becomes critical.

In California, when a lessee transfers his entire estate to another, the transfer operates as an assignment.<sup>28</sup> If the lessee transfers less than his entire estate, then the transfer does not operate as an assignment, but instead creates a new tenancy between the lessee and his transferee.<sup>29</sup> The important question thus becomes what minimum interest in the leasehold, retained by the lessee, is sufficient to classify the transfer as a sublease.

To create a sublease the lessee retains a reversionary interest. In a majority of American states<sup>30</sup> a reversion is created only when the lessee transfers an interest in the leasehold to the transferee which is of shorter *duration* than the lessee's original interest.<sup>31</sup> Even if the term of

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22. See 1 AMERICAN LAW OF PROPERTY §3.57, at 297 (A.J. Casner ed. 1952) [hereinafter cited as ALP].

23. See ALP, *supra* note 22, §3.57, at 297.

24. "Every covenant contained in a grant of an estate in real property, which is made for the direct benefit of the property, or some part of it then in existence, runs with the land." CAL. CIV. CODE §1462.

25. See ALP, *supra* note 22, §3.57, at 297.

26. See ALP, *supra* note 22, §3.57, at 297.

27. See ALP, *supra* note 22, §3.57, at 297.

28. See *Hartman Ranch Co. v. Associated Oil Co.*, 10 Cal. 2d 232, 242, 73 P.2d 1163, 1168 (1937).

29. See *id.* at 243, 73 P.2d at 1168.

30. See ALP, *supra* note 22, §3.57, at 298.

31. See ALP, *supra* note 22, §3.57, at 297-98.

the sublease expires a single day before his own, the lessee has created a sublease.

In California, as well as in a number of other states,<sup>32</sup> a sublease may be created even when the entire possessory right is transferred by reserving a power of termination.<sup>33</sup> In the seminal Massachusetts case of *Dunlap v. Bullard*,<sup>34</sup> a covenant by the sublessee to pay rent to the lessee at an increased rate was deemed a reversionary interest in the lessee, and the court classified the transfer a sublease,<sup>35</sup> stating that:

To constitute an assignment of a leasehold interest, the assignee must take precisely the same estate in the whole or in part of the leased premises which his assignor had therein. . . .<sup>36</sup>

On the other hand, a sublease results when:

. . . by the terms of the conveyance . . . new conditions with a right of entry or new causes of forfeiture are created, then the tenant holds by a different tenure, and a new leasehold interest arises, which cannot be treated as an assignment or a continuation to him of the original term.<sup>37</sup>

The common law assignment-sublease distinction developed to meet specific needs of owners of interests in land.<sup>38</sup> By creating a sublease, a tenant for a term of years could alienate a portion of his interest and still retain the status bestowed by ownership.<sup>39</sup> Retaining a reversion, even for a day, created a sublease so that the tenant could maintain this position. Should the tenant transfer his entire term, he lost any interest he had in the land.<sup>40</sup>

The advantages of one form of transfer over another have disappeared over time.<sup>41</sup> Today the common law distinction between an assignment and sublease is a mere technicality which should yield to the intention of the parties.<sup>42</sup> The following subsections illustrate that the distinction is inappropriately applied not only because the oil and gas lease is dissimilar to an ordinary lease, but also because the conse-

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32. See ALP, *supra* note 22, §3.57, at 298.

33. See ALP, *supra* note 22, §3.57, at 298.

34. 131 Mass. 161 (1881).

35. See *id.* at 162.

36. See *id.*

37. See *id.*

38. See 7 W. HOLDSWORTH, A HISTORY OF ENGLISH LAW, 249-50 (2d ed. 1937) [hereinafter cited as HOLDSWORTH].

39. In feudal law, land was always held "of the king either immediately or mediately." Each person in the chain of holding owed duties to his overlord such as military service or the payment of rents. To enforce these duties the landlord had the remedy of distress. Under this view of society, therefore, each person must have an estate in order to maintain his position in the chain of ownership. See 1 F. POLLOCK & F. MAITLAND, THE HISTORY OF ENGLISH LAW, 232-37 (2d ed. 1968).

40. See *Jaber v. Miller*, 219 Ark. 59, 62, 239 S.W.2d 760, 762 (1951).

41. See *id.* at 65, 239 S.W.2d at 763.

42. See *id.* at 66, 239 S.W.2d at 763-64.

quences of the distinction can lead to consequences contrary to the intentions of the lessor and lessee when they negotiated the lease.

A. *The Assignment-Sublease Distinction Applied to Transfers of the Oil and Gas Lease*

In *Hartman Ranch Co. v. Associated Oil Co.*,<sup>43</sup> the California Supreme Court extended the common law distinction between assignments and subleases to the transfer of an oil and gas lease.<sup>44</sup> In *Hartman Ranch*, the lessor sued the transferee of the lease for damages resulting from a breach of the implied covenant to protect against drainage.<sup>45</sup> Although the court found that the transferee of the lease had allowed unreasonable drainage to nearby properties,<sup>46</sup> the lessor had no cause of action against the transferee-sublessee because the transfer was characterized as a sublease, rather than an assignment.<sup>47</sup> Since the court applied the assignment-sublease distinction without considering whether the parties intended to adopt the legal consequences of a sublease, it becomes essential to know when a transfer will be viewed as a sublease.<sup>48</sup> Otherwise, unwary parties to a lease transfer could fall into the sublease trap.

Unfortunately, there is no agreement on what minimum quantum and quality of retained interest in the lessee is sufficient to classify the lease transfer as a sublease rather than an assignment.<sup>49</sup> In *Hartman Ranch*, the court committed California to the Massachusetts rule defining the type of retained interest or power which will prevent the transfer from operating as an assignment.<sup>50</sup> The court noted that the transfer instrument under which the sublessee gained possession of the premises reserved a larger royalty in the lessee than that provided for in the original lease.<sup>51</sup> The lessee also retained a right of re-entry for breach of any stipulation in the transfer agreement.<sup>52</sup> Committed to the Massachusetts rule, the *Hartman Ranch* court concluded that:

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43. 10 Cal. 2d 232, 73 P.2d 1163 (1937).

44. *See id.* at 242, 73 P.2d at 1168.

45. This covenant creates a contractual duty, either express or implied, to use due diligence to protect the leasehold from drainage of oil or gas which may be occurring as a result of production operations conducted at another part of the same oil or gas field. When the duty is an implied one, the lessee must drill an offset well if substantial drainage is taking place and if an ordinarily prudent operator would do so under similar circumstances. *See generally* 5 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §§821-826.3 (1980) [hereinafter cited as 5 WILLIAMS & MEYERS].

46. *See* 10 Cal. 2d at 241-42, 73 P.2d at 1168.

47. *See id.* at 242-43, 73 P.2d at 1168. The court subsequently allowed recovery on a third party beneficiary theory. *See id.* at 243-47, 73 P.2d at 1168-69.

48. *See Logan, supra* note 15, at 418.

49. *See notes* 54-61 and accompanying text *infra*.

50. 10 Cal. 2d at 243, 73 P.2d at 1168.

51. *See id.* at 242-43, 73 P.2d at 1168.

52. *See id.* at 243, 73 P.2d at 1168.

where the transferor reserves the right to re-entry for breach of conditions he has a 'contingent reversionary interest' which prevents his transfer from operating as an assignment of the whole unexpired term. Instead, a sublease arises.<sup>53</sup>

Later California cases have not clearly stated whether retention of an overriding royalty in the lessee without a right of re-entry for breach of covenant is sufficient by itself to denominate the transfer a sublease. In *Chase v. Trimble*,<sup>54</sup> the California Second District Court of Appeal found that reservation of a two and one-half percent overriding royalty alone did not make the transfer a sublease.<sup>55</sup> In *Garner v. Knudsen*,<sup>56</sup> however, the court was faced with a transfer in which the parties expressly agreed that the "[a]ssignors shall not have . . . any right to enforce any of the terms . . . as against [the] [a]ssignee."<sup>57</sup> The only rights retained were an overriding royalty, and the benefit of a covenant requiring the "assignee" to give the "assignor" written notice of intent to surrender the lease and to reassign it to the assignors upon their timely request.<sup>58</sup> As the court deemed this surrender clause the functional equivalent of a right of re-entry,<sup>59</sup> a sublease arose.<sup>60</sup> This decision shows the willingness of the courts to use a flexible definition of the sublease in order to further a particular policy—in this case, supporting the lessor's ability to clear title of fractional interests carved out of the working interest. Although the result may be proper under the circumstances, using the sublease rationale to expand the sublease classification to accommodate the facts of the case creates precedent for further expansion of the sublease distinction in the field of oil and gas.<sup>61</sup> In light of the undesirable consequences of the distinction, it would be preferable to base the decision squarely on the identified policy.

### B. *The Effect of the Assignment-Sublease Distinction of Classification of Oil and Gas Lease Transfers*

Whether it is ultimately held that a sublease is created by retaining an overriding royalty alone without also retaining a right of re-entry,

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53. *See id.*

54. 69 Cal. App. 2d 44, 158 P.2d 247 (1945).

55. *See id.* at 49-50, 158 P.2d at 250.

56. 129 Cal. App. 2d 747, 277 P.2d 890 (1954).

57. *Id.* at 749 n.2, 277 P.2d at 892 n.2.

58. *See id.*

59. *See id.* at 755-56, 277 P.2d at 896.

60. *See id.* at 756, 277 P.2d at 896.

61. Language in the *Garner* opinion indicates that retaining an overriding royalty alone is sufficient to create a sublease. For example, the *Garner* court cites AMERICAN JURISPRUDENCE to the effect that ". . . a transfer of the leasehold . . . will be deemed a sublease if he reserves a rental or an overriding royalty." *Id.* at 755, 277 P.2d at 895.



many lease transfers in California may be so classified.<sup>62</sup> If oil and gas lease transfers were sold outright by the lessee to a transferee, then the assignment-sublease distinction would not be of major significance.<sup>63</sup> Yet because the oil and gas lease is an attractive investment,<sup>64</sup> and because financing methods are designed to spread the risk of leasehold development<sup>65</sup> and promote capital formation,<sup>66</sup> retained interests of the type held to create subleases<sup>67</sup> are common. In the ordinary course of the oil and gas business, part or all of an oil and gas lease is often transferred at least once before production is obtained.<sup>68</sup> Since a large capital investment is not required,<sup>69</sup> professional "lease brokers" make a business of acquiring oil and gas leases, usually with no intention of obtaining production themselves.<sup>70</sup> In addition, favorable tax treatment<sup>71</sup> and the possibility of sharing the profits of an oil strike also make the oil and gas lease an attractive investment.<sup>72</sup> The oil and gas lease rights thus obtained can be transferred for a profit to other speculators when interest in the area is high or to a party intending to explore and develop the lease.<sup>73</sup> Rather than selling the lease for cash consideration, many brokers prefer to retain an overriding royalty, allowing them to share in any profits of a discovery.<sup>74</sup>

Besides receiving cash or retaining an overriding royalty, lessees commonly obtain consideration for transferring all or part of a lease by reserving an oil payment.<sup>75</sup> This payment is a right to a share of oil produced from the leased premises and terminates when a certain vol-

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62. See generally *Hutchinson*, *supra* note 14, *Logan*, *supra* note 15.

63. Because no contingent reversionary interest is retained, the transfer is an assignment and privity of estate between the lessor and the transferee will support an action by the lessor against the transferee. See ALP, *supra* note 22, §3.57, at 297.

64. See *Logan*, *supra* note 15, at 396.

65. A common method of obtaining a lease is by transfer, and reservation of an overriding royalty in the transferor. See 2 H. WILLIAMS & C. MEYERS, OIL & GAS LAW §418, at 340 (1981) [hereinafter cited as 2 WILLIAMS & MEYERS]. Another form of consideration for the transfer of a lease is an oil payment. See 2 WILLIAMS & MEYERS §422, at 369-70.

66. Brown, *Assignments of Interests in Oil and Gas Leases, Farm-Out Agreements, Bottom Hole Letters, Reservations of Overrides and Oil Payments*, PROCEEDINGS OF THE FIFTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION AS IT AFFECTS THE OIL AND GAS INDUSTRY, 25, 36 (1954) [hereinafter cited as *Brown*].

67. See notes 49-61 and accompanying text *supra*.

68. See Warren, *Transfer of the Oil and Gas Lessee's Interest*, 34 TEX. L. REV. 386, 386 (1956) [hereinafter cited as *Warren*].

69. *Logan*, *supra* note 15, at 396.

70. "A person who seeks to secure leases for speculation and resale in areas where survey or exploration work is being done." H. WILLIAMS & C. MEYERS, OIL & GAS TERMS, 242 (3d ed. 1971).

71. *Logan*, *supra* note 15, at 396.

72. See *Logan*, *supra* note 15, at 396.

73. See *Warren*, *supra* note 68, at 386-87.

74. See *Warren*, *supra* note 68, at 388; *Logan*, *supra* note 15, at 396.

75. An oil payment is a share of the oil produced without deduction for the costs of production. The payment terminates when a stated amount of production is attained, or a stated sum is paid. See 2 WILLIAMS & MEYERS, *supra* note 65, §422, at 365-66.

ume is produced or a fixed sum is paid.<sup>76</sup> Despite the difference between the duration of the oil payment and an overriding royalty, they are substantially similar in effect.<sup>77</sup> By reserving an economic interest in the lease, the lessee-transferor does not convey his entire interest—the distinctive feature of the sublease. Although California courts have not held that an oil payment creates a sublease, no logical reason exists for distinguishing it from an overriding royalty.<sup>78</sup>

Even when the parties to an oil and gas lease transfer understand that retaining interests may prevent an assignment, attempts to draft the transfer instrument to preclude a judicial finding of a sublease can be unpredictable. In *Higgins v. Exeter Oil Co.*,<sup>79</sup> a lessee entered into a “contract of employment” with the party who was to develop the lease. To circumvent a covenant in the original lease prohibiting both assignments *and* subleases, the instrument recited that the lease owner, Exeter Oil, desired to hire Barnsdall Co. to drill and thereafter operate an oil and gas well for Exeter.<sup>80</sup> In finding the contract was neither an assignment nor a sublease, the *Higgins* court noted that the letter:

contained no words of transfer or assignment of any estate in any real property; . . . The Exeter Company retained possession of the premises, and there was lacking those persuasive elements of a sublease—exclusive possession, a fixed term, a fixed rental and right of re-entry in event of covenant broken.<sup>81</sup>

Although the instrument was substantially in the form of a sublease because Exeter retained the functional equivalents of a royalty interest and a right of termination for breach of contract while Barnsdall undertook all development and operations subject to reimbursement, the court distinguished this agreement from a sublease.<sup>82</sup> As a result, the

76. See note 75 *supra*.

77. See 2 WILLIAMS & MEYERS, *supra* note 65, §422.3, at 376.

78. One commentator, confessing to difficulty understanding the reason for distinguishing between the two interests, nevertheless believes that retaining an oil payment should not cause the transfer to be classified as a sublease “as it reduces the number of transfers to be classified as subleases rather than assignments.” 2 WILLIAMS & MEYERS, *supra* note 65, §413.4, at 333-34.

79. 45 Cal. App. 2d 792, 115 P.2d 13 (1941).

80. If Barnsdall were unsuccessful in the first well, it had the option of terminating the lease or commencing another. Barnsdall was also authorized to enter and do all work on the premises necessary to obtain production. All work and materials were provided by Barnsdall at its own expense. Barnsdall was to be compensated as follows:

from all gas and oil sold from the well, one-sixth should be deducted as the landowner's share. The remaining five-sixths should be paid to Barnsdall Oil Company until that company had been fully reimbursed for moneys advanced in drilling and operating of [sic] the well, and after being so reimbursed the lessee was to pay the Barnsdall Company the costs of operation and sixty percent of the remaining five-sixths . . . . In case of default, the Exeter Oil Company could, after notice, terminate the contract . . . .

It was further expressly provided that the contract was not intended to convey or assign any interest in the premises. *Id.* at 794, 115 P.2d at 14.

81. *Id.* at 795, 115 P.2d at 14.

82. See *id.*, 115 P.2d at 14.

covenant precluding lease transfers was not breached, and therefore was not a ground for forfeiture under a forfeiture clause.<sup>83</sup>

The contracting parties in *Higgins* knew of the potential consequences of reserving an override and a right of re-entry and so drafted a contract to avoid them. Because most lease transferors wish to conclude their liability on the lease and pass ownership of the rights created under it,<sup>84</sup> a transferor required to undertake operating duties to preclude a judicial finding of a sublease, as in *Higgins*, is faced with an undesirable agreement. Parties to many lease transfers also may not fully contemplate the legal consequences attending the lease transfer.<sup>85</sup> As the following sections illustrate, the legal consequences of the assignment-sublease distinction do not justify its continued application to oil and gas leases.

### 1. Legal Consequences of the Assignment-Sublease Distinction

When a lessee transfers his entire lease interest, the transfer operates as an assignment.<sup>86</sup> The transferee is in privity of estate with the lessor and liable on all covenants in the original lease which run with the land. In a sublease, however, privity of estate does not exist, and the sublessee owes no duty to the lessor on the covenants in the original lease. In *Hartman Ranch*, the court employed this reasoning to preclude sublessee liability in damages to the lessor for breach of an implied covenant after the court had characterized the lease transfer as a sublease.<sup>87</sup> *Hartman Ranch* has serious consequences for both the lessor and the original lessee because in many instances the parties engaged in the oil and gas business do not intend a variance in the *form* of a transfer to have major practical significance.<sup>88</sup> For instance, some leases contain clauses permitting assignment of the lease and requiring the lease covenants to extend to heirs, executors, and assignees. Courts following the rule of strict construction of oil and gas leases find these clauses refer only to *assignments*, not to subleases. Therefore, privity of contract does not exist with respect to a transferee's duty to the lessor to perform the covenants of the original lease. In *Hartman Ranch*, the court found the transferee liable only because his express assumption of the original lease evidenced his intent to benefit the lessor. This sup-

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83. See *id.* at 793, 115 P.2d at 13.

84. See MERRILL, *supra* note 15, §178, at 398. Although a lessee remains liable to the lessor on both express and implied covenants of the lease when privity of contract exists, normally a lease contains a clause relieving the lessee of liability upon assignment. 2 WILLIAMS & MEYERS, *supra* note 65, §403.1, at 263-64.

85. See Logan, *supra* note 15, at 396.

86. See note 36 and accompanying text *supra*.

87. See notes 43-47 and accompanying text *supra*.

88. See Warren, *supra* note 68, at 409-10.

ported the lessor's recovery on a third party beneficiary theory.<sup>89</sup> One commentator has submitted that the assumption is not a significant enough indication of the parties' intent to make the variance in the *form* yield practical results of such magnitude stemming from classifying the transfer as a sublease.<sup>90</sup> In most cases, the lessor probably knows the person to whom he is giving a lease has no intention of personally exercising the operating rights obtained.<sup>91</sup> The lessor executes the lease anyway in the belief that the lessee is the best person to find a party who will develop the lease for oil and gas.<sup>92</sup> Thus, it is not convincing to argue that after the lessor includes covenants concerning activities of the lease operator, the lessor intended to bind only the non-operating lessee, but not the operating transferee. The lease transferor typically has no right to control the operations of the transferee.<sup>93</sup> The operating transferee on the other hand has *direct* control of the operation and so is in the best position to cure any breach of covenant.<sup>94</sup> The lessor would thus prefer to hold the transferee directly responsible.<sup>95</sup>

Another reason for binding the lessee's transferees to the original lease covenants is that the lessee is frequently a lease broker who might not be in a financial position to respond in damages to liability arising out of a breach. In this case, the lessor would prefer to hold the lease transferee liable because the transferee is often better able to pay a resulting judgment.<sup>96</sup> Precluding transferee liability for breach of covenants on the ground that he is operating as a sublessee rather than as an assignee is not based on a consideration of usual oil business realities.<sup>97</sup>

Examining the lessee's position, it is also difficult to find an intent on his part to remain solely responsible for his transferee's operations.<sup>98</sup> By creating a sublease rather than an assignment, the lessee has greatly increased his chances of being sued for breaches caused by his transferee. Yet, in the usual transfer, the lessee does not reserve any control over the transferee's operations.<sup>99</sup> This is inconsistent with an intent to

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89. See *Hartman Ranch Co. v. Associated Oil Co.*, 10 Cal. 2d 232, 246, 73 P.2d 1163, 1169 (1937).

90. See MERRILL, *supra* note 15, §178, at 394.

91. See Warren, *supra* note 68, at 400.

92. See Warren, *supra* note 68, at 386.

93. See Warren, *supra* note 68, at 409.

94. See Warren, *supra* note 68, at 400.

95. See Brown, *supra* note 66, at 36.

96. See Brown, *supra* note 66, at 36.

97. See Hutchinson, *supra* note 14, at 550-51; Merrill, *The Partial Assignee—Done in Oil*, 20 Tex. L. Rev. 298, 322 (1942); Warren, *supra* note 68, at 400.

98. See Brown, *supra* note 66, at 37.

99. The party actually operating the lease may have taken his working interest after a long chain of lease transfers. If the original lessee retained some control of the remote transferee's operations, this would be a disruptive influence in the production process. See Warren, *supra* note 68, at 400-01.

create a sublease. Concluding that a lessee is solely liable for any breach is difficult to justify simply on the ground that the lessee desired to share in the profit of a possible oil strike by retaining an overriding royalty interest.<sup>100</sup>

In *Hartman Ranch*, the court was able to avoid the harsh result of finding the transferee not liable to the lessor for breach of a lease covenant by adopting the theory that the lessor was a third party beneficiary of the transfer agreement between the lessee and the transferee.<sup>101</sup> The court found the transferee had *expressly* assumed the covenants in the original lease, thus inferring an intent by the lessee to secure the discharge of his debt or performance of his duty to the lessor.<sup>102</sup>

Subsequent to *Hartman Ranch*, a wary lessor should include a lease covenant requiring that all lease transferees expressly assume the covenants of the original lease. Even so, this will be insufficient to provide an avenue of recovery to the unwary landowner or to those who entered pre-*Hartman Ranch* leases, not recognizing the necessity of such a clause.

## 2. *Impact of Hartman Ranch*

The *Hartman Ranch* decision stands as precedent for further applications of landlord and tenant law to oil and gas leasing. However, the case lacks an analysis of similarities of the relationship created by an oil and gas lease to that of landlord and tenant, as well as a consideration of how any similarities justify extending the rule of landlord and tenant law to oil and gas leasing. California courts have not consistently adopted a uniform definition of a sublease, nor have the common law consequences of such a distinction been uniformly applied in the oil and gas field. Predicting when a California court will rely on an incident of the assignment-sublease distinction to decide a case is, therefore, made difficult.

For example, in *Chase v. Trimble*,<sup>103</sup> the issue was whether a transferee's surrender of an oil and gas lease to the lessor extinguished the original lessee's overriding royalty.<sup>104</sup> The common law rule is that an assignee or sublessee can not surrender a lease so as to affect the rights of the transferor.<sup>105</sup> Therefore, it would appear that a sublessee surren-

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100. See *Warren*, *supra* note 68, at 409.

101. See *Hartman Ranch Co. v. Associated Oil Co.*, 10 Cal. 2d 232, 245-47, 73 P.2d 1163, 1169-70 (1937).

102. The court found that the transferee had expressly assumed the covenants in the original lease, thus inferring an intent by the lessee to secure the discharge of his debt or performance of his duty to the third party. See 10 Cal. 2d at 243-47, 73 P.2d at 1169-170.

103. 69 Cal. App. 2d 44, 158 P.2d 247 (1945).

104. See *id.* at 47, 158 P.2d at 248-49.

105. See *Rosenberg v. Taft*, 94 Vt. 458, 111 A. 583 (1920).

der will not extinguish the overriding royalty. The *Chase* court held that the lessee's overriding royalty was extinguished because the transferee was actually an assignee since a right of re-entry was not retained.<sup>106</sup> California authority that retaining an overriding royalty alone creates a sublease<sup>107</sup> was ignored. Thus, a practicing attorney may conclude either that an assignment will be found unless a right of re-entry is retained along with an overriding royalty or that characterizing a transfer as a sublease is not dispositive of this issue. If the latter, California has departed from the common law when the assignment-sublease distinction is potentially most valuable to the lessee. Permitting the transferee to extinguish the lessee's overriding royalty leaves the lessee vulnerable to having his overriding royalty extinguished at the transferee's option.

The salient problem then is to find which features of a relationship created under an oil and gas lease are sufficiently analogous to a landlord-tenant relationship to support application of landlord-tenant doctrines. California courts unfortunately have proffered little clear guidance on this issue. This comment submits that before a landlord and tenant concept is applied to the oil and gas lease the relationship of lessor and lessee should be examined to determine whether the agreement contemplated application of landlord and tenant principles.<sup>108</sup>

A second area which may cause un contemplated results is the analogy by California courts of oil and gas royalties to a landlord's rent. The following section illustrates that the concepts of royalty and rent should not be used interchangeably.

#### ANALOGIZING OIL ROYALTY TO A LANDLORD'S RENT

In California when the landowner-lessor executes an oil and gas lease, he retains a reversionary interest and a right to royalty. Even if a lease is not executed, the landowner has a royalty interest as part of the rights of fee ownership which he can assign in whole or in part.<sup>109</sup> In *Callahan v. Martin*,<sup>110</sup> the California Supreme Court held that this interest is an incorporeal hereditament, the benefit of which can be held in gross.<sup>111</sup> The court supported its conclusion with the rationale that royalty is synonymous with rent, "or so closely analogous to rent as to partake of the incidents thereof."<sup>112</sup> Because at common law the right

106. See 69 Cal. App. 2d at 48, 158 P.2d at 250.

107. See notes 56-61 and accompanying text *supra*.

108. See Merrill, *The Partial Assignee—Done in Oil*, 20 Tex. L. Rev. 298, 302 (1942).

109. See *Callahan v. Martin*, 3 Cal. 2d 110, 124, 43 P.2d 788, 793-94 (1935).

110. 3 Cal. 2d 110, 43 P.2d 788 (1935).

111. See *id.* at 128, 43 P.2d at 797.

112. *Id.* at 123, 43 P.2d at 793.

to future rents is classified as an incorporeal hereditament,<sup>113</sup> this analogy of royalty to rent served the *Callahan* court with a convenient analogue from which it concluded that an assigned royalty interest survived both the termination of the outstanding lease and the subsequent conveyance of the mineral estate by the assignor.<sup>114</sup>

The function which royalty and rent perform in their respective fields, however, is not analogous. Because the conception of royalty to rent is incomplete, potentially misleading, and often contrary to the intentions of the parties to the lease, the notion of royalty as rent should be abandoned.

#### *A. Is Royalty a Rent?*

Rent has been defined as a:

return of certain amount, which is regarded as issuing out of the land, as part of its actual or possible profits, and is payable by one having an estate in the land as compensation for its use, possession and enjoyment of the land, or occasionally, as a charge on the land.<sup>115</sup>

To assert that royalty payments are given to the lessor for the use of his land is only partially correct. First, the lessee who uses the land for the purpose of exploration may never owe the lessor a royalty payment if no production is obtained.<sup>116</sup> In addition, the lessee may owe a royalty to a non-participating mineral owner who has no right to use the land. A more accurate statement is that royalty is owed not for use of the land but for the right to *extract* minerals underlying the land.

Second, royalty owed is not a certain amount as is rent. Instead, the amount of royalty owed directly depends on how much oil and gas is produced.<sup>117</sup> This factor also supports the view that royalty is not owed just for the *use* of the land; the use of the land may remain constant, whereas production, and resulting royalties, can increase or decrease.

In the usual oil and gas lease, payment of royalty does not function directly to keep the lease in force, although non-payment of rent may be a ground by which the lessor may put the lessee in default and declare a forfeiture.<sup>118</sup> Even though the lessor enters into a leasing arrangement under which he is entitled to royalty payments, the primary objective of the lease is to obtain "paying production" of oil and gas.<sup>119</sup>

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113. *Id.* at 124, 43 P.2d at 793.

114. *See id.*

115. 3 TIFFANY, THE LAW OF REAL PROPERTY §876 (3d ed. 1939).

116. *See generally* 2 WILLIAMS & MEYERS, *supra* note 65, §327.1.

117. *See* 2 WILLIAMS & MEYERS, *supra* note 65, §327.1.

118. *See* 3 WILLIAMS, *supra* note 4, §656.2, at 697.

119. *See* *Dabney v. Edwards*, 5 Cal. 2d 1, 15 (1935).

Should the lessee fail to produce in paying quantities, the usual lease expires automatically.<sup>120</sup>

In California, paying production is generally defined as that amount of production which will return a profit to the producer after paying royalty and the costs of production.<sup>121</sup> The rationale is that a lessee who is motivated solely by an intent to develop the potential oil and gas resources will hold the lease only if it proves profitable. A lessee who continues operations on the land without realizing a profit is merely speculating on the future value of the lease at the lessor's expense.<sup>122</sup> The lessor intended to preclude this by making paying production a special limitation to the duration of the oil and gas lease.<sup>123</sup> In a sense, the limitation is an indirect method of insuring that the producing lessee will use his best efforts to develop the oil and gas potential of the leased premises.<sup>124</sup>

The danger in analogizing royalty to rent is that remedies designed to address situations such as a landlord's acceptance of rent, or a tenant's failure to pay rent, may be applied to similar situations in the oil and gas context. Extending these remedies may result in the court rewriting the lease to afford rights and remedies not initially contemplated at the time the lease was executed, thus providing for an unbargained windfall.

### *B. Consequences of Analogizing Royalty to Rent*

The problems created when royalty is analogized to rent will first be illustrated by tracing the application of California's holdover tenant doctrine to the field of oil and gas law. A problem created by the royalty-rent analogue is that it can be used to support an extension of rights and remedies designed to address the situation of landlord and tenant.

#### *1. Common Law Holdover Tenant Doctrine*

Under common law rules, a landlord has a choice of remedies when faced with a tenant holding over after expiration of the lease.<sup>125</sup> The

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120. The oil lease with a phrase stating that the lease continues so long after the end of the primary term as production is in paying quantities creates a determinable fee which terminates upon the happening of the named event. No notice is required, and no forfeiture results. *Renner v. Huntington-Hawthorne Oil & Gas Co.*, 39 Cal. 2d 93, 98, 244 P.2d 895, 899 (1952); *Montana-Fresno Oil Co. v. Powell*, 219 Cal. App. 2d 653, 666, 33 Cal. Rptr. 401, 409 (1963).

121. *See* 39 Cal. 2d at 99, 244 P.2d at 899-900.

122. *See* *Richfield Oil Corp. v. Bloomfield*, 103 Cal. App. 2d 589, 591, 229 P.2d 838, 840 (1951).

123. *See id.*

124. *See id.*

125. *See* 1 TIFFANY, THE LAW OF REAL PROPERTY §175, at 281 (3d ed. 1939) [hereinafter cited as TIFFANY].



landlord may elect to treat the holdover tenant as a trespasser.<sup>126</sup> The landlord may bring an action for possession and an action for damages, which may include the reasonable rental value of the premises during the holdover period.<sup>127</sup>

The landlord's second alternative is to treat the holdover tenant as a tenant for another term rather than as a trespasser.<sup>128</sup> In California, it has been held that "[v]ery slight acts on the part of the landlord, or a short lapse of time, are sufficient to conclude his [the landlord's] election and make the tenant his occupant."<sup>129</sup> At common law, the landlord's acceptance of rent from the holdover tenant raised a presumption that an agreement for a new term had been made.<sup>130</sup> This presumption is now codified in California Civil Code Section 1945 which states in part that:

[i]f a lessee of real property remains in possession thereof after the expiration of the hiring, and the lessor accepts rent from him, the parties are presumed to have renewed the hiring on the same terms. . . .

In *Renner v. Huntington-Hawthorne Oil & Gas Co.*,<sup>131</sup> the California Supreme Court applied Civil Code Section 1945 when asked to declare the legal status of an oil and gas lessee in possession of the premises under an expired lease. The lease had expired by its own terms when paying production had not been obtained<sup>132</sup> at the end of the primary term.<sup>133</sup> Because the lessor continued to accept royalty payments tendered by the lessee after the lease had expired, the court concluded that a month-to-month tenancy was created.<sup>134</sup> Furthermore, since the lessor did not give the prescribed thirty days notice of termination of the lease,<sup>135</sup> the tenancy was not terminated, and the lessor's quiet title action could not be sustained.<sup>136</sup>

The *presumption* of a new tenancy arising from the landlord's acceptance of rent tendered by the holdover tenant is justified perhaps in the

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126. See *Samuels v. Singer*, 1 Cal. App. 2d 545, 548, 36 P.2d 1098, 1102 (1934).

127. *Cowell v. Snyder*, 15 Cal. App. 634, 638, 115 P. 961, 963 (1911).

128. See *TIFFANY*, *supra* note 125, §175, at 281.

129. *Cowell v. Snyder*, 15 Cal. App. 634, 638, 115 P. 961, 963 (1911).

130. See *Skaggs v. Elkus*, 45 Cal. 154, 160 (1872).

131. 39 Cal. 2d 93, 244 P.2d 895 (1952).

132. *Id.* at 98, 244 P.2d at 899.

133. "The period of time, typically five or ten years, during which a lease may be kept alive by a lessee even though there is no production in paying quantities by virtue of drilling operations on the leased land or the payment of rentals." H. WILLIAMS & C. MEYERS, *OIL AND GAS TERMS*, 344-45 (3d ed. 1971).

134. 39 Cal. 2d at 102, 244 P.2d at 900.

135. "A hiring of real property, for a term not specified by the parties, is deemed to be renewed as stated in . . . [section 1945], at the end of the term implied by law unless one of the parties gives written notice to the other of his intention to terminate the same . . ." CAL. CIV. CODE §1946.

136. 39 Cal. 2d at 102, 244 P.2d at 900.

ordinary landlord and tenant relationship.<sup>137</sup> Whether this same presumption should arise when an oil and gas lessor accepts royalties from the holdover lessee depends on the similarity between the relationships created under an ordinary lease and those created by an oil and gas lease. Because the kinds of operations usually found in the oil and gas industry were not contemplated by the California Legislature at the time Section 1945 was adopted in 1872,<sup>138</sup> the two different types of relations should be compared to determine whether it is appropriate to apply the statute which raises a presumption of a month-to-month tenancy to the oil and gas context.

Presumptions are devices by which the burdens of producing evidence and of persuasion are shifted from one party to another.<sup>139</sup> The following paragraphs set forth the policy protecting the lessor's right to create a lease interest determinable upon the happening of a special event. Because the presumption which arises under Section 1945 dilutes the protections which this policy was designed to achieve, it should not be applied to the field of oil and gas.

The oil and gas lease typically expires automatically when production falls below paying quantities.<sup>140</sup> California recognizes and protects the lessor's right to provide for an automatic termination as a method of describing the duration of the lease.<sup>141</sup> The lease continues, not so long as royalties are received, but so long as paying production is maintained. This mechanism protects the lessor from the speculator-lessee who would otherwise be able to hold the lease by paying nominal royalties from a low level of production.<sup>142</sup> A primary reason for using the limitation of "paying production," then, is to insure that operations on the lease are not merely speculative by providing incentive for the lessee to develop the resource potential of the lease above minimum levels.<sup>143</sup> Although maximum production is ordinarily in the lessee's best interest also, when declining oil and gas production nears the point at which the lessee makes no profit, the lessee must make a choice. In order to keep the lease alive, he may choose to invest in reworking the wells or commence secondary recovery operations, or he may choose to surrender the lease. When the lessee knows he may be

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137. See TIFFANY, *supra* note 125, §175, at 282-83.

138. See CAL. CIV. CODE §1945.

139. The reasons for creating presumptions may be out of considerations of fairness to the parties, to correct for a party's superior access to items of proof, or out of social or economic considerations. See MCCORMICK, LAW OF EVIDENCE §343, at 805-06 (2d ed. 1972).

140. See *Richfield Oil Corp. v. Bloomfield*, 103 Cal. App. 2d 589, 591, 229 P.2d 838, 840 (1951).

141. See *Montana-Fresno Oil and Gas Co. v. Powell*, 219 Cal. App. 2d 653, 659-66, 33 Cal. Rptr. 401, 409 (1963).

142. See *id.*, 33 Cal. Rptr. at 409.

143. See 103 Cal. App. 2d at 591, 229 P.2d at 840 (1951).

liable for the full amount of oil produced above the cost of production,<sup>144</sup> or in the case of a bad-faith trespasser,<sup>145</sup> for the oil's gross value, the lessee will either make the necessary investments to keep the lease alive or quitclaim the lease.

The practical effect of the *Renner* decision<sup>146</sup> provides the lessee faced with the prospect of non-profitable production with a third alternative—he may continue to hold the lease by operating the stripper well and recover any possible profits he may make while continuing to pay royalty to the lessor. Because *Renner* holds that the lessee is operating under a month-to-month tenancy,<sup>147</sup> the lessee is not liable for the oil and gas produced.<sup>148</sup> As a result, there is less incentive for the lessee to maintain production at paying quantities, and more protection for the speculating lessee.<sup>149</sup>

The *Renner* holding results in a retrenchment from the long-standing policy protecting the lessor's ability to terminate automatically the lease. Furthermore, there is a possibility that the lessor cannot terminate the tenancy implied by law with thirty days' notice as provided in Civil Code Section 1946.<sup>150</sup> Section 1945 provides that the terms of the tenancy created by the holdover statute are presumably the same as of the previous tenancy.<sup>151</sup> Most oil and gas leases are grants which continue so long as paying production is maintained.<sup>152</sup> If this "thereafter" clause<sup>153</sup> of the original lease is held to become a term of the lease implied by Section 1945, a holdover lessee who later brings production back up to paying quantities would continue to have the right to pro-

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144. See 1 WILLIAMS & MEYERS, *supra* note 1, §226.2, at 378-79.

145. See 1 WILLIAMS & MEYERS, *supra* note 1, §226.1, at 373.

146. In *Renner* the court held that the leases had terminated when production had fallen below paying quantities, which in the lease was defined as an average of fifty barrels of oil per day for a period of thirty consecutive days. Nevertheless, the court concluded that the lessor's subsequent acceptance of regularly tendered royalties created a tenancy from month-to-month which could not be terminated without giving notice. See notes 131-136 and accompanying text *supra*. Cf. 219 Cal. App. 2d at 670-71, 33 Cal. Rptr. at 412 (acceptance of irregularly tendered royalty payments with long intervening gaps was not enough to create a month-to-month tenancy).

147. See note 148 and accompanying text *infra*.

148. The measure of damages for wrongful extraction of oil and gas depends on whether the act is characterized as being in good faith or bad faith. The plaintiff can recover the value of oil and gas extracted minus the costs of development, production, and operation from a good faith trespasser. See 1 WILLIAMS & MEYERS, *supra* note 1, §226.2, at 378-79. The bad faith trespasser, however, is not entitled to a deduction for his costs. See 1 WILLIAMS & MEYERS, *supra* note 1, §226.1, at 373.

149. 103 Cal. App. 2d at 591, 229 P.2d at 840.

150. See Note, *Oil and Gas: Use of Landlord-Tenant Concepts in Construction of Leases: Remedy for Failure to Pay Royalties*, 4 U.C.L.A. L. REV. 485, 488 (1957) [hereinafter cited as *Oil & Gas*].

151. CAL. CIV. CODE §1945.

152. See notes 142-145 *supra*.

153. See note 120 *supra*.

duce so long as the profitable level of production is maintained.<sup>154</sup> This result should be avoided because the lessor would lose the chance to renegotiate the lease,<sup>155</sup> and the lessee will be rewarded for his speculative holding.

This comment does not suggest that the lessee should be exposed to liability for operations on the leasehold when it appears from the conduct of the lessor that a lease exists between the lessor and the lessee. This comment submits, however, that the lessee should not have the benefit of a presumption. Instead, the burden should be on the lessee to prove the existence of an implied lease, rather than on the lessor to disprove it. This approach would more fully accord with the policy to promote production<sup>156</sup> and to protect the lessor's ability to prevent speculative holding.<sup>157</sup>

Extending the holdover tenant statute to oil and gas leases is one result of analogizing royalty to rent. A second occasion when California courts may rely on the royalty as rent concept involves application of the California unlawful detainer statute<sup>158</sup> to terminate an oil and gas lease in a manner not contemplated by the parties.

## 2. *Unlawful Detainer is an Inapplicable Remedy for Failure to Pay Royalty*

A second hazard created by an analogy of royalty to rent is that it will serve as a basis for applying the California unlawful detainer statute to forfeit a lessee's lease for failure to pay rent. The standard lease reserves a royalty interest in the lessor<sup>159</sup> and may also contain a covenant requiring the lessee to make prompt payment of the royalty.<sup>160</sup> Another common lease provision gives the lessor a right to declare a forfeiture if the lessee breaches any of the substantial lease terms.<sup>161</sup> Upon breach, the lessor may elect to put the lessee in default and terminate the lease if the default is not cured within an agreed-on number of

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154. The landlord's acceptance of rent has been held to create a *new* term and not merely an extension of the old term. *Earle v. Kelly*, 21 Cal. App. 480, 485, 132 P. 262, 264 (1913). Civil Code Section 1945 provides that the duration of the new term is presumed to be the same as the prior term—not to exceed one year. It is clear that a lease in the primary term is not renewed beyond a one year term by the acceptance of delay rentals. *See Stetson v. Orland Oil Syndicate*, 42 Cal. App. 2d 139, 142, 108 P.2d 463, 464-65 (1940). Where the lessee has *regained* paying production which propels the lease into the "thereafter" term, a question remains as to whether section 1945 will limit the determinable fee as well. *See Oil & Gas, supra* note 150, at 488.

155. *See Oil & Gas, supra* note 150, at 488.

156. *See* note 142-145 and accompanying text *supra*.

157. *See* note 142-145 and accompanying text *supra*.

158. CAL. CODE CIV. PROC. §1161.

159. *See* 1 WILLIAMS & MEYERS, *supra* note 1, §202.3, at 25.

160. *See* 2 WILLIAMS & MEYERS, *supra* note 65, §428.8, at 485.

161. *See* 4 H. WILLIAMS, OIL AND GAS LAW §681, at 313 (1980).

days.<sup>162</sup> This right of forfeiture is the mutually agreed-on method by which the lessor can terminate the lease for failure to pay royalty.

In 1872, California adopted an unlawful detainer statute<sup>163</sup> to provide a landlord with a summary remedy for the lessee's failure to pay rent.<sup>164</sup> In two separate opinions, California courts have strongly suggested that an unlawful detainer action could be maintained against the lessee for non-payment of royalty. In *Martin v. Southwest Royalties, Inc.*,<sup>165</sup> the lessor brought an action for unlawful detainer and an action to quiet title. The court noted the allegations in both counts had been answered by the defendant lessee. Although the court appeared to base its judgment on the quiet title count, it stated that:

Both the unlawful detainer and the quiet title counts of the complaint were in fact answered by the defendant, thus putting all material allegations of both counts in issue. The evidence introduced was equally applicable to both counts. The theory upon which the case was tried is to be ascertained by reference to the issues framed by the pleadings and to findings made by the courts (citation omitted) . . . Assuming the unlawful detainer count to be *defective*, we must presume that the judgment was based solely upon the quiet title count. . . .<sup>166</sup>

The defect referred to in the opinion was that the plaintiff failed to give the required notice, not that the statute was inapplicable to oil and gas leases.<sup>167</sup>

This decision has serious consequences for the lessee. In the ordinary oil and gas lease, the lease is terminated automatically only on failure to produce oil and gas in paying quantities.<sup>168</sup> The parties did not agree to a summary right of termination on failure to pay royalty.<sup>169</sup> Thus, a ruling extending the remedy of unlawful detainer would be contrary to the express intent of the parties. Furthermore, application of the unlawful detainer statute would give a windfall to

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162. See 4 H. WILLIAMS, OIL AND GAS LAW §682.1, at 340 (1980).

163. CAL. CODE CIV. PROC. §1161.

164. A tenant of real property is guilty of an unlawful detainer if he continues in possession of the premises after default in the payment of rent and is served with three days notice demanding the sum due and owing. See CAL. CIV. PROC. CODE §1161. The right is designed to correct for the common law rule that non-payment of rent by a tenant does not result in forfeiture of the lease unless the lease expressly so provides. See ALP, *supra* note 22, §3.11, at 203. This was because at common law the covenant to pay rent was not dependent. See ALP, *supra* note 22, §3.11, at 202. "The tenant can retain possession until the end of the term though it be morally certain that the landlord will receive no rent." 3A G. THOMPSON, REAL PROPERTY §13353, at 607 (J. Grimes ed. 1981). This rule has long been recognized in California. See *Chipman v. Emeric*, 3 Cal. 273, 283 (1853).

165. 41 Cal. App. 2d 161, 106 P.2d 433 (1940).

166. *Id.* at 168, 106 P.2d at 447.

167. *Id.*

168. See notes 130-132 and accompanying text *supra*.

169. See notes 158-161 and accompanying text *supra*.

the lessor not bargaining for a right of re-entry for a breach of covenant.<sup>170</sup> The lessor gains an unbargained-for summary remedy for failure of the lessee to pay royalty.

Application of the unlawful detainer statute is an inappropriate remedy in light of the normal operations of the oil and gas business. Royalty payments may be delayed for many justified reasons.<sup>171</sup> Because the royalty interest is freely alienable and also a lucrative investment security, payment often may be delayed until the complexities of royalty ownership can be determined by a reliable title search.<sup>172</sup> When an area becomes the scene of increasing speculation, the oil person must act swiftly to obtain a lease. Often there will be only enough time to conduct a thorough search for mineral owners.<sup>173</sup> Once this is accomplished he can safely begin operating. Yet, because royalties are severable from the mineral interest, questions of royalty ownership have not been solved by the initial search.<sup>174</sup> When a lease covers a large area, it is not unusual to find numerous conveyances and partitions to various royalty owners who must all be found and which contribute to the delay.<sup>175</sup>

In addition to problems of title, delay may also be generated by complexities in determining the price to be received from sales of oil to buyers.<sup>176</sup> Although this problem was much more complex before oil and gas prices were deregulated, delay may still result when the price is tied to contract contingencies of quality, time, place of delivery, and accounting complexities.

In light of the large investment of time and money required to obtain production under a lease, providing the lessor with the summary remedy of unlawful detainer for non-payment of royalty imposes a heavy burden on the oil and gas lessee. To protect himself from loss of a lease for failure to pay royalty, the lessee may have to make a royalty payment based on estimates of the proceeds of a sale. To protect from forfeiture by a royalty owner, the lessee may choose to make double royalty payments to insure that the doubtful owner does not initiate forfeiture proceedings when the owner discovers that he has an interest

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170. Even when the original lease does not give the landlord a right to re-entry for breach of the covenant to pay rent, the court may still give judgment for the lessor, returning possession to him if payment has not been made within five days of notice. See CAL. CIV. PROC. CODE §1174(c).

171. Arata, *Timely Payment of Royalty*, 11 LOY. L. REV. 163 (1963) [hereinafter cited as *Arata*].

172. See *Arata*, *supra* note 170, at 165-68.

173. See *Arata*, *supra* note 170, at 164-65.

174. See *Arata*, *supra* note 170, at 165.

175. See *Arata*, *supra* note 170, at 165.

176. See *Arata*, *supra* note 170, at 172.

in royalty.<sup>177</sup> When the parties to the oil and gas lease have expressly agreed on a specific remedy and manner of enforcing the remedy in the lease, it is inappropriate to extend the summary remedy which was designed for a true landlord and tenant relationship to the oil and gas field. Such an extension fails to recognize the special needs of the oil and gas business.

### RECOMMENDATIONS

A first step toward correcting inequities resulting from the application of landlord and tenant doctrines is made when courts recognize that these doctrines were an outgrowth of a society and economy based on the land and agriculture.<sup>178</sup> The needs of today's large oil producers have little in common with the feudal tenant.<sup>179</sup> The oil producer only seeks to produce oil and gas from the land for the profits it returns; ownership of an estate does not provide the producer with status. To produce these resources, large capital investments must be made. The oil producer often must negotiate with more than one landlord to obtain drilling rights on enough land to make the operation successful. The landowner for his part is not seeking to maintain a social status or to put someone in possession for the rents that may be derived. He can continue using his land as before, but now the opportunity exists to share in the profits earned from producing oil and gas.<sup>180</sup>

California courts have been reluctant to make a discriminating analysis of these differences as a basis for departure from common law doctrine. The courts often have noted that oil and gas leases are not easily compared to ordinary usufructuary leases. In *Callahan v. Martin*,<sup>181</sup> the California Supreme Court stated that:

The difficulty experienced in defining with exactitude the nature of the assignee's rights is due in part to the fact that the oil industry is of very recent development, while in this country, by statute and judicial precedent, our classification of property as realty or personalty is based on common law definitions which crystalized in a time when oil interests were not the subject of judicial cognizance.<sup>182</sup>

But after noting this problem, however, the California Supreme Court relied on the analogy of royalty as rent without analyzing the ways in which they are similar.<sup>183</sup> As a result, California courts have cited this

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177. See 3 WILLIAMS & MEYERS, *supra* note 4, §656.3, at 704.4.

178. See HOLDSWORTH, *supra* note 38, at 248-50.

179. See HUTCHINSON, *supra* note 14, at 550-51.

180. See note 8 and accompanying text *supra*.

181. 3 Cal. 2d 110, 43 P.2d \_\_\_ (1935).

182. See *id.* at 115, 43 P.2d at 791.

183. See *id.* at 123, 43 P.2d at 795.

opinion for the proposition of royalty as being rent and have still not conducted the analysis needed to determine the differences between the two.<sup>184</sup>

Nevertheless, since the courts are generally sensitive to the real problems of the parties coming before them, the *results* of many cases are not subject to criticism. What is open to question is the use of legal theory designed to meet another purpose; that is, the theory is extended to oil and gas leases as a convenient argument to avoid reaching a bad result.

In *Hartman Ranch*, for example, the court applied the assignment-sublease distinction which was developed to meet the needs of an agricultural society. To avoid an undesirable result, the court then looked to a theory of third party beneficiary to support the lessor's recovery of damages from the lessee.<sup>185</sup> A more realistic view of the transfer agreement is that the parties intended it to have the effect of an assignment.<sup>186</sup> Merely because the transferor retained certain economic interests should not stand alone as evidence of the parties' intent to create a sublease—at least for the purpose of extending the legal consequences of a common law sublease.<sup>187</sup> These consequences should be applied only upon a clear expression of intent in the lease or transfer agreement.

The Canadian courts<sup>188</sup> have been sensitive to the oil and gas lease as an expression of the parties' intent to create specific legal rights and duties, holding that the oil and gas lease:

does not create the relation of landlord and tenant and the common law rights and liabilities arising out of the relation of landlord and tenant have no application to the agreement in question . . . .

Once the nature of the document is determined by a consideration of "the true intendment of the instrument" (citation omitted) the agreement is to be construed according to well-known rules of construction.

The parties have entered into a contract which they clearly had the right to make.<sup>189</sup>

Recognizing that an oil and gas lease is not appropriately classified as creating a landlord and tenant relationship, ". . . the guiding principle,

184. See *Atlantic Oil Co. v. County of Los Angeles*, 69 Cal. 2d 585, 594, 446 P.2d 1006, 1015, 72 Cal. Rptr. 886, 893 (1968); *Schiffman v. Richfield Oil Co.*, 8 Cal. 2d 211, 233, 64 P.2d 1081, 1085-086 (1937).

185. See note 47 and accompanying text *supra*.

186. See 2 WILLIAMS & MEYERS, *supra* note 65, §414, at 334.2-34.3.

187. See *Warren*, *supra* note 68, at 409-10.

188. See generally MacIntyre, *The Development of Oil and Gas Ownership Theory in Canada*, 4 U. BRIT. COLUM. L. REV. 245 (1969).

189. *Langlois v. Canadian Superior Oil of Cal. Ltd.*, 23 W.W.R. (n.s.) 401, 407 (1957).



polestar or lodestar of interpretation, whether the form or nature of the instrument, is always the same: To ascertain the will, or intent, of the maker."<sup>190</sup> The rules of interpretation were designed ultimately to ascertain the intent of the parties.<sup>191</sup>

California courts have recognized this principle and applied it to oil and gas leases. In *Renner v. Huntington-Hawthorne Oil & Gas Co.*,<sup>192</sup> the court refused to alter the phraseology of the habendum clause to preclude termination of the lease. In so doing, the court stated:

the elementary rule of construction, applicable to oil leases as well as other documents, [is] that the function of the court is not to make a new lease for the parties but to interpret the lease which they have made, 'without regard to its wisdom or folly.' (citations omitted).<sup>193</sup>

California has joined with the majority of oil and gas states in *implying* lease covenants when it was necessary to carry out the intended objectives of the parties to the agreement.<sup>194</sup>

In light of this, the primary problem is not that the California courts reject the view that an oil and gas lease has both express and implied contractual features, but is that the courts fail to realize that common law doctrines relating to landlord and tenant were founded on a now-outdated view of the parties' intent, apparent from their acts and the surrounding circumstances. For instance, at one time it was accurate to state that retention of a reversionary interest by the assignor of a lease evidenced his intent *in fact* to create a sublease and to adopt all of the legal incidents recognized by the courts as flowing from that relationship.<sup>195</sup> Today, it is unrealistic to hold that retention of a reversion should be determinative of the issue of the sublessee's liability to the lessor for breaches of covenants in the original oil and gas lease.<sup>196</sup> When the parties to a lease use a technical legal term such as "assignment," the courts should not adopt the property law meaning of the word. Instead, they should look to the way the parties intended to use the word in light of the object of the lease and the normal business practices in the oil and gas industry.

In *Hinds v. Phillips Petroleum Co.*,<sup>197</sup> the Oklahoma Supreme Court acknowledged that including technical property terms in an oil and gas

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190. 4 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS §600 (3d ed. 1961).

191. *Id.*

192. 39 Cal. 2d 93, 244 P.2d 895 (1952).

193. *See id.* at 100, 244 P.2d at 899.

194. *See, e.g.*, *Baldwin v. Kubetz*, 148 Cal. App. 2d 937, 307 P.2d 1005 (1957) (implied covenant to develop the lease); *Jones v. Interstate Oil Corp.*, 115 Cal. App. 302, 1 P.2d 1051 (1931) (implied covenant to protect from drainage).

195. *See notes 38-40 supra.*

196. *See Warren, supra note 68*, at 409.

197. 591 P.2d 697 (Okla. 1979).

lease does not necessarily mean the parties intended to be bound by the legal incidents a technical reading of the term would imply. The court implied that the parties' intent was controlling:

If the term 'assignment,' used in the lease, may be construed as synonymous with 'transfer' or 'alienation' rather than as its more technical common law meaning would require, a question we need not decide here, it is clear that alienation of separately severed lease-conferred interests was clearly within the parties' contemplation.<sup>198</sup>

California should adopt the view that the controlling principle for determining the meaning of technical legal terms should be in accordance with the parties' intent.

#### STATUTORY REFORM

The problem created by an inappropriate use of common law property analogies may be corrected by legislative action as well as by a change of judicial philosophy. Although a single legislative statute cannot correct all of the problems that may arise from improper use of property concepts, a few statutes could be tailored to correct the most serious.

This comment proposes the following statute be enacted:

"To the extent of the interest acquired, an assignee or sublessee acquires the rights and powers of the lessee and becomes responsible directly to the original lessor for the performance of the lessee's obligations of which he has notice at the time of taking interest."<sup>199</sup>

This statute would conform more closely to the conduct of the oil and gas business. The duty of a transferee of the lease would be clear: to perform all covenants of the original lease. This duty would not impose hardship upon the lease transferee because in the normal course of business, he will assume the original covenants.<sup>200</sup> The statute would protect lessors who failed to require an assumption by subsequent transferees.

Furthermore, because oil and gas leases are routinely recorded instruments, the transferee can be certain of the covenants for which he will be liable. A search of the record will show all covenants of the original lease as well as subsequent transfers. Should the lessee negotiate a lease and include a term the parties clearly intended as personal to the original lessee and not binding on subsequent transferees, the burden then falls on the lessee to include language in the lease expressing this intent. This burden is not unreasonable because in most in-

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198. *Id.* at 700.

199. This proposed statute is taken verbatim from LA. MIN. CODE ANN. art. 128.

200. See note 102 and accompanying text *supra*.

stances the lessee is the oil producer and possesses detailed knowledge of the oil and gas law. Presumably, he has the legal advice necessary to avoid these pitfalls.

Should the lessee forget to include a term indicating personal liability on a particular covenant, no irreversible loss would result because his transferee is presumed to have knowledge of all the covenants of record;<sup>201</sup> he knows he will be bound to perform them. If the transferee believes some of the covenants are undesirable, he is in a position to adjust his burden when negotiating the terms under which the lease is transferred to him from the original lessee.

A second problem which could be corrected by legislative action is to preclude application of Civil Code Section 1945 and Code of Civil Procedure Section 1166 to oil and gas leases. Adopting the following statute would accomplish this:

Oil and gas royalties shall not be rent for the purpose of terminating an oil and gas lease, for such reasons as are not included in the lease under which the lessee holds. In addition, oil and gas royalties shall not be considered rent for the purpose of raising a presumption of an oil and gas lease from the conduct of parties to a prior oil and gas lease.

The result of this statute would be that lease terms established by the parties to an oil and gas lease would dictate their rights and would control the duration of the lease. This would provide more certainty to the lease and would prevent termination of the lease for reasons not contemplated by the parties.

Adopting both of the above proposed statutes would provide that oil and gas leases are not subject to the application of law intended to apply to ordinary leases. The California Legislature has previously recognized the differences that exist<sup>202</sup> and has acted to preclude a remedy for damages being applied to oil and gas leases.<sup>203</sup>

#### CONCLUSION

An oil and gas lease is a legal instrument tailored by the owner of the mineral interest and the lessee to convey the right to explore, develop, and produce oil and gas from beneath the surface.<sup>204</sup> The lease is also a contract creating rights and duties between the parties. The terms of the contract may cover a wide range of activity including conducting

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201. The recordation of an oil and gas lease is to be given the same effect as recordation of any interest in real property. CAL. CIV. CODE. §1219. *See also id.* §1213.

202. CAL. CIV. CODE §1952.4.

203. See 9 CAL. L. REVISION COMM'N REP. 153 (1969).

204. See notes 6-10 and accompanying text *supra*.

operations on the land, transferability of the lease, payment of royalties, and limiting the duration of the lease.

California courts have applied the landlord and tenant distinction between assignment and sublease of the lease.<sup>205</sup> A sublease can be created by the lessee's retention of an overriding royalty.<sup>206</sup> One result is that without an assumption of the terms of the original lease by the transferee, the lessee has no duty to the lessor for breach of covenant.<sup>207</sup> Such a result is contrary to the needs of the oil and gas business; therefore, it should be abandoned, and the lessee should be held liable on all covenants in the original lease of which he had knowledge at the time he succeeded to the lease interest.<sup>208</sup>

California courts have also analogized royalty to rent.<sup>209</sup> This analogy has been relied on by the California Supreme Court to conclude that tender and acceptance of royalty by the lessor after the lease has expired creates a month-to-month tenancy which may only be terminated by giving thirty days' notice.<sup>210</sup> An argument exists, however, that the lease is not terminated by such notice if the "thereafter" clause is incorporated as a term of the implied tenancy.<sup>211</sup>

The royalty to rent analogy exists as a basis for applying the unlawful detainer statute to return possession of the premises to the lessor when the lessee delays making royalty payments. Such application would provide the lessor with an unintended, un contemplated, and unbargained-for remedy.

For these reasons, the courts should abandon the use of landlord and tenant analogy, and the royalty and rent analogy as bases for determining the rights and duties between parties to an oil and gas lease. Instead, the lease should be viewed as a contract designed to respond to the needs of the parties. Courts should construe the contract according to the intent of the parties.<sup>212</sup> The general intent of those engaged in the oil business is to hold all subsequent transferees of the lease liable to the lessor. Non-payment of royalty is not a ground for forfeiture of the lease absent an express forfeiture clause, and acceptance of royalty by the landlord should not serve as the basis for creating a lease interest.

Although the courts can correct these problems, it may take time.

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205. See notes 43-48 and accompanying text *supra*.

206. See notes 49-61 and accompanying text *supra*.

207. See note 47 and accompanying text *supra*.

208. See notes 189-201 and accompanying text *supra*.

209. See notes 110-114 and accompanying text *supra*.

210. See notes 131-136 and accompanying text *supra*.

211. See notes 152-155 and accompanying text *supra*.

212. See notes 191-201 and accompanying text *supra*.

The legislature, therefore, should adopt specific legislation to provide the corrective remedy.

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