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Assignments by the Landowner and the Lessee

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INTRODUCTION

Whereas the basic principles of oil and gas law have been defined and quite well established on the subjects of the nature of oil and gas in place, lease clauses and their operative effect, and the constitutionality of conservation statutes and regulations, the field of assignments has been a prolific source of litigation. This is due chiefly to two things: First the lack of preciseness in the drafting of mineral deeds and royalty assignments and secondly a misuse of printed forms. This is attributable in great measure to a failure to distinguish between the various interests of a landowner and a lessee that may be separately assigned. The result has been that the parties or their successors go to the courts for a judicial construction of the instruments and the courts are called upon to ascertain the intent of the parties and the operative effect of their agreement when the parties themselves can neither agree nor apparently ascertain what that intent was.

Inasmuch as this is such a broad subject and because there are so many seemingly irreconcilable cases, it may be well to outline the scope of this paper. In other words, we should visualize the mosaic and then proceed to construct it by dissecting the individual parts and reassembling them.

To this end, we will first discuss the various types of interests that may be assigned. Following this we will consider some of these interests individually by discussing permissible assignments by a landowner. Then we will examine permissible assignments by a lessee. Following this there will be certain miscellaneous items such as the obligations of a lessee on express and implied covenants in a lease after he has assigned his interest, and a brief reference to the application of securities regulations of the federal and state governments to the assignment of fractional interests.

A. TYPES OF PERMISSIBLE ASSIGNMENTS

The Nature of Assignable Interests

The owner of the fee simple, or the absolute owner of a tract of land, has all of the rights recognized by the law in both the surface and the minerals. In disposing of his ownership he can transfer all of his rights in the entire premises or in a part thereof.[1] From his ownership he can carve out subordinate interests.[2] This results in a transfer of a part of his rights but leaves in him a residue of interest that is also subject to subsequent transfer.[3]

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[1]Thus, if *A* owns Section 16, Township 4 North, Range 6 West, he can sell all of Section 16 or any part thereof, such as the NW¼.

[2]Thus *A*, in the example given in footnote 1 *supra*, can lease the NW¼ to party *B* for agricultural purposes.

[3]Where *A* as the owner of Section 16 leases the NW¼ to party *B*, *A* is not entitled to possession for the term of the lease, but his right to receive rent and his reversionary interest in the leased premises are both transferable to *B* or to any other person.

Thus, a landowner can sell, *i.e.*, make an outright disposition of, his entire interest in a specified tract.[4] He can sell the surface and retain the minerals or vice versa, in which event there is a severance of his interest into a surface estate and a mineral estate or at least a severance of the surface from those rights in the oil and gas which are recognized in that particular jurisdiction.[5] He can sell all,[6] a segregated part,[7] or an undivided interest[8] in the minerals. He can sell all, or a part, of his interest in the proceeds from the minerals, as distinguished from a sale of the minerals themselves.[9]

The oil and gas lease is the outstanding example of a landowner carving out subordinate interests from his ownership and transferring them to another.[10] The interests transferred are subordinate in the sense that they are not the equivalent of the landowner's rights, and they may terminate and go back to the landowner if the terms of the lease are not complied with.[11]

[4]"When the owner of the entire estate in land conveys it by ordinary form of deed containing no exception or reservation, his grantee acquires the same title which his grantor had, and such title includes all minerals." Harris v. Currie, 142 Tex. 93, 176 S.W.2d 302, 304 (1943).

[5]"The owner of the entire estate in land may convey the minerals therein separately from the surface. Conversely, he may convey the surface separately from the minerals. Stated in another way: The owner has the right to sever his land into two estates, and he may dispose of the mineral estate and retain the surface or he may dispose of the surface estate and retain the minerals. . . . A severance of the mineral estate from the remainder of the land may be effected either by the conveyance of the minerals alone or by the conveyance of the land with a reservation of the minerals. . . . When the mineral estate in land has been severed from the balance of the land there come into existence two separate and distinct estates, each having all the incidents and attributes of an estate in land. . . . The mere grant or reservation of minerals in place does not vest the grantee or reserver with any title to the surface. In spite of this, the grant or reservation of minerals carries with it, as a necessary appurtenance thereto, the right to use so much of the surface as may be necessary to enforce and enjoy the mineral estate conveyed or reserved. This is because a grant or reservation of minerals would be wholly worthless if the grantee or reserver could not enter upon the land in order to explore for and extract the minerals granted or reserved." Harris v. Currie, 142 Tex. 93, 176 S.W.2d 302, 304 (1943). And see Tomlinson v. Thumon, 189 La. 959, 181 So. 458 (1938).

[6]Thus, if *A* owns Section 16, Township 4 North, Range 6 West, he can "grant, bargain, sell, convey, transfer, assign, and deliver unto *B*, all of my right title and interest in and to all of the oil, gas, and other minerals in and under and that may be produced from Section 16, Township 4 North, Range 6 West," *etc.*

[7]In the example in footnote 6, *supra*, the minerals conveyed would be "in and under and that may be produced from the NW¼ of Section 16, Township 5 North, Range 6 West, *etc.*"

[8]In the example in footnote 6, *supra*, the granting clause would provide: "grant, bargain, sell, convey, transfer, assign, and deliver unto B, *an undivided ¼ interest* in and to all of the oils," *etc.*

[9]A grant of the minerals would include as an incident, all of the proceeds therefrom, such as the bonus payment, the delay rentals, and the royalties which go to the landowner who executes an oil and gas lease. However, the proceeds, *i.e.*, the bonus, the delay rentals, and the royalties, can be conveyed separately from a conveyance of the minerals. Thus, a conveyance of a fractional mineral interest in advance of the execution of an oil and gas lease would entitle the purchaser thereof to share in the bonus, delay rental and royalty payable thereunder.
But a conveyance of a fractional royalty interest in advance of the execution of an oil and gas lease would not entitle the purchaser to share in the bonus or the delay rental but only in the royalty if production was obtained. This is so because a royalty interest is merely an interest in the proceeds from the mineral—the amount payable because of a contract or a conveyance in the event of production—and not an interest in the minerals themselves.

[10]Other examples would be a royalty conveyance limited in duration to the term of an existing lease or term mineral deeds or term royalty deeds.

[11]They are not subordinate in the sense that the lessee is entitled to ⅞ of the gross production. In some jurisdictions the execution of a lease is regarded as the conveyance of an undivided ⅞ interest in the oil and gas in place, subject to being terminated however, in the event no production is obtained.

As consideration for the execution of the lease and under the provisions thereof, the landowner retains certain rights: (1) To receive the bonus money paid for the execution of the lease; (2) to receive delay rentals under th terms of the lease; (3) to receive royalties under the terms of the lease; (4) the possibility of reverter in the minerals in the event there is no production during the primary term or in the event production in paying quantities ceases during the indefinite term; and (5) to use the surface so long as he does not interfere with the operations of the lessee thereon.

Each of these rights under an oil and gas lease is a separate and distinct interest in real property, which can be conveyed separately.[12] Different fractional parts of these various interests can be transferred in the same instrument.[13] If the landowner desires, his entire remaining interest may be transferred, in which event the rights of the purchaser are subject to those of the lessee so long as the lease continues.

There are also a number of permissible assignments which may be effected by an oil and gas lessee. He can transfer his entire interest under the lease; he can transfer his entire interest and reserve an undivided interest or a fractional interest payable only out of production; or he can grant fractional or undivided interests from his 7/8 working interest. A few jurisdictions, such as Montana, construe some of these transfers as sub-leases rather than assignments.

B. ASSIGNMENTS BY A LANDOWNER

Mineral Deeds

A mineral deed is an instrument which transfers the minerals as they exist in place, or the right to obtain them. In form, it is similar to a general warranty deed, and was adapted from the forms of conveyance used to transfer ownership of solid minerals. The rights acquired in oil and gas under such an instrument are as follows:

1. The right to go upon the land, conduct exploratory operations, and produce oil and gas. If there is a subsisting oil and gas lease, this right is subject thereto, but may be exercised if and when the lease terminates;
2. The right to execute an oil and gas lease. If there is a subsisting lease, this right is also subject thereto;
3. The right to a share in the bonus under future leases;
4. The right to a share in the rentals under existing and future leases;
5. The right to share in the royalties under existing and future leases.

[12]"Having leased the realty for oil and gas purposes he was then vested with three distinct and separate interests—(1) the fee simple title to the surface estate, (2) the reserved royalty interest, and (3) the possibility of a reverter of the minerals. . . . Each of these interests is an interest in real property, alienable and may be conveyed separately and independently of the others." Brown v. Copp, 105 Cal. App. 2d 1, 232 P.2d 868, 871 (1951). And see La Laguna Ranch Co. v. Dodge, 18 Cal. 2d 132, 114 P.2d 351, 135 A.L.R. 546 (1941); Abney v. Lewis, 213 Miss. 105, 56 So. 2d 48 (1952)—reservation of rentals did not include royalties; Dale v. Case, 217 Miss. 298, 64 So. 2d 344 (1953)—fractional part of rights under future leases, not rights under present lease; Benge v. Scharbauer, ... Tex. ....., 259 S.W.2d 166 (1953).

[13]"It seems to us that many seemingly irreconcilable conflicts could be resolved without resort to oral evidence if the courts and practitioners would recognize that in the same instrument competent parties may grant a fractional interest in the minerals rights, another and different fractional interest in the royalties and another and different fractional interest in the bonuses and rentals, as the Supreme Court did in the Hinkle case [Hinkle v. Gauntt, 201 Okla. 432, 206 P.2d 1001 (1949)]." Mason, *Mineral Rights or Royalties*, 22 OKLA. B.A.J. 621 (1951).

Inasmuch as these rights may be transferred separately, it is difficult in many instances to distinguish a true mineral deed from other types of oil and gas conveyances. The name given to the instrument does not control.[14] The extent of the rights conveyed serves as an index of the intent of the parties and of the purpose for which the instrument was executed.

Thus in the Texas case of *Danciger Oil and Refining Co. v. Powell*,[15] an oil and gas lease was distinguished as follows:

> . . . a lease is usually for only a limited time, with provision for termination thereafter upon cessation of production; whereas, a conveyance is unlimited as to time. But the most essential difference is the fact that the predominating purpose of a lease is to secure the exploitation and development of the property for the purpose set out in the lease.

Fractional Mineral Deeds

In the construction of mineral deeds the entire instrument is to be considered,[16] but difficulties arise where only part of the elements of a mineral interest are conveyed or reserved. This is especially true where such fractional interests are not clearly defined and where the conveyance is made subject to an existing lease. Where the mineral deed is made subject to an existing lease, it has been held that there is a grant of an undivided interest (½) in the minerals as specified in the granting clause of the mineral deed, and a lesser undivided interest (1/16) in the royalties payable under the existing lease.[17] In other words, the recital of the existence of a lease has the effect of modifying the granting clause of the deed. However, a contrary result has been reached in other jurisdictions[18] and the decision has been criticized on the theory that a consideration of the entire instrument indicates that the parties intended that the transfer of the fractional mineral interest and the interest in the royalties be the same.[19]

In the Montana case of *Krutzfeld v. Stevenson*[20] the grantor conveyed:

> . . . five per cent interest in and to all of the oil, gas and other minerals in and under and that may be produced from the following

[14]Rutland Saving Bank v. Steel, 155 Kan. 667, 127 P.2d 471 (1942); Midstates Oil Corp. v. Keener, ...Okla....., 266 P.2d 467 (1953)—instrument labeled "royalty deed" held to be a conveyance of mineral rights; Texas Gulf Prod. Co. v. Griffith, 218 Miss. 109, 65 So. 2d 834 (1953)—provisions of the instrument must be considered to ascertain the nature of the interest transferred.

[15]134 Tex. 484, 154 S.W.2d 632, 635 (1941).

[16]Lathrop v. Eyestone, 170 Kan. 419, 227 P.2d 136 (1951).

[17]Hoffman v. Magnolia Petroleum Co., 273 S.W. 828 (Tex. Civ. App. 1925).

[18]"When there is an existing oil lease at the time the lessor executes a mineral deed, it is not uncommon for the deed to grant not only a given fraction of all the oil in, under, and that may be produced from the land, but also the same fractional interest in the royalties payable under the lease. . . . If the first clause of such a deed were construed as creating an expense-free royalty interset, it would grant the stated fraction of the total production rather than the stated fraction of the landowner's royalty reserved under the lease, and therefore would be inconsistent with the second clause. It has been held, however, that such deeds are not internally inconsistent and that the grant of the stated fraction of the royalties under the existing lease is merely a statement of the legal effect of granting the same fraction of all the oil in, under, and that may be produced from the land." Little v. Mountain View Dairies, Inc., 35 Cal. 2d 232, 217 P.2d 416, 418 (1950); and see Brokerick v. Stevenson Consolidated Oil Co., 88 Mont. 34, 290 Pac. 244 (1930).

[19]Williams, *Hoffman v. Magnolia Petroleum Co.: The 'Subject-To' Clause in Mineral and Royalty Deeds*, 30 TEXAS L. REV. 395 (1952).

[20]86 Mont. 463, 284 Pac. 553 (1930).

> described lands, . . . together with the right of ingress and egress . . . for the purpose of mining . . . and removing the same therefrom.
> And said lands being now under . . . lease (providing for ⅛ royalty) . . . it is understood and agreed that this sale is made subject to said lease, but covers and includes two-fifths of all the oil royalty and gas rental or royalty due or to be paid under the terms of said lease.
> It is agreed and understood that two-fifths of the money rentals which may be paid to extend the term of said lease is to be paid to the said L. C. Stevenson, Trustee.

The instrument went on to recite that if the existing lease became cancelled or forfeited then the lease interests and all future rentals for oil, gas and mineral privileges should be owned jointly by Krutzfeld and Stevenson in the ratio of 3/5ths and 2/5ths respectively. The Montana Supreme Court construed the instrument as an entirety and concluded that its effect was to transfer a 2/5ths interest in the rents and royalties under the existing lease and a 2/5ths interest in the grantor's reversion in the minerals. Professor Summers[21] interprets this as a grant of a 2/5ths of the mineral fee made subject to an existing lease and a grant of 2/5ths of the rents and royalties under the existing lease rather than the grant of a royalty expanding into a mineral fee as it has been referred to by some others.

Mr. Walker states[22] that in these cases the grantor intends to convey two different groups of property interests, namely the designated fraction of the grantor's reversionary interest or possibility of reverter in the minerals and secondly the rentals and royalties payable under the terms of the existing lease. Because of the practice of making mineral deeds subject to existing leases as a protection to the grantor on his general covenant of warranty, the grant of these additional privileges under the existing oil and gas lease is necessary to avoid the construction that the grantor intended to convey only a present mineral fee, and rents and royalties under future leases. For this reason, Mr. Walker recommends[23] that where typical printed forms of mineral deeds are utilized, the same fraction should be inserted in the granting clause providing for a conveyance of minerals, the royalty and rental transfer clause, and in the terminal clause wherein it is provided that if the existing lease terminates the grantee shall own a certain fractional share of the minerals.

It has been held that a full mineral interest, or a fractional part thereof, may be conveyed, and that a conveyance of different fractional amounts of the diverse elements of a full mineral interest may be made in the same instrument. Thus:

> A grantor may reserve unto himself mineral rights, and he may also reserve royalties, bonuses, and rentals—either one, more, or all. . . . An instrument may convey two separate estates in the minerals, one of which may be a full mineral interest and the other a royalty, or other interest in the minerals.[24]

[21] 10 TEXAS L. REV. 1, 16 (1931).

[22] WALKER, CASES ON OIL AND GAS, 733-36 (1949).

[23] WALKER, CASES ON OIL AND GAS, 734-45 (1949).

[24] Benge v. Scharbauer, ... Tex. ....., 259 S.W.2d 166, 168 (1953); Hinkle v. Gauntt, 201 Okla. 432, 206 P.2d 1001 (1949)—"except a 1/16 interest in the oil and gas deposits that may be developed on said land, and also an undivided ½ interest in the

Inasmuch as the term "royalty" is frequently used when the parties intend to convey a mineral interest, it is imperative to distinguish the two interests if clarity of thought and precision of statement are to be achieved. Thus, where a conveyance of a 1/32 interest is made, the grantee would get 1/32 of the production as a free royalty if in fact a royalty interest had been conveyed. However, if it were a conveyance of the mineral interest he would get 1/32 of the production less that fraction of the cost of production, or he would join in a lease and get that fraction of the 1/8 royalty reserved in the lease, that is, 1/256.[25] In the former case, an expense-free royalty interest has been transferred; in the latter case, an expense-bearing mineral fee interest has been conveyed.[26]

Fractional Conveyances by Owners of Fractional Interests

The greatest difficulty in interpretation arises in those cases where the owner of an undivided interest undertakes to convey or reserve a fractional interest that is smaller than that which he owns. The validity of such conveyances is recognized,[27] but in most instances, it is difficult to ascertain whether the conveyance is of a fraction of the undivided fractional interest of the grantor or of a fraction of the entire premises in which the grantor has merely an undivided fractional interest. Thus, in a Texas case where the owner of an undivided 5/8 interest conveyed an undivided 1/4 interest in all the oil and gas under the premises, it was held that the deed evidenced an intent to convey an undivided 1/4 interest in the minerals in the entire tract.[28] And where the owner of an undivided 1/2 interest, by a deed describing the whole tract, reserved an undivided 1/8 of the customary 1/8 royalty on all oil that may be produced from the land, it was held that he was entitled to a full 1/8 of the royalty (1/64 in other words) and not merely 1/2 of 1/8 of the royalty (or 1/128).[29]

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bonus and rental of oil and gas lease now existing against said land, and the crop rental for the year 1919." (Petition to reform deed to show reservation of ½ interest in the minerals denied.)

[25]"The ownership of a given fractional interest in the minerals when a lease is executed entitles the owner to the same fractional part of the royalty. A ½ of the minerals gives him ½ of the royalty, and a 1/16 of the minerals 1/16 of the usual ⅛ royalty, not ½ of it. The ownership of 1/16 of the minerals before leasing does entitle the owner to 1/16 of the entire production, *but not free of cost*, and the costs after leasing are borne by the lessee in return for ⅞ of the said 1/16 of the production. At a ratio of ⅛ to ⅞, is requires ½ of the production to enable the lessee to deliver 1/16 free of cost. And, it requires ½ of the oil and gas in place to enable the owner to [receive] ½ of the production before costs. If he is to receive 1/16 clear, he must own ½ in place." Langford, *Arkansas Form of Royalty Deed for Oil and Gas Conveyances*, 3 ARK. L. REV. 190 (1949). And see Wilson v. Stearn, 202 Ark. 1197, 149 S.W.2d 571 (1941).

[26]Little v. Mountain View Dairies, Inc., 35 Cal. 2d 232, 217 P.2d 416 (1950). But see Hardy v. Greathouse, 406 Ill. 365, 94 N.E.2d 134 (1950).

[27]See, for example, Dennett v. Meredith, 168 Kan. 58, 211 P.2d 117 (1949); Brown v. Kirk, 127 Colo. 453, 257 P.2d 1045 (1953).

[28]Spell v. Haines, 139 S.W.2d 229 (Tex. Civ. App. 1940)—although the deed provided "above grant to apply to our undivided interest in the above described land," the court held that this was merely a direction that the grant should be of a portion of the undivided interest.

[29]King v. First Nat. Bank of Wichita Falls, 144 Tex. 583, 192 S.W.2d 260 (1946). In Hooks v. Neill, 21 S.W.2d 532 (Tex. Civ. App. 1929) where the owner of an undivided ½ interest conveyed his entire interest reserving a 1/32 in the land conveyed, it was held that he had reserved 1/32 of ½ only. And see Continental Oil Co. v. Tate, 211 La. 852, 30 So. 2d 858 (1947); Fatherree v. McCormick, 199 Miss.

Where the conveyance is by warranty deed and the interest reserved is of the same fractional interest as that reserved by the predecessor in title of the grantor, it has been held that the grantor intended, in the absence of a showing to the contrary, merely to limit the operation of the general covenant of warranty rather than to reserve a new and additional undivided interest.[80] However, even if the grantor did intend to reserve an interest, he will be estopped to assert his title if the interest which the deed purports to convey to the grantee would be reduced thereby.[81]

Description of Fractional Mineral Interests

In the matter of describing the fractional interest conveyed, consideration should be given to whether a stipulated fraction should be used, for example, an undivided 1/4 mineral interest in a 160-acre tract, or whether the specified number of undivided acres out of the tract should be used, *e.g.*, an undivided 40 acre interest in the minerals in a 160 acre tract. When the conveyance is of a specified undivided fractional interest, the grant is made with respect to each part of the described premises, and a failure of title to a part of the land will decrease proportionately the interest acquired by the grantee.[82] On the other hand, where the conveyance is of a specified number of mineral acres, the grantee would be entitled to the full number of mineral acres out of whatever the grantor owned.[83] If the grantor owned more than the number of acres recited in the deed, of course, the use of a designated fraction would effect a proportionate increase in the interest acquired by the mineral grantee. From the standpoint of the lessee, the use of a designated fraction is preferable because the division of bonus, rental, and royalty payments may be computed with certainty without the necessity of determining the total amount of acreage owned by the grantor.

Term Mineral Deeds

In addition to the unqualified grant or reservation of fractional mineral interests, there is also widespread use of term mineral conveyances. These

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248, 24 So. 2d 724 (1946) ; Perkins v. Kemp, 274 S.W.2d 892 (Tex. Civ. App. 1954) —joinder by owners of undivided one-half interests in conveyance of undivided one-half interest in the minerals, held a conveyance by each of undivided one-quarter interest only.

[80]Klein v. Humble Oil and Refining Co., 126 Tex. 459, 86 S.W.2d 1077 (1935) ; Rose v. Cook, 207 Okla. 582, 250 P.2d 848 (1952)—instrument construed by four corners disclosed intent to limit warranty and not to reserve mineral interest; Murphy v. Athans, ... Okla. ....., 265 P.2d 461 (1953)—parol evidence not admissable to show intent to reserve mineral interest rather than limitation of covenant of warranty.

[81]Duhig v. Peavy-Moore Lumber Co., Inc., 135 Tex. 503, 144 S.W.2d 878, 885 (1940)—owner of undivided ½ conveyed with reservation of one-half interest. "The granting clause of the deed . . . purports to convey to the grantee the land described, that is, the surface estate and all of the mineral estate. The covenant warrants the title to 'the said premises' . . . Thus the deed is so written that the general warranty extends to the full fee simple title to the land except an undivided one-half interest in the minerals.

[82]Daniel v. Allen, 129 S.W.2d 392 (Tex. Civ. App. 1939)—interest of grantee in part of tract actually owned by his grantor will not be increased to make up the loss. Remedy is action for money damages for breach of warranty. And see Olvey v. Jones, 95 S.W.2d 980 (Tex. Civ. App. 1936) ; Turner v. Hunt, 116 S.W.2d 688 (Tex. Civ. App. 1938).

[83]Sims v. Woods, 267 S.W.2d 571 (Tex. Civ. App. 1954)—conveyance of 25/200 of the minerals, "It being the intention of the Grantor herein to convey to Grantee a full undivided 25 acre mineral interest," held conveyance of 25/200 interest only even though tract subsequently was found to contain 226.88 acres.

conveyances are either for a specified term of years or for a term and so long thereafter as oil or gas is produced from the premises. Where the conveyance is for a specified term, the mineral interest terminates at the expiration of the fixed period even though there is production in paying quantities.[84]

Where the conveyance is for a specified term and so long thereafter as oil and gas are produced, the interest terminates at the end of the fixed period in the absence of production.[85]

Royalty as the Subject Matter of Assignment

Royalty is a share in production. As applied to an oil and gas lease, it means the share of the oil which is received by the lessor from production under the lease[86] in return for permission to use the property by withdrawing the oil therefrom.[87] In its broadest sense, however, it refers to an interest that the landowner may create by outright grant or reservation either before or after the execution of an oil and gas lease.[88] When used in this sense, the ownership of royalty gives no right to enter upon the land for any purpose or to interfere with the landowner in any way.[89] Moreover, it gives no right or interest in the minerals in place, the right to royalty being contingent upon production.[90] It has been referred to as "nonparticipating royalty" to distinguish it from a grant of the rights that are incident to the transfer of a full mineral interest.[91] That is, it is an interest that bears no part of the cost of production and which does not entitle the owner thereof to participate in the execution of a lease on the premises nor share in the bonus or delay rental payments thereunder. In *Schlittler v. Smith*, the Texas Court of Appeals observed that:

> royalty rights . . . does not include a reservation of bonuses or rentals, but only of an interest in oil, gas, or minerals paid, received, or realized as 'royalty' *under any lease existing on the land at the time of the reservation, or thereafter xecuted* by the grantee, his heirs or assigns.[92]

[84]Kokernot v. Caldwell, 231 S.W.2d 528 (Tex. Civ. App. 1950)—twenty years; Peppers Ref. Co. v. Barkett, 208 Okla. 367, 256 P.2d 443 (1953)—twenty-five years.

[85]Greenshields v. Superior Oil Co., 204 Okla. 681, 233 P.2d 959 (1951); Wilson v. Holm, 164 Kan. 229, 188 P.2d 899 (1948)—rules construing "thereafter" provision of habendum clause in oil and gas leases are applicable to "thereafter" provisions in mineral deed; Owens v. Day, 207 Okla. 341, 249 P.2d 710 (1952); but in Beatty v. Baxter, 208 Okla. 686, 258 P.2d 626 (1953)—the strict rules of construction applicable to the habendum clause in leases was held inapplicable because reason for rule not present.

[86]Davis v. Hurst, 150 Kan. 130, 90 P.2d 1100, 122 A.L.R. 957 (1939).

[87]Carroll v. Bowen, 180 Okla. 215, 68 P.2d 773 (1937).

[88]Watkins v. Slaughter, 144 Tex. 179, 189 S.W.2d 699 (1945); Palmer v. Crews, 203 Miss. 806, 35 So. 2d 430, 4 A.L.R. 2d 483 (1948).

[89]Moore v. City of Beaumont, 195 S.W.2d 968 (Tex. Civ. App. 1946), aff'd, 146 Tex. 46, 202 S.W.2d 448 (1947).

[90]Pease v. Dolezal, 206 Okla. 696, 246 P.2d 757 (1952).

[91]Jones, *Non-Participating Royalty*, 26 TEXAS L. REV. 569 (1948); Hanson v. Ware, ... Ark. ....., 274 S.W.2d 359 (1955).

[92]101 S.W.2d 543, 544 (Tex. Civ. App. 1937), emphasis supplied, judgment reformed in 128 Tex. 628, 101 S.W.2d 543 (1937) to allolw recovery of one-half of royalty reserved under future leases: in Skelly Oil v. Cities Service Oil Co., 160 Kan. 226, 160 P.2d 246 (1945), royalty was interpreted to mean not oil in place but the share in the oil and gas produced and paid as compensation for the right to drill and produce, and not to include a perpetual interest in the oil an gas in the ground.

A royalty interest, in the strict sense, is distinguished from a mineral interest by the absence of any operating rights and the denial of participation in bonus and delay rental payments.[43]

The Analogy of Common Law Rent

In its nature, royalty is comparable to common law rent.[44] It is to be distinguished from delay rentals payable under an oil and gas lease which are money payments for the purpose of deferring drilling operations.[45] *Common law rent* is generally defined as the profit, either in money, provisions, or labor, issuing out of lands and tenements, in return for their use.[46]

Royalty as Real or Personal Property

Inasmuch as the term has been used in various senses, royalty has been declared to be both real and personal property.[47] The interest in *accrued royalties,* that is, in the oil and gas that have been produced, is personal

[43]"The essential difference between a sale of a royalty interest and a sale of a mineral interest in lands is that the purchaser of the royalty interest has not right or interest in the minerals in place or in the land, and receives nothing unless production is obtained. Whereas, under a sale of a mineral interest the purchaser is entitled to lease his mineral interest and receive the bonus and rentals therefor and thereunder and is entitled to enter upon the land himself and develop and produce the oil and gas therefrom." Pease v. Dolezal, 206 Okla. 696, 246 P.2d 757, 758 (1952).

[44]"It may be owned, held, enjoyed and assigned by the owner of the land. It is not merged in his title to the land. It is not an estate in the land. It is an incorporeal hereditament whose owner has an estate in it besides and collateral to an estate in his land, whether it is rent or not. If not rent, it is more like rent than anything else conceivable or known to the law and is generally treated as rent, wherefore the principle of analogy requires rights respecting it to be tested by the rules and principles governing rents." Musgrave v. Musgrave, 86 W. Va. 119, 103 S.E. 302, 312, 16 A.L.R. 564, 580 (1920), J. Poffenbarger, dissenting.

In La Laguna Ranch Co. v. Dodge, 18 Cal. 2d 132, 114 P.2d 351 (1941), it was held that royalties were a distinct species of property, that the analogy to rent applies to lessor's and overriding royalties but not to lessee's or landowner's royalties. But see O'Neal v. Union Producing Co., 153 F.2d 157 (C.C.A. La. 1946), cert. den., 329 U.S. 715—payment of royalty is payment of rent; Ohio Oil Co. v. Wright, 386 Ill. 206, 53 N.E.2d 966 (1944).

[45]Carroll v. Bowen, note 37, *supra.*

[46]2 BOUVIER, LAW DICTIONARY (Rawle's ed. 1914) 2880.

[47]"For the term *royalty* is used in three distinct senses: as an object of property rights, as respecting quantum of the estate therein, and as the actual payment made or to be made to the holder of a royalty interest. Within the meaning of the suggested criterion, royalty, as an object of property rights, is real property. In respect of duration, the royalty holder may enjoy a real property estate, as where the extent of his interest is fee simple or fee qualified, or he may be vested with a personal property estate, as where the extent of his interest is for a term of years. The actual payment of accrued royalty is, of course, personal property. To further emphasize the importance of qualifying the term *royalty,* it may be said that in the objective sense royalty is always real property, that in the duration sense royalty is always personal property." Blake, *Oil Royalties: A Suggested Criterion,* 13 MISS. L.J. 307, 322 (1941). And see Palmer v. Crews, 203 Miss. 806, 35 So.2d 430, 4 A.L.R.2d 483 (1948).

As Real Property: Baker v. Vanderpool, 296 Ky. 663, 178 S.W.2d 189 (1944); Duvall v. Stone, 54 N. Mex. 27, 213 P.2d 212 (1949); Sheffield v. Hogg, 124 Tex. 290, 77 S.W.2d 1021 (1934), 80 S.W.2d 741 (1935); and see Schlittler v. Smith, 128 Tex. 628, 101 S.D.2d 543 (1937).

As Personal Property: Hickey v. Dirks, 156 Kan. 326, 133 P.2d 107 (1934); Lathrop v. Eyestone, 170 Kan. 419, 227 P.2d 136 (1951)—conveyance of royalty under existing lease; Tegarden v. Beers, 175 Kan. 610, 265 P.2d 845 (1954)—agreement to assign stipulated fraction of royalties "if and when oil and gas are produced from the land."

property, but the interest in *unaccrued royalty* is an interest in land and real property.[48]

Royalty Deeds

The importance of establishing the analogy between royalties and rents rests in the application of settled principles of law applicable to rents to the problems created by royalty conveyances. Thus, just as unaccrued rent is severable from the reversion, but will pass with a transfer of the reversion without express mention, so also royalty may be created in perpetuity[49] or for a term,[50] before[51] or after[52] the execution of an oil and gas lease on the premises, and will pass as an incident of the conveyance of the lessor's estate unless specifically excepted therefrom.[53]

Fractional royalty conveyances present much the same problem as fractional mineral conveyances, and may be resolved on much the same basis.[54] Thus, the word "of" in a conveyance providing for "1/16 of 1/8 of lessor's usual royalty" has been construed as meaning "times" and not merely descriptive of the nature of the interest transferred.[55]

A royalty conveyance may include an assignment of a percentage of the delay rentals payable under existing or future leases without conveying a mineral, as distinguished from a royalty, interest.[56] In the same instrument, a separate interest in the royalties and in the minerals may be conveyed.[57]

Extent of the Interest Created by Royalty Conveyances

The nature and extent of the interest acquired by the grantee depends upon the intent of the grantor as expressed in the instrument of conveyance.[58]

The difficulty of ascertaining whether the grantor intended to convey a royalty interest or a mineral fee interest is illustrated by the following exception and reservation in a contract for the sale of a specified tract of land:

> . . . excepting and reserving unto the said first parties all except two per cent (2%) of the landowner's royalty rights in and to all

[48]Mark v. Bradford, 315 Mich. 50, 23 N.W.2d 201 (1946); McCully v. McCully, 184 Okla. 264, 86 P.2d 786 (1939).

[49]Federal Land Bank of Wichita v. Nicholson, 207 Okla. 512, 251 P.2d 490 (1952).

[50]Schlittler v. Smith, 128 Tex. 628, 101 S.W.2d 543 (1937).

[51]Davis v. Hurst, 150 Kan. 130, 90 P.2d 1100, 122 A.L.R. 957 (1939).

[52]Callahan v. Martin, 3 Cal. 2d 110, 43 P.2d 788, 101 A.L.R. 871 (1935); and see DeMuth, *Conveyance of Royalty Rights Under Existing Leases*, 24 ROCKY MT. L. REV. 250 (1952).

[53]White v. McVey, 168 Okla. 19, 31 P.2d 850, 94 A.L.R. 656 (1934); Local Federal Sivings and Loan Assn. v. Eckroat, 186 Okla. 660, 100 P.2d 261 (1940).

[54]See Sullivan, HANDBOOK OF OIL AND GAS LAW § 113, Fractional Mineral Deeds, (1955).

[55]Richardson v. Hart, 143 Tex. 392, 185 S.W.2d 563 (1945)—terms not ambiguous and so 1/16 times 1/8 times 1/8 or 1/1024 was the interest conveyed; King v. First National Bank, 144 Tex. 583, 192 S.W.2d 260 (1946)—owner of undivided 1/2 interest in fee conveyed it to owner of other undivided 1/2 and reserved fractional royalty interest "an undivided 1/8 of the usual and customary 1/8 royalty interest." Held reservation of 1/8 of entire 1/8 and not merely 1/8 of 1/2 of 1/8 of royalty; Fleming v. Ashcroft, 142 Tex. 41, 175 S.W.2d 401 (1943)—grant of fractional, limited, non-participating royalty.

[56]Miller v. Sooy, 120 Kan. 81, 242 P. 140 (1926).

[57]Richardson v. Hart, note 55, *supra*.

[58]Krutzfeld v. Stevenson, 86 Mont. 463, 284 P. 553 (1930); Paddock v. Vasquez, 122 Cal. App. 2d 396, 265 P.2d 121 (1954).

> oil, gas and other minerals in, under or upon said premises, said two per cent (2%) of said landowner's royalty rights to be deeded to the said second party . . .

If the term royalty has a well defined meaning and if in its nature it is analogous to common law rent, then the instrument is not ambiguous. The term landowner's royalty has been characterized as that interest which may exist independently of any lease upon the property. It is distinguishable from lessor's royalty which may be limited to the duration of an oil and gas lease. This is a further example of how some order would be established out of the chaos presently existing if the analogy to real property principles, specifically that of common law rent, were adopted.

Fee and Term Royalty Deeds

Royalties, as well as minerals, may be conveyed in fee[59] or for a definite term of years. Where the grant or reservation of the royalty interest is made before the execution of an oil and gas lease on the premises and is not otherwise limited as to time, the interest created is referred to as a *perpetual non-participating royalty.*[60] If there is an existing lease on the property, the conveyance should specify that the royalty interest conveyed thereby is perpetual to avoid the contention that it conveys only the royalty under the existing lease.[61] The grant or reservation of a "fee royalty of 1/32 of the oil and gas" conveys that fraction of the entire production from the tract conveyed[62] whereas the conveyance of 1/32 of royalty would transfer only 1/32 of 1/8 or 1/256.

The conveyance of royalty for a term may take one of two forms; it may be for a stipulated period, such as twenty years, or for a stipulated period and as long thereafter as oil and gas are produced in paying quantities.[63] The interest may be created either before or after the execution of an oil and gas lease on the premises. As in the case of mineral deeds, the conveyance of an interest for a term only will terminate at the end of the period even though there are producing wells on the premises as of that date.[64] Where a "thereafter" clause is appended to the term grant, the continuation of the interest is dependent upon the execution of a lease, where none is in existence, and obtaining production prior to the end of the term specified in the royalty deed and the continuation of such production without interruption.[65]

[59]Brown v. Smith, 141 Tex. 425, 174 S.W.2d 43 (1943).

[60]Denver Joint Stock Land Bank v. Dixon, 57 Wyo. 523, 122 P.2d 842 (1942) ; that is, perpetual in the sense of duration; non-participating in the sense of no right to participate in the making of future leases or share in the bonus and rental payments thereunder.

[61]Dabney-Johnston Oil Corp. v. Walden, 4 Cal. 2d 637, 52 P.2d 237 (1935) ; First National Bank v. Evans, 169 S.W.2d 754 (Tex. Civ. App. 1943).

[62]Caraway v. Owens, 254 S.W.2d 425 (Tex. Civ. App. 1953).

[63]For a form of thereafter clause used in connection with a term mineral grant see Schlittler v. Smith, 128 Tex. 628, 101 S.W.2d 543 (1937) ; see also Miller v. Speed, 259 S.W.2d 235 (Tex. Civ. App. 1952).

[64]Peppers Refining Co. v. Barkett, 208 Okla. 367, 256 P.2d 443 (1953)—term mineral deed.

[65]Beatty v. Baxter, 208 Okla. 686, 258 P.2d 626 (1953—temporary cessation after expiration of primary term of royalty grant will not terminate the interest where the shut-down was for purposes of rehabilitating the well. Upshaw v. Norsworthy, 267 S.W.2d 566 (Tex. Civ. App. 1954)—recovery by swabbing, so long as it was in paying quantities, constitutes "production of oil" within meaning of "thereafter clause."

C. ASSIGNMENTS BY THE LESSEE

A lessee may transfer his entire interest in the premises under lease,[66] his entire interest in a part of the premises under lease,[67] or a fraction of his rights in the premises, or a part thereof, under lease, for the whole or a part of the remaining portion of the unexpired term of the lease.[68] They may be granted outright by the lessee or reserved in a conveyance of the leasehold. Thus, a lessee may convey oil payments, overriding royalties, and undivided interests,[69] or he may transfer his entire interest in a part of the leased premises by a farm-out agreemnt.[70]

Overriding Royalty

An *overriding royalty* is a certain percentage of the working interest which, as between the lessee and the assignee, is not charged with the cost of development or production.[71] That is, it is an assignment of a part of the lessee's seven-eighths interest under the conventional oil and gas lease and neither impairs nor diminishes the landowner's one-eighth royalty. It may be created by an outright grant by the lessee or by a reservation in the assignment of the operating rights of the lessee.[72]

Overriding royalties are to be distinguished from the royalty payable to the lessor under the conventional oil and gas lease.[73] They are also to

[66]Fischer v. Magnolia Petroleum Co., 156 Kan. 367, 133 P.2d 95 (1943).

[67]Wilson v. Texas Co., 147 Kan. 499, 76 P.2d 779 (1938) ; and see Merrill, *The Partial Assignee—Done in Oil*, 20 TEXAS L. REV. 298 (1942).

[68]Pansy Oil Co. v. Federal Oil Co., 91 S.W.2d 453 (Tex. Civ. App. 1936)—oil payment out of fractional share of production; Fairburn v. Eaton, 6 Cal. App. 2d 264, 43 P.2d 113 (1935)—overriding royalty.

[69]"An overriding royalty is a certain percentage of the working interest which as between the lessee and the assignee is not charged with the cost of development or production. The oil payment is similar to the overriding royalty, except that the interest of the assignee ceases upon his receiving a certain amount of money or value out of oil or gas produced from a certain percentage of the working interest. The interest commonly spoken of as an 'undivided interest' is an undivided percentage of the working interest, which differs from the oil payment or the overriding royalty in that it is chargeable with its pro tanto share of the cost of development and production." Knight v. Chicago Corporation, 183 S.W.2d 666, 670 (Tex. Civ. App. 1944).

[70]In a farm-out the lessee of a large tract transfers or agrees to transfer to a third person the leasehold estate as to a designated area in return for the agreement of the third party to drill a well thereon. See Rex Oil and Gas Co. v. Busk, 335 Mich. 368, 56 N.W.2d 221 (1953).

[71]Phillips Pet. Co. v. Oldland, 187 F.2d 780 (C.C.A. Colo. 1951) ; Wright v. Brush, 155 F.2d 265 (C.C.A. Kan. 1940) ; Thornburgh v. Cole, 201 Okla. 609, 207 P.2d 1096 (1949) ; Knight v. Chicago Corp., note 69, *supra*.

[72]Zephyr Oil Co. v. Cunningham, 265 S.W.2d 169 (Tex. Civ. App. 1954)—reservation is in fact an exception because it withholds from the operation of the assignment something existant in the assignor which otherwise would pass to the assignee. For an example of the methods of creating overriding royalties, see Robinson v. Jones, 119 Kan. 609, 240 Pac. 957 (1925) ; and see Hershberger, *Landowner's Royalties and Overriding Royalties*, 9 KANSAS B.A.J. 29 (1940) ; Comment, *Overriding Royalties, Proceeds Interests*, 26 CALIF. L. REV. 480 (1938).

[73]"The term 'overriding royalty' is applied generally in the industry to such fractional interests in the production of oil and gas as are created from the lessee's estate . . . the term 'royalty' is generally applied to the fractional interests in the production which are created by the owner of the land either by a reservation when an oil and gas lease is entered into or by direct grant to a third person." La Laguna Ranch Co. v. Dodge, 18 Cal. 2d 132, 114 P.2d 351, 353, 135 A.L.R. 546 (1941).

be distinguished from assignments by the lessor of a part of the royalty payable to him under existing or future leases.[74]

Although the term "overriding royalty" is not conclusive of the nature of the interest created,[75] it does have a usage in the indsutry as denoting a share in the gross production which is carved out of the lessee's interest.[76]

An agreement to pay an overriding royalty is a covenant that runs with the lease and not with the land. Therefore, absent fraud or bad faith, a termination of the lease will extinguish the overriding royalty[77] An express provision in the assignment that the override will continue in the event the lease is extended or renewed will preclude termination of the overriding royalty.[78] In the absence of such a provision, the override will continue in force if there is bad faith on the part of the lessee[79] or if the lessee has failed to discharge a duty owing to the owner of the overriding royalty interest.[80]

Oil Payments

Oil payments are similar to overriding royalties, *i.e.*, they are assignments or reservations of a fractional part of the working interest which are not charged with the cost of production. They differ in respect to duration: the override continues throughout the life of the lease; the oil payment terminates upon payment of a certain amount of money or value out of oil and gas produced from a stipulated percentage of the working interest.[81] It has been classified as an interest in personal property,[82] as creating a debtor-

[74]"Where after entering into such an oil and gas lease, the lessor assigns to third person fractional interests in the royalties which he has reserved to himself, the holder of such a fractional interest acquires an interest in real property, an incorporeal hereditament analogous to the right to receive future rents of real property." La Laguna Ranch Co. v. Dodge, note 73, *supra*.

[75]Dashko v. Friedman, 59 S.W.2d 203 (Tex. Civ. App. 1933)—term denotes freedom from costs of production and not an interest in land.

[76]Cities Service Oil Co. v. Geolograph Co., Inc., 208 Okla. 179, 254 P.2d 775 (1953)—use of term "overriding royalty" construed according to operative usage of industry.

[77]La Laguna Ranch Co. v. Dodge, note 73, *supra*—quit claim deed by lessee to lessor to avoid forfeiture for failure to drill; Smith v. Drake, 134 Cal. App. 700, 26 P.2d 313 (1933)—surrender; Ascher v. Midstates Oil Corp., 222 La. 812, 64 So. 2d 182 (1953)—override is appendage of the lease, and if lease is still in effect the override is not separately prescriptible; Dos Puebles R. & I. Co. v. Ellis, 44 Cal. App. 2d 299, 112 P.2d 302 (1941)—cancellation of lease by lessor; and see Collins v. Atlantic Oil Prod. Co., 74 F.2d 122 (C.C.A. Tex. 1934); Henderson Co. v. Murphy, 189 Ark. 87, 70 S.W.2d 1036 (1934).

[78]Probst v. Hughes, 143 Okla. 11, 286 Pac. 875, 69 A.L.R. 929 (1930); and see Robinson v. Eagle-Picher Lead Co., 132 Kan. 860, 297 Pac. 697, 75 A.L.R. 840 (1931). Contra: Berman v. Brown, 224 La. 619, 70 So. 2d 433 (1954)—not binding upon successor to assignee; noted 28 TULANE L. REV. 408.

[79]Smith v. Drake, note 77, *supra*—collusion between lessor and lessee indicated as a possible basis for imposition of trust for benefit of owner of override on subsequently executed lease.

[80]Hivick v. Urschel, 171 Okla. 17, 40 P.2d 1077 (1935)—constructive trust where assignee failed to give assignor option to repurchase lease as per terms of assignment.

[81]Knight v. Chicago Corporation, 183 S.W.2d 666 (Tex. Civ. App. 1944). For a discussion of the principles considered in this section, see Walker, *Oil Payments*, 20 TEXAS L. REV. 259 (1942); Brown, *Assignments of Interests in Oil and Gas Leases: Farm Out Agreements, Bottom Hole Letters, Reservation of Overrides and Oil Payments*, FIFTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 25 (1954).

[82]McCrae v. Bradley Oil Co., 148 Kan. 911, 84 P.2d 866 (1938)—oral agreement all right, not within the statute of frauds.

creditor relationship,[83] as constituting an equitable lien,[84] and as an interest in land whether payable in kind or in money.[85] As an interest in land, it has been characterized as bonus and not royalty[86] and as subject to the payment of gross production taxes unless the parties agree otherwise.[87]

An agreement to make oil payments is not merely personal but is a covenant that runs with the land.[88] However, there is no personal liability in the sense of an absolute promise to pay. The obligation arises only when production is obtained.[89] The burden of the covenant runs with the land and binds an assignee of the party agreeing to make the oil payment.[90] The benefit of the covenant likewise runs and inures to a purchaser of such an interest.[91] An oil payment is an encumbrance within the purview of a general covenant of warranty and constitutes a breach thereof.[92]

The doctrine of implied covenants is applicable to oil payments as well as to overriding royalties.[93] In respect to termination, the principles applicable to overrides likewise controls, *i.e.*, the interest is one which runs with the lease and not with the land and it will terminate unless active fraud or some fiduciary obligation can be established.[94] Termination of the lease in accordance with the terms thereof, in the absence of bad faith, will terminate the oil payment.[95]

[83]Posey v. Fargo, 187 La. 122, 174 So. 175 (1937).

[84]Davis v. Lewis, 187 Okla. 91, 100 P.2d 994 (1940).

[85]Tennant v. Dunn, 130 Tex. 285, 110 S.W.2d 53 (1937)—payable in oil; Sheppard v. Stanolind Oil and Gas Co., 125 S.W.2d 643 (Tex. Civ. App. 1939)—payable in money; and see Denio v. City of Huntington Beach, 22 Cal. 2d 580, 140 P.2d 392, 149 A.L.R. 320 (1943).

[86]State National Bank of Corpus Christi v. Morgan, 135 Tex. 509, 143 S.W.2d 757 (1940).

[87]Cities Service Oil Co. v. McCrory, 191 S.W.2d 791 (Tex. Civ. App. 1945); Texas Co. v. Fontenot, 200 La. 753, 8 So. 2d 689 (1942).

[88]Western Oil and Ref. Co. v. Venago Oil Corporation, 218 Cal. 733, 24 P.2d 971 (1933).

[89]Sheppard v. Stanolind Oil and Gas Co., note 85, *supra;* Texas Co. v. Mattocks, 211 Ark 972, 204 S.W.2d 176 (1947). Contra: Nigh v. Haas, 139 Kan. 307, 31 P.2d 28 (1934)—covenant does not run with the land and bind parties dealing with an assignee.

[90]Texas Co. v. Mattocks, note 89, *supra.*

[91]Goetter v. Manahan, 192 Okla. 600, 138 P.2d 113 (1943); Local Federal Savings and Loan Assn. v. Eckroat, 186 Okla. 660, 100 P.2d 261 (1940). For a consideration of the proposition that benefits and burdens of a covenant may run independently, see CLARK, REAL COVENANTS AND OTHER INTERESTS WHICH RUN WITH LAND, 101 (2d ed., 1947).

[92]Compton v. Trico Oil Co., 120 S.W.2d 534 (Tex. Civ. App. 1938).

[93]Stanolind Oil and Gas Co. v. Kimmel, 68 F.2d 520 (C.C.A. Okla. 1934)—implied covenant to develop; Phillips Pet. Co. v. Taylor, 116 F.2d 994 (C.C.A. Tex. 1941) cert. den. 313 U.S. 565—implied covenant to prevent drainage; Cole Petroleum Co. v. United States Gas and Oil Co., 121 Tex. 59, 41 S.W.2d 414, 86 A.L.R. 719 (1931) —implied covenant to market production; Simms Oil Co. v. Colquitt, 2 S.W.2d 421 (Tex. Civ. App. 1921)—assignee of lessee not obligated to drill but could either drill or pay delay rentals as per terms of original lease; Tunstill v. Gulf Production Co., 79 S.W.2d 657 (Tex. Civ. App. 1934)—assignee of lessee entitled to abandon the lease where production not sufficient to make operation profitable, even though oil payment not satisfied. And see Merrill, *Implied Covenants Between Others Than Lessors and Lessees*, 27 WASH. U.L.Q. 155 (1942).

[94]Smith v. Drake, note 77, *supra;* Hivick v. Urschel, note 80, *supra;* MacDonald v. Follett, 193 S.W.2d 287 (Tex. Civ. App. 1946)—partnership or joint venture.

[95]Gordon v. Empire Gas and Fuel Co., 63 F.2d 487 (C.C.A. Tex. 1933); and see cases cited in note 77, *supra.*

D. OBLIGATIONS ON COVENANTS

The Distinction between Assignments and Subleases

Every transfer of an interest in the lease by an oil and gas lessee is not an assignment. Thus:

> The distinction between an assignment of a lease and a sublease is that, in an assignment, the assignor transfers his entire interest in the lease insofar as it affects the property on which the lease is assigned; whereas, in a sublease, the original lessee, or sublessor, retains an interest in the lease insofar as it affects the property subleased—by imposing some obligation upon the sublessee in favor of the sublessor. . . .[96]

The term "lease" as applied to oil and gas operating rights is a misnomer. However, it is the usage of the industry, and in a few jurisdictions the distinction between an assignment and a sublease has been made in defining the rights and obligations of an assignee of the lessee. Thus, the reservation of an overriding royalty,[97] of a right of re-entry,[98] and the transfer for less than the entire portion of the remaining term,[99] have resulted in subleases rather than assignments. In such a case there is neither privity of contract nor privity of estate between the original lessor and the transferee of the lessee. Consequently, an attempted release by such a transferee to the original lessor is invalid,[100] and the transferee is not bound by the covenants in the original lease[101] unless he expressly assumes them.[102] Where the distinction is recognized, it would also be material in the interpretation of a lease provision relieving a lessee of all obligations upon assignment.

Effect of Assignment upon the Obligations of the Lessee—In General

After assignment the lessee remains liable upon all express covenants in the lease because the privity of contract with the original lessor continues to subsist.[103] The assignee is bound because of privity of estate; the lessee remains bound because of privity of contract. An express release by the lessor, or one which may be inferred from the circumstances, is necessary before this liability of the lessee terminates. Contemporary lease forms contain a provision in the assignments clause that the lessee will be relieved of the obligations of the lease after assignment.

[96]Roberson v. Pioneer Oil and Gas Co., 173 La. 313, 137 So. 46, 48, 82 A.L.R. 1264 (1931). For a consideration of the problems in Louisiana, see Moses, *The Distinction Between a Sublease and an Assignment of a Mineral Interest in Louisiana*, 18 TEXAS L. REV. 159 (1940), 13 TULANE L. REV. 231 (1948); and see Garner v. Knudsen,—Cal. App. 2d.—, 277 P.2d 890 (1954).

[97]Sunburst Oil and Ref. Co. v. Callender, 84 Mont. 178, 274 Pac. 834 (1929).

[98]Saling v. Flesch, 85 Mont. 106, 277 Pac. 612 (1929).

[99]Jackson v. Sims, 201 F.2d 259 (C.C.A. Okla. 1953).

[100]Saling v. Flesch, note 98, *supra*.

[101]McNamer Realty Co. v. Sunburst Oil and Gas Co., 76 Mont. 332, 247 Pac. 166 (1926).

[102]Hartman Ranch Co. v. Associated Oil Co., 10 Cal. 2d 232, 73 P.2d 1163 (1937)—lessor protected on theory of third party beneficiary.

[103]Benson v. Nyman, 136 Kan. 445, 16 P.2d 963, 964 (1932)—"It is agreed that it is one of the conditions of the lease, and of the acceptance thereby by the said second party that he and his successors or assigns, shall have the right at any time on payment of One Dollar ($1.00) . . . to surrender this lease for cancellation after which all payments and liabilities thereafter to accrue under and by virtue of its terms shall cease and determine."

Liability of the Lessee after Assignment

However, in addition to the express covenants of the lease, there are certain implied covenants that impose additional obligations upon the lessee. The continuing obligation of the lessee after assignment depends upon whether these covenants are implied in fact or in law. If implied in fact, they conform to the unexpressed intent of the parties and therefore are contractual in nature, and the obligations of the lessee continue.[104] If implied in law, they stem from the mutual relationship of the parties and therefore privity of estate is a prerequisite, and the obligations of the lessee terminate upon assignment.[105]

Liability of the Assignee upon Covenants in the Lease

The liability of an assignee of the lessee is predicated upon privity of estate unless he expressly assumes the obligations of the lease in the instrument of assignment.[106] Therefore, his liability is limited to those breaches which occur during his ownership of an interest in the leasehold estate, *i.e.*, he is not liable for breaches that occurred before he acquired his interest or after he has disposed of it.[107] The burden of both express and implied covenants runs with the land and binds an assignee so long as privity of estate continues.[108]

The doctrine of *equitable servitudes*—that a person who acquires an interest in land with notice of a restriction thereon which touches and concerns the land and which the parties intended to be binding upon subsequent owners will be bound by the restriction even though there is no privity of estate with the person for whose benefit the restriction was imposed—is likewise applicable to oil and gas assignees.[109]

The assignee is entitled to the benefits of those covenants that run with the leasehold estate so long as the relationship of privity of estate continues.[110]

[104]Gillet v. Elmhurst Investment Co., 111 Kan. 755, 207 Pac. 843 (1922) ; and see Bodcaw Oil Co. v. Atlantic Ref. Co., 217 Ark. 50, 228 S.W.2d 626 (1950) ; Indian Territory Ill. Oil Co. v. Rosemond, 190 Okla. 46, 120 P.2d 349, 138 A.L.R. 246 (1941) ; Danciger Oil and Ref. Co. v. Powell, 137 Tex. 484, 154 S.W.2d 632, 137 A.L.R. 408 (1941) ; Adkins v. Adams, 152 F.2d 489 (C.C.A. Ill. 1945).

[105]For a criticism of the view that they are implied in fact, see MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES, § 220 (1940).

[106]Hartman Ranch Co. v. Associated Oil Co., note 102, *supra*.

[107]Herigstad v. Hardrock Oil Co., 101 Mont. 22, 52 P.2d 171 (1933) ; Ardizzone v. Archer, 71 Okla. 289, 160 Pac. 446 (1916) ; that the benefit of express covenants in the lease run in favor of an assignee of the lessor, see Cummings v. United Fuel Co., 116 W. Va. 599, 182 S.E. 789, 102 A.L.R. 264 (1935)—benefit of express covenant to protect against drainage and develop premises runs to wards on whose behalf an oil and gas lease was executed by guardians.

[108]Gillett v. Elmhurst Inv. Co., 111 Kan. 755, 207 Pac. 943 (1922).

[109]Southwest Pipe Line Co. v. Empire Natural Gas Co., 33 F.2d 248, 64 A.L.R. 1229 (C.C.A. Okla. 1929)—assignee of lease who took with notice of gas purchase contract executed by lessee with gas transmission company; British-American Oil Prod. Co. v. Buffington, 116 F.2d 363 (C.C.A. Tex. 1940) *cert. denied* 312 U.S. 708—assignee of lease who took with notice of preferential drilling contract executed by lessee with drilling contractor.

[110]Tomlinson v. Thurmon, 189 La. 959, 181 So. 458 (1938)—implied warranty against eviction; Prairie Oil and Gas Co. v. Jordan, 151 Okla. 147, 3 P.2d 170, 79 A.L.R. 492 (1931)—covenant of general warranty does not run with land but may be assigned pursuant to express provision in lease permitting assignment of lease and all covenants therein.

Effect of Performance by a Partial Assignee

There is a sharp conflict in authority as to whether the express and implied obligations of an oil and gas lessee are divisible, *i.e.*, whether the benefit of performance or the burden of failure to perform will inure to partial assignees or assignors who have retained a partial interest.[111] Thus, the lease is considered an entirety in so far as the duty to pay delay rentals is concerned, and a partial assignee may not tender a fraction of the delay rental and preserve his interest in the absence of an express provision in the lease.[112]

As to development and production, the lease is regarded as indivisible so that drilling or securing production on any part of the severally assigned tract will inure to the benefit of all segregated parts of the original lease[113] Thus, it has been observed:

> Of oil and gas leases generally it may be said that ordinarily they are regarded as indivisible as to the express conditions which fix the vesting of the determinable fee, such as the drilling of a certain number of wells, when that is required, or the obtaining of production in the absence of a specific requirement, and that assignees under an original lease hold their titles to their several tracts without the necessity of further rental payments, or of further compliance with these express drilling conditions when they have been complied with on any part of the lease.[114]

On principle it would appear that the partial assignee is subject to the implied duty to market the production obtained and to protect that part of the lease which he owns from drainage caused by wells outside the limits of the tract as originally leased.[115]

Farm-Out Agreements

A *farm-out agreement* is a contract between an oil and gas lessee and a third person to assign, or an outright assignment of, the lease-hold interest in a described tract, conditional, however, upon the drilling of a test well and the performance of specified obligations incident thereto. The purpose of such an agreement is to secure the drilling of a well prior to the expiration of the primary term of the lease. The agreemnt has many variations. The lessee may make an outright assignment of his entire interest in a part of the land under lease together with dry hole contribution money with the assignee assuming an obligation to drill to a specified depth.[116] Where the lessee owns widely scattered and comparatively small blocks of

[111]See Merrill, *The Partial Assignee—Done in Oil*, 20 TEXAS L. REV. 298 (1942).

[112]Cosden Oil Co. v. Scarborough, 55 F.2d 634 (C.C.A. Tex. 1932).

[113]Meacham v. Halley, 103 F.2d 967 (C.C.A. Tex. 1939) ; Pearson v. Black 120 S.W.2d 1075 (Tex. Civ. App. 1938—drilling operations by one partial assignee abates the rentals as to the entire tract. And see Wilson v. Texas Co., 147 Kan. 449, 76 P.2d 779 (1938) ; Texas Co. v. Waggoner, 239 S.W. 354 (Tex. Civ. App. 1922) ; Cowman v. Phillips Pet. Co., 142 Kan. 762, 51 P.2d 988 (1935)—production by assignor continued lease as to partial assignee; Gypsy Oil Co. v. Cover, 78 Okla. 158, 189 Pac. 540. 11 A.L.R. 129 (1920)—production by partial assignee continues portion of leased premises retained by assignor; Dacamara v. Binney, 146 S.W.2d 440 (Tex. Com. App. 1941).

[114]Cosden Oil Co. v. Scarborough, 55 F.2d 634, 637 (C.C.A. Tex. 1932).

[115]See Merrill, *The Partial Assignee—Done in Oil*, 20 TEXAS L. REV. 298, 311 (1942)

[116]For a discussion of this approach in the Williston Basin, see Ralph, *Basin at Awkward Age*, 52 OIL AND GAS J., 74 (Sept. 14, 1953).

acreage, the assignment may be of the entire interest with a reservation of an overriding royalty or a carried interest.

The farm-out agreement may be an informal letter of the lessee endorsed by the intended assignee, or it may be a formally executed contract.[117]

Contributing to the Cost of Drilling a Well

A reduction in the cost of drilling a well may be obtained by securing agreements to contribute to the cost in return for the information secured thereby or by securing agreements to purchase a portion of the acreage under lease as soon as the well reaches a specified depth. In the former case, the party agreeing to make contribution may own leases in the viciinty and is willing to pay for a test of a specified formation that also underles his land. He may be willing to pay whether the well produces or not; in which event, a "bottom hole letter"[118] is executed. He may feel that obtaining production is a sufficient reward for drilling the well and so agrees to contribute only if the well is nonproductive; in which event, a "dry hole letter" is executed.

Securities Regulation of Assignments

The issuance and transfer of securities are regulated to prevent the frauds previously perpetrated upon the investment public.[119] In the states it is accomplished through the so-called "blue-sky" laws,[120] whereas on the federal level and with respect to interstate transactions it is accomplished through the Securities Act.[121] The federal approach is predicated upon a full disclosure of all pertinent facts through the filing of a registration statement with the Securities and Exchange Commission and the tender of a prospectus containing similar information to prospective purchasers.[122] In

[117]For an illustration of an informal letter-type greement, see Brown, *Assignments of Interests in Oil and Gas Leases, Farm-Out Agreements, Bottom Hole Letters, Reservations of Overrides and Oil Payments*, FIFTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 25, 70 (1954); and see Rex Oil and Gas Co. v. Busk, 335 Mich. 368, 56 N.W.2d 221 (1953).

[118]A bottom hole letter includes much the same language as a dry hole letter with the exception of the terms upon which payment is to be made. There is also a specific provision defining the drilling obligation where an impenetrable substance is encountered above the specified depth. See Anderson v. Bell, 70 Wyo. 471, 251 P.2d 572 (1952). For a short form of bottom hole letter, see Brown, *Assignments of Interests in Oil and Gas Leases, Farm-Out Agreements, Bottom Hole Letters, Reservations of Overrides and Oil Payments*, FIFTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 25, 82 (1954).

[119]"The object of the law is to protect the public from the dishonesty, incompetence, ignorance and irresponsibility of persons engaged in the business of disposing of scurities of uncertain value whereby the inexperienced and confiding are likely to suffer loss." Stewart v. Brady, 300 Ill. 425, 133 N.E. 310, 317 (1921).

[120]Illustrative of the blue sky laws applicable in the oil-producing states are the following: *Arkansas*, ARK. STAT. ANN. §§ 76-1201 – 1234 (1947); *California*, CAL. CORP. CODE ANN., Tit. 4. Div. 1 (Deering, 1948); *Kansas*, KAN. GEN. STAT., § 17-1223 *et seq.* (Corrick, 1949); *Montana*, REV. CODE OF MONT., § 66-2001 *et seq.* (Replacement 1953); *Oklahoma*, OKLA. STAT. ANN. § 77-1 *et seq.* (1951); *Texas*, TEX. REV. CIV. STAT., Art. 600a (Vernon, 1948).

[121]48 Stat. 74 (1933); 15 U.S.C. § 77a *et seq.* (1951).

[122]"The main requirement of the act is that the issuer of securities sold or delivered through interstate commerce or the mails must, prior thereto, file a registration statement with the Securities Exchange Commission, stating information deemed appropriate by Congress. The Commission must register any issue regardless of the security, where the registration statement is not on its face incomplete or inaccurate. The speculative nature of the enterprise is no ground for refusing the use of the mails or the channels of commerce for its sale." Crosby v. Weil, 382 Ill. 538, 48 N.E.2d 386, 388 (1943).

the states the methods of regulation vary; the most prevalent is a licensing of dealers and an investigation of the proposed issue by the Securities Commissioner.[123] The assignments of interests in oil and gas are the proper objects of such regulation by virtue of their inclusion in the definition of "security".[124] The fact that they are also interests in land and that their sale involves a transfer of real property, is immaterial.[125] Failure to comply with these regulatory provisions subjects the issuer to civil liability and entitles the purchaser to rescind within a stipulated period even though the transaction is a fair one.[126]

The original lease is not a fractional undivided interest and therefore is not within the definition of a security under the federal act.[127] However, the subdivision of the original lease and the sale of fractional parts thereof constitutes an investment contract under the act and is subject to regulation.[128] The act applies to issuers of fractional undivided interests, *i.e.*, to an owner of such an interest who in turn creates fractional interests therein for the purpose of offering them to the public for sale.[129]

There are three instances in which the registration provisions of the Securities Act do not apply: intrastate offerings, private offerings, and offerings less than $300,000.

Where intrastate offerings are involved, the issuer and purchaser must be residents of the same state and the assignment must not be for purposes of resale to persons outside the state.[130]

The distinction between public offerings and private offerings within terms of the exemption of the latter under the Act[131] is difficult to make. It has been held that:

> . . . Congress did not intend the term "public offering" t mean an offering to any and all members of the public who cared to avail

[123]BALLANTINE, CORPORATIONS §§ 367, 368 (1946); and see the statement of purpose in the state blue sky laws.

[124]The Texas Securities Act includes in the definition of security ". . . certificate or any instrument representing any interest in or under an oil, gas or mining lease, fee or title . . ." TEX. REV. CIV. STAT. ANN., Art. 600a, § 2(a) (Vernon, 1948).

An oil and gas lease has been held to be a security within the terms of this definition, Herren v. Hollingsworth, 140 Tex. 263, 167 S.W.2d 735 (1943).

The Securities Act includes in the definition of security ". . . fractional undivided interest in oil, gas, or other mineral rights. . . ." 15 U.S.C. § 77b(1) (1951). Under some circumstances an oil and gas lease falls within this definition, S.E.C. v. C. M. Joiner Leasing Corp., 320 U.S. 344, 64 Sup. Ct. 120, 88 L.E. 88 (1943).

[125]Herren v Hollingsworth, note 124, *supra*—lease; Morello v. Metzenbaum, 25 Cal. 2d 494, 154 P.2d 670 (1944)—fractional part of landowners royalty; Cosner v. Hancock, 149 S.W.2d 239 (Tex. Civ. App. 1941)—oil payment.

[126]15 U.S.C. § 77(1) (1951); TEX. REV. CIV. STAT. ANN., Art. 600a, § 33a (Vernon, 1948).

[127]Note 124, *supra*.

[128]S.E.C. v. C. M. Joiner Leasing Corp., note 124, *supra*. An *investment contract* for purposes of the Securities Act has been defined as ". . . a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits *solely from the efforts of the promoter or a third party*, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." S.E.C. v. W. J. Howey Co., 328 US. 293, 66 Sup. Ct. 1100. 90 L.Ed. 1244 (1946)—emphasis supplied. Leases may constitute securities within the meaning of this definition if the promoter promises to drill a well in the vicinity which, if successful, will increase the value of the leasehold estate.

[129]For a discussion of who is an issuer in such a case, see Federal Trade Commission, *Security Act Release* 185 (1934); that underwriters and dealers are also included, see 17 Code of Federal Regulations § 230.300 (1949).

[130]15 U.S.C. § 77c (a) (11) (1951).

[131]15 U.S.C. § 77d (1) (1951).

themselves of the offer. . . . An offering to stockholders, other than a very small number, was a public offering.[132]

The general exemption under Regulation A[133] is not applicable to fractional undivided interests in oil and gas.

There is a special regulation, referred to as Regulation B,[134] which provides for a short form of registration where the issue is not in excess of $300,000.[135] This provision is available only to registered dealers,[136] where the working interest retained by the operating lessee equals 20 per cent or the issuance is less than $30,000,[137] and when a specified form of offering sheet is filed with the Commission before any offer to sell is made.[138]

The broad definition of *security* in the state Securities Laws[139] includes all oil and gas assignments, whether fractional or entire.[140] However, there are numerous specific exemptions.[141] Thus, if the owner of such interests does not engage in the sale of securities as a business, he may effect such transactions in his own behalf without complying with the provisions of the Act.[142] Failure to comply with the requirements of the state Securities Laws subjects the issuer to both civil and criminal liability and entitles the purchaser to rescind.[143] Similar penalties are provided for under the federal laws.[144] However, the civil liability is subject to a one year statute of limitations.[145] Individuals engaged in the business of buying and selling fractional undivided interests in oil and gas or entire interests that may be classified as investment contracts are also subject to regulation. That is, in addition to complying with the registration provisions applicable to securities, they must also register personally as dealers, if engaged in business on their own account, or as brokers, if acting for others on an agency basis.[146]

CONCLUSION

Assignments of oil and gas interests must be prepared with extreme care and great attention to detail. Attention has been devoted herein only

[132] S.E.C. v. Sunbeam Gold Mines Co., 95 F.2d 699, 702 (C.C.A. Wash. 1938).

[133] 17 Code of Federal Regulations, § 230.220 (1949). However, the offerer can avail himself of the registration procedures under Regulation A by organizing a corporation, transferring the oil and gas interests to the corporation, and making public offering of the corporate stock.

[134] 17 Code of Federal Regulations, §§ 230.300-456 (1949).

[135] *Ibid.*, § 230.310.

[136] 15 U.S.C. § 78 (o) (1951).

[137] 17 Code of Federal Regulations, § 230.314 (1954 Supp.)

[138] 17 Code of Federal Regulation, §§ 230.320, 230.330 (1949).

[139] See note 124 *supra*, for the Texas definition.

[140] See cases cited in notes 124 and 125, *supra*.

[141] ARK. STAT. ANN. § 67-1204(g) (1947); COLO. STAT. ANN. c. 148, § 13 (1) (1935); OKLA. STAT. ANN. § 71-21 (i) (1951); REV. CODE OF MONT. § 66-2003 (9) (Replacement 1953); TEX. REV. CIV. STAT., Art. 600a, § 3 (Vernon, 1948).

[142] Tex. Rev. Civ. Stat., Art. 600a § 3 (Vernon, 1948); Colo. Stat. Ann. c. 148, § 13 (1) (1935); OKLA. STAT. ANN. § 71-72 (i) (1951).

[143] Note 126, *supra*. For a general discussion of the problems involved, see Comment, *The Texas Securities Act as It Applies to Interests in Oil and Gas*, 22 TEXAS L. REV. 346 (1944); Meer, *Oil Finance and the Securities Laws*, 29 TEXAS L. REV. 885 (1951); Comment, *Oil and Gas Interests as Securities*, 26 CALIF. L. REV. 359 (1938); Bloomenthal, *SEC Aspects of Oil and Gas Financing*, 7 WYO. L.J. 49 (1953).

[144] 15 U.S.C. §§ 771, 77m, 77x (1951).

[145] 15 U.S.C. § 77m (1951).

[146] 48 Stat. 881 (1934); 15 U.S.C. § 780 (1951)—other than those whose business is exclusively intrastate.

to the substantive considerations involved. In many instances, however, the form which a particular transfer will take is dictated by certain peripheral considerations such as the minimization of tax consequences or the avoidance of regulation under the various Securities Laws. The technicality of such transfers and the ambiguity that may result where general language is used must be foremost in the mind of the draftsman in order that the dual objectives of effecting a transfer of the intended interest and at the same time reaping the tax advantages of careful planning maybe realized.