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## A 1952 Survey of Basic Oil and Gas Law

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## A 1952 SURVEY OF BASIC OIL AND GAS LAW

*Wilmer D. Masterson, Jr.\**

### I

#### *The Physical Nature of Oil and Gas and the Effect*

#### *Thereof upon Oil and Gas Law.*

SOME formations or strata beneath the earth's surface are sufficiently porous to contain oil and gas. When a well is drilled into such a stratum, it may prove to be completely devoid of either substance; it may, however, contain large quantities of oil or gas, or both. The outer boundaries of the reservoir created by such a mineral-bearing stratum are, generally speaking, fixed by the places at which the stratum terminates or ceases to hold oil or gas.

Let us assume for present purposes the existence of a stratum holding both oil and gas, and that the reservoir thus formed underlies the tracts of several owners, *A*, *B*, and *C*.

Until the reservoir is pierced, the oil and gas remain stationary in the porous formation; however, when a well pierces the stratum, the oil and gas move from all sides toward the opening. Thus, when *A* drills a well, he can produce from it not only the oil and gas which originally underlay his land but also can drain oil and gas from the land of *B* and *C*. This migratory factor, which at once distinguishes oil and gas from solid minerals, has been and is the most important single factor in the development of oil and gas law. It raises problems that cross-section this entire field of

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law. For example, does *B* own the oil and gas underlying his land? If *A*'s well produces oil from under *B*'s tract, who is entitled to such oil? Can there be valid governmental control over how much oil and gas can be produced; how it can be produced; how the oil and gas shall be divided among *A*, *B*, and *C*? Can *A* transfer his interest, if any, in the minerals? Is such interest one in realty or one in personalty?

Frequently, the key to the solution of these and other problems can be found in the fact that, because of the migratory nature of oil and gas, operations upon one tract usually have a direct effect upon the oil and gas underlying other tracts in the same reservoir.

## II

### *Theories as to the Interest or Title Which can be Acquired in Oil and Gas.*

It is elementary that at common law the landowner with a fee simple title owns to the center of the earth. As a corollary, except in Louisiana,<sup>1</sup> which applies civil law, courts have found no difficulty in holding that such an owner owns the solid minerals underlying his tract. As to oil and gas, however, there has been confusion. The early cases assumed that it was necessary to hold that the landowner owns oil and gas produced from a well bottomed on his tract even though the oil and gas were drained from under another's tract. The reason usually given was that because of the impossibility of determining the tracts drained, and the extent of drainage, any other rule would be unworkable. This rule that one owner can rightfully drain oil and gas from other tracts, and acquire title to the oil and gas so drained, adopted in the various states with remarkable consistency, became known as the rule of capture. The next problem was to reconcile a rule which

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<sup>1</sup> *Wemple v. Nabors Oil & Gas Co.*, 154 La. 483, 97 So. 666 (1923).

would allow *A* to appropriate oil and gas from under *B*'s land with the rule that each owner owns to the center of the earth.<sup>2</sup> Obviously, this rule precluded a holding that the owners of the tracts constituting the reservoir owned the substances therein as tenants in common.

One possible solution was to hold that because of the migratory nature of oil and gas, they are owned by no one until captured. True, each landowner has an exclusive right to drill wells on his land and to capture oil and gas from the reservoir. This right is an interest in the nature of an easement or profit à prendre, and can be sold or transferred in the same manner as can any other property interest. This rule that no one can own the oil and gas until capture, but that the right to capture them is a property right which can be owned, is usually referred to as the qualified ownership doctrine.<sup>3</sup>

Another solution was to hold that each owner owned the oil and gas beneath his land, but would lose ownership if and when they migrated beyond his borders. This rule became known as the doctrine of absolute ownership.<sup>4</sup>

Frequently there will be conflicting statements within a single jurisdiction, with the result that it cannot be definitely classified as committed to either theory.<sup>5</sup> In effect, a given state may apply the qualified ownership rule for some purposes and the absolute ownership rule for others.

When and the extent to which the theory of ownership is important will be considered in connection with the various matters yet to be discussed.

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<sup>2</sup> This matter is fully discussed in 1 SUMMERS, *THE LAW OF OIL AND GAS* (Perm. ed. 1938) § 62.

<sup>3</sup> The case most frequently cited in support of this proposition is *Ohio Co. v. State of Indiana*, 177 U. S. 190 (1900).

<sup>4</sup> *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S. W. 290, 29 A. L. R. 566 (1923).

<sup>5</sup> See, for example, *Callahan v. Martin*, 3 Cal. 2d 110, 43 P. 2d 788 (1935).

## III

*Correlative Rights and Duties as Among the Owners  
of the Reservoir.*

*A*, *B*, and *C* own in severalty three tracts of land which include an oil and gas reservoir. As previously stated, if *A* taps the reservoir with a well on his tract, this will have a direct effect upon the oil and gas underlying the tracts of *B* and *C*. This at once poses two problems: (1) Does *A* owe any duties to *B* and *C* as to transactions involving the common reservoir? (2) May such duties validly be imposed by statute or regulation?

Numerous articles and decisions could be cited arguing these question pro and con, particularly with reference to the importance to be attached to the theory of ownership applied in the state in question. These discussions are of historical interest only. While some recent decisions have referred to the theory of ownership as a factor,<sup>6</sup> all jurisdictions which have considered the problems now recognize that there are some correlative rights and duties existent under common law, and that reasonable additional ones can validly be imposed by legislation.<sup>7</sup>

The rights and duties which will be recognized aside from those imposed by legislation may well vary as the petroleum industry grows and changes. It seems clear that once the duty is established, whether by common law or statute, a breach thereof would constitute a tort and could form the basis of a cause of action in favor of any one injured thereby.<sup>8</sup> The discussion immediately following deals with the more important rights and duties recognized at present.

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<sup>6</sup> Thus, in *Eliff v. Texon Drilling Co.*, 146 Tex. 575, 579, 580, 210 S. W. 2d 558, 560 (1948) the court said: "We do not regard as authoritative the three decisions by the Supreme Court of Louisiana... because in that state only qualified ownership of oil and gas is recognized...."

<sup>7</sup> *Bandini Petroleum Co. v. Superior Court*, 284 U. S. 8, 78 A. L. R. 826 (1931); *Thompson v. Consolidated Gas Utilities Corp.*, 300 U. S. 55 (1937); *Manufacturers' Gas & Oil Co. v. Indiana Gas & Oil Co.*, 155 Ind. 461, 57 N. E. 912, 50 L. R. A. 768 (1900).

<sup>8</sup> *Peterson v. Grayce Oil Co.*, 37 S. W. 2d 367 (Tex. Civ. App. 1931).

(a) *Duty to plug abandoned wells.*

*A* has a producing well on his tract. It ceases to produce in amounts sufficient for *A* to realize a profit, and so *A* abandons it. Oil and gas from under the lands of *B* and *C* continue to migrate to and escape from *A*'s abandoned well. Their complaint is met by *A*'s contention that under the law of capture, he is entitled to produce all he desires, and it is none of *B*'s and *C*'s business whether the oil and gas are actually used or are allowed to escape into the air. Probably this contention of *A* would be overruled even in the absence of legislation. This is unimportant now because all producing states have express requirements as to plugging.<sup>9</sup>

(b) *Duty not to use unusual means to capture.*

The rule of capture has been construed to authorize capture only by customary or usual means.<sup>10</sup> This restriction is based on reasoning to the effect that each owner should be given a reasonable opportunity to capture his fair share of the oil and gas in the reservoir, which opportunity would be impaired if unusual means were used. This seems illogical where each owner has an equal opportunity to use unusual means. A sounder ground would be to measure the duty by the standard next discussed, *i.e.*, the duty which each owes to the others not to unreasonably damage the common reservoir.

What constitutes usual and unusual means would depend largely upon custom in the industry at the time of the complained of action. This problem is usually solved by legislation or regulation thereunder as to the methods of capture.

(c) *Duty not to unreasonably injure the reservoir.*

It is clear that *A* owes a duty to *B* and *C* not to unreasonably injure the reservoir by reducing its capacity to produce. Such injury may occur through physical damage to the reservoir. Thus, to increase porosity and permeability of a possibly productive structure, *A* might and frequently would cause an explosion in

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<sup>9</sup> Plugging requirements are listed by states in 1 SUMMERS, THE LAW OF OIL AND GAS (Perm. ed. 1938) § 72.

<sup>10</sup> Peterson v. Grayce Oil Co., 37 S. W. 2d 367 (Tex. Civ. App. 1931).

the well. This is customarily referred to as "shooting the well." This explosion might cause damage to the structure itself, or it might result in the intrusion of salt water from another structure.

It is clear that *A* owes a duty not to willfully damage the reservoir, and, further, that *A* owes a duty not to negligently cause such damage.<sup>11</sup> Possibly some states would apply absolute liability even in the absence of negligence or some other recognized tort. Oklahoma applies absolute liability in many situations, but refused to do so as to this type of damage. The Oklahoma Supreme Court held applicable the rule that when both plaintiff and defendant are engaged in an inherently dangerous transaction, absolute liability will not be applied.<sup>12</sup>

Of course, sometimes a duty will be breached aside from any question of correlative rights and duties. Thus, if *A*'s well physically intrudes into the subsurface of *B*'s land, this would be a trespass.<sup>13</sup> The same rule would seem applicable if a subsurface explosion causes substances to move without interruption into another's tract.<sup>14</sup>

Another way in which the reservoir may become unnecessarily damaged is by inefficient production methods. Only one reported case seems to have discussed this matter, and it held in effect that as long as the method was not in violation of a valid law, use of an inefficient method would not breach any duty.<sup>15</sup>

*(d) Duty not to waste gas.*

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<sup>11</sup> *Comanche Duke Oil Co. v. Texas and Pacific Coal and Oil Co.*, 298 S. W. 554 (Tex. Comm. App. 1927).

<sup>12</sup> *Larkins v. Watchorn*, 198 Okla. 12, 174 P. 2d 589 (1946).

<sup>13</sup> *Alphonzo & Bell Corp. v. Bell View Oil Syndicate*, 24 Cal. App. 2d 587, 76 P. 2d 167 (1938).

<sup>14</sup> This possibility was mentioned but not passed upon in *Comanche Duke Oil Co. v. Texas & Pac. Coal and Oil Co.*, 298 S. W. 554 (Tex. Comm. App. 1927). Possibly a vibration would be held a trespass, although such a contention as to an above-surface explosion was rejected in *Indian Territory Illuminating Oil Co. v. Rainwater*, 140 S. W. 2d 491 (Tex. Civ. App. 1940). A similar result was reached in *Stanolind Oil & Gas Co. v. Lambert*, 222 S. W. 2d 125 (Tex. Civ. App. 1949). See Comment, 3 *Southwestern L. J.* 458 (1949).

<sup>15</sup> *Western Gulf Oil Co. v. Superior Oil Co.*, 92 Cal. App. 2d 299, 206 P. 2d 944 (1949). All producing states have laws as to methods of production, varying from state to state.

Of course, if the rule of capture were literally applied, *A* would have a right willfully to waste gas. But the decisions have qualified this rule to the extent that there are now instances in which *A* owes a duty to *B* and *C* not to cause or allow waste.

First, suppose the waste is willful? Here the answer may turn upon whether the court considers that the waste is for a justifiable purpose. In an early Pennsylvania case<sup>16</sup> *B* had a market for his gas and *A* did not. *A* vented the gas from his well for the admitted purpose of forcing *B* to share his market. The supreme court, reversing an intermediate court, held that this was a legitimate use of the rule of capture.

In a Kentucky case *A* and *B* were competitors. *A* purchased interests in the gas fields from which *B* was producing, and began wasting gas for the purpose of putting *B* out of business. The court held that waste for such a purpose constituted a breach of duty.<sup>17</sup>

Next, suppose that the waste itself is neither willful nor unlawful, but that it results from a well blowout, which blowout was caused by negligence. If the negligence amounts to gross negligence, Louisiana has recognized the resulting waste as a proper basis for recovery.<sup>18</sup> Even when the blowout is caused by common negligence, Texas treats the loss of oil and gas as a basis for recovery.<sup>19</sup>

The statement was made that the theory of ownership is unimportant in defining correlative rights and duties. Distinguish this problem from the one of determining the measure of damages in the event a duty is breached. In a qualified ownership state, the usual measure of the difference in value before and after the loss would seem applicable. There could be no conversion, or taking

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<sup>16</sup> *Hague v. Wheeler*, 157 Pa. 324, 27 Atl. 714 (1893).

<sup>17</sup> *Louisville Gas Co. v. Kentucky Heating Co.*, 117 Ky. 71, 77 S. W. 368 (1903); *id.*, 132 Ky. 435, 111 S. W. 374 (1908).

<sup>18</sup> *McCoy v. Arkansas Nat. Gas. Co.*, 184 La. 101, 165 So. 632 (1936).

<sup>19</sup> *Elliff v. Texon Drilling Co.*, 146 Tex. 575, 210 S. W. 2d 558 (1948), *later proceedings*, 216 S. W. 2d 824 (Tex. Civ. App. 1948).



of another's property, when we start with the premise that no one had title until capture.

In states applying the absolute ownership theory, if the rule of capture is held inapplicable, the courts could logically hold that damages should be measured by the actual value of the substances which escape. It is submitted that such a measure is unfair in that it fails to take into account several important factors, including, among others, the fact that the market price is affected to a substantial degree by governmental regulations restricting production, whereas the measure of damages in question would allow an adjoining landowner to recover for oil or gas produced far in excess of that which could legally be produced from a well under control. Further, *A* is not actually appropriating the oil and gas—they are escaping into the air.<sup>20</sup> Perhaps the most important objection to this measure is that it subjects any person drilling for oil or gas to a potential liability of millions of dollars. If it is suggested that the requirement of negligence justifies this result, the answer is that there are and will be many border-line cases as to common negligence.

#### IV

#### *Governmental Regulation of Exploration for and Production of Oil and Gas.*

It is now settled that there is no constitutional objection to reasonable regulation by states of exploration for and production of oil and gas. As in the case of correlative rights, much could be and has been written on this question, particularly with reference to the theory of ownership applied in a given state. The rule, however, is now too well established to justify such a discussion.

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<sup>20</sup> Texas, while perhaps not irrevocably committed, has indicated that a proper measure is one based on the market value of the substances which escaped. *Elliff v. Texon Drilling Co.*, cited in note 19. For further discussions of the problem, see Walker, *Important Oil and Gas Decisions*, 11 Tex. B. J. 480 (1948); Masterson, *The Legal Position of the Drilling Contractor* in SOUTHWESTERN LEGAL FOUNDATION FIRST ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION (1949) 183, 212 *et seq.*

We still have the important primary problem of whether a given statutory or regulatory provision is reasonable and the secondary procedural problem of how this question can be put in issue.

As to the primary problem, it is now settled that any provision which bears a reasonable relationship either to conservation of these natural resources or to the adjustment of correlative rights of the owners thereof, or to both, is valid.<sup>21</sup> As long as there is no discrimination, an order absolutely prohibiting production could possibly bear a reasonable relationship to conservation and hence constitute a valid order.<sup>22</sup> When feasible, however, the order to be reasonable would usually have to afford each owner a fair opportunity to produce from the common pool an amount of oil or gas approximating that which underlay his land prior to regulation, or, alternatively, to receive payment based upon such an amount.<sup>23</sup>

(a) *Methods of regulation.*

(1) *Regulation as to location of wells.*

In the absence of regulation, *A*, *B*, and *C* each has an incentive to drill as near his boundary line as possible, in order to drain oil and gas from under his neighbor's land. Each also has an incentive to drill as many wells as possible in order to stay even or ahead in the race to capture the oil and gas from the reservoir. This results in inefficient recovery methods and in numerous unneces-

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<sup>21</sup> Republic Nat. Gas Co. v. State of Oklahoma, 334 U. S. 62 (1948); Henderson v. Thompson, 300 U. S. 258 (1937); Thompson v. Consolidated Gas Utilities Corp., 300 U. S. 55 (1937). In the first cited case the rule is discussed in a dissenting opinion, the majority being of the opinion that the order in question was not final and hence not appealable. The reasoning in both opinions, however, leaves no doubt that the dissenting opinion reflects the Court's view on the merits.

<sup>22</sup> Marblehead Land Co. v. City of Los Angeles, 47 F. 2d 528 (9th Cir. 1931), *cert. denied*, 284 U. S. 634 (1931).

<sup>23</sup> See cases cited *supra* note 21 and in addition the following: Champlin Refining Co. v. Corporation Commission, 286 U. S. 210, 86 A. L. R. 403 (1932); Marrs v. Railroad Commission, 142 Tex. 294, 177 S. W. 2d 941 (1944). Several possible factors which have been mentioned but not fully developed by the authorities are as to the importance if any, of greater production from one of the tracts prior to regulation, or prior to attack upon a regulation, and as to the importance, if any, of the fact that because of greater porosity or some other physical condition, more can be produced from one tract than from another, although originally equal amounts of oil were trapped under each tract.

sary wells. It is a recognized scientific fact that a reservoir can be most efficiently and economically drained when the wells are drilled under a uniform spacing pattern. The difficulty is to reconcile such a program with the divergent property interests usually existent in various tracts in the same field or reservoir. Thus, in a given field it might be that an advisable spacing pattern would be one well located in the center of each ten acres. But suppose *A* owns this center acre, while *B* owns 5 adjoining acres and *C* the other four. Under the law of capture, *A* will receive all of the production. Obviously such a result would be contrary to the rule that each owner must be given a reasonable opportunity to recover the oil and gas originally underlying his tract. Thus, unless the regulation forces *A* to share production from his tract with *B* and *C*, it would usually be unreasonable. The validity of a regulation forcing such sharing will be discussed presently. It is sufficient at this point to note that while regulation through well-spacing is helpful, it is usually not a satisfactory solution of the problem of efficient and economical production.

The Texas decisions furnish an interesting picture of the difficulties involved where there is divergent ownership, and also some possible partial solutions thereof.

In Texas the Railroad Commission, under enabling legislation, in 1919, adopted Rule 37, which provides in effect that no well shall be drilled contrary to the prescribed pattern in a given field unless such a well is necessary to prevent waste or to avoid confiscation. The rule further provides that where confiscation is the ground, a permit will not be granted if the tract as to which an exception is necessary was subdivided from a tract as to which an exception would not be necessary, subsequent to oil and gas activity in the vicinity in question. In other words, an owner desiring an additional well could not subdivide a portion of his tract for the purpose of securing a permit for such well.<sup>24</sup>

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<sup>24</sup> Rule 37 is set forth and discussed at length in *Gulf Land Co. v. Atlantic Refining Co.*, 134 Tex. 59, 131 S. W. 2d 73 (1939). See also *Brown v. Humble Oil and Refining Co.*, 126 Tex. 296, 83 S. W. 2d 935, 87 S. W. 2d 1069; 99 A. L. R. 1107, 101 A. L. R. 1393 (1935).

In applying this rule the Commission grants a permit for at least one well to each tract too small to conform to the spacing pattern, when such tract was subdivided in good faith and prior to oil and gas activity in the vicinity. In addition, and regardless of the time of subdivision, the Commission grants permits for as many additional wells as are necessary to prevent waste. In this connection, such a permit will not be granted unless there are physical differences between the tract as to which the permit is sought and other tracts in the field.<sup>25</sup>

(2) *Proration.*

Let us assume that *A*, *B*, and *C* each has a well upon his tract. The extent to which each will be allowed to produce can be fixed by reasonable regulation. Here again the test is whether the regulation affords each owner a reasonable opportunity to recover the oil and gas underlying his tract prior to regulation. A state can validly prohibit completely a use for a wasteful purpose.<sup>26</sup> Further, a state can validly determine market demand on a statewide basis, and then allocate allowable production among the various fields in the state. This is held to be reasonable on the ground that production beyond market demand would inevitably result in wasteful practices.<sup>27</sup> Proration on a state-wide basis involves determination of the state allowable and then a distribution of this allowable among the various fields in a state. Thus, conservation of resources is the primary factor; a secondary factor is the adjustment of correlative rights of the owners in a given field in determining the allowable to be granted to each. It is clear that the fact that *A* has a market while *B* does not, does not of itself give *A* a right to a higher allowable. However, if there is actually no drainage from *B*'s well to *A*'s well, an order which in effect forces *A* to

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<sup>25</sup> See authorities cited in note 24.

<sup>26</sup> *Henderson v. Thompson*, 300 U. S. 258 (1937).

<sup>27</sup> *Champlin Refining Co. v. Corporation Commission*, 286 U. S. 210, 86 A. L. R. 403 (1932); see Hardwicke, *Market Demand as a Factor in the Conservation of Oil in* SOUTHWESTERN LEGAL FOUNDATION FIRST ANNUAL INSTITUTE ON OIL AND GAS LAW (1949) 149.

share his market with *B* might be invalid as without reasonable basis.<sup>28</sup>

(3) *Pooling or unitization.*

Let us again assume that *A*, *B*, and *C* are the owners of separate tracts which together constitute part of an oil or gas reservoir, *A*'s tract including one acre, *B*'s five acres, and *C*'s four acres. It is determined scientifically that but one well should be drilled to drain this ten-acre portion of the field and that it should be drilled on *A*'s one acre. If the law of capture is applied, however, *A* will receive the benefit of oil or gas drained from under the land of *B* and *C*. To avoid such an unfair result, it will be necessary to allow *B* and *C* to drill wells, which actually are unnecessary, or to nullify the law of capture, and permit *B* and *C* to share in production from *A*'s tract. This latter method is referred to as forced pooling or unitization. It is now settled that there is no constitutional objection to a state regulation which unitizes the interests of owners in a given field, provided always that such regulation is reasonable. Reasonableness *vel non* again will depend upon whether the amounts which each owner will receive bear a reasonable relationship to the amount of oil and gas underlying each tract prior to regulation.<sup>29</sup>

Of course, forced pooling cannot apply unless there is a valid state law authorizing such action. Some states, including Oklahoma and Louisiana, have such laws. Others do not. In Texas the

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<sup>28</sup> In *Thompson v. Consolidated Gas Utilities Corp.*, 300 U. S. 55, 69, 70 (1937), the Court said: "But, obviously, the proration orders would not be valid if shown to bear no reasonable relation either to the prevention of waste, or the protection of correlative rights or if shown to be otherwise arbitrary." See, also, *Champlin Refining Co. v. Corporation Commission*, note 27; *Railroad Commission v. Continental Oil Co.*, 157 S. W. 2d 695 (Tex. Civ. App. 1941) *er. ref. w.o.m.*

<sup>29</sup> *Hunter Co. v. McHugh*, 320 U. S. 222 (1943); *Patterson v. Stanolind Oil and Gas Co.*, 182 Okla. 155, 77 P. 2d 83 (1938), *app. dismissed*, 305 U. S. 376 (1939). The simplest formula for unitizing is to take the total acreage in a unit as a denominator and the acreage contributed by each owner as a numerator. Thus, in the example posed, *A* would receive 1/10 of the production payable to the landowners, *B* would receive 5/10 thereof and *C*, 4/10. Sometimes such a formula would not do justice because of different geological conditions in the tracts involved. Thus, *A*'s tract might have a more permeable sand, or a thicker sand, or a higher pressure. In these instances, formulas are worked out which include such other factors.

law expressly prohibits the Railroad Commission from enforcing pooling. Even where authorized, the power is infrequently used, because this method has not as yet found much popularity among mineral owners. Whenever possible, resort to such power is avoided by securing voluntary unitization agreements.<sup>30</sup>

(4) *Direct sharing.*

Throughout the years there has been constant controversy between the owners with a market and those without. Forced sharing has resulted indirectly through proration, and directly through pooling. In the latter instance the justification usually given is that such sharing avoids unnecessary wells. Suppose, however, that *A* and *B* each has a well. *A* has a market and *B* has not. Absent regulation, *B* could give *A* an incentive to share by allowing the oil or gas to escape from his well, thus draining such oil or gas from under *A*'s land.<sup>31</sup> *B* cannot now resort to this method because of state conservation laws. Can a state validly force *A* to share his market? This question was answered in the affirmative in recent Oklahoma cases.<sup>32</sup> This result is consistent with the idea that reasonableness simply requires that each owner be given an opportunity to realize the value of the oil and gas underlying his land prior to regulation. Of course, if there was actually no drainage from *B*'s tract to that of *A*, then it seems clear that the order would be unreasonable.<sup>33</sup>

(5) *Transportation.*

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<sup>30</sup> For a collection of the conservation laws of the various states, see SECTION OF MINERAL LAW, A. B. A., CONSERVATION OF OIL AND GAS, A LEGAL HISTORY (Blakely M. Murphy, 1948); SUMMERS, THE LAW OF OIL AND GAS (Perm. ed. 1938), vols. 6 and 7. Interesting problems arise as to the effect of governmental regulations upon the contract rights of the parties. See, for example, *Hunter Co. v. Shell Oil Co.*, 211 La. 893, 31 So. 2d 10 (1947); *Crichton v. Lee*, 209 La. 561, 25 So. 2d 229 (1946); *Ohio Oil Co. v. Kennedy*, 28 So. 2d 504 (La. App. 1946).

<sup>31</sup> This was what the one in *B*'s position did in *Hague v. Wheeler*, cited *supra* note 16.

<sup>32</sup> *Cities Service Gas Co. v. Peerless Oil & Gas Co.*, 340 U. S. 179 (1950) *aff'g* 203 Okla. 35, 220 P. 2d 279 (1950); *Republic Natural Gas Co. v. State*, 198 Okla. 350, 180 P. 2d 1009 (1947). Appeal to the United States Supreme Court in the latter case was dismissed on a procedural point. See *supra* note 21. As there pointed out, the opinions in that Court leave no doubt that if the case had been considered on the merits, the order would have been sustained.

<sup>33</sup> *Thompson v. Consolidated Gas Utilities Co.*, 300 U. S. 55 (1937).

The final way to control production is by regulation of transportation of oil or gas produced. Such regulation by a state is, when reasonable, valid as to intrastate movement, and to a limited degree, valid as to interstate shipments.<sup>34</sup> Federal regulation is authorized as to interstate shipments.

*(b) Court review of legislative or administrative orders.*

Many of the earlier cases attacking statutes or regulations as unreasonable were instituted in the federal district courts. At first this practice was at least by implication sanctioned by the United States Supreme Court,<sup>35</sup> assuming, of course, the usual requisites for federal jurisdiction were present. It seems to be the present position of the Supreme Court, however, that admitting jurisdiction in the lower federal courts, as a matter of policy those courts should not take jurisdiction. Rather, the complaining party should exhaust his remedies in the state courts, and, after this has been done, he may ask the Supreme Court to take jurisdiction.<sup>36</sup>

The methods of review in state courts vary. In Texas, for example, the court action must be filed in the district court of Travis County, and review is limited to the question of whether the Railroad Commission order is reasonably supported by substantial evidence, adduced before the trial court, which question is one of law.<sup>37</sup> Appeal is available to an intermediate court and sometimes directly from the trial court to the Texas Supreme Court.<sup>38</sup>

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<sup>34</sup> This discussion of governmental control omits the matter of federal legislation. Briefly, until the products enter interstate commerce, regulation is left primarily with the state governments. One notable exception is the Fair Labor Standards Act of 1938, as amended, which applies to any drilling activities which might result in a subsequent interstate movement, even though such activities result in a dry hole. *Warren-Bradshaw Drilling Co. v. Hall*, 317 U. S. 88 (1942); *Culver v. Bell & Loffland*, 146 F. 2d 29 (9th Cir. 1944).

<sup>35</sup> See, for example, *Thompson v. Consolidated Gas Utilities Co.*, cited *supra* note 33.

<sup>36</sup> *Burford v. Sun Oil Co.*, 319 U. S. 315 (1943); *Railroad Commission v. Rowan & Nichols Oil Co.*, 310 U. S. 573 (1940), 311 U. S. 614 (1941); *id.*, 311 U. S. 570 (1941); see Note, 56 *Harv. L. Rev.* 1162 (1943).

<sup>37</sup> *Hawkins v. Texas Co.*, 146 Tex. 511, 209 S. W. 2d 338 (1948).

<sup>38</sup> TEX. CONST. Art. 5, § 3-b; TEX. REV. CIV. STAT. (Vernon, 1948) art. 1738a; *Railroad Commission v. Sterling Oil & Refining Co.*, 147 Tex. 549, 218 S. W. 2d 415 (1949); *Harris, A Reappraisal of the Substantial Evidence Rule in Texas Administrative Law*, 3 *Southwestern L. J.* 416 (1949).

## V

*Severance of Mineral Interests from the Surface.**(a) In general.*

All states recognize that interests may be owned in oil and gas separate and apart from any title or interest in the surface. The various theories as to the extent to which such an interest can be owned have been discussed. Where the severance purports to vest a fee title in a mineral interest, as distinguished from an attempted severance by execution of an oil and gas lease or any other instrument purporting to grant less than a full mineral interest, the severed interest, except in Louisiana, is now usually treated as having all of the elements of a fee simple title.<sup>39</sup> This is true whether the question arises in a state applying the qualified ownership doctrine or in one applying the absolute ownership doctrine.

There are various ways in which severance may occur. The owner of the entire estate may execute a deed to the surface only; he may in the granting clause of a deed purport to convey the entire estate, but in a subsequent clause expressly except and reserve the minerals; he may execute a deed granting only a mineral interest; or he may execute an oil and gas lease.

*(b) Grants of mineral interests other than oil and gas leases.**(1) Grant of a full mineral interest.*

Assume that *A* conveys to *B* all of the minerals under a given tract. The interest which *B* thereby acquires includes the following: (a) a right to develop—that is, to drill wells upon the tract in question and produce and market the oil and gas recovered; (b) power to execute oil and gas leases; (c) right to bonuses paid by the oil and gas lessee; (d) right to delay rentals payable by

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<sup>39</sup> See, for example, *Bodcaw Lumber Co. v. Goode*, 160 Ark. 48, 254 S. W. 345, 29 A. L. R. 578 (1923); *Callahan v. Martin*, 3 Cal. 2d 110, 43 P. 2d 788, 101 A. L. R. 371 (1935); *Jilek v. Chicago, Wilmington & Franklin Coal Co.*, 382 Ill. 241, 47 N. E. 2d 96, 146 A. L. R. 871 (1943); *Wilson v. Holm*, 164 Kan. 299, 188 P. 2d 899 (1948); *Barker v. Campbell-Ratcliff Land Co.*, 64 Okla. 249, 167 Pac. 468, L. R. A. 1918A, 487 (1918); *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S. W. 290, 29 A. L. R. 566 (1923).



said lessee; (e) right to royalties so payable; (f) right to any other interests reserved to the lessor.

(2) *Analysis of the above elements of a mineral interest.*

(a) *Right to develop.* This is self-explanatory. The mineral owner rarely uses this right. The expense of drilling a well when balanced against the possibility of a dry hole is one factor contributing to the result. Another is the necessity of specialized knowledge and facilities as to the various phases of drilling and development.

(b) *Power to execute oil and gas leases.* The customary method employed by the mineral owner in attempting to secure production is to execute an oil and gas lease. The oil and gas lessee is usually an individual or company equipped to carry on the necessary operations. Sometimes, however, one not so equipped will secure a lease for speculative purposes. He does not intend to operate under the lease but hopes to sell the lease at a profit.

(c) *Right to bonuses.* Most oil and gas leases provide for a specific consideration. Usually such provision is for a cash payment, payable upon delivery of the lease. Sometimes it is payable later, or in installments. In others it is payable out of and only if there is production.<sup>40</sup> This specific payment is called a bonus.

(d) *Right to delay rentals.* Most oil and gas leases provide for a specific term, called the primary term, during which the lease may be continued in force by periodic payments of money. These payments are called delay rentals because by making them the lessee delays the necessity of commencing drilling operations.<sup>41</sup>

(e) *Right to royalties.* Usually an oil and gas lease provides that in the event of production, a stipulated proportion thereof shall enure to the benefit of the lessor. In some lease forms the provision defining this interest is worded to vest in the lessor an undivided interest in the minerals; in others the lessor is simply

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<sup>40</sup> See, for example, *State National Bank of Corpus Christi v. Morgan*, 135 Tex. 509, 143 S. W. 2d 757 (1940). When the payment is to be out of, and only if there is, production, it is usually referred to as an oil payment.

<sup>41</sup> The custom is to provide in the lease for a primary term of either five or ten years.

given the right to share in the proceeds when the oil or gas is marketed. Logically, the language used is important in determining whether the interest of the lessor is realty or personalty. Looking to the substance of the matter, however, which is that under either form the lessor participates in the proceeds of production, it seems that both forms should be treated alike.<sup>42</sup>

The interest reserved to the lessor is usually one-eighth of total production or a right to the proceeds from a sale of one-eighth. However, in California the lessor's fraction is frequently one-sixth. There and elsewhere, when the land is established as being capable of production, the lessor's royalty is often larger.<sup>43</sup>

Customarily, the interest of the royalty owner is not chargeable with any of the drilling, operation or production expenses. It is partly because of this factor that by the agreement the lessee is given the larger interest. If, however, there is no ready market available and the lessee incurs unusual expenses in securing a market, then the lessor may be liable for his proportionate share of the expense.<sup>44</sup>

(3) *Grant of one or more of the elements or parts of a mineral interest.*

Many times the interest granted or reserved is less than a full mineral interest. Thus, *A* may sell to *B* all of the minerals but reserve to himself the right to execute oil and gas leases. Or *A* may reserve the right to lease and the right to bonuses. Or the reservation may be of those two rights and of the right to delay rentals. Or it may be limited to a right to share in royalties payable under present and future oil and gas leases, either or both.

Whenever less than all of the elements of a mineral interest (other than an oil and gas lease) are purportedly conveyed or

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<sup>42</sup> The suggested rule was applied in *Sheffield v. Hogg*, 124 Tex. 290, 77 S. W. 2d 1021, 80 S. W. 2d 741 (1934).

<sup>43</sup> For a good discussion of the methods of paying the lessor, see 2 WALKER, CASES OF OIL AND GAS (1949) 572, 573.

<sup>44</sup> *Molter v. Lewis*, 156 Kan. 544, 134 P. 2d 404 (1943), and authorities cited therein. Of course, if the lease form has a provision expressly covering this point, there is no problem.

reserved, serious and difficult problems arise as to whether such grant or reservation violates the Rule against Perpetuities.

In a recent California case it was held that a reservation of a right to execute oil and gas leases with no reservation of any interest in production violated the Rule.<sup>45</sup> Much more far-reaching is the Kansas case of *Lathrop v. Eyestone*.<sup>46</sup> This case held void an attempted perpetual grant of a fractional interest in bonuses and royalties payable under future leases executed by the grantor or his assigns, at least insofar as the instrument purported to give such power to assignees. The court reasoned that a future lease might not be executed within the prescribed period and that no interest could vest in payments under such lease until its creation. The court's result was obviously influenced by its stated conclusion that rights under oil and gas leases to bonuses and royalties are personalty and not realty. The same question was presented recently in Texas where an opposite result was reached.<sup>47</sup> Thus, under the Kansas view a perpetual royalty, or a similar interest, is void, at least insofar as it purports to be in perpetuity. Under the Texas view such an interest is valid, at least for as long as the one with the power to execute leases also has an interest in production.

It is submitted that the Texas view is preferable, and it is hoped that future cases will follow that view and reject the Kansas doctrine. If it be argued that the Kansas result is inevitable because no right under a lease vests until its execution, it is submitted that it can be argued at least with equal logic that the right vests immediately and it is only its enjoyment which is delayed. Cer-

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<sup>45</sup> *Dallapi v. Campbell*, 45 Cal. App. 2d 541, 114 P. 2d 646 (1941).

<sup>46</sup> 170 Kan. 419, 227 P. 2d 136 (1951).

<sup>47</sup> *Superior Oil Co. v. Stanolind Oil and Gas Co.*, 230 S. W. 2d 346 (Tex. Civ. App. 1950), affirmed without discussion of, but necessarily with approval of, the holding on this point, 240 S. W. 2d 281 (Tex. 1951); *Odstrcil v. McLaughlin*, 230 S. W. 2d 353 (Tex. Civ. App. 1950); see also, Jones, *Problems Presented by the Separation of the Exclusive Leasing Power from Ownership of Land, Minerals or Royalty*, in SOUTHWESTERN LEGAL FOUNDATION SECOND ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION (1951) 271; Summers, *Transfers of Oil and Gas Rents and Royalties*, 10 Tex. L. Rev. 1, 17 *et seq.* (1931); Walker, *Developments in the Law of Oil and Gas in Texas During the War Years—A Resume*, 25 Tex. L. Rev. 1, 18-20 (1946); Note, 15 So. Cal. L. Rev. 119 (1941).

tainly the Texas rule more nearly fits the needs and customs of the oil and gas industry.

Even the Texas rule leaves several problems unanswered. For example, suppose the one with the power sells all of his interest except that he attempts to reserve the power to lease, which, under said view, was originally a valid power. Or suppose said party reserves the power to lease and fractional interests in bonuses and delay rentals but no interest in production. It is submitted that the more the elements of a mineral interest remain attached to the power to lease, the stronger the argument in favor of validity becomes, but that even under the Texas view it cannot at present be safely assumed that a power to lease is valid where the purported owner thereof has no interest in royalties payable thereunder at the time he purports to exercise the power.

(4) *Construction of the instrument which defines or attempts to define the interest granted or reserved.*

The above discussion assumed that there was no question about the interest which the parties intended to create. Frequently, however, the instrument is ambiguous, or actually defines one of the elements of a mineral interest when the parties intended to define an entirely different one. This is particularly true when the question is whether the interest intended is a full mineral interest or is only a royalty interest—that is, a right to share in the royalties reserved to the lessor in a present or in future oil and gas leases, or both. This confusion results from the fact that the words “royalty” and “mineral” are frequently used interchangeably as referring to a full mineral interest. Suppose, for example, that *A* conveys to *B* “the full royalty interest” in a given tract.

One view is that the word “royalty” is ambiguous and that therefore even in a collateral attack upon the instrument parol evidence is admissible to determine the intent of the parties. Another is that “royalty” is not ambiguous; that it clearly refers to and is limited to the interest in production which is reserved to

the lessor in oil and gas leases.<sup>48</sup> As to which rule better reflects the custom in the industry, for years "royalty" was frequently used interchangeably with "mineral" as referring to all of a lessor's rights in and as to oil and gas leases. In more recent years "royalty" usually has been understood to refer only to the lessor's interest in production.

(5) *Rights under existing or future leases.*

When the interest in question is limited to part of the lessor's rights under oil and gas leases, and is silent as to duration, there is presented the problem of whether the parties intend the grant to continue in force for only as long as an existing oil and gas lease remains in effect, or whether they intend the grant to be perpetual. One view is that when the deed is silent as to duration, the grant is with sole reference to the existing lease.<sup>49</sup> It is submitted that a better view is that in this situation the grant should be construed as perpetual.<sup>50</sup> This latter view seems to be the only one possibly applicable when no lease is in effect at the time of the grant.

When the grant is of the full mineral interest, and is silent as to oil and gas leases, then it seems clear that it is perpetual. Here, however, the converse of the problem last discussed is presented. That problem had to do with a specific grant of rights created or to be created by an oil and gas lease. The present problem involves a mineral grant which does not refer to any lease. As to

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<sup>48</sup> Oklahoma and Texas cases illustrate this difference in views. *Melton v. Sneed*, 188 Okla. 388, 109 P. 2d 509 (1940); *Schlittler v. Smith*, 128 Tex. 628, 630, 101 S. W. 2d 543, 544 (1937); *cf. Carroll v. Bowen*, 180 Okla. 215, 68 P. 2d 773 (1937). In the *Schlittler* case the court said:

"The words 'royalty,' 'bonus,' and 'rentals' have a well-understood meaning in the oil and gas business. Likewise, 'minerals' and 'mineral rights' have a well-recognized meaning. Broadly speaking a reservation of minerals and mineral rights without limitation would include royalties, bonuses and rentals. A conveyance of land without reservations would include all minerals and mineral rights. However, it is well settled that a grantor may reserve minerals or mineral rights and he may also reserve royalties, bonuses and rentals, either one, more or all. Here we have a reservation of only 'royalty rights.' It is obvious, it seems to us, that this 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 executed by the grantee, his heirs or assigns."

<sup>49</sup> *Bellport v. Harrison*, 123 Kan. 310, 255 Pac. 52 (1927).

<sup>50</sup> *Schlittler v. Smith*, cited *supra* note 48. And see Notes, 122 A. L. R. 959 (1939) and 4 A. L. R. 2d 492 (1948).

future leases, the answer is easy. The grantee will be entitled to execute such leases and to receive all benefits thereby vested in the lessor. As to a lease in existence at the time of the grant, the answer may depend on whether the rights created by that lease (bonuses, rentals and royalties) are treated as personalty or as realty, or on whether such rights are considered as incident to mineral ownership or as incident to surface ownership. While there is a conflict, it is submitted that the better view is that all unaccrued benefits under an existing lease pass to the mineral grantee.<sup>51</sup>

(6) *The question of whether a given interest is realty or personalty.*

This question is often an important one. It may be a decisive factor in determining whether the Statute of Frauds is applicable, whether title to the interest can be lost by abandonment, whether the interest passes by a conveyance of the land which does not specifically refer to the interest, and whether it is taxable as real estate. With many courts starting with the premise that it is impossible to have title to oil and gas until capture, confusion as to whether the interest, whatever it may be called, is realty or personalty was inevitable. Modern decisions are fairly uniform in holding a full mineral interest to be realty. Confusion continues when the interest consists of simply an element of a mineral interest. Most of the cases involving the question are concerned with royalty interests, because sales of such interests are much more voluminous than sales of other interests. In the same jurisdiction the court may hold a royalty interest to be personalty for one purpose and realty for another. Even in a state which recognizes the right to create a realty interest in royalty, the answer to whether it is realty may depend on the wording of the instrument, *i.e.*, whether it purports to vest an immediate interest, or whether it

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<sup>51</sup> This view was adopted in Texas in *Harris v. Currie*, 142 Tex. 93, 176 S. W. 2d 302 (1943), wherein the court expressly overruled a prior inconsistent case. For a good discussion of earlier cases see Summers, *Transfers of Oil and Gas Rents and Royalties*, 10 Tex. L. Rev. 1, 29-33 (1931).

purports to grant an interest which will not become effective until after severance.

It is submitted that at least as to royalty, the better view is to treat the interest of one entitled thereto as an interest in realty, and that this should be done regardless of the language used in creating the interest.<sup>52</sup>

(7) *Some of the advantages and disadvantages of buying a royalty as distinguished from a full mineral interest.*

The obvious disadvantage is that as the royalty owner has no power to execute oil and gas leases or himself to develop, he is largely at the mercy of the owner of the power to lease. True, the statement is sometimes found that the one with the power owes some sort of a duty to the royalty owner, but it would probably be difficult to establish such duty and its breach except in extreme cases.<sup>53</sup> This disadvantage is even more important as to a term royalty—a royalty interest which will continue for a specific number of years and as long thereafter as production continues.

Another disadvantage is that the royalty owner acquires no interest in any of the other elements of a mineral interest. These include the right to develop, to execute oil and gas leases and to collect as owner all bonuses and delay rentals.

On the credit side, the royalty interest does not contribute to the interest of the oil and gas lessee, frequently referred to as the working interest. Thus, the owner of a 1/16 mineral interest would be entitled to execute a lease and to proportionate bonuses and delay rentals thereunder, but would have to grant a part of his

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<sup>52</sup> See *Hickey v. Dirks*, 156 Kan. 326, 133 P. 2d 107 (1943); *Gulf Production Co. v. Continental Oil Co.*, 139 Tex. 183, 164 S. W. 2d 488 (1942); *Waco-Tex. Materials Co. v. Lee*, 210 S. W. 2d 886 (Tex. Civ. App. 1948); *Dashko v. Friedman*, 59 S. W. 2d 203 (Tex. Civ. App. 1933); Notes, 90 A. L. R. 770 (1934), 101 A. L. R. 884 (1936), 131 A. L. R. 1371 (1941). In the *Gulf Production* case the question was important to a determination of whether the husband could accept something other than money in lieu of delay rentals. If this amounted to a change in a realty interest, the joinder of the wife was necessary because the property was homestead. The court first held that realty was involved, but withdrew that opinion and in the cited opinion in effect treats the delay rental interest as personalty.

<sup>53</sup> *Schlittler v. Smith*, cited *supra* note 48. In *McCall v. Nettles*, 37 So. 2d 635 (Ala. 1948), the duty was compared to that of a trustee.

interest to the lessee. Under the usual lease, he would grant  $1/16$  of  $7/8$ , thereby reserving a right to share in only  $1/16$  of  $1/8$ , or  $1/128$  of gross. On the other hand, the owner of a  $1/16$  royalty interest would not be a necessary party to the lease and would not be entitled to any bonuses or rentals; however, in the event of production under an oil and gas lease, he would be entitled to receive  $1/16$  of gross production free of costs.<sup>54</sup>

(8) *Effect of attempt by one with power to lease to pool the royalty interest with the royalty interest in another tract.*

Many times an oil and gas lessee takes a single lease from owners of adjoining tracts. This lease may have an express provision pooling the interests of lessors, or such pooling may be implied. Similarly, many leases covering a tract as to which one party has power to lease authorize the lessee to pool this tract with another. How far will such an agreement by one with a power to lease be binding on the royalty owner in one of the tracts pooled? There are three possible solutions: (1) the power to lease includes the power to pool the royalty with royalty in an adjoining tract; (2) the power to lease does not include a power to pool; however, as to the tract as to which the power to lease exists, the lease will be held valid, the pooling provision being a nullity; (3) the entire lease, because of the attempt to pool, will be held to be a nullity. The second possible solution is believed preferable.<sup>55</sup>

(9) *Some of the questions to consider in analyzing a proposed royalty or other mineral element transaction.*

(a) Is it the intent of the parties to limit the interest to royalty

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<sup>54</sup> As heretofore indicated, difficult problems can arise as to whether a given interest is properly to be construed as a mineral interest or as a royalty interest. Frequently there is the added problem of whether the fraction refers to gross production or to a fractional share of royalties. Thus,  $1/16$  of royalties, if the lease provided for a  $1/8$  royalty, would clearly grant only a right to  $1/128$  of gross production. See, for example, *Bellport v. Harrison*, 123 Kan. 310, 255 Pac. 52 (1927); *Watkins v. Slaughter*, 144 Tex. 179, 189 S. W. 2d 699 (1945); *Richardson v. Hart*, 143 Tex. 392, 185 S. W. 2d 563 (1945).

<sup>55</sup> This rule was applied in *Parker v. Parker*, 144 S. W. 2d 303 (Tex. Civ. App. 1940) *er. ref.* See also *Peerless Oil Co. v. Tipken*, 190 Okla. 396, 124 P. 2d 418 (1942); Note, 116 A. L. R. 1267 (1938).



payments, with no interest in any of the other elements of a mineral interest?

(b) Will one of the parties be left with an interest possibly void under the Rule against Perpetuities, or the rule against unreasonable restrictions upon alienation?

(c) Does the instrument cover a situation wherein the owner of the elements other than royalty develops, as distinguished from development under a lease providing for royalties?

(d) Is there a minimum royalty provision—that is, that in no event shall a lease be executed providing for less than a  $\frac{1}{8}$  royalty, or whatever other fraction is agreed upon?

(e) Is the royalty to be limited to a single lease? Is it to be for a term of years and as long thereafter as production continues? Is it to be perpetual?

(f) Are the duties of the one with the power to lease adequately defined?

(g) Is the problem of pooling sufficiently covered—both with reference to any existing pool and with reference to the right to pool in the future?<sup>56</sup>

(h) Does the instrument have a “mother hubbard” clause? This is a clause providing that the deed covers not only the specifically described property but also any adjoining property, or, sometimes, any property in an adjoining survey. It is frequently found in lease forms, but infrequently in mineral grants. Its purpose is to pick up strips to which the grantor has acquired limitation title. Of course, the grantor should refuse to include such a clause if he knows he owns other property which would be caught thereby, and which other property the parties do not intend to cover.

(i) Is the power to lease adequately defined? The usual printed forms provide for a right of ingress and egress, and such right

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<sup>56</sup> Knight v. Chicago Corp., 144 Tex. 98, 188 S. W. 2d 564 (1945); Brown v. Smith, 141 Tex. 425, 174 S. W. 2d 43 (1943). There is a conflict of authority as to whether an existing interest in a pool passes as an incident to a mineral grant. See Tanner v. Title Ins. & Tr. Co., 20 Cal. 2d 814, 129 P. 2d 383 (1942); Merrill Engineering Co. v. Capitol National Bank, 192 Miss. 378, 5 So. 2d 666 (1942).

would in any event be inferred in favor of a mineral grantee unless expressly negated by the deed.<sup>57</sup> However, this right of ingress and egress usually falls far short of the surface rights which most lease forms purport to vest in a lessee. This point must be watched in securing a mineral grant from the owner of both the surface and minerals, and also in analyzing the interest validly vested in a lessee by a lease executed by one owning no surface interest.

(j) Are rights under an existing lease adequately defined where the conveyance is of an interest in a part only of the property under lease? Assume that the lease covers Section 4, which includes 640 acres. *A* conveys to *B* the minerals in the northwest one-fourth of said section. The deed recites that the sale is subject to any outstanding valid lease but covers and includes one-fourth of all rentals and royalties payable thereunder. Notice that two interests or estates have been granted. One covers a situation where the mineral interest is unleased; the other the situation while the present lease is in effect. A literal interpretation of the instrument is that the grantee will receive one-fourth of all royalties paid under the lease, whether from production from the tract described in the mineral deed or from production elsewhere.<sup>58</sup> To avoid this result, there should always be at least added the phrase, "in so far as said lease covers the above described land." Problems incident to a deed with such a clause will be next considered.

Assume that in the last mentioned conveyance from *A* to *B* of a mineral interest in the northwest one-fourth of said section, the phrase had been added, "in so far as said lease covers the above described land." Under the majority view this would grant to *B* one-fourth of royalties payable by virtue of production on said northwest one-fourth. It would grant to him no rights whatever as to production from any other part of the leased property, and he would have no right to complain because minerals were being

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<sup>57</sup> *Jilek v. Chicago, Wilmington & Franklin Coal Co.*, 382 Ill. 241, 47 N. E. 2d 96, 146 A. L. R. 871 (1943), and cases there cited; *Melton v. Sneed*, 188 Okla. 388, 109 P. 2d 509 (1940) (overruling a prior case).

<sup>58</sup> *Hoffman v. Magnolia Petroleum Co.*, 273 S. W. 828 (Tex. Comm. App. 1925).

drained from under his tract.<sup>59</sup> Of course, if this is the intention of the parties, the lawyer's duty is met when he inserts this clause. Frequently, however, either this is affirmatively not the intention, or the parties simply have not considered the point one way or another. Sometimes they will desire to "spread" the royalty payments—that is, to provide that grantor and grantee shall participate on the basis of the acreage contributed by each, regardless of where the wells are located. Thus, under this arrangement *B* would be entitled to 160/640 of all royalties, regardless of the well locations. To effectuate this intent, the "in so far as" clause should be followed by a clause reading substantially as follows: "Provided, however, that all royalties accruing under and by virtue of said oil and gas lease, regardless of where the well or wells are located, shall be treated as an entirety and shall be divided between and paid to grantor and grantee herein in the proportion that the acreage owned by each bears to the entire leased acreage."<sup>60</sup>

Assume that in said conveyance from *A* to *B* of the minerals in the northwest one-fourth of said section, this provision had been added: "This grant shall continue for 10 years from date and as long thereafter as oil, gas or other mineral is produced." If the property is not under lease at the time of the grant, *B*, under the majority view, can take steps to assure that a well will be drilled during said primary term; if, however, the land is under lease at the time of the grant, *B* is largely at the mercy of the lessee. This points to the advisability of adding a clause to the effect that production anywhere upon leased premises will continue the mineral interest in effect. In states in which forced pooling is permissible, or even where it might become permissible—and that would include any state—an added provision should be inserted to the effect that production anywhere in such a pooled area would con-

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<sup>59</sup> *Carlock v. Krug*, 151 Kan. 407, 99 P. 2d 858 (1940) (citing cases holding both ways); *Japhet v. W. C. McRae*, 276 S. W. 669 (Tex. Comm. App. 1925).

<sup>60</sup> Similar explanatory clauses should be used where interests other than royalties are involved, as, for example, oil payments.

tinue the interest in effect.<sup>61</sup> If the lease itself authorizes the lessee to pool, a similar provision should be inserted. In fact, to cover all contingencies in this regard, a catch-all clause could be used, as, for example, "in the event the tract hereby conveyed is now or hereafter becomes part of a validly pooled tract, then production anywhere upon said pooled tract will continue this interest in effect." Notice that this question is in addition to and different from that of the rights of a grantee in production from a tract not described in the deed.

Another point which the parties to a term grant should consider is whether production to continue the grant in effect would have to be in paying quantities. Production in paying quantities means sufficient production that after payment of amounts reserved to the lessor, and expenses incident to production, the lessee, or his assigns, could still show a profit. In several states the habendum clause of an oil and gas lease which simply states "as long thereafter as oil, gas or other mineral is produced" has been construed to mean "produced in paying quantities."<sup>62</sup> To avoid this question as to a term mineral or royalty deed, the intention of the parties should be ascertained and then clearly defined. Thus, if the parties intend to require paying quantities, the phrase "in paying quantities" should be added. If they intend any production to be sufficient, there should be added, "whether or not in paying quantities." If it is a matter of construing a deed which has omitted express definition, then the problem is whether the decisions concerning oil and gas leases are applicable to term mineral grants, and if so, whether they should be followed in a state in which the question is open. While the lease cases are at least persuasive, it seems that they are not necessarily controlling. They are based on the premise that the primary objective of an oil and

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<sup>61</sup> Louisiana reaches this result even in the absence of an express provision to such effect.

<sup>62</sup>Walden v. Potts, 194 Okla. 453, 152 P. 2d 923 (1944); Gypsy Oil Co. v. Marsh, 121 Okla. 135, 248 Pac. 329 (1926); Garcia v. King, 139 Tex. 578, 164 S. W. 2d 509 (1942), and cases there cited.

gas lease is to secure production in paying quantities; that the parties did not intend to authorize the lessee to produce at a loss, but still hold the lease for speculative purposes. This is not usually a primary objective in a mineral deed. Here a term is usually inserted to avoid forever encumbering the full fee simple title to an undeveloped tract of land.

A final word of caution as to a term mineral or royalty interest should be stated. Sometimes the parties state the term but omit the "and as long thereafter" clause. Of course, where this is done, the interest will end with the term even though there be production.<sup>63</sup>

(k) Will the proposed mineral deed have the effect of reviving by ratification an oil and gas lease which has terminated? Frequently the parties to a mineral grant do not know definitely whether the last lease executed is still in effect. In many instances if they make the grant subject to such lease, this reference will be held to have revived it.<sup>64</sup> To avoid this possibility, it is usually advisable to word the lease reference substantially as follows: "This grant is subject to any valid, recorded<sup>65</sup> oil, gas and mineral lease, but covers and includes. . . ."

(l) Is the deed actually a deed as distinguished from a quitclaim? This problem is, of course, not peculiar to an oil and gas conveyance. Briefly, it might be important in determining whether one is a bona fide purchaser; whether after-acquired title in the grantor would inure to the benefit of the grantee; whether there has been a breach of warranty; and whether a fractional interest

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<sup>63</sup> *Fleming v. Ashcroft*, 142 Tex. 41, 175 S. W. 2d 401 (1943). This case offers a possible alternative to the grantee—that possibly a correct construction would be that as to any lease in existence at the time of the grant, the grantee's interest will be extended by production under that lease.

<sup>64</sup> See, for example, *Reserve Petroleum Co. v. Hodge*, 147 Tex. 115, 213 S. W. 2d 456 (1948). The opinion in this case includes language indicating that ratification follows as a matter of law, even though not intended. When it is considered that the lessee is not even a party to the mineral deed, it is submitted that actual intent should be a factor.

<sup>65</sup> The reference to "recorded" is to avoid ratification by the grantee of a valid but unrecorded lease, which otherwise the grantee would cut off as a bona fide purchaser. *Gulf Refining Co. v. Harrison*, 201 Miss. 294, 30 So. 2d 44, 807 (1947).

reserved elsewhere in the deed is referable to the entire title or simply to the title of the grantor at the time of the deed.<sup>66</sup>

(m) Is a warranty included, and if so, is it special or general?<sup>67</sup>

(10) *Some of the points to consider where less than a full interest is assigned or reserved.*

(a) *Right of owner of a fractional mineral interest to develop or to authorize development.* The majority view is that the owner of a partial interest has a right to develop or to empower a lessee to do so. As long as this is done in good faith, the partial owner or his lessee need only account to the other owner for his interest less reasonable drilling and operating costs.<sup>68</sup> Thus, *A*, owning a one-half mineral interest, leases to Rex Oil Company. *B*, owning the other one-half, does not lease. *A* would receive a free 1/16 of gross production (assuming a usual 1/8 royalty provision in the lease). Rex would be entitled to the rest of production until reimbursed for reasonable expenditures. Thereafter, Rex would have to account to *B* for 1/2 of total production, less reasonable expenditures, to *A* for a free 1/16 of gross, and would be entitled to appropriate the balance, if any.

Under the minority view consent of all owners is essential before there can be development.<sup>69</sup>

(b) *Designating the fraction.* The parties frequently think of the interest of the grantor as 1/8, because of the custom of reserving a 1/8 royalty. With this in mind, the parties in attempting to convey 1/2 of the grantor's interest have sometimes designated this interest as "one-half of the grantor's one-eighth," or, worse, "one-half of one-eighth of the minerals."<sup>70</sup> The advisable course is to

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<sup>66</sup> The last problem is dealt with subsequently.

<sup>67</sup> The problem is merely mentioned because it is a general one incident to any conveyance. It should be kept in mind that usually liability on a warranty is limited to the purchase price received, and that many times this amount will be far less than the later value of a mineral interest.

<sup>68</sup> *Prairie Oil & Gas Co. v. Allen*, 2 F. 2d 566, 40 A. L. R. 1389 (8th Cir. 1924), and cases there cited; see Note, 5 A. L. R. 2d 1368 (1949).

<sup>69</sup> Louisiana, West Virginia and Illinois have applied the minority view. For a good discussion with citations, see I WALKER, *CASES ON OIL AND GAS* (1949) 386, 387.

<sup>70</sup> See, for example, *Richardson v. Hart*, 143 Tex. 392, 185 S. W. 2d 563 (1945).

use the same fraction throughout the instrument. Thus, in the present example, in the absence of a lease, the deed should convey a  $\frac{1}{2}$  mineral interest. The grantee, if and when he executed a lease, would then be required to contribute his proportionate share to the lessee and would be entitled to  $\frac{1}{2}$  of royalties and other payments under the lease. If a lease is outstanding, the original grant should be of  $\frac{1}{2}$ . Then in referring to rights under the existing lease, the same fraction should be used. Thus, if there is a valid outstanding lease in favor of Rex Oil Company, the deed should recite, "said land being under an oil and gas lease to Rex Oil Company, this deed is subject to that lease, but covers and includes  $\frac{1}{2}$  of all rentals, royalties or other interests or amounts payable thereunder, in so far as said lease covers the above described land."<sup>71</sup>

(c) *The "double fraction" danger.* *A*, owning an undivided one-half mineral interest executes a quitclaim deed in favor of *B*. The granting clause reads "all of my right, title and interest." Later in the instrument appears the clause, "there is reserved from this grant an undivided  $\frac{1}{4}$  mineral interest to *A*." This raises the question whether the parties intend for *A* to reserve  $\frac{1}{4}$  of the interest granted, that is,  $\frac{1}{4}$  of  $\frac{1}{2}$ , or  $\frac{1}{4}$  of the whole.<sup>72</sup>

(d) *When it is advisable to convey undivided acres rather than a specific fraction.* Many times the agreement is with reference to the number of acres to be conveyed. For example, assume that royalty is selling in a given area at \$100 per acre. *B* desires to purchase a 10-acre interest in a 100-acre tract. There are two ways in which to describe this interest. It may be referred to as an undivided 10-royalty-acre interest;<sup>73</sup> or it may be converted into a fraction, by taking as a numerator the number of acres to be

<sup>71</sup> Of course, if it is intended that the grantee share in production from other land under the lease, an added clause would be necessary.

<sup>72</sup> *Hooks v. Neill*, 21 S. W. 2d 532 (Tex. Civ. App. 1929) *er. ref.* See also *Pollock v. McAlester Fuel Co.*, 215 Ark. 842, 223 S. W. 2d 813 (1949); *King v. First National Bank of Wichita Falls*, 144 Tex. 583, 192 S. W. 2d 260 (1946).

<sup>73</sup> Of course, if the conveyance is of a mineral interest, the reference should be to mineral acres.

conveyed and as a denominator the number of acres in the tract. Thus, under the second method the fraction would be 10/100. Sometimes the parties will be mistaken as to the total number of acres in the tract. In this event, the fraction method would not effectuate the intention of the parties. If the tract actually contained 200 acres and the deed conveyed a 1/10, the grantee would receive a twenty-acre interest. If the tract contained only 20 acres, he would receive a two-acre interest. Notice that if undivided acres had been used, in either instance the grantee would receive ten acres, which, in the example, is what he paid for.

From the lessee's standpoint, the fraction method is always preferable because payments then can be computed with certainty. If one owns a 1/10 mineral interest, we know that he is entitled to 1/10 of bonuses, rentals and royalties. If he owns an undivided 10-acre interest, we do not know to what he is entitled until we ascertain total acreage.

(e) *Effect of a prior sale.* Suppose that *A* first sells a 1/2 interest to *B*. *A* later executes a deed in favor of *C*, but with a reservation of a 1/2 interest to *A*. If the parties intend that *A* shall actually own a one-half interest after the sale to *C*, this intention would be defeated. This follows from either of two rules: (1) there is a presumption that *A* by the reservation simply intended to refer to the prior grant to *B*; (2) even if *A* intended to reserve to himself the one-half interest, it would nevertheless jump to *C* under a doctrine similar to that of after-acquired title.<sup>74</sup> Therefore, in analyzing a deed with a reservation it is important to ascertain and keep in mind the interest owned by the grantor at the time of the reservation. In preparing such a deed, it is important to refer to both the prior grant and the interest to be reserved to the grantor. Another method is to provide expressly that the reserved interest is to be owned by the grantor and that in no event, by warranty, estoppel or otherwise, shall grantee acquire any interest in such reserved interest.

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<sup>74</sup> Duhig v. Peavey-Moore Lumber Co., 135 Tex. 503, 144 S. W. 2d 878 (1940).



(f) *A reference back.* It is pointed out that all of the matters discussed with reference to a conveyance of a full interest are equally applicable to a conveyance of a fractional interest.

(c) *Analysis of a typical oil and gas lease and the interest thereby created.*<sup>75</sup>

Under the qualified ownership theory, it is impossible to vest a fee title by execution of an oil and gas lease. This immediately poses the problem whether in such states the interest should be treated as realty or as personalty. This in turn will determine, among other matters, whether the Statute of Frauds is applicable, whether the registration statutes apply, whether the interest is taxable as realty, and whether the interest can be lost by abandonment. The cases are in much confusion as to whether the interest is realty or personalty. It is clear that because of the large amounts frequently involved in transactions in this field, justice is best served by treating the interest as realty. This factor, when added to the consideration that actually an oil and gas lease does vest a present interest in land (even assuming the premise that there cannot be actual title to oil and gas until discovery), has resulted in a definite trend in favor of treating the interest as one in realty.<sup>76</sup>

The remainder of this article will be devoted to an analysis of the various provisions usually included in an oil and gas lease.

(1) *The date.* The date the parties intend the instrument to become effective should be inserted. Some of the older forms have a blank for the date at the top of the instrument and another at the bottom. To avoid confusion, only the top date should be used.

When a ratification instrument, or a lease amendment, or a

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<sup>75</sup> This subject is treated at length in SOUTHWESTERN LEGAL FOUNDATION SECOND ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION (1951).

<sup>76</sup> For a good discussion see Summers, *Validity of Oil and Gas Leases*, 34 Yale L. J. 383 (1925). The cases in each state are collected in 1 SUMMERS, *THE LAW OF OIL AND GAS* (Perm. ed. 1938) § 155 *et. seq.* See also, KULP, *CASES ON OIL AND GAS* (3d ed. 1947) 91 *et seq.* Even in a state recognizing power to vest title by an oil and gas lease, there is a possible question whether the language in a given lease does so. It is submitted that the better view is that taken by the Texas Supreme Court, that substance and not language should control. See *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S. W. 290, 29 A. L. R. 566 (1923).

correction lease is executed, it is important to provide expressly which date shall govern. In one case where the dates were different, the lessee paid delay rentals on the basis of the date in the correction instrument. These payments were held insufficient on the ground the date in the original lease controlled.<sup>77</sup>

(2) *Lessors*. Generally, the rules applicable to sales of other interests control in determining the parties who must execute in order to create a valid oil and gas lease. There are several problems more or less peculiar to this field, however, which merit brief discussion.

(a) *Securing a lease from less than all of the owners*. This problem has been discussed from the lessor's standpoint. From the lessee's standpoint, the following factors should be considered:

Is the land in a state which authorizes development under such a lease?<sup>78</sup>

Assuming a right to develop, can this be done profitably under the rule that the lessee must account to the non-joining owner for the latter's proportionate interest in gross, less reasonable expenses?

How strong is the possibility of partition?<sup>79</sup> In the event of partition, how probable is it that partition will be by sale, or, if in kind, that the desirable part of the tract will be allocated to your lessee-client? An important matter in connection with the last question is whether by prior dealings by the tenant in common executing the lease, or by the other owners, or by all of them, prior equities have been created. Conceivably, such equities might result in the lease in question actually passing no interest at all.<sup>80</sup>

(b) *Life tenant and remainderman*. The general rule is that

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<sup>77</sup> *Humble Oil & Refining Co. v. Mullican*, 144 Tex. 609, 192 S. W. 2d 770 (1946).

<sup>78</sup> See text at notes 68 and 69 *supra*.

<sup>79</sup> In some states partition is a matter of right. In others it is discretionary. In still others there cannot be partition of leasehold estates. Even after it is decided that there will be partition, the problem remains of whether it shall be by sale or in kind. The authorities are collected and discussed in 2 WALKER, CASES ON OIL AND GAS (1949) c. VII.

<sup>80</sup> See, for example, *Simpson-Fell Oil Co. v. Stanolind Oil Co.*, 136 Tex. 153, 125 S. W. 2d 263, 146 S. W. 2d 723 (1939).

both a life tenant and remainderman are necessary parties to a lease.<sup>81</sup> An exception exists, known as the open mine doctrine, where at the time the life estate begins there is production. Even here, however, it would usually be inadvisable to deal only with the life tenant because upon his death the lease would terminate.

In the event of production under a valid lease, the problem is presented of how royalty payments should be distributed, absent, of course, any express statement in this respect.

If the open mine doctrine is applicable, the life tenant is entitled to all royalty payments accruing during his lifetime.<sup>82</sup> If it is not applicable, the money should be invested and interest paid to the life tenant, the corpus going to the remainderman upon such tenant's death.<sup>83</sup> In the absence of an agreement between the life tenant and remainderman, the lessee is faced with the alternative of withholding payments or filing an interpleader suit.

(c) *Possible unborn owners.* When a possible owner is not in being, how is his interest to be covered? Kansas holds that a court of equity has inherent power to appoint a trustee to represent un-

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<sup>81</sup> See Note, 43 A. L. R. 811 (1926). Apparently *contra* the usual rule is *Davis v. Atlantic Oil Refining Co.*, 87 F. 2d 75 (5th Cir. 1936).

<sup>82</sup> The open mine doctrine is usually applied where there is actual production at the time the life estate is created. It has also been held applicable where production has been authorized prior to inception of the life estate. *Bramer v. Bramer*, 84 W. Va. 168, 99 S. E. 329 (1919); see note 81. An interesting question is presented where oil and gas leases were executed prior to the creation of the life estate, but none were in effect at the time of such creation. The open mine doctrine was applied in a Texas case to give the surviving spouse all royalties from a probate homestead. *White v. Blackman*, 168 S. W. 2d 531 (Tex. Civ. App. 1942) *er. ref. w.o.m.* Cf. *Brandenburg v. Petroleum Exploration Co.*, 218 Ky. 557, 291 S. W. 757 (1927); *Lawley v. Richardson*, 101 Okla. 40, 223 Pac. 156, 43 A. L. R. 803 (1924).

<sup>83</sup> *Burden v. Gypsy Oil Co.* 141 Kan. 147, 40 P. 2d 463 (1935); *Aldridge v. Houston Oil Co.*, 116 Okla. 281, 244 Pac. 782 (1926), and cases there cited; *Davis v. Bond*, 138 Tex. 206, 158 S. W. 2d 297 (1942). In the absence of an agreement, court action as to actually investing the money is necessary. *Davis v. Bond*, *supra*. A similar question is presented as to bonuses, delay rentals, and other payments under a lease. It seems that bonuses should be treated as corpus and thus subject to the same rules as royalties. It could be reasonably argued that the same is true of delay rentals. However, there is authority to the contrary. *Commissioner of Internal Revenue v. Wilson*, 76 F. 2d 776 (5th Cir. 1935); *Aldridge v. Houston Oil Co.*, *supra*; *Andrews v. Brown*, 283 S. W. 288 (Tex. Civ. App. 1926), *rev'd on other grounds*, 10 S. W. 2d 707 (Tex. Comm App. 1928). The *Aldridge* case lends support to a contention that bonus or any other payment prior to production should be treated as income.

born beneficiaries.<sup>84</sup> Oklahoma, Arkansas, Kentucky, and Texas have statutes concerning the problem.<sup>85</sup>

(d) *Persons acting in a representative capacity.* Most problems here are not peculiar to oil and gas. Mistakes in the past suggest the importance of bearing in mind the elemental rule that each state has exclusive jurisdiction of land within its borders. Thus, if a guardian's lease on Oklahoma land is desired, the guardianship laws of that state must be complied with.

Another point to remember is that powers delegated to one without title are strictly construed. Even in a state regarding an oil and gas lease as a sale, it does not follow that power to sell includes power to execute an oil and gas lease.<sup>86</sup>

(e) *Effect of joinder as lessors in a single lease of owners of separate tracts.* As heretofore discussed, such joinder, under a usual lease form, has been held to result in an implied pooling of such tracts.<sup>87</sup>

(3) *Lessee.* There are no unusual problems here. It is important, although not necessary, to include the lessee's address. This facilitates giving and receiving notices required in other parts of the lease.

(4) *The bonus and granting clause.* The bonus is the consideration, usually cash, paid to the lessor. In determining whether a bonus or some other consideration is necessary, the question whether the lease constitutes a conveyance becomes very important. Thus, if it is a conveyance, no consideration would be necessary.

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<sup>84</sup> Robinson v. Barrett, 142 Kan. 68, 45 P. 2d 587 (1935).

<sup>85</sup> ARK. STAT. 1947 ANN. § 53-302 *et seq.*; KY. REV. STAT. (1946) § 381.420; 60 OKLA. STAT. ANN. (Perm. ed. 1949) § 71; TEX. REV. CIV. STAT. (Vernon, 1950 Supp.) art. 2320c. See 1 WALKER, CASES ON OIL AND GAS (1949) 418.

<sup>86</sup> *Avis v. First National Bank of Wichita Falls*, 141 Tex. 489, 174 S. W. 2d 255 (1943); *Bean v. Bean*, 79 S. W. 2d 652 (Tex. Civ. App. 1935) *er. ref.* The *Avis* case sometimes has been erroneously relied upon as supporting the view that a power of sale includes power to lease. In fact, the court expressly left that question open. See also TEX. REV. CIV. STAT. (Vernon, 1948) art. 7425b and the other authorities collected in 1 WALKER, CASES ON OIL AND GAS (1949) 452-455.

<sup>87</sup> See text at note 55 *supra*.

Otherwise a consideration would be necessary.<sup>88</sup>

(5) *Property description.* The only part of this section peculiar to the oil and gas field is the "mother hubbard" clause. This clause, heretofore mentioned, sometimes provides that the lease covers any land owned or claimed by the lessor and which adjoins the land specifically described. Sometimes the provision is made broader to include land in adjoining surveys, even though not contiguous to the specifically described tract. Obviously, this clause should be deleted or modified in any instance in which it would cover land owned by the lessor and which the parties do not intend to include in the lease.<sup>89</sup>

(6) *The habendum clause.* This clause designates the time during which the lease can be held without production, usually five years or ten years, and then provides "and as long thereafter as oil, gas or other mineral is produced." Literally construed, production would be sufficient whether or not in paying quantities. However, several recent cases have held that by implication the clause requires production in paying quantities.<sup>90</sup> From the lessee's standpoint it is advisable to include the phrase "whether or not in paying quantities." The premise in the cases implying "paying quantities" is that the parties do not intend that the lessee, though operating at a loss, can hold the lease for speculative purposes. Admitting this premise, the question of whether production is in paying quantities is frequently a difficult one. It is to avoid this dangerous fact question that a specific provision is advisable.

Literally construed, the habendum clause requires actual production to hold the lease. In other words, it is not sufficient that a well is completed which is capable of producing. Under one

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<sup>88</sup> 2 SUMMERS, THE LAW OF OIL AND GAS (Perm. ed. 1938) § 233 *et seq.* See also, KULP. CASES ON OIL AND GAS (3rd ed. 1948) 95.

<sup>89</sup> There is an "unwritten law" in the oil and gas industry that tracts inadvertently caught will be released. However, as is true of other such "laws," it is not always complied with. For cases involving such clauses, see *United Gas Public Service Co. v. Mitchell*, 188 La. 651, 177 So. 697 (1937); *Cummings v. Midstates Oil Corp.*, 193 Miss. 675, 9 So. 2d 648 (1942); *Sun Oil Co. v. Burns*, 125 Tex. 549, 84 S. W. 2d 442 (1935).

<sup>90</sup> Cases cited *supra* note 62.

view the clause is literally construed and actual production is necessary.<sup>91</sup>

Another view is that if the well is capable of production in paying quantities, the habendum holds the lease for as long as the lessee diligently seeks a market.<sup>92</sup> This matter is now usually covered by specific provisions in the lease. All cases agree that a temporary cessation of production does not terminate the lease.<sup>93</sup>

All cases further agree that when production is not sufficient, termination, insofar as the habendum clause is concerned, is automatic. It is simply a matter of a conditional estate ending by its own terms, no question of forfeiture being involved.

Of course, here as elsewhere, there is always the possibility that the lessor may so act as to estop himself from asserting that the lease has terminated, or as to ratify and thus reinstate said lease.

(7) *The royalty paragraph.* No attempt will be made herein to analyze the customary royalty provisions. One rather recent innovation, however, should be mentioned—the shut-in royalty provision. This provision is to give the lessee a sure way to keep the lease in effect when he has a well capable of producing, but no market therefor. It provides that in such an instance, stipulated payments can be made and that as long as they are made, the situation shall be the same as if there were actual production. From the lessee's standpoint it would be advisable to make this clause applicable to both oil and gas. However, because it is usually feasible to find a market for oil within a reasonably short time, the usual shut-in clause does not apply to a well capable of producing oil. Thus, oil can be shipped to market by truck or tank car. Gas, on the other hand, can be transported practicably only by pipe line.

The earlier shut-in clauses were restricted to wells capable of

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<sup>91</sup> *Stanolind Oil and Gas Co. v. Barnhill*, 107 S. W. 2d 746 (Tex. Civ. App. 1934) *et. ref.*

<sup>92</sup> *Christianson v. Champlin Refining Co.*, 169 F. 2d 207 (10th Cir. 1948), involving Kansas law and in which prior Kansas decisions are discussed and distinguished; *Eastern Oil Co. v. Coulehan*, 65 W. Va. 531, 64 S. E. 836 (1909).

<sup>93</sup> See, for example, *Christianson v. Champlin Refining Co.*, cited in note 92; *Watson v. Roehmill*, 137 Tex. 565, 155 S. W. 2d 783, 137 A. L. R. 1032 (1941).

producing gas only. The more recent forms have expanded the clause to read substantially as follows: "if gas only, or gas condensate and/or other liquefiable hydrocarbons. . . ."

There is one important distinction between holding the lease in force by actual production and seeking to hold it by shut-in payments. If there is sufficient actual production, then failure to pay royalties, or erroneous payment thereof, would not terminate the lease, because it is the production, not the payment therefor, which keeps the lease alive. On the other hand, if it is a shut-in-payment, the payment and it alone can keep the lease in effect. Hence, unless such payment is timely and correctly paid, the lease will automatically terminate as to the parties not correctly paid.<sup>94</sup>

(8) *The pooling provision.* Of course, from the lessee's standpoint, a provision authorizing the lessee to pool the leased tract with other tracts is very desirable. This provision sometimes limits the right to relatively small units as to oil and to larger units as to gas. Sometimes, however, there is no acreage limitation.<sup>95</sup> From the lessor's standpoint, such a clause may be undesirable. After pooling and as a result thereof numerous parties originally owning interests in other tracts may have interests or claims in the leased premises.<sup>96</sup> Further, the lessor may be forced to share proceeds from production from his tract with owners of other tracts. Conversely, he may share in production from an adjoining tract, which otherwise would be lost to him under the law of capture, even though the oil or gas was in fact drained from beneath his tract.

It is again pointed out that in determining the validity of a pooling provision, it is necessary to analyze carefully the extent of the power of the one executing the lease.

(9) *The delay rental clause.* This provision authorizes the lessee to hold the lease during the primary term by periodic money

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<sup>94</sup> Freeman v. Magnolia Petroleum Co., 141 Tex. 274, 171 S. W. 2d 339 (1943).

<sup>95</sup> For examples of pooling provision, see 3 STAYTON ANN. TEX. FORMS (1948) §§ 4145-4147.

<sup>96</sup> See, for example, Veal v. Thomason, 138 Tex. 341, 159 S. W. 2d 472 (1942).

payments to either the lessor or to his credit in a designated depository bank. The usual modern lease forms condition the duration of the lease upon proper payments of delay rentals.<sup>97</sup> Hence, if a rental is not timely or properly paid, the lease automatically terminates.

One of the mistakes most frequently made in such a payment is when the amount payable includes a fraction of a cent. Suppose the total rental stipulated is \$25. Suppose that *A* owns a  $\frac{2}{3}$  mineral interest and *B* a  $\frac{1}{3}$ . It would be a mistake to pay *A* \$16.67 and *B* \$8.33. This would be an underpayment as to *B*. The only practicable way to handle the matter would be to make an overpayment, paying to *A* \$16.67 and to *B* \$8.34. If several parties are named as lessors in the same lease, and execute that lease, problems incident to determining the amount payable to each can be avoided by depositing the rental to the joint credit of the lessors in the depository bank designated in the lease.<sup>98</sup>

As to when equity should relieve against termination through a good faith erroneous payment, or a good faith failure to pay, the theory of ownership may be decisive. It must be remembered that a forfeiture is not involved; that the lease has by its own terms terminated. Nevertheless, in jurisdictions holding that the lease does not vest a title, an analogy to forfeitures is drawn, and equity will relieve against good faith, excusable mistakes.<sup>99</sup> In Texas, which holds that a lease on a usual form vests a determinable fee title, it has been held that equity will not relieve unless

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<sup>97</sup> The history of this provision is traced in Summers, *Validity of Oil and Gas Leases*, 34 Yale L. J. 383 (1925).

<sup>98</sup> *Gulf Production Co. v. Perry*, 51 S. W. 2d 1107 (Tex. Civ. App. 1932). When ownership changes, and the lessee is properly notified thereof, a joint deposit would be incorrect. The lessors by joining in a single lease in effect agree that rental payments may be by joint deposit. They do not agree to joint deposits to them and to a person not a lessor.

<sup>99</sup> *Cloyd v. Mid-West Refining Co.*, 62 F. 2d 483 (10th Cir. 1933); *Browning v. Weaver*, 158 Kan. 255, 146 P. 2d 390 (1944). The authorities are collected and discussed in 2 WALKER, CASES ON OIL AND GAS (1949) 531, 532.



the lessor is in some way at fault.<sup>100</sup> It is submitted that this difference in theory is not a proper basis for applying different criteria in determining whether equity should relieve. In either instance the usual rules incident to equitable relief should control.

If the lessor accepts a late delay rental, this may estop him from asserting termination.<sup>101</sup> However, it would be erroneous to assume that any late acceptance creates an estoppel. For example, the owner may be able to establish satisfactorily that he accepted by reason of a good faith mistake. Such acceptance might in some instances constitute a ratification.

(10) *The dry hole clause.* Prior to the use of this clause, there was confusion as to the status of an oil and gas lease where a dry hole was drilled during the primary term. Did completion of the dry hole entitle the lessee to hold the lease for the primary term without payment of rentals? Was it necessary for the lessee to resume payments, and if so, when? Did the dry hole accelerate the term and end the lease?<sup>102</sup> To cover this situation, this clause attempts to define specifically the rights of the parties when a dry hole is drilled. It usually provides that the lease can be held without delay rental payments as long as not more than a designated period elapses between completion of a dry hole and commencement of another well, and that within a designated period after any such completion, the delay rental clause shall again become applicable.

Experience has demonstrated that limiting this clause to dry holes does not adequately protect the lessee. A similar clause is necessary when a well capable of producing is completed, but shut

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<sup>100</sup> *Humble Oil & Refining Co. v. Harrison*, 146 Tex. 216, 205 S. W. 2d 355 (1947), and cases there cited. In this case the lessee made an erroneous payment to a grantee under an ambiguous mineral deed. The payment was enough in advance that the mineral grantee learned of the mistake in ample time to advise the lessee and give it an opportunity to correct the mistake before the deadline. The grantee was held estopped to assert termination.

<sup>101</sup> *Mitchell v. Simms*, 63 S. W. 2d 371 (Tex. Comm. App. 1933).

<sup>102</sup> See, for example, *Texas Co. v. Davis*, 113 Tex. 321, 254 S. W. 304, 255 S. W. 601 (1923); *Whelan v. Shell Oil Co.*, 212 S. W. 2d 991 (Tex. Civ. App. 1948) *er. ref.*; *Tennant v. Matthews*, 19 S. W. 2d 1115 (Tex. Civ. App. 1929) *er. ref.*; Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 8 Tex. L. Rev. 482, 515 (1930); 2 SUMMERS, *THE LAW OF OIL AND GAS* (Perm. ed. 1938) 266.

in for lack of a market (in some instances, however, the shut-in producing in paying quantities ceases so to produce, or ceases producing but not in paying quantities, or when a well originally producing in paying quantities ceases to produce, or ceases production entirely. Some recent forms cover all or part of these contingencies.

Another part of this clause covers the situation where at the end of the primary term, operations have been commenced but there is not actual production. Notice that the habendum clause literally construed requires actual production before the primary term ends. While there is a conflict of authority, some cases have so construed it; others have held that when it is considered with the delay rental clause, commencing the well within the term is sufficient if this well is later completed as a sufficient producer.<sup>103</sup> It is to avoid this question that an express provision concerning this matter is now usually inserted. This provision usually covers also a situation where the well drilling at the expiration of the primary term is completed as a dry hole or as an insufficient producer.

(11) *Assignment and change of ownership provision.*

(a) *The right to assign.* Either party is given an express right to assign his interest in whole or in part. Such assignments by the lessor have been heretofore discussed. An assignee of the lease as to a part of the land covered thereby is usually given the right to keep the lease in effect as to that tract by paying delay rentals in the proportion which said tract bears to the entire acreage. Under practically all lease forms, actual production upon any part of the leased premises, if sufficient to continue the lease in effect as to that part, will continue the lease as to all parts. This follows from the wording of the habendum clause. For example, assume that an oil and gas lease is executed covering lots 2 and 3, and that thereafter the lease as to lot 2 is assigned to Rex. The lease owner as to lot 3 secures production in paying quantities. This production, under most forms, continues the lease in effect as to

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<sup>103</sup> The cases are collected in 2 WALKER, CASES ON OIL AND GAS (1949) 488.

both lots 2 and 3. This factor is important not only with reference to a contemplated lease, but also in determining whether a prior lease, not released of record, has terminated.

It is important to distinguish between the owner of a lease as to a part of the property covered thereby and the owner of an undivided interest in the entire leasehold. Most leases would not give the latter owner a right to continue the lease by a payment based upon his fractional interest. In fact, there is a possible question, as yet unanswered by the cases, under the usual wording, whether he can continue the lease by a full payment, when such payment is not authorized by the other owners. It is the writer's opinion that the fractional owner should have this right.<sup>104</sup>

(b) *The change in ownership clause.* By this clause it is agreed that no change in ownership of the lessor's interest, or any part thereof, shall be binding upon the lessee until the lessee receives actual notice of the change and certain other specified information. This clause is valid and the lessee is entitled to a compliance therewith before there is any duty upon his part to change his records.<sup>105</sup> It is surprising how many times persons have purchased valuable mineral interests, and have then neglected to give proper notice, or, for that matter, any notice to the lessee. Perhaps the most usual reason for this mistake is the rule that when an instrument is properly recorded, it serves as notice to the world. It is important to remember that by most lease forms this rule is superseded by the express contractual provision under discussion.

(12) *The surrender clause.* This provision gives the lessee the option to terminate the lease at any time, as to all or any part of the leased premises. Some early cases held that the effect of this was to give a similar option to the lessor, and thus give either party an option to cancel, at least at any time prior to drilling operations. These cases overlooked the rule that a unilateral option

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<sup>104</sup> This, in turn, raises problems with reference to the rights and liabilities of the owner making the full payment and those not making any payment.

<sup>105</sup> *Gulf Refining Co. v. Shatford*, 159 F. 2d 231 (5th Cir. 1947); *Cassity v. Smith*, 193 S. W. 2d 991 (Tex. Civ. App. 1946) *er. ref.*

supported by consideration is valid. The more recent cases uniformly apply this latter rule.<sup>106</sup>

The clause is designed to give the lessee the right to terminate the lease completely, and thus rid himself of all future liability thereunder, or, if he desires to keep the lease as to part of the property, to reach the same result as to the unwanted part. The obligations will be discussed presently. The clause is also used to reduce the amount of rental payments. There is no obligation to pay rentals under the usual lease. Payment is simply a condition upon which the estate is limited. Suppose that a lease covers 1,000 acres. The lessee is interested in continuing the lease as to only 100 acres. He should release as to the balance, thus reducing the amount of rentals necessary to hold the lease and limiting his implied and express covenants to the acreage retained.

One rather hidden point is where some other part of the lease imposes an express obligation upon the lessee, to be met in the future, as, for example, an obligation to drill a well within a given period. If the lease is literally construed, this obligation could be avoided by releasing under the surrender clause prior to default.<sup>107</sup>

(13) *The force majeure, or act of God, clause.* This clause simply enumerates conditions beyond the control of lessee which, unless contracted against, might result in termination or breach of covenant. It provides in effect that while such a condition exists, compliance with the provisions affected is excused.

(14) *The partial ownership clause.* By this provision, if the lessor owns less than the entire interest, rental and royalty payments are to be reduced proportionately. Frequently, at the time leases are procured, the exact interests of the various owners are unknown, this information being subsequently ascertained by title examination. For this and other reasons, the lessee usually attempts to have the lease executed without reference to the extent of ownership. Of course, the lessor's objection is that this would

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<sup>106</sup> For a splendid discussion of this problem, its background and history, see Summers, *Validity of Oil and Gas Leases*, 34 Yale L. J. 383 (1925).

<sup>107</sup> *Guardian Trust Co. v. Brothers*, 59 S. W. 2d 343 (Tex. Civ. App. 1933) *cr. ref.*

constitute breach of warranty. There are at least three possible answers to this objection: (1) lessor will be paid only on the basis of his actual interest, and thus there would be no basis for assessing damages against him; (2) there is an unwritten rule in the industry that the warranty provision will not be enforced in such an instance; (3) the matter can be covered by limiting the warranty, rather than by placing the fraction in the granting clause. On the other side of the ledger, the lessor wants the record to show that there has been no breach. This objection can be met by limiting the warranty. Further, if the lessor is contracting with reference to a specific interest, it is important that he contract against the possibility of thereafter acquiring additional interests and immediately losing them under the doctrine of after-acquired title.

In addition to the fact that the lessee may not know the exact interests, another objection, from his standpoint, to inserting the fraction in the granting clause, is that it raises the question whether the partial ownership clause refers to a full interest in the fraction stated or to a full interest in the land described.<sup>108</sup>

The best procedure from an impartial standpoint is to make the reference to the fraction a part of the warranty clause, with an express negation of the possibility of the application of the doctrine of after-acquired title. A situation which the usual partial ownership clause may not cover is when the lease provides for payments not strictly delay rentals or royalty—as, for example, an oil payment, or a bonus. If it is desired to have this provision apply to one or more of these payments, there should be an express provision to that effect.

The importance of this partial ownership clause from the lessee's standpoint cannot be overly stressed. Suppose, for example, a lease is accepted from the owner of a 1/32 interest. The lessee in the event of production and absent such clause would then be required to pay the entire stipulated royalty to such owner. Thus,

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<sup>108</sup> See text at note 72, *supra*.

if the lease provided for a one-eighth royalty, this is what the lessee would have agreed to pay. Whereas, if the partial ownership clause had been used, the payment would be  $1/32$  of  $1/8$ , which is usually what the parties actually intended should be paid.

(15) *Summary of the principal conditions which will terminate a lease automatically, unless the lease is being held by compliance with one or more of the other conditions therein.*

(a) *Failure to pay delay rentals.*

(b) *Failure to have production, as that term is used in the habendum clause.*

(c) *Failure to pay shut-in royalties at a time when the lease is in effect.*<sup>109</sup>

(16) *Implied covenants.* The trend is toward implying as one covenant, that the lessee will act as would a reasonable and prudent operator, except insofar as such action is expressly negated by the lease.

The two usual covenants referred to and which have frequently resulted in litigation are the covenants to reasonably develop and the covenant to offset. These covenants are easily defined although frequently difficult to apply. The numerous cases which have dealt with them were chiefly concerned with whether there had been a breach and, if so, what the measure of recovery should be.

The covenant of reasonable development simply requires that lessee drill at least as many wells and produce therefrom as would a reasonable and prudent operator. The covenant to offset is based upon drainage. If under the law of capture, wells are legitimately draining oil from Lot 6, it is but reasonable to require that the lessee counteract such drainage by drilling on Lot 6, provided a profitable well can be drilled.

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<sup>109</sup> Another condition mentioned in earlier cases is abandonment of the lease by lessee. As this condition could rarely if ever occur under modern forms, it deserves no more than passing mention. See *Texas Co. v. Davis*, cited *supra* note 102. Abandonment as a condition should be distinguished from abandonment as a ground for forfeiture, hereinafter discussed. It should also be distinguished from an intentional relinquishment of title. See MERRILL, *COVENANTS IMPLIED IN OIL AND GAS LEASES* (2d ed. 1940) § 8. Logically, this type of abandonment could be possible only in states treating the interest of the lessee as in the nature of personality.

Problems which will likely give rise to added covenants occur when because of governmental regulations, wells cannot be drilled on Lot 6. How far must the lessee go in seeking to meet this situation by securing voluntary pooling agreements, or, in a state authorizing involuntary pooling, in procuring such pooling? It is believed that here again the test is simple, *i.e.*, what would a reasonable and prudent operator do? However, as with the other covenants mentioned, it frequently will be difficult to determine whether there has been a breach.

Granted a breach of an implied or express covenant, what should be lessor's remedy? In qualified ownership cases such breach at first was treated as an abandonment which authorized forfeiture of the lease. In earlier cases the opinions sometimes did not clearly distinguish between an intentional abandonment of title, which, if possible under the theory applicable to a lessee's interest in a given jurisdiction would have resulted in automatic termination,<sup>110</sup> and abandonment which is relied upon as a breach

<sup>110</sup> See note 109.

of covenant. Here there would not be automatic termination. Rather, the lessor would have to secure a decree forfeiting the lease.

In many early cases, particularly in states applying the qualified ownership doctrine, forfeiture was both requested and granted. The present trend, however, is to limit the lessor to damages, or to render an alternative decree, fixing past damages and requiring the lessee either to comply with the covenant within a stipulated time or to submit to forfeiture.<sup>111</sup>

It is important for the lessee to keep in mind that many times the surrender clause, above discussed, can be used to avoid breaching one or more express or implied covenants.

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<sup>111</sup> A detailed analysis of the problems here involved is not within the scope of this article. For further analyses, the reader is referred to *Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 509, 19 S. W. 2d 27 (1929); *Indian Territory Illuminating Oil Co. v. Rosamond*, 190 Okla. 46, 120 P. 2d 349, 138 A. L. R. 246 (1941), and cases there cited; Notes, 19 A. L. R. 437 (1922) and 60 A. L. R. 950 (1929); MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES (2d ed. 1940) §§ 93-117; 2 SUMMERS, OIL AND GAS (Perm. ed. 1938) § 398 *et seq.*; Walker, *Express Clauses in Oil and Gas Leases Affecting the Usual Implied Obligations of the Lessee*, 13 Miss. L. J. 292 (1941).