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CONFUSION OF TERMINOLOGY IN OIL AND GAS

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A surprising amount of confusion exists in the interpretation and use of the terms "royalty" and "minerals" as used in oil and gas transactions. Clear cut distinctions between the terms are seldom made and the effects and incidents of the interests are not often understood or delineated with any certainty. Confusion of terminology appears even among those who work with these interests and employ the terms constantly and with assurance.[1] As the courts have not been too helpful in establishing any clear and certain distinctions, this area has continued to provide much litigation.

The term "royalty" was defined at an early date as, "a share of the product or profit reserved by the owner for permitting another to use the property."[2] As pointed out by Summers this definition is correct insofar as it goes, but in the main is meaningless in attempting any rationalization of the complex problems involved.[3] In fact Summers avoids broad statements in this regard and breaks down the construction and interpretation of the term "royalty" by states.[4]

However, it is usually understood by the people in the industry that mineral ownership will carry with it the exclusive right to lease (at times referred to as the executive right), the right to receive bonus money for entering into an oil and gas lease, the right to receive delay rentals in lieu of drilling, and finally to receive royalties in the event of commercial production. In contrast an owner of oil and gas royalties is entitled *only* to his proportionate share of production, if any, free of the cost of development.[5] In the absence of production the royalty owner is entitled to nothing. He has no right to enter into an oil and gas lease; he may not enter and develop the land himself; and he is not entitled to bonus money or delay rentals. Of course all rights and incidents accruing to a royalty owner may be changed or modified contractually, but to change the incidents is to change the species.

Unfortunately, the parties to a lease frequently fail to define with

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1. Hickey v. Dicks, 156 Kan. 326, 133 P.2d 107, 109 (1943); Rist v. Toole County, 117 Mont. 426, 159 P.2d 340, 162 A.L.R. 406 (1945); Douglas v. Douglas, 176 Okla. 378, 56 P.2d 366 (1936); Dabney-Johnson Oil Corp. v. Walden, 4 Cal.2d 637, 52 P.2d 244 (1935); Melton v. Sneed, 188 Okla. 388, 169 P.2d 512, 513 (1940).
2. Indiana Natural Gas and Oil Company v. Stewart, 90 N.E. 384, 45 Ind. App. 554 (1910).
3. Summers, *Oil and Gas* § 572 (2d ed. 1938).
4. Ibid, et seq.
5. Professor Richard C. Maxwell in his article, "The Mineral-Royalty Distinction and the Expense of Production," 33 Tex. Law Rev. 463, contends that the distinction under discussion is clearly determined by establishing whether or not the interest is expense bearing. If the interest bears its proportionate share of the costs of production, it is a mineral interest; if not, it is royalty.

certainty the interest sought to be created, and rely solely on a personal understanding of common terms, such as "royalty" without fully considering all incidents. A conflict often arises when one party contends the interest created or reserved was a mineral interest while his opponent contends that a royalty interest was created. Since "mineral interests" and "royalty interests," as previously defined, do involve definite and separate incidents, dispute as to the proper characterization of the incidents covered by the lease is inevitable if there has not been a consistent use of terms. This is especially true when substantial amounts of money are paid as bonus consideration for the entering into an oil and gas lease. The mineral owner naturally contends he has the exclusive or executive right to enter into an oil and gas lease and seeks to exclude the royalty owner from participation in bonus and delay rental money. The chagrined royalty owner, thinking he is entitled to the incidents of mineral ownership may seek counsel and the issue will be joined in a conflict over construction of the entire instrument involved.

It is not always advantageous, however, to have an interest declared a mineral interest. Consider as an example, that an undivided 1/24th interest in oil and gas is conveyed by deed, it being customary to create fractional or percentage interests when minerals or royalties are transferred. It is entirely possible, by judicial construction, that the words of conveyance may have the effect of granting a 1/24th interest in *all* of the oil and gas produced, while the grantor intended only a 1/24th of the landowner's royalty (usually ⅛th) be granted. If a lease in existence called for the usual landowner's royalty of ⅛th then the grantee in this example would receive 1/24th of all the oil and gas produced when it was intended that he receive only a 1/24th *of* ⅛th or a 1/192nd of the production.[6]

It is obvious then that these problems give rise to delicate points of construction. Usually the words granting or reserving "the oil and gas produced and saved from the land" have the effect of creating a royalty interest,[7] while a grant of the "oil and gas in and under the land" denotes the desire to create a mineral interest.[8] It should be pointed out that the absence or presence of either of these phrases alone or in combination is far from controlling.[9] They are, however, strong indicia of intent and carry heavy weight in construing oil and gas instruments. The phrase, "with the right of ingress and egress" also indicates the intent to establish a mineral interest since a royalty owner has no right to go on the land

6. Miller v. Speed, 259 S.W.2d 235 (Tex. Civ. App. 1952); Armstrong v. Bell, 199 Miss. 29, 24 So.2d 10 (1945); Swearingen v. Oldham, 195 Okla. 532, 159 P.2d 247 (1945) construing as mineral as against contention of royalty; 3 Summers, *Oil and Gas* § 599 (2d ed. 1938).
7. Miller v. Speed, id. at page 255.
8. Mitchell v. Hannah, 123 Mont. 152, 208 P.2d 812 (1949); Hardy v. Greathouse, 406 Ill. 365, 94 N.E.2d 134 (1950); Armstrong v. McCracken, 204 Okla. 319, 229 P.2d 590 (1951).
9. Miller v. Speed, 259 S.W.2d 235, 239 (Tex. Civ. App. 1952); Douglas v. Douglas, 176 Okla. 378, 56 P.2d 366 (1936).

and explore for oil and gas.[10] Then, too, it should be remembered that royalty interests are, of necessity, carved out of mineral interests.

The cardinal rule of seeking the intent of the parties is everywhere urged and applied,[11] only to occasionally stumble against the parol evidence rule since here ordinarily is a written instrument not to be amended or varied by parol evidence.[12]

The rule against perpetuities also rears its head. Kansas, holding that a royalty interest is a personal property interest which vests only when oil is reduced to possession, has held that a perpetual non-participating royalty is void under the rule.[13] Thus at times is struck down one of the most commonly created royalty interests, that is, one which goes beyond the term of any existing lease and may in fact be established in the absence of a lease. It is non-participating (and therefore designated as "pure" by some) since the owner of this type of royalty does not participate in the execution of leases and receives income only in the event of production. Neither does he pay any of the costs of development or production in absence of a contract to the contrary. Recent learned discussions of the rule have appeared as it applies to oil and gas interests.[14]

Printed forms commonly used throughout the industry with the headings "Mineral Deed," "Royalty Deed," "Mineral and Royalty Deed," etc., are futile in their headings if the body of the form contains contrary provisions since most courts apply the rule of looking within all four corners of the instrument.[15] The familiar rule of construing the instrument most strongly against the grantor begs practical application (in the absence of fraud, etc.) when it is realized that most often the grantee (or purchaser) proffers the printed form when purchasing minerals or royalties.

Part of the confusion appears to arise from the wide variety of interests which may be created without a specific label. As the conflicts multiply the courts are called on to construe instruments designated as mineral when they are, in reality, royalty or bear the characteristics of both mineral and royalty. The following types appear most often:

(1) Ordinary mineral conveyances or reservations which carry the incidents previously mentioned and recognized in the industry. A mineral

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10. Pease v. Dolezal, 206 Okla. 696, 246 P.2d 757 (1952); Moore v. City of Beaumont, 195 S.W.2d 968 (Tex. Civ. App. 1946) Aff'd., 202 S.W.2d 448 (Tex. Sup. 1947).
11. 3 Summers, *Oil and Gas* § 599 (2d ed. 1938); Kulp, *Oil and Gas Rights* § 10.6, 10.85 (1954); Krutzfield v. Stevenson, 86 Mont. 463, 284 Pac. 553 (1930); Maxwell v. Hunter, 116 F.2d 260 (5th Cir. 1940); Westcott v. Bozarth, 202 Okla. 1149, 211 P.2d 258 (1949).
12. 2 Summers, *Oil and Gas* § 599 (2d ed. 1938).
13. Lathrop v. Eyestone, 170 Kan. 419, 227 P.2d 143 (1951).
14. Kuntz, "The Rule Against Perpetuities and Mineral Interests," 8 Okla. Law Rev. 183 (1955); Meyers, "The Effect of the Rule Against Perpetuities on Perpetual Non-Participating Royalty and Kindred Interests," 32 Tex. Law Rev. 369 (1954).
15. Paddock v. Vasquez, 122 Cal. App.2d 396, 265 P.2d 121 (1954); Arkansas Valley Royalty Co. v. Arkansas-Oklahoma Gas Co., 222 Ark. 213, 258 S.W.2d 51 (1953); Rogers v. Jones, 40 F.2d 333 (10th Cir. 1930); Acklin v. Fugua, 193 S.W.2d 297 (Tex. Civ. App. 1946); Kulp, *Oil and Gas Rights* § 10.6 (1954).

interest may also be created for a limited time only or for a term and so long as oil and gas is produced. It is generally agreed that the term "mineral" includes oil and gas and other hydrocarbon substances, except in those special situations in which reservations were made at the time and place where exploration for oil and gas was rare or unknown.[16]

(2) The perpetual non-participating royalty. As intimated previously this interest may be established at any time independently of a lease and is free of the costs of development. It continues in perpetuity in those jurisdictions that consider such an interest to be a vested real property interest.

(3) Royalties created for a term. Such royalties are created for fixed terms only, and at the end of the term the royalty ceases, even in the event of production.

(4) Royalties created for the term of a then existing lease. Such a royalty may be realized for a period longer than the primary term. If production is realized before the expiration of the primary term, the royalty interest will continue so long as production is realized. Should no production be had prior to the cessation of the lease, then the royalty is automatically terminated. This is a tenuous and speculative interest indeed, when it is realized that oil leases are commonly held by lessees for as short a period as one year, or even less.

(5) A combination mineral-royalty interest. These interests are formed by conveying a fractional interest in the landowner's royalty (i.e., a 1/16th or ½ of a ⅛th royalty) in a then existing lease and simultaneously in the same instrument, a fractional interest in the minerals is conveyed and consequently a share of the bonus and rentals to be received now and in the future.

A wide variation of the above interests may also be created limited only by the ingenuity and imagination of the conveyancer. However, the landowner's royalty which is properly carved out of the lessor's interest and with which this paper is principally concerned should not be confused with overriding royalties (frequently referred to as merely "overrides") which come out of the "working interest" of the lessee.

The peculiar nature attributed to oil and gas has given the courts much trouble and produced a variety of theories. One such theory has come to be known as the "ownership in place" doctrine,[17] under which minerals are an estate in land, subject to severance from the surface. Thus a grant or reservation of minerals under this theory will create a separate mineral estate, sometimes referred to as a mineral fee by which the minerals are owned in place. Still other jurisdictions favor what has come to be

16. Burke v. Southern Pacific R.C. Co., 234 U.S. 669, 34 S.Ct. 907, 58 L.Ed. 1527 (1914); contra, Carothers v. Mills, 233 S.W. 155 (Tex. Civ. App. 1921). For a general discussion of the point see: Kuntz, "Law Relating to Oil and Gas in Wyomin," 3 Wyo. Law J. 107 (1949).

17. 1 Summers, *Oil and Gas* § 62 (2d ed. 1938); Kulp, *Oil and Gas Rights* § 10.5 (1954).

known as the "non-ownership" theory and hold that the owner of minerals has only the exclusive right to reduce the oil and gas to possession. These jurisdictions categorically reject the doctrine of ownership in place.[18] Nevertheless this exclusive right to reduce the oil and gas to possession is recognized also as an estate in land and is sometimes termed a profit a prendre, which is an interest in real property in the nature of an incorporeal hereditament, equivalent to a mineral fee in ownership in place jurisdictions.[19] If the grant is only for a term of years, it is designated as a chattel real.[20]

The non-ownership theory apparently arose from the concept that oil and gas is a fluid and fugacious in nature and therefore not subject to ownership until reduced to possession, by a fanciful analogy to animals ferae naturae. [21] It should be noted, however, that oil and gas is fugacious only when it is disturbed in its source by man (or rarely by nature, as by earthquakes) and if left undisturbed by a probing drill, migration is negligible except as measured in geologic time.

The ownership in place theory, based on analogy to solid minerals, is not without its persuasive critics both in law and logic. Summers points out that, although theories are patently erroneous, the result of determining who is properly entitled to reduce the oil and gas to possession is usually realized.[22]

Those who are called upon to deal in and interpret mineral and royalty interests must exercise the utmost care to avoid any misunderstanding. Meticulous and informed draftsmanship must be applied to avoid establishing an interest contrary to intent. The latest pronouncements of the courts of the pertinent jurisdiction must also be studied. It is also fairly common practice for mineral and royalty buyers to cross state boundaries with printed forms in hand which in their terms apply only to their home states. These must be scrutinzed with exceptional care, when used in jurisdictions other than the one in which they were originally drafted.

The whole problem breaks down then to a confusion of terminology which may be avoided by careful conveyancing based upon familiarity with the jurisdictional peculiarity of the oil and gas law applicable. Finally as the Supreme Court of Wyoming stated in *Denver Joint Stock Land Bank v. Dixon*,[23] "terminology is convenient and in fact necessary, but it should not be abused."

18. Ibid; Callahan v. Martin, 3 Cal.2d 110, 43 P.2d 788, 101 A.L.R. 871 (1935).
19. Ibid.
20. Callahan v. Martin, supra, note 18.
21. 1 Summers, *Oil and Gas* § 62 (2d ed. 1938).
22. Ibid.
23. 57 Wyo. 542, 122 P.2d 849, 140 A.L.R. 1270 (1942).