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# CLASSIFICATIONS, IN WYOMING, OF INTEREST IN OIL AND GAS FOR VARIOUS PURPOSES AND THEIR CONSEQUENCES

Several recent Wyoming cases make an exploration into the field of classification of the nature of oil and gas interests and the consequences thereof especially worthwhile at this time. In addition, there are many older cases that must be considered in order to present the current Wyoming scheme of classifications. The Supreme Court of Wyoming draws freely on authority from many jurisdictions having diverse theories concerning the nature of interests in oil and gas,[1] and it would be unwise to assume the acceptance of all the ramifications of classification contained in decisions of any one jurisdiction cited by the court. Therefore, this article will, insofar as possible, deal with Wyoming decisions.

## FEE SIMPLE INTERESTS, MINERAL ESTATE, MINERAL INTEREST

The most extensive bundle of rights with respect to oil and gas interests is the fee simple interest. The old common law rule was that a landowner owned everything within his boundaries both over and under his land. Courts have long recognized that a mineral estate may be reserved or severed from the surface estate[2] and that fee simple may be created in the mineral estate. Justice Blume in the case of *Picard v. Richards*[3] said: "There may be an estate in mineral larger than a royalty interest . . . which is called a mineral estate at times stated as a 'mineral interest,' it is an estate in fee simple and to the minerals." Of course all mineral estates are not fee simple interests. There can be interests for a term of years or for life, or in fee simple defeasible.[4]

The court in the earlier case of *Ohio Oil Co. v. Wyoming Agency*[5] in speaking of a severed mineral estate said: "After severance, the two estates, owned separately, are held by separate and distinct titles . . . the two estates are 'as distinct as if they constituted two different parcels of land' . . . (It) is not material that the plan by which the properties are separated is horizontal instead of vertical."

The court went on to say: "Each estate may be occupied, conveyed, encumbered, sold by the sheriff, or alloted in partition without any effect upon the other." The court held upon the facts of the case that possession of the surface of the land could not be adverse to the owner of the severed mineral estate, as no minerals had been discovered and worked.

1. An example of this is the case of Picard v. Richards, Wyo. 366 P.2d 119 (1961), in which the Supreme Court of Wyoming cites cases from jurisdictions that follow the ownership in place theory as well as nonownership theory jurisdictions.
2. An article in the Wyoming Law Journal, Kuntz, *The Law Relating to Oil and Gas in Wyoming,* 3 Wyo. L.J. 107 (1948), discusses some of the language used in the earlier cases to sever mineral interests and speculates as to the situation in Wyoming concerning what language would be necessary in order to sever or reserve a mineral interest. There have been no new cases on the subject since the article was written.
3. 366 P.2d 119 (1961).
4. Williams and Meyers, Oil and Gas Law, § 202.2; Goodson v. Smith, 69 Wyo. 493, 243 P.2d 163 (1952).
5. 63 Wyo. 187, 179 P.2d 773 (1947).

The case further held that the owner of a severed mineral estate, by his title to such estate, has constructive possession necessary to bring an action to quiet title.

The case of *Milliron Oil Co. v. Connaghan*[6] is in agreement with the *Ohio Oil Co.* case upon the question of adverse possession. The *Milliron* case further holds that a tax sale of the surface estate does not carry with it the severed mineral estate, because if there has been no assessment taxes made against the mineral estate there can be no delinquency and therefore no valid tax sale of the mineral estate can be made. However, it has been held in another case,[7] that a gross products tax upon production is a tax upon the severed product which is personalty and therefore not a tax upon real estate.

There are many consequences that flow from a fee simple mineral estate classification. In the *Picard* case[8] the Wyoming Supreme Court endorsed this language from a Texas case,[9] that is a good statement of some of the more important consequences: "The ownership of an unrestricted mineral interest includes all the incidents of ownership, some of which are the right to execute oil, gas and mineral leases and the right to receive royalties." Perhaps the most important incident of ownership of a mineral estate is to be able to go upon the land to explore for and develop and produce gas and oil or remove the minerals.[10]

Undivided interests in the mineral fee interest may be conveyed in which case the holders of these interests become tenants in common, and while each of these owners may exercise the incidents of ownership, including the giving of a lease, one who does this has to account to any nonconsenting cotenant for any profit made.[11]

There has been some confusion as to whether Wyoming is a nonownership theory state or an ownership in place theory state when considering the nature of the interest the landowner or the holder of a mineral interest or estate has in the oil and gas underlying his property. Professors Williams and Meyers in their treatise conclude that the theory held by a state, as to the nature of ownership, has little significance apart from the influence it may have upon the classification of mineral, royalty and leasehold interests as corporeal or incorporeal.[12] As indicated below, Wyoming seems to consider that the owner of the mineral estate owns the minerals in place, although the court has designated a leasehold interest as an incorporeal interest.[13] Such a distintcion is not uncommon.[14]

6. 76 Wyo. 330, 302 P.2d 256 (1956).
7. Oregon Basin Oil & Gas Co. v. Ohio Oil Co., 70 Wyo. 263, 248 P.2d 198 (1952).
8. Picard v. Richards, Wyo., 366 P.2d 119 (1961).
9. Burns v. Andas, Tex. Civ. App., 231 S.W.2d 417 (1958).
10. Williams and Meyers, Oil and Gas Law, § 202.2.
11. Torgensen v. Connelly, Fyo., 348 P.2d 63 (1959).
12. Williams and Meyers, Oil and Gas Law, § 204.9.
13. See § III infra.
14. Williams and Meyers, Oil and Gas Law, § 204.2.

The Supreme Court of Wyoming freely cites authority from ownership in place, nonownership and qualified ownership theory states,[15] but a case has never turned upon the question of which theory applies in this state. However, it does appear to this writer that the Wyoming Supreme Court has adopted the ownership in place theory with respect to the mineral fee owner. The court in the case of *Denver Joint Stk. Ld. Bank v. Dixon*[16] stated that the direct interest in and to the *oil in place* had been reserved by the owner of the mineral interest, and in *Picard v. Richards*[17] the court said: "A conveyance or reservation thereof (speaking here of a mineral interest) gives title to the minerals in place." The cases of *Ohio Oil Co. v. Wyoming Agency*[18] and *State ex rel. Cross v. Bd. Ld. Comrs.*[19] also seem to support this theory.

## ROYALTY INTEREST

Some of the greatest confusion in the classification of oil and gas interests arises when the court must construe an ambiguous instrument in order to determine if it creates a royalty interest or a mineral estate. The Wyoming Supreme Court has said: "As we have had frequent occasion to observe terms relating to conveyance of oil and gas interests have often been loosely and inaccurately used."[20]

A true royalty interest is a right to receive a certain amount of the oil and gas produced from particular tracts of land.[21] It is an interest carved out of the mineral fee estate.[22] Of course the holder of a lease may grant or reserve a royalty interest, but the lease has itself been carved out of the mineral fee estate.[23] A royalty interest granted or reserved by the holder of a mineral fee estate, unless the right to participate in making future leases is reserved or granted, is usually designated as a perpetual non-participating interest,[24] while a royalty granted or reserved by a holder of a lease is designated as an overriding royalty, and it must be

15. Picard v. Richards, Wyo., 366 P.2d 119 (1961). Here the court cites cases from Colorado, Montana, Texas and Mississippi, all ownership in place states and from Louisiana, a nonowernship state and from Oklahoma, a qualified ownership state. Denver Joint Stk. Ld. Bank v. Dixon, 57 Wyo. 523, 122 P.2d 842 (1942). Here the court relied principally on cases from California which is a nonownership state and Texas which is an ownership in place state. See Williams and Meyers, Oil and Gas Law, at p. 31 for a table of classification of states as to theories concerning ownership in place of gas and oil.
16. 57 Wyo. 523, 122 P.2d 842 (1942).
17. Wyo., 366 P.2d 119 (1961).
18. 63 Wyo. 187, 179 P.2d 773 (1947).
19. 50 Wyo. 181, 58 P.2d 423 (1936).
20. Picard v. Richards, Wyo., 366 P.2d 119 (1961).
21. Dame v. Mileski, 80 Wyo. 156, 340 P.2d 205 (1959); Picard v. Richards, .... Wyo., 366 P.2d 119 (1961). The court in the Dame case, supra, and in the case of Denver Joint Stk. Ld. Bank v. Dixon, 57 Wyo. 523, 122 P.2d 842 (1942), gives the impression that it might call an assignment of oil and gas from no specified source a royalty, but this would not be logical and the court in the later Picard case, supra, used language that indicates that royalty interest is an interest that has relation to a specific property.
22. Picard v. Richards, supra note 16.
23. Dame v. Mileski, 80 Wyo. 156, 340 P.2d 205 (1959); Brenimer v. Cockburn, 254 F.2d 821 (10th Cir. 1958).
24. Denver Joint Etk. Ld. Bank v. Dixon, 57 Wyo. 523, 122 P.2d 842 (1942).

*satisfied out of production attributed to the interest held by the owner* of the lease.[25]

The distinguishing characteristics of a non-participating royalty interest are: "(1) Such share of production is not chargeable with any of costs of discovery and production; (2) the owner has no right to do any act or thing to discover and produce the oil and gas; (3) the owner has no right to grant leases; and (4) the owner has no right to receive bonuses or delay rentals."[26]

A royalty interest is an interest in real property and as such it must be recorded in order to be protected against a later purchaser in good faith and for value.[27]

Most of the important consequences of an interest being designated a royalty interest are set out above; for it is very hard to separate the classification of an interest as a royalty interest from the consequences of such classification. An example of this is that the distinguishing characteristics of a non-participating royalty interest set out above are also the chief consequences that flow from such classification; so in dealing with royalties a certain amount of circular reasoning is necessary. The court must look both at the language the parties used to create the interest and to the consequences the parties intended to flow from the transaction in order to determine whether the parties have created a royalty interest or mineral estate.

The instrument in the case of *Picard v. Richards*[28] is a good example of the loose language the courts must sometimes construe in order to determine the nature of an interest created. Here the interest created was described as "a life estate in a non-participating undivided one-fifth of the mineral estate owned by the parties in the described lands and premises." This language was further qualified by a statement that the person retaining the remainder of the interest would have control over the said one-fifth interest subject to accounting and full disclosure. This sounds as though the parties intended to create a mineral estate with authority for the execution of leases in one party. The court held that while the owner of the interest described above had a mineral estate it was an interest "in the nature of a royalty interest" and as such he had no right to participate in bonus payments or delay rentals, but was entitled only to a share of production.

There is one very troublesome area in the *Picard* case. After the above described interest had been reserved, the parties executed an oil lease retaining the usual one-eighth royalty interest. The court held that the holder of the inerest under consideration was entitled to only one-fifth

25. Brenimer v. Cockburn, 254 F.2d 821 (10th Cir. 1958).
26. Picard v. Richards, Wyo., 366 P.2d 119 (1961).
27. Denver Joint Stk. Ld. Bank v. Dixon, 57 Wyo. 523, 122 P.2d 842 (1942). Dame v. Mileski, 80 Wyo. 156, 340 P.2d 205 (1959).
28. Wyo., 366 P.2d 119 (1961).

of the one-eighth royalty interest or in other words one-fortieth of all minerals produced. This confined to the facts of the case is alright for it was conceded that this was the intent of the parties and the interest created was in fact a mineral estate though "in the nature of a royalty interest." However, the court then stated: "If she were entitled to one-fifth or twenty percent of all the minerals produced, she would get all of the one-eighth royalty specified in the lease to the California Company. In addition to that, she would be entitled to 7½ precent from someone—not the California Company. That is too irrational and the court cannot accept such interpretation even without testimony in that connection." This language is very disturbing for it sounds as if the court is saying that a royalty interest must come out of the one-eighth royalty given as consideration for a lease, when the generally accepted rule is that a royalty owner is entitled to the stated fraction of all the oil and gas produced.[29] The court then cites the Oklahoma case of *Cook v. McClellan*[30] as presenting a similar situation. However, the question in the *Cook* case is whether the language considered created a royalty interest so that the holder of the interest would receive a fraction of the total production from the land, or a mineral interest so that the holder of the interest would only be entitled to a fraction of the landowner's royalty. The Oklahoma court held that under the facts of the case it created a mineral interest, and so, for this reason, the holder of the interest was only entitled to a fraction of the landowner's royalty. The rule in Oklahoma is that if the interest is a royalty in the usual sense then the fraction applies to the total production of oil and gas.[31]

One very important consequence arising out of the fact that a royalty interest has been designated an interest in real property is that in *Denver Joint Stk. Ld. Bank v. Dixon.*[32] The owner of the surface estate also owned a royalty interest in the minerals which had been reconveyed to him by the owner of the severed mineral esate. The owner of the surface interest mortgaged the property to the bank by means of an ordinary real estate mortgage describing the surface boundaries and with no mention of the royalty interest. The court held that the royalty was also conveyed by the mortgage as the interest was real property and had not been reserved. From this it follows that if the owner of a surface estate, from which the mineral estate has been severed, also owns a royalty interest in the same lands, and if he wishes to keep the royalty interest, then he had better specifically reserve it in any conveyance he might make of the surface estate; for if he does not reserve the royalty interest, it will be conveyed along with the surface estate.

### OIL AND GAS LEASE

A third very important interest in oil and gas is the lease. An oil

29. Williams and Meyers, Oil and Gas Law, § 303.1.
30. Okla., 311 P.2d 244, 254 (1957).
31. Hooks v. Rocket Oil Co., 191 Okla. 431, 130 P.2d 846 (1942).
32. 57 Wyo. 523, 122 P.2d 842 (1942).

and gas lease is not a lease in the same sense as a real estate lease. An oil and gas lease is a right granted by the holder of the mineral estate giving the lessee the authority to search for oil and gas and to remove either if found.[33] There are surprisingly few Wyoming cases dealing with the problems of classification of leasehold interests and the consequences arising therefrom.

The leading case considering the nature of oil and gas leases in Wyoming is *Boatman v. Andre.*[34] The court in this case held that an oil lease is a profit a prendre and therefore an incorporeal hereditament. The court then said that while title to land cannot be lost by abandonment, a lease which is only an incorporeal hereditament may be abandoned. The court, moreover, said that:: "Abandonment will be more readily found in cases of oil and gas leases than in most other instances."

The attorney general of Wyoming, in an official opinion of November 6, 1952,[35] stated that it was his opinion that a "lessee's interest under an oil and gas lease, whether a producing lease, or not, is real property and subject to taxation under the Inheritance Tax Laws of Wyoming, if held by a deceased non-resident." This opinion was born out by the later case of *State v. Stringer*[36] in which the court held that an oil and gas lease, although only a profit a prende, created a "right" and as such was an interest in land so that proper notice should have been given under the applicable statute requiring notice be given to all persons claiming any interest in any lands before such lands could be condemned.

Surprisingly the Wyoming Supreme Court has never had occasion to decide a case on the basis of whether covenants could be implied in an oil and gas lease.[37] Implied covenants are usually one of the most important consequences of an interest in oil and gas being designated as a lease since most jurisdictions recognize that there are certain obligations implied in a lease. At any rate there is nothing to keep the court from implying covenants in a proper situation as the local statute prohibiting implied covenants in conveyances has been specifically amended to except conveyances of oil, gas and other minerals.[38]

### OPERATING AGREEMENT

An operating agreement could almost be characterized as a contract; it is less than a royalty interest and less than a lease.[39] Nevertheless, an operating agreement can serve as a conveyance of an interest in oil and

33. Boatman v. Andre, 44 Wyo. 352, 12 P.2d 370 (1932).
34. Ibid.
35. Official Opinions of Attorney General, p. 799 (1948-1953).
36. 77 Wyo. 198, 310 P.2d 730.
37. A note at, 11 Wyo. L.J. 58 (1958), discusses this situation in detail. However, Wyo. Stat. § 34-36 (1957), was amended subsequent to the time the note was written.
38. Wyo. Stat. § 34-36 (1957).
39. Torgensen v. Connelly, Wyo., 348 P.2d 63 (1959).

gas and as "oil and gas interest in land are real property," such an operating agreement is within the statute of frauds.[40]

In the case of *Torgesen v. Connelly*[41] the court had to construe an operating agreement "for a term of twenty years and so long thereafter as oil, gas and other hydrocarbon substances are produced in commercial quantities." This agreement was held to be a grant and sublease of the exclusive right to drill upon property covered by a lease from the United States. The court, describing the interest created, said: "It in effect conveys a portion of the lease or the rights thereunder and constitutes real property." Therefore, the instrument should have been recorded in the county in which the land was located in order to be protected from the rights of a subsequent bona fide purchaser.

### MORTGAGES OF OTHER INTERESTS IN OIL AND GAS

There have been two recent cases concerning mortgages of oil and gas interests. In the case of *Elliott v. Sioux Oil Co.*[42] the court had to construe an instrument called an "Assignment of Proceeds" which stated in its pertinent parts that it ". . . does hereby assign, transfer and set over unto . . . (Black Hills) . . . the sum of . . . ($25,252.05) . . . payable from proceeds from the sale of crude oil from . . . (leases located in Weston County, Wyoming, and all other leases owned by assignor)." The issue in the case was whether or not the above described instrument constituted an interest in real property that would be recordable under the Wyoming Statutes applicable to real property. If it were such an interest in real property, then it would defeat a prior federal tax lien which had not been filed in Weston County. The court held that although the "instrument would profit from refinement and precision" he was nevertheless led to the conclusion that the instrument was executed as security for a debt and as such it constituted a mortgage upon real estate and should be recorded under the state laws relating to real estate.

The instrument in the case of *Pheister v. Ogden Smelting Inc.*[43] stated that it was a mortgage of an oil lease, together with all licenses, easements, rights and privileges and all incomes, rents, royalties, proceeds, profits and oil and gas produced from the mortgaged property. This mortgage was properly recorded in the county in which the leased property was located. The question the court had to consider was whether or not this mortgage had priority over a mechanics lien arising from work done on the lease after the mortgage had been recorded, insofar as proceeds from oil produced after the work had been done were concerned. The court held that the mechanics lien had priority in this case over the mortgage. The court said that the mortgage was a mortage of "real estate" and entitled to be recorded as any other real estate mortgage.

40. Hageman v. Clark, 69 Wyo. 154, 238 P.2d 919 (1951).
41. Wyo., 348 P.2d 63 (1959).
42. 191 F. Supp. 847 (Wyo. 1960).
43. Wyo., 364 P.2d 1078 (1961).

However, the part of the mortgage concerning the oil and gas produced was held to be analogous to a mortgage of real estate together with the rents, issues and profits thereof, and the general rule is that the mortagage has no rights to such rents and profits until he has taken some action on his part to reduce them to possession. Production was construed as being analogous to profits.

It is thus clear from these cases that the important consequence of an instrument being classified as a mortgage which extends to production is that the courts consider such a mortgage a mortgage of real estate, and as such it is subject to being recorded under the statutes pertaining to the recording of conveyances of real estate. The fact that such a mortgage was recorded did not help the mortgagee in the *Pheister* case, but the court in that case did refer to a federal case[44] wherein the mortgage had procured division and transfer orders and as such was held to be in constructive possession so as to perfect a position of priority as to production. Therefore, it is apparent that a person who takes a mortagage of the oil and gas produced, as in the *Pheister* case, must go further and also obtain a division order or in some other way obtain constructive possession of the production in order to have a meaningful interest.

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44. Riverview State Bank v. Ernest, 198 F.2d 876, 34 A.L.R.2d 892 (10th Cir. 1952).
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