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# FIDUCIARY PROTECTION OF NONOPERATING OIL AND GAS INTERESTS AGAINST THE ACTS OF AN OPERATOR

## I. INTRODUCTION

In the routine transactions associated with energy exploration and development, the interests in the mineral property frequently become divided between many persons and into many forms. While divided ownership of any real property is fraught with potential disputes as to the precise rights of each party, the rights of holders of nonoperating oil and gas interests are particularly vulnerable because they arise from the leasehold rather than from the underlying mineral estate. Most instruments creating nonoperating interests contain no provisions defining the oil and gas operator's obligations to the holder of the nonoperating interest. Thus, courts are left with the difficult task of determining the scope of protection to afford nonoperators against the acts of an operator that extinguish the nonoperating interest. The purpose of this Comment is to assist persons interested in the development of oil and gas law to assess the relationship between operators and nonoperators, to consider the importance of protective clauses within the creating instrument, and to explore factors that are important in determining the extent of protection nonoperators should be allowed.

## II. NATURE OF NONOPERATING INTERESTS

Nonoperating interests are interests in minerals in which the owner of the interest has no right to engage in operations to remove the minerals.<sup>1</sup> The most common types of nonoperating interests<sup>2</sup> created are the overriding royalty,<sup>3</sup> the production payment,<sup>4</sup> the carried interest,<sup>5</sup> and the net profits interest.<sup>6</sup>

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1. 5 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 63.1, at 197 (1978).

2. *Id.*

3. An overriding royalty is an interest "severed" out of the working interest or lessee's share of the oil, free of the expenses of development, operation, and production. *See id.* § 63.2, at 197-98.

4. The production payment is an interest created or carved out of any greater interest in the minerals. The interest entitles its owner to a specific share of oil and/or gas, or to a payment determined by a specific share of production, free of costs. *Id.* § 63.3, at 213.

5. The carried interest is a fractional interest in oil and gas property. The party owning the remaining fraction of the working interest, the carrying party, pays the entire cost of drilling and

Nonoperators may realistically be concerned that an operator will allow a lease to expire, thus terminating the nonoperating interest. Ordinarily, the nonoperator has no remedy in this situation since a nonoperating interest is carved out of the working interest of a lease and depends for its existence upon the continuation of the lease. The nonoperating interest will be extinguished on the termination of the lease.<sup>7</sup> This is true whether the lease expires by its own terms,<sup>8</sup> by the failure of the operator to comply with a drilling clause,<sup>9</sup> or by the operator's surrender of the lease.<sup>10</sup> One court stated the general rule that a nonoperating interest may be lost entirely by "cancellation, surrender, abandonment resulting from diminution of production beyond economic feasibility, [or] total failure to secure production in paying quantities."<sup>11</sup> In Oklahoma, even where oil and gas are discovered during the primary term of the lease, if the acquisition of a market does not take place until after the expiration of the primary term, a nonparticipating term interest will terminate with the primary term.<sup>12</sup>

Although the nonoperating interest easily may be lost, an operator ordinarily has no duty to a nonoperator to keep a lease alive.<sup>13</sup> The mere existence of a nonoperating interest will not impose an implied obligation on the operator to preserve,<sup>14</sup> develop,<sup>15</sup> or give notice

operation, including costs attributable to the carried party's interest. Thereafter, the carrying party is entitled to all the benefits of production from the entire working interest until all his costs, including those attributable to the carried interest, have been recovered. The carrying party may also be entitled to recover a penalty in addition to recouping actual costs to take into account risk or interest factors. *See id.* § 63.4, at 224-25.

6. The net profits interest is a specified share of the net profits from production, without personal liability for costs or losses. *See id.* § 63.5, at 228.

7. 3 W. SUMMERS, THE LAW OF OIL AND GAS § 554, at 634 (1958); *see also* Standard Oil Co. v. Marshall, 265 F.2d 46, 53 (5th Cir. 1959) (oil payment expires with termination of lease), *cert. denied*, 361 U.S. 915 (1959); Fain & McGaha v. Biesel, 331 S.W.2d 346, 348 (Tex. Civ. App. 1960) (override extinguished on surrender of leasehold).

8. *See* Davis v. Cities Serv. Oil Co., 338 F.2d 70, 74 (10th Cir. 1964).

9. *See* Phillips v. Bruce, 41 Cal. App. 2d 404, —, 106 P.2d 922, 924 (1940).

10. Keese v. Continental Pipe Line Co., 235 F.2d 386, 388-89 (5th Cir. 1956).

11. DeMik v. Cargill, 485 P.2d 229, 233 (Okla. 1971).

12. McEvoy v. First Nat'l Bank & Trust Co., 624 P.2d 559, 559-62 (Okla. Ct. App. 1980). The court distinguished non-participating interest cases from oil and gas lease cases. In lease cases, a lessee has by implication a reasonable time to obtain a market even after the primary term has expired. The court explained that a grantor or reserver of terminable nonoperating interests does not contemplate operations by the lessee for the mutual benefit of the parties. *Id.*

13. 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 420.1, at 353 (1981); *see* Davis v. Cities Serv. Oil Co., 338 F.2d 70, 74-75 (10th Cir. 1964).

14. *See* Davis v. Cities Serv. Oil Co., 338 F.2d 70, 74-75 (10th Cir. 1964); Keese v. Continental Pipe Line Co., 235 F.2d 386, 389 (5th Cir. 1956); *see also* Collins v. Atlantic Oil Prod. Co., 74 F.2d 122, 124 (5th Cir. 1934) (covenant to keep the lease alive by payment of rentals is not to be implied in assignment of lease because it would add a burden to assignment on the operator that was perhaps not intended). *But cf.* Howell v. Cooperative Refinery Ass'n, 176 Kan. 572, —, 271

before releasing a lease.<sup>16</sup> The duty to develop or give notice arises by express contractual provision. A duty to preserve a lease may arise from a statute or a fiduciary relationship between the parties<sup>17</sup> as well as by express contractual agreement.<sup>18</sup> Furthermore, the mere assignment of a lease reserving a nonoperating interest does not establish such a fiduciary relationship. It must be created by the express terms of the assignment.<sup>19</sup>

Also, a special situation may be present when an operator voluntarily surrenders a lease. It has been suggested that where an operator voluntarily surrenders a lease to the landowner, there is some doubt as to the extinguishment of nonoperating interests without joinder of the nonoperator.<sup>20</sup> However, the weight of authority upholds the operator's right to voluntarily surrender the lease during its primary term, thereby extinguishing the carved-out interest.<sup>21</sup>

A nonoperator may have some degree of inherent protection against an operator's relinquishing the lease because of the parties' community of interests. The operator has the more valuable interest to protect and will presumably give it up only when it appears to be non-profitable.<sup>22</sup> In some instances, however, "inherent protection" may be inadequate to secure his interest. A nonoperator may therefore insert clauses in the transfer agreement requiring the operator to preserve the lease, to develop the mineral interest, and to give notice of an intent to terminate the lease with a right to demand reassignment.<sup>23</sup> When these

P.2d 271, 275 (1954) (implied obligation to keep lease alive where there is confidential relationship); H. WILLIAMS & C. MEYERS, *supra* note 13, § 420.2, at 359 ("there may be a duty to use good faith in determining whether to let a lease expire").

15. Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798, 804-05 (Tex. 1967). *But cf.* Howell v. Cooperative Refinery Ass'n, 176 Kan. 572, —, 271 P.2d 271, 275 (1954) (implied obligation to develop where there is confidential relationship).

16. See Phillips Petroleum Co. v. McCormick, 211 F.2d 361, 364 (10th Cir. 1954).

17. Davis v. Cities Serv. Oil Co., 338 F.2d 70, 74-75 (10th Cir. 1964).

18. See Guinand v. Atlantic Richfield Co., 485 F.2d 414, 417 (10th Cir. 1973); Davis v. Cities Serv. Oil Co., 338 F.2d 70, 74-75 (10th Cir. 1964).

19. Davis v. Cities Serv. Oil Co., 338 F.2d 70, 75 (10th Cir. 1964).

20. Discussion Notes, 6 OIL & GAS REP. 368, 369 (1956).

21. McClintock, *Legal Relations Between Lessees and Owners of Interests Carved Out of Leases*, 7 ROCKY MTN. MIN. L. INST. 139, 149-50 (1962); see Chase v. Trimble, 69 Cal. App. 2d 44, —, 158 P.2d 247, 249-50 (1947); Fain & McGaha v. Biesel, 331 S.W.2d 346, 348 (Tex. Civ. App. 1960); W. SUMMERS, *supra* note 7, at 641 (Operators may even obtain a quitclaim, joinder, or other release so there will be no uncertainty as to the termination.); *cf.* H. WILLIAMS & C. MEYERS, *supra* note 13, § 418.2, at 347 n.2 (probably not serious risk not to obtain such releases).

22. Warren, *Transfer of the Oil and Gas Lessee's Interest*, 34 TEX. L. REV. 386, 413-14 (1956).

23. Extension and renewal provisions are ineffective where the operator does not take a second lease because there is no renewal lease to which the interest may attach. *Id.* at 414. As will be seen, however, such clauses may provide substantial protection when the operator does take a second lease. See *infra* text accompanying notes 72-80 & 97-99.

covenants are included in the assignment, the operator will be liable for failure to perform the covenant. Although the nonoperating interest will still be extinguished on termination of the lease, the nonoperator will be entitled to damages, if proved, for the breach of the covenant.<sup>24</sup>

Although a nonoperator cannot claim fiduciary protection of his interest in the event of a termination of the lease, a "vaguely defined duty of fair dealing owed by the operator" to the nonoperator appears to be developing.<sup>25</sup> Encompassed within this duty may be an obligation to use good faith in determining whether to allow a lease to expire. The remedy for a failure to use good faith in this regard is the imposition of a constructive trust upon any benefits realized as a result of this failure.<sup>26</sup> One court suggests that where an operator has voluntarily undertaken to pay delay rentals, an action may arise for failure to make timely payments.<sup>27</sup> There may be some evidence of bad faith when an operator surrenders a producing lease.<sup>28</sup> However, it is difficult to establish that the operator surrendering the lease has acted in bad faith if he does not subsequently take a new lease on the premises.<sup>29</sup> When an operator does take a new lease on the premises and "washes out" the nonoperating interest, courts may more readily perceive that the opera-

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24. See *Gladys Belle Oil Co. v. Turner*, 12 S.W.2d 847, 849 (Tex. Civ. App. 1929) (damages for failure to reassign are market value of leasehold estate lost). McClintock believes this measure of damages is reasonable despite the fact that most nonoperators probably feel they should be entitled to the full measure of production had the lease not been lost. McClintock, *supra* note 21, at 157-58. *But cf.* *Walton v. Atlantic Richfield Co.*, 501 P.2d 802, 805 (Wyo. 1972) (no damages for failure to give notice when due to error, but damages for fair market value of overriding royalty interest). Some companies now limit damages to a specific amount, such as the sum paid for the assignment. McClintock, *supra* note 21, at 158. On the basis of such a clause, an operator was held liable for failing to give notice, with damages to be measured by the market value of the leases on the date of the breach. *Connell v. Sun Oil Co.*, 42 Colo. App. 311, —, 596 P.2d 1215, 1218 (1979). The court explained that unlike a liquidated damages provision, the agreement limiting damages did "not create an unconditional promise by defendant to pay a definite sum in the event of a breach, neither [did] it set the minimum amount which plaintiffs shall recover if defendant breaches." *Id.* at —, 596 P.2d at 1217. See generally H. WILLIAMS & C. MEYERS, *supra* note 13, §§ 428-430, at 468-94 (direct effect of protective clauses in assignment); Eaton, *The Reassignment Provision—Meaningful or Not?*, 20 ROCKY MTN. MIN. L. INST. 601 (1975) (direct effect of reassignment provision).

25. H. WILLIAMS & C. MEYERS, *supra* note 13, § 420.2, at 359.

26. *Id.* at 359-60.

27. *Gilroy v. White Eagle Oil Co.*, 201 F.2d 113 (10th Cir. 1952) (dictum).

28. See *Cain v. Neumann*, 316 S.W.2d 915, 920 (Tex. Civ. App. 1958). An attempted termination of producing lease was ineffective. There were additional factors, however, that evidenced bad faith on the part of the operator. *Cf.* *Wier v. Glassell*, 216 La. 828, —, 44 So. 2d 882, 889 (1950) (dictum that there may be some evidence of fraud if production has been obtained when top lease is taken and base lease is then allowed to expire).

29. See *La Laguna Ranch Co. v. Dodge*, 18 Cal. 2d 132, —, 114 P.2d 351, 356 (1941); *cf.* *Phillips Petroleum Co. v. McCormick*, 211 F.2d 361, 363-64 (10th Cir. 1954) (no bad faith where operator did not later acquire or claim any interest in new lease).

tor acted in bad faith.<sup>30</sup>

### III. WASH-OUTS IN THE ABSENCE OF PROTECTIVE CLAUSES

A so-called "wash-out" transaction is "conduct of the operator designed to extinguish the nonoperating interest while preserving the operator's interest in the premises."<sup>31</sup> This may be done in two ways: the operator may take a top lease before the end of the primary term of the lease and then allow the lease to terminate,<sup>32</sup> or he may terminate the existing lease and afterwards obtain a new lease.<sup>33</sup>

Unlike the situation in which the operator merely terminates the lease, the nonoperator has no inherent protection against wash-out transactions. An operator may further his own interest at the expense of the nonoperator by "shaking off" the nonoperating interest and obtaining a new lease unburdened by that interest. This situation, which generally involves some bad faith on the part of the operator, seems to call for added protection from the courts. Otherwise, the nonoperator is completely at the mercy of the operator. Accordingly, some courts respond with substantial protection for the nonoperator.<sup>34</sup>

However, the argument may also be made that a nonoperator does not need increased court protection since he may easily protect himself by inserting provisions in the transfer agreement requiring reassignment; notice of intent to surrender; or an interest in renewals, modifications, and extensions of the lease.<sup>35</sup> One commentator has stated, "If the transferor has neglected to protect himself by taking elementary precautions in the transfer agreement, his plight evokes little sympathy."<sup>36</sup> This is especially true when the nonoperator is an experienced

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30. *See* *Cain v. Neumann*, 316 S.W.2d 915 (Tex. Civ. App. 1958); *Wier v. Glassell*, 216 La. 828, 44 So. 2d 882 (1950).

31. *H. WILLIAMS & C. MEYERS*, *supra* note 13, § 420.2, at 354.

32. *See, e.g.*, *Goocey v. Hopkins*, 206 Ky. 176, 266 S.W. 1087 (Ky. Ct. App. 1924); *Thomas v. Whyte*, 5 Mich. App. 281, 146 N.W.2d 721 (1966); *Probst v. Hughes*, 143 Okla. 11, 286 P. 875 (1930).

33. *See, e.g.*, *Independent Gas & Oil Producers, Inc. v. Union Oil Co.*, 669 F.2d 624 (10th Cir. 1982); *Howell v. Cooperative Refinery Ass'n*, 176 Kan. 572, 271 P.2d 271 (1954).

34. *E.g.*, *Independent Gas & Oil Producers, Inc. v. Union Oil Co.*, 669 F.2d 624 (10th Cir. 1982); *Howell v. Cooperative Refinery Ass'n*, 176 Kan. 572, 271 P.2d 271 (1954); *Rees v. Briscoe*, 315 P.2d 758 (Okla. 1957).

35. *E.g.*, *Honolulu Oil Corp. v. Kennedy*, 251 F.2d 424, 432 (9th Cir. 1957) ("If they had desired to establish an express trust, there would have been no difficulty for an expert draftsman to have chosen apt language to create such a relationship."); *see also* *K & E Drilling, Inc. v. Warren*, 185 Kan. 29, —, 340 P.2d 919, 923 (1959) (parties may protect themselves with appropriate language).

36. *Warren*, *supra* note 22, at 417.

investor in the oil and gas industry.<sup>37</sup> A look at the cases reveals how courts have struggled with the problem of whether operators should be allowed protection when they have neglected to include protective provisions in their transfer agreements. To find a basis for such protections, courts look to the specific language in the assignment, a fiduciary relationship between the parties as shown by the particular facts of the case, or a duty of fair dealing.

Traditionally, courts have been hesitant to protect the nonoperator in a situation in which an assignment has been made without renewal or similar protective provisions.<sup>38</sup> The opinions generally state that apart from the terms of his contract, a nonoperator has no protection.<sup>39</sup> The relationship between the operator and nonoperator does not automatically rise to the level of a fiduciary relationship so as to require protection for the nonoperator.<sup>40</sup> Courts have not found a duty on the part of the operators which prevents them from acquiring a top lease before allowing an existing lease to expire.<sup>41</sup> The general rule has been stated:

In ordinary circumstances, the mere reserving of an overriding royalty interest in the assignment of an oil and gas lease—alone and without more—does not create a confidential or

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37. *Id.*; see H. WILLIAMS & C. MEYERS, *supra* note 13, § 420.2, at 359 (“[I]nformed parties, dealing at arm’s length, may be expected to include the provision if such be their intent.”).

38. See *Keese v. Continental Pipe Line Co.*, 235 F.2d 386 (5th Cir. 1956); *Gordon v. Empire Gas & Fuel Co.*, 63 F.2d 487 (5th Cir. 1933), *cert. denied*, 289 U.S. 751 (1933); *Goocey v. Hopkins*, 206 Ky. 176, 266 S.W. 1087 (Ky. Ct. App. 1924).

39. *E.g.*, *Honolulu Oil Corp. v. Kennedy*, 251 F.2d 424, 432 (9th Cir. 1957); *K & E Drilling, Inc. v. Warren*, 185 Kan. 29, —, 340 P.2d 919, 923 (1959); *Fain & McGaha v. Biesel*, 331 S.W.2d 346, 348 (Tex. Civ. App. 1960).

40. See *Bardill, Inc. v. Bird*, 346 S.W.2d 25 (Ky. Ct. App. 1961). *Bardill* is typical in its characterization of the relationship between the operator and the nonoperator. The court said that the mere assignment of an oil and gas lease creates no fiduciary relation. That relationship must be created by the assignment agreement, not by operation of law. In the absence of contractual provisions, neither party has a duty “to keep the lease alive for the benefit of the other *or* to recognize the beneficial interest of the other in a new lease with the owner,” *id.* at 26 (emphasis added). The court explains by saying that the rights of the operator and the nonoperator in the leasehold are for most purposes separable. Although certain actions inure to the benefit of both, “there is no duty by implication of law upon either to take affirmative action for the benefit of the other.” *Id.* (citing *Cameron v. Lebow*, 338 S.W.2d 399 (Ky. Ct. App. 1960)).

41. *Wier v. Glassell*, 216 La. 828, 44 So. 2d 882 (1950); *Thomas v. Whyte*, 5 Mich. App. 281, 146 N.W.2d 721 (1966); see *Goocey v. Hopkins*, 206 Ky. 176, 266 S.W. 1087 (Ky. Ct. App. 1924) (nonoperator has no cause of action when an operator acquires a new lease prior to the termination of the base lease); *cf.* *Henry v. Gulf Ref. Co.*, 179 Ark. 138, 15 S.W.2d 979 (1929) (assignee not entitled to any interest in top lease obtained by lessee); *Hawkins v. Klein*, 124 Okla. 161, 255 P. 570 (1927) (sublessee may take top lease and sublessor’s override will terminate on expiration of primary lease), *cert. denied*, 276 U.S. 588 (1928). *But cf.* *Akin v. Marshall Oil Co.*, 188 Pa. 602, 41 A. 748 (1898) (top lease will not be effective as against override retained on sublease where top lease taken while base lease still in effect).

fiduciary relationship between the assignor and the assignee which denies to the assignee the right to obtain from the owner of the land a top lease to take effect after the expiration of the assigned lease free of the burden of the overriding royalty, either in the form of a constructive trust or otherwise.<sup>42</sup>

Courts have similarly denied nonoperators protection when an operator releases a lease and subsequently obtains a new lease on the same property.<sup>43</sup>

In apparent recognition of a potential for abuse by operators of their right to "shake off" nonoperating interests while preserving their own, some courts have intimated that protection may be forthcoming in situations involving fraud or collusion.<sup>44</sup> One early case suggested that "[i]f fraud or inequity were present, the courts would stand ready to provide redress for the injured party."<sup>45</sup> That suggestion was later translated into a duty of good faith.<sup>46</sup> "Quite apart from any stipulations in the lease, the law implies a duty on the part of the assignee to exercise good faith with respect to the assignor's retained interest in the lease."<sup>47</sup> Although courts agree that a nonoperator might be protected if fraud or collusion could be shown, courts have not allowed a showing of fraud by parol evidence.<sup>48</sup> The Statute of Frauds bars such proof because it would vary the terms of the written instrument creating the nonoperating interest. Although a question exists as to what type of activity constitutes fraud, some cases suggest that fraud may be present if production has been obtained when a top lease is taken.<sup>49</sup>

Courts may also protect nonoperators where there is collusion be-

42. *Brannan v. Sohio Petroleum Co.*, 260 F.2d 621, 622 (10th Cir. 1958).

43. *E.g.*, *Keese v. Continental Pipe Line Co.*, 235 F.2d 386 (5th Cir. 1956).

44. *E.g.*, *La Laguna Ranch Co. v. Dodge*, 18 Cal. 2d 131, 114 P.2d 351, 356 (1941); *Campbell v. Nako, Corp.*, 195 Kan. 66, 402 P.2d 771 (1965); *Thomas v. Whyte*, 5 Mich. App. 281, 146 N.W.2d 721 (1966); see S. GLASSMIRE, OIL AND GAS LEASES AND ROYALTIES 240 (2d ed. 1938) (court of equity may enjoin surrender of lease obtained by fraud or collusion to cut out the nonoperating interest and substitute new lease); Discussion Notes, 6 OIL & GAS REP. 1339 (1957) ("[T]here is still the possibility of constructing a trust in the event of fraud or other circumstances which touch the conscience of equity.").

45. *La Laguna Ranch Co. v. Dodge*, 18 Cal. 2d 131, —, 114 P.2d 351, 356 (1941). The court, however, found no fraud or inequity.

46. *Phillips Petroleum Co. v. McCormick*, 211 F.2d 361 (10th Cir. 1954). The court did not, however, find a lack of good faith.

47. *Id.* at 364.

48. *Wier v. Glassell*, 216 La. 828, —, 44 So. 2d 882, 889 (1950).

49. *Id.*; see also *Root Ref. Co. v. Olvey*, 46 F.2d 444 (8th Cir. 1931) (duty of good faith breached if nonoperator can prove that oil and gas were known to be present in commercially producible quantities and were not produced by operator). In accordance with that view, the court in *Cain v. Neumann* did protect a nonoperator against a surrender of a producing lease by the operator. *Cain v. Neumann*, 316 S.W.2d 915 (Tex. Civ. App. 1958). In addition, under the facts of *Cain*, delivery of the release was conditioned on the delivery of a new lease. This type of



tween the lessor and the lessee-operator. In *Campbell v. Nako Corp.*,<sup>50</sup> a nonoperator alleged that such collusion was used to eliminate his override. The court indicated that "there seems clearly emerging a *duty of fair dealing* required on the part of the lessee to which doctrine this court has definitely inclined."<sup>51</sup> The court went on to state the rationale for the duty as follows:

Thus it would seem that the particular circumstances under which a lease is terminated and the presence or absence of bad faith does play a part in determining the duration of the overriding royalty. This would appear right and just as otherwise the holder is completely at the mercy of any collusive overreaching on the part of the owners of the other interests and, though having bargained in good faith for an interest in oil produced during the term of the lease, the law would be powerless to protect him from an unjust cancellation of that lease.<sup>52</sup>

The difficulty with the duty of fair dealing is recognizing what constitutes fraud or other wrongdoing.<sup>53</sup> Since, in the absence of specific provisions in the transfer agreement, the operator is free to take a top lease or surrender the old lease and take a new lease, a question is raised as to how that action is fraudulent or inequitable by reason of the lessee's desire to be rid of a nonoperating interest.<sup>54</sup> Another problem is that with the increasing use of extension and renewal clauses, parties dealing at arm's length may be expected to include such provisions if that is their intent. In the absence of such provisions, it may be difficult to persuade a court to find a duty of fair dealing.<sup>55</sup> Clearly, no fiduciary relationship arises automatically between an operator and nonoperator, but there appears to be developing a somewhat vaguely defined duty of fair dealing,<sup>56</sup> "the scope of which remains undefined."<sup>57</sup>

In accordance with their reluctance to protect nonoperators from

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release appeared to be a sham. To protect the nonoperator, the court held that the surrender was ineffective and that the base lease was still in effect. *Id.* at 920.

50. 195 Kan. 66, 402 P.2d 771 (1965).

51. *Id.* at —, 402 P.2d at 777 (citations omitted; emphasis added).

52. *Id.*

53. McClintock, *supra* note 21, at 163.

54. *Id.* at 163-64; *see also* Cain v. Neumann, 316 S.W.2d 915, 923 (Tex. Civ. App. 1958) (Murray, J., dissenting) (existence of override does not prevent operator from exercising right to surrender lease and acquire new one).

55. H. WILLIAMS & C. MEYERS, *supra* note 13, § 420.2, at 358.

56. *Id.* at 359.

57. *Id.* at 362.

wash-out transactions, courts will refuse to protect nonoperators when the operator acquires an interest in the premises adverse to or not covered by the base lease.<sup>58</sup> Generally, courts will not protect nonoperators when the operator obtains a protection lease from the lessor who asserts that the base lease has expired prior to the assignment.<sup>59</sup>

In certain special situations, however, courts provide increased protection for nonoperators in the absence of protective clauses in the transfer agreement. These situations include joint ventures,<sup>60</sup> federal

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58. See *Whitten v. Daws*, 226 Miss. 96, 83 So. 2d 744 (1955) (override did not attach to interest acquired by assignee after it developed that part of mineral interest held by other persons and not subject to lease); *H. WILLIAMS & C. MEYERS*, *supra* note 13, § 420.2, at 361. *But cf.* *Carroll v. Caldwell*, 12 Ill. 2d 487, 147 N.E.2d 69 (1957). After discovering a defect in the title to the leasehold, the operator acquired a new interest in the premises, to which the nonoperator's override attached. The holding was based, however, on the finding of a fiduciary relationship between the parties based on a joint venture.

59. See *Lambe v. Glasscock*, 360 S.W.2d 169 (Tex. Civ. App. 1962). In this case, the operator had an option to surrender on notice, and an option to reassign if he could not verify if delay rentals had been paid. The operator, after discovering that delay rentals had not been paid and that the senior lease had terminated, obtained a new junior lease through a third party. One commentator stated,

The practical effect of the holding in the subject case is that an assignee whose title is doubtful, or which is questioned or disputed, may take steps to perfect his leasehold estate by taking a new lease from the lessor without being irrevocably committed or obligated to perform contractual obligations or payment of overriding royalty to an assignor of the lease subsequently determined to have expired prior to its assignment.

Discussion Notes, 17 OIL & GAS REP. 358 (1963); see also *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 804-05 (Tex. 1967) (override did not attach to lease taken by operator when question arose as to validity of base lease); *cf.* *Arkansas Louisiana Gas Co. v. Evans*, 232 Ark. 495, —, 338 S.W.2d 666, 669-70 (1960) (Lessor holding a void tax title was not protected when operators acquired a lease from the true owners and refused to pay royalties to the lessor. The court said the operators were not estopped to deny their lessor's title.); *Knight v. Herndon Drilling Co.*, 296 P.2d 158, 165 (Okla. 1955) (An assignee was not obligated to account to lessee-assignor for override on production under protection lease. The court held that the first lease was canceled in an action by the lessor against the lessee-assignor.). It must be remembered, however, that if the nonoperating interest is carved out by the operator from his leasehold interest, the operator may be required to share the new interest with the nonoperator. Nonoperating interests, such as nonparticipating royalty interests, may be created by the mineral owner or lessor. Many other nonoperating interests are created out of an oil and gas lease by the lessee through grant or reservation. *E. KUNTZ*, *supra* note 1, § 63.1, at 197. This result would be due to the doctrine of after-acquired title or estoppel by deed. *H. WILLIAMS & C. MEYERS*, *supra* note 13, § 420.2, at 362. *But see* *Lambe v. Glasscock*, 360 S.W.2d 169, 172-73 (Tex. Civ. App. 1962) (estoppel to assert invalidity of senior lease was not applicable because operator did not claim under that lease); *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 805 (Tex. 1967) (although operator paid override out of base lease after termination, estoppel not applicable). The court in *Sunac* did not believe the making of the override payments "constituted a material misrepresentation on [the operator's] part, or that [the non-operator], in reliance on these payments, acted to his prejudice or changed his position." *Id.*

60. Where a fiduciary relationship exists due to a joint venture, courts will protect the nonoperator, even absent provisions in the transfer agreement. See *Carroll v. Caldwell*, 12 Ill. 2d 487, 147 N.E.2d 69 (1957) (constructive trust imposed because joint venturer violated duty to act for benefit of joint venture). A fiduciary relationship exists where parties work together to obtain rights or where there is some sort of joint undertaking. *Id.* at —, 147 N.E.2d at 74. "When the relationship between the parties is that of concurrent owners, partners, or participants in a joint venture, the courts appear ready to find a fiduciary relationship between the parties." *H. WIL-*

oil and gas leases,<sup>61</sup> and mergers.<sup>62</sup>

LIAMS & C. MEYERS, *supra* note 13, § 442.1, at 560.10. Where a fiduciary relationship is created by a joint venture, federal oil and gas lease, or merger, a constructive trust acts to preserve the nonoperating interest on a lease acquired by the operator in violation of his fiduciary obligations. E. KUNTZ, *supra* note 1, § 63.2, at 208. However, the interest must be within the scope of the fiduciary duty. If not, the operator will not be required to share the benefits of his enterprise. H. WILLIAMS & C. MEYERS, *supra* note 13, § 442.1, at 256. The burden is on the nonoperator seeking to impose a constructive trust to show that a confidential relationship exists. E. KUNTZ, *supra* note 1, § 63.2, at 208-09. A fiduciary relationship may be shown by establishing the existence of a mining partnership. *See, e.g.*, *Hatten v. Interocean Oil Co.*, 182 Okla. 465, 469, 78 P.2d 392, 397 (1938); *Smith v. Bolin*, 294 S.W.2d 280, 284-85 (Tex. Civ. App. 1956) (fiduciary relationship between mining partners prevented operator from permitting partnership's leases to lapse, terminating nonoperating interests, and then obtaining renewal leases for himself). *See generally* McKay, *Joint Ventures and Mining Partnerships*, 7 U. KAN. L. REV. 22 (1958) (discussion of formation and consequences of mining partnerships). McKay writes:

The relationship between a managing partner and his associates is fiducial, and there is a consequent duty of acting in good faith and with honesty and diligence. The duty of an operating partner to account to a non-operating partner applies to a mining partnership the same as to a general partnership.

*Id.* at 25 (footnotes omitted). A fiduciary relationship may be established by an agreement that both parties will attempt to secure an oil and gas lease. *See Howell v. Cooperative Refinery Ass'n*, 176 Kan. 572, —, 271 P.2d 271, 274-75 (1954); *cf. MacDonald v. Follett*, 142 Tex. 616, —, 180 S.W.2d 334, 337 (1944) (If a nonoperator can establish that the joint owner of an override agreed to negotiate a renewal to protect both overriding interests, there is evidence of a fiduciary relationship.). In addition, courts may find a fiduciary relationship when the parties jointly participate in a plan of unitization, or enter into an operating agreement at the time the nonoperating interest is created. *See Carroll v. Caldwell*, 12 Ill. 2d 487, —, 147 N.E.2d 69, 74 (1958) (rights and duties governed by unitization agreement); *Jack v. Hunt*, 75 N.M. 686, —, 410 P.2d 403, 409 (1966) (operating agreement created fiduciary relationship).

61. A special situation arises in cases involving federal oil and gas leases. The exchange lease and preference right lease are created by Congress. The laws change, extensions are granted, and different forms of leases are issued to the operator while the first lease remains in effect. McClintock, *supra* note 21, at 150; *see also id.* at 150 n.20 (traces changes in federal leasing law). It has been suggested that courts will "go a long way" to enforce operating interests carved out of permits and leases issued between 1920 and 1935, despite meager provisions in the instruments as to extensions, renewals, and substitutions. *Id.* at 156. Prospecting permits and discovery leases were substituted for the location method in 1920 pursuant to the Mineral Leasing Act of Feb. 25, 1920, 41 Stat. 437. Exchange leases were provided for in the Act of Aug. 21, 1935, 49 Stat. 674. McClintock, *supra* note 21, at 150 n.20. McClintock suggests that one reason for expanded protection might be that on private land the fee owner may grant as many leases as he wishes. Under a federal lease, the land covered is removed from further leasing during the term of the lease. The nonoperator is completely at the mercy of the lessee who can surrender the lease and refile. As long as the lease is in effect, no other application for a lease can be filed. *Id.* at 156. In *Mimi Corp. v. Hill*, 310 F.2d 467 (10th Cir. 1962), the court preserved a nonoperating interest in a lease on public land despite the absence of provisions for renewal or for the nonoperating interest to carry forward to a preference lease. The court pointed out that a new preference lease had been acquired through a statutory preference right in the base lease. *Id.* at 469. The new lease was, therefore, merely a continuation or "direct outgrowth" of the prior lease, so the nonoperating interest attached. *Id.* at 470. One commentator suggests that "[t]he decision reflects a result that would not be anticipated if the royalties had been carved out of a lease of privately owned land." Discussion Notes, 17 OIL & GAS REP. 653, 653 (1963). It appears that McClintock would agree with the result in *Mimi*. In discussing extensions of exchange leases and preference right leases, he says, "In these circumstances, it appears that there would be every presumption that the extensions are merely continuations of the original grant even though only the government assignment form is used and nothing is said therein about extensions." McClintock, *supra* note 21, at 156; *see Kutz Canon Oil & Gas Co. v. Harr*, 56 N.M. 358, 244 P.2d 522 (1952); *cf. Oldland v. Gray*, 179 F.2d

## IV. PROTECTIVE CLAUSES IN TRANSFER AGREEMENTS

To avoid uncertainty, nonoperators desiring to protect their interests may include an extension and renewal clause or a notice and offer of reassignment provision in the transfer agreement. In addition to directly protecting the nonoperator's interest, protective clauses may serve as a basis for the imposition of a constructive trust. A constructive trust can be imposed if a court determines that inclusion of the protective clause creates a fiduciary relationship.<sup>63</sup> Courts consider the surrounding circumstances and the parties' intent, as evidenced by inclusion of the protective clause, to determine whether a fiduciary relationship exists.

Courts determine the parties' intent in including extension and renewal provisions by looking to the language of the provisions.<sup>64</sup> However, the intent of parties in including certain language is not always

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408, 414-15 (10th Cir. 1950) (fiduciary relationship created by assignment of prospecting permit not extinguished by 1935 amendment to the Mineral Leasing Act), *cert. denied*, 339 U.S. 948 (1950); *Jack v. Hunt*, 75 N.M. 686, —, 410 P.2d 403, 411 (1966) (equity requires that override be proportionately reduced but not extinguished by subsequent increase in royalty rate of government, as lessor, due to fiduciary relation created by operating agreement).

62. Where contractual language in a transfer agreement indicates an intent that an override remain in effect upon a merger of interests, a court will preserve the overriding royalty. *See Page v. Fees-Krey, Inc.*, 617 P.2d 1188 (Colo. 1980). In this case, the interests of a sublessor and sublessee merged by transfer to one person. The court preserved the overriding royalty reserved out of the sublease, stating,

Application of the doctrine of merger to defeat an overriding royalty interest contrary to the intent of the holders of the interests of the sublessor and sublessee as expressed in the document by which both such interests came together in one owner would be inequitable; neither policy nor precedent requires such a result.

*Id.* at 1195. In another case, even the terms of an agreement could not be extinguished by merger of interests. A lease was assigned pursuant to a farmout agreement containing an extension and renewal clause. The lease did not contain the clause. When the operator obtained a renewal lease, he argued that the farmout terms were merged and superseded so that he would not have to pay the overriding royalty. The court said the farmout agreement and the assignment together constituted the contract. Construed together, the nonoperating interest attached to the renewal lease. *See Phillips Petroleum Co. v. Stack*, 246 So.2d 546, 547-48 (Miss. 1971). Furthermore, even without contractual provisions, at least one court has indicated that an oil payment holder might have protection against a merger of the operating interest with the lessor's estate, saying, "Equity would not countenance a merger of interests by [the operator] to the prejudice of [the nonoperator]." *Matthews v. Ramsey-Lloyd Oil Co.*, 121 Kan. 75, —, 245 P. 1064, 1067 (1926).

63. *See Probst v. Hughes*, 143 Okla. 11, 286 P. 875 (1930).

64. *Bown v. Austral Oil Co.*, 322 So. 2d 866, 870 (La. Ct. App. 1975). In *Bown*, an agreement to assign nonoperating interests stated that the nonoperating interest was to be assigned from two specific leases in a prospect. *Id.* at 871. The court easily concluded that by including such language, the parties did not intend for nonoperating interests to be assigned out of all the leases acquired in the prospect. *Id.* at 872. Furthermore, the court found that upon the expiration of two specific leases, the nonoperating interest terminated and the operator was free to acquire any new leases or renewals of the old leases from the landowners. *Id.* The agreement did not demonstrate that the parties intended the nonoperating interest to attach to renewals or subsequent leases. *Id.* at 870-72.

clear. As a result, the same provision may have a different effect on the relationship between the parties depending on the court's construction of the provision.<sup>65</sup> Courts also look at the surrounding circumstances of a particular case to determine whether a fiduciary relationship is intended.<sup>66</sup> Factors which indicate that a fiduciary relationship exists include the presence of a drilling covenant and the fact that a major part of the consideration for the transfer was to be paid out of the oil produced.<sup>67</sup> The Oklahoma Supreme Court in *Rees v. Briscoe*<sup>68</sup> found a fiduciary relationship based on the factors of an assignment made for no consideration, the nonoperator's lack of action based on his conviction that his interest would be protected despite his knowledge that the operator was obtaining new leases, and prior dealings between the parties.<sup>69</sup> The fact that the nonoperator easily could have protected himself by express language in the transfer agreement and elected not to do so only served to further convince the court that the nonoperator had

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65. This result may be illustrated by cases construing a provision that the reserved nonoperating interest is a "covenant running with the land." Although recognizing that an overriding royalty is not a covenant running with the land, one court found that by including such a provision, the nonoperator "sought" to establish a fiduciary relationship. *Kennedy v. Seaboard Oil Co.*, 99 F. Supp. 730, 733 (N.D. Cal. 1951). This case exemplifies "a court straining to protect [a nonoperator] who foresaw the washout problem but tried to protect himself in an inept manner." Warren, *supra* note 22, at 418 n.105. In a factually similar case with the same protective language, the court did not find a fiduciary relationship. *Honolulu Oil Corp. v. Kennedy*, 251 F.2d 424, 432 (9th Cir. 1957). The court stated that the inclusion of the clause was for the limited purpose of assuring the nonoperator that his interest would not be cut off by the actions of the nonoperator. To bolster its determination that no fiduciary relationship was intended, the court said, "If they had desired to establish an express trust, there would have been no difficulty for an expert draftsman to have chosen apt language to create such a relationship." *Id.* The different results in the cases are due to the differing views of the courts as to the parties' intent in including such a provision. It appears that language in a transfer agreement that the nonoperating interest is a "covenant running with the land" will not create a fiduciary relationship. In one case, a court said that contractual obligations depend on the intent of the parties and that parties do not intend "covenant running with the land" to mean that an override would apply to unrelated new leases subsequently acquired. *K & E Drilling, Inc. v. Warren*, 185 Kan. 29, —, 340 P.2d 919, 923 (1959). The court supported its conclusion by saying that if the parties intended the override to apply to new leases, they might have said so in appropriate language. *Id.*

66. See *MacDonald v. Follett*, 142 Tex. 616, 180 S.W.2d 334 (1944). McClintock writes in agreement: "[I]t is apparent that the question of whether the old interest should be charged against the new lease depends upon all the facts and circumstances of the particular case and, in the event of litigation, evidence will be received as to the negotiations and representations of the parties." McClintock, *supra* note 21, at 155.

67. *Hivick v. Urschel*, 171 Okla. 17, 20, 40 P.2d 1077, 1080 (1935). The court states that a fiduciary relationship may exist under many circumstances. "[I]t exists in all cases where there has been a special confidence reposed in one who in equity and conscience is bound to act in good faith and with due regard to the interests of the one reposing the confidence." *Id.* at 20, 40 P.2d at 1080. *But see Goocey v. Hopkins*, 206 Ky. 176, —, 266 S.W. 1087, 1088 (1925) (no fiduciary relationship regardless of existence of drilling covenant).

68. 315 P.2d 758 (Okla. 1957).

69. *Id.* at 761-63 (court imposed a constructive trust on new leases acquired by operator).

full confidence in and relied upon the operator. The court said, "Had the [nonoperator] doubted [the operator] he would no doubt have seen that such provisions were included in his assignments."<sup>70</sup>

The decision in *Rees v. Briscoe* evoked a dissent by three justices,<sup>71</sup> and created uncertainty regarding appropriate application of the rule that no fiduciary relationship exists between an operator and a nonoperator. *Rees* has been interpreted as requiring an examination of "the underlying facts" to determine whether a fiduciary relationship exists between the parties which requires the operator to protect a nonoperating interest when taking a new lease.<sup>72</sup> However, it has been suggested that "the conscience of the court was touched by the overall circumstances of the case making the court feel it necessary, to prevent injustice, to give the judgment [for the holder of the nonoperating interest]."<sup>73</sup>

Extension and renewal clauses are being used increasingly in instruments creating nonoperating interests. For an extension and renewal clause to be effective, it must appear in the instrument creating the nonoperating interest.<sup>74</sup> When these clauses do appear, a court must consider whether a new lease is actually an extension or renewal of the old lease. Furthermore, the existence of the clause may have the indirect effect of demonstrating that the parties intended a fiduciary relationship to exist. One commentator wrote,

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70. *Id.* at 763.

71. *Id.* at 764 (Williams, Davison & Jackson, JJ., dissenting).

72. Note, *supra* note 67, at 87-88 (1958).

73. Note, *Oil and Gas: Relationship Between Assignor and Assignee of Lease*, 11 OKLA. L. REV. 92, 94 (1958). This commentator believes *Rees* is a special case and that the decision must be limited to its facts. *Id.* at 94-95. In a case decided the following year, the court found that there was no fiduciary relationship between the parties and distinguished the facts in *Rees*. *Brannan v. Sohio Petroleum Co.*, 260 F.2d 621 (10th Cir. 1958). The court pointed out that in *Brannan*, substantial consideration had been paid for the assignment, there was no covenant to drill, and there were no prior dealings between the parties. *Id.* at 622-23.

74. *Texas Pacific Coal & Oil Co. v. Honolulu Oil Corp.*, 241 F.2d 920 (5th Cir. 1957). In *Texas Pacific*, a nonoperating interest holder could not claim an interest in a new lease. An attempted addition of a clause into an instrument executed after termination of the lease, that the nonoperating interest would attach to any new leases made between the assignee and landowners, was ineffective. *Id.* at 923. Courts cannot hold parties to provisions that are not present in the original agreement because the parties might have intended not to include them. See *Bardill, Inc. v. Bird*, 346 S.W.2d 25, 26 (Ky. Ct. App. 1961) (no duty to keep lease alive where not provided for by express terms of contract); cf. *Fain & McGaha v. Biesel*, 331 S.W.2d 346, 348 (Tex. Civ. App. 1969) (language in release ineffective to alter nature of nonoperating rights under instrument creating nonoperating interest). One commentator believes that the *Texas Pacific* decision turns on "equity under the particular set of facts rather than on any well-defined rules for construction of instruments." He says the court thought that the nonoperator had "beefed up" the assignment agreement beyond the contemplation of the parties. *Cage, Anatomy of a Farmout*, 21 INST. ON OIL & GAS L. & TAX'N 153, 173 (1970).

When there is a covenant which provides that the rights of the interest owner shall apply to any extension or renewal of the lease, the courts will generally give effect to what it deems to be the intention of the parties in the agreement and it will not give a narrow interpretation to the terms used.<sup>75</sup>

Early cases found a fiduciary relationship existed when the lease assignment contained an extension and renewal provision.<sup>76</sup> Upon expiration or renewal of the base lease, this provision would allow the court to attach the nonoperating interest to any new leases acquired by the operator prior to the expiration of the old lease. In *Howell v. Cooperative Refinery Association*,<sup>77</sup> the court held that due to a confidential relationship between the parties a nonoperating interest attached to a new lease acquired more than a year *after* the expiration date of the old lease. This result might be explained not only by the court's interpretation of the language, but also by the particular facts involved.<sup>78</sup>

A clause interpretation rule emerged that where the assignment of a lease expressly provides that the reservation of a nonoperating interest should apply to extensions, renewals, or modifications of any lease acquired by the assignee or his successors, such provision indicates a relationship of trust and confidence between the assignor and his assignees entitling the assignor to payment of the nonoperating interest reserved out of oil or gas produced under a subsequent lease.<sup>79</sup> However, this policy of broad protection for nonoperators was limited by later cases.<sup>80</sup>

Relying on an "intent" analysis, these courts found that extension and renewal clauses did not create a fiduciary relationship between an operator and a nonoperator. In *K & E Drilling, Inc. v. Warren*,<sup>81</sup> there was an extension and renewal clause, the assignment was made in consideration of the operator drilling a test well, and there was a provision

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75. McClintock, *supra* note 21, at 154.

76. *E.g.*, *Oldland v. Gray*, 179 F.2d 408, 414 (10th Cir. 1950) (case involved assignment of oil and gas prospecting permit on public lands with assignee promising to drill and develop); *Probst v. Hughes*, 143 Okla. 11, 286 P. 875 (1930).

77. 176 Kan. 572, 271 P.2d 271 (1954).

78. *Id.* at —, 271 P.2d at 275. A geologist assigned leases to an oil company reserving an override. Prior to the expiration of the leases, the geologist called to the operator's attention the fact that the leases needed to be renewed. The geologist worked closely with the operator to obtain the renewals after the leases expired. *Id.* Under these facts, the equities were with the nonoperator.

79. W. SUMMERS, *supra* note 7, § 554, at 637-39.

80. *Meeker v. Ambassador Oil Co.*, 308 F.2d 875, 885 (10th Cir. 1962); *K & E Drilling, Inc. v. Warren*, 185 Kan. 29, 340 P.2d 919 (1959).

81. 185 Kan. 29, 340 P.2d 919 (1959).

that the reservation was deemed to be a covenant running with the land.<sup>82</sup> Although earlier courts might have easily found an intent to create a fiduciary relationship based on these facts, this court held that by including an extension and renewal clause the parties merely intended the nonoperating interest to apply to production under specific leases or extension or renewals thereof. The court reasoned that if the parties had intended the nonoperating interest to apply to unrelated new leases subsequently acquired in the same property, they would have expressly said so in appropriate language.<sup>83</sup>

At present, substantial confusion exists concerning the direct effect of extension and renewal clauses and the indirect effect of the clauses as manifesting an intent to create a fiduciary relationship. Finding no fiduciary relationship, the court in *Meeker v. Ambassador*,<sup>84</sup> without mentioning *Howell*,<sup>85</sup> distinguished *Rees* and other earlier cases on the basis that in those cases, new leases were obtained *prior* to the termination of the base lease.<sup>86</sup> The court's distinction is a non sequitur. Whether a new lease is acquired before or after the termination of the base lease should have little bearing in determining whether a fiduciary relationship exists between the parties, unless the lease is acquired so much later that the fiduciary relationship can no longer be said to exist. If the parties intended to create a fiduciary relationship by including an extension and renewal clause, the circumstances under which a new lease is acquired should have no bearing on the existence of the fiduciary relationship.<sup>87</sup> Rather than considering the indirect effect, the court

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82. *Id.* at —, 340 P.2d at 920.

83. *Id.* at —, 340 P.2d at 923. A clause that would apply to "new leases" has been held to be in violation of the rule against perpetuities. *See Cities Serv. Oil Co. v. Sohio Petroleum Co.*, 345 F. Supp. 28, 30 (W.D. Okla. 1972). This rule voids any property right that may vest more than 21 years after some life in being at the creation of the interest. *Independent Gas & Oil Producers v. Union Oil Co.*, 669 F.2d 624, 628 (10th Cir. 1982). It has been held, however, that property interests in extensions and renewals of the lease do not violate the rule against perpetuities because all rights under the lease and clause are vested at the time of the assignment of the nonoperating interest. *See id.*; *Howell v. Cooperative Refinery Ass'n*, 176 Kan. 572, —, 271 P.2d 271, 275-76 (1954). One commentator writes, "This is a valid conclusion if it is assumed that the new lease is in substance the old lease extended. If it is in substance a new lease, then the conclusion on the application of the rule against perpetuities is questionable." E. KUNTZ, *supra* note 1, § 63.2, at 207. In the latter situation, the extension and renewal clause would seem to amount to a contractual provision for the creation of a new lease in the future, and no rights can be vested in the new lease until it is granted. *Id.*

84. 308 F.2d 875 (10th Cir. 1962).

85. 176 Kan. 572, 271 P.2d 271 (1954). In *Howell*, a new lease was acquired more than a year after the termination of the base lease, and the court found a fiduciary relationship. *Id.*

86. *Meeker v. Ambassador Oil Co.*, 308 F.2d 875, 885-87 (10th Cir. 1962).

87. The circumstances under which a new lease is acquired may have bearing on the question of whether the operator acted in good faith. *See Campbell v. Nako Corp.*, 195 Kan. 66, —, 402 P.2d 771, 777 (1965) ("[T]he particular circumstances under which a lease is terminated and the



in *Meeker* focused on the direct effect of the language, holding that a new lease could not "constitute an extension or renewal of a lease that had theretofore terminated and no longer existed."<sup>88</sup>

In the more recent case of *Sunac Petroleum Corp. v. Parkes*,<sup>89</sup> the court held that no fiduciary relationship is created by the existence of an extension or renewal clause.<sup>90</sup> Although the court did not confuse the direct and indirect effect of the extension and renewal clause, it employed an unusual method to negate its indirect effect.

In *Sunac*, the court correctly pointed out that a fiduciary relationship may be based on: "1) specific language in the assignment or 2) the close relationship between the parties shown by the particular facts involved."<sup>91</sup> By focusing on the direct effect of the extension and renewal clause, the court found that the new lease was not an "extension" or "renewal" because the base lease "had long since expired" and the new lease was on substantially different terms and for a new consideration.<sup>92</sup> The court then considered the facts and found no fiduciary relationship, saying, "There is no evidence that Sunac occupied a position of confidence or trust with Parkes other than the clause relating to extensions or renewals."<sup>93</sup> The court seemed to distinguish *Howell* on the basis of a fiduciary relationship existing independently of the extension and renewal clause. Although recognizing that courts typically interpret such clauses to create a fiduciary relationship, the court in *Sunac* negated the effect of an extension and renewal clause on the basis of a provision in the assignment which stated that the operator would have no duty to keep the lease alive. By construing the provisions together, the court found that the provision relieving the operator of the duty to perpetuate the lease also relieved him of the duty to perpetuate the nonoperating interest.<sup>94</sup> This analysis was vigorously attacked by three

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presence or absence of bad faith does [sic] play a part in determining the duration of the overriding royalty."); *cf.* *K & E Drilling, Inc. v. Warren*, 185 Kan. 29, —, 340 P.2d 919, 923 (1959) (circumstances of acquisition of new lease did not manifest bad faith). Surrounding circumstances may also be relevant as to whether the new lease is in fact an extension or renewal of the base lease. *See Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 803 (Tex. 1967).

88. *Meeker v. Ambassador Oil Co.*, 308 F.2d 875, 887 (10th Cir. 1962).

89. 416 S.W.2d 798 (Tex. 1967).

90. *Id.* at 804-05. The operators had been producing oil under a lease for a year when a question arose as to whether the lease had terminated before drilling operations had begun. The operators obtained a new lease while the well was still producing, then ceased to pay an overriding royalty to the nonoperator. The court determined that the original lease had terminated and that the override did not attach to the subsequently acquired lease. *Id.* at 802-03.

91. *Id.* at 803.

92. *Id.* at 802.

93. *Id.* at 804.

94. *Id.*

dissenting justices<sup>95</sup> who argued that the extension and renewal clause, "irrespective of, and in the complete absence of, any confidential or personal relation between such parties,"<sup>96</sup> imposed a fiduciary relationship between the parties.

*Sunac* is noteworthy in that the analysis employed by both the majority and the dissenting opinions sets up a framework for determining the effect of an extension and renewal clause. The court first considered whether the clause directly applied to the new lease and then whether the new lease was actually an extension or renewal of the old lease. Whether the new lease was acquired before or after the termination of the contract and the terms of the new lease were important factors. The court then looked to the underlying facts to determine whether a fiduciary relationship existed independent of the extension and renewal clause. Finally, the court reached the question of whether a fiduciary relationship may be imposed by virtue of the extension and renewal clause. Differing opinions as to the intent of the parties underlie the differences between the majority and dissent on this question. The majority believed that any intent to create a fiduciary relationship based on an extension and renewal clause was overcome by a contrary intent manifested by the inclusion of the provision relieving the operator of any duty to perpetuate the lease.<sup>97</sup> The dissent, on the other hand, believed that the inclusion of an extension and renewal clause was de facto evidence of an intent to create a fiduciary relationship, regardless of the other provision.<sup>98</sup> In addition to its value as a framework for analyzing the effect of clauses in an assignment, *Sunac* lends support to the growing number of cases denying nonoperators protection after the lease has expired.<sup>99</sup>

However, a recent case has reopened the possibility for a nonoper-

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95. *Id.* at 806 (Smith, Hamilton & Pope, JJ., dissenting). Hamilton says, "The provision relieves [the operator] of no duty imposed by the lease . . . . Consequently, it is difficult to understand by what reasoning the Court can say that such provision destroys the relationship of trust and confidence created by the 'renewal or extension' provision contained in the assignment." *Id.* at 811. The dissent also argued that a confidential relationship existed between the parties independently of the "extension and renewal" clause, due to circumstances existing when the new lease was taken. The nonoperator's rights were equally involved when the lease's validity was questioned, and in a suit on the matter, the nonoperator would have been an indispensable party. *Id.*

96. *Id.* at 809.

97. *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 804 (Tex. 1967).

98. *Id.* at 807-08.

99. *E.g.*, *Gasperson v. Christie, Mitchell & Mitchell Co.*, 418 S.W.2d 345 (Tex. Civ. App. 1967); *cf.* *McCormick v. Krueger*, 593 S.W.2d 729 (Tex. Civ. App. 1979) (third party who obtained salvage rights under lease with extension and renewal clause not bound by lease terms when he obtained new lease; therefore, overriding royalty did not apply to new lease).

ator to protect his interest even after the lease has expired, at least in Oklahoma.<sup>100</sup> In *Independent Gas and Oil Producers, Inc. v. Union Oil*,<sup>101</sup> the court held that the new lease was "converted" into a renewal of the old one by the extension and renewal provision of the contract and that the existence of the clause "triggered" the operation of the fiduciary rule. The court went on to state, "This rule has been applied even where the new lease did not issue until the old one had expired for lack of production."<sup>102</sup> Like the dissent in *Sunac*, the court found that the intent expressed by the inclusion of the clause itself provided a basis for imposing a fiduciary relationship. "Where an assignment provides that subsequent lease extensions and renewals are subject to an overriding royalty, the assignee stands as a quasi-trustee vis-a-vis the assignor and must exercise the utmost good faith in protecting the latter's interest in the leasehold."<sup>103</sup>

The court did not, however, rely solely on the existence of the clause. Having found that the fiduciary rule had been triggered, the court then looked for additional support for the propriety of the rule's application in light of other "underlying facts."<sup>104</sup> Important factors were that the royalty was an important part of the consideration for the assignment,<sup>105</sup> the operator believed the lease to be lucrative despite temporary cessation,<sup>106</sup> and the operator exhibited bad faith in attempting to cheat Union out of the royalty.<sup>107</sup> The court considered it immaterial that Union paid nothing additional for the new lease, that Independent was not responsible for the termination of the original lease, that Independent obtained the second lease through a third party, and that Union waited several months after terminating the second lease before bringing its claim.<sup>108</sup> The court concluded that the second lease was a renewal to which Union's overriding royalty attached.

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100. *Independent Gas & Oil Producers, Inc. v. Union Oil Co.*, 669 F.2d 624 (10th Cir. 1982).

101. *Id.* In this case, Union conveyed an oil and gas lease to Independent, reserving an overriding royalty. There was an extension and renewal clause in the transfer agreement, and the consideration for the assignment was the royalty and a drilling covenant. A test well problem developed and, to protect its interest, Independent obtained a second lease through a third party. Independent refused to recognize Union's override, theorizing that the second lease was not an extension or renewal of the first lease. *Id.*

102. *Id.* at 627.

103. *Id.*

104. *Id.* The court leaves open the circumstances under which application of the fiduciary rule would be inappropriate. *Id.*

105. *Id.*; see *Rees v. Briscoe*, 315 P.2d 758, 763 (Okla. 1957).

106. 669 F.2d at 627; see *Probst v. Hughes*, 143 Okla. 11, 13, 286 P. 875, 877 (1930).

107. 669 F.2d at 627.

108. *Independent Gas & Oil Producers v. Union Oil*, 669 F.2d 624, 627-28 (10th Cir. 1982).

As in *Sunac*, the court went through a proper analysis in determining whether a fiduciary relationship existed between the parties. The primary focus of the court should be on the intentions and objectives of the parties, as expressed in the language of the assignment and the surrounding circumstances.<sup>109</sup> The existence of an extension and renewal clause in an assignment should be a signal to the court that the parties may have intended to create a fiduciary relationship. The court must then examine other language in the assignment and the surrounding circumstances to determine whether the creation of a fiduciary relationship was in fact intended by the parties or was necessary to achieve their objectives. Important factors include the consideration for the assignment, the presence or absence of drilling covenants, prior dealings or trust between the parties, and the equities of the case.

## V. CONCLUSION

Since the interests of nonoperators receive little or no protection apart from the terms of the transfer agreement, the prudent nonoperator will include protective clauses in the transfer agreement. When experienced nonoperators do not include such provisions, courts should feel no compulsion to protect the nonoperator. However, recognizing that the inclusion of an extension and renewal clause is generally some evidence of an intent to create a fiduciary relationship, courts should give these protective clauses a broad reading. When courts fail to perceive this "indirect" effect of the protective clauses and construe them narrowly, nonoperators are vulnerable to defeasement by acts of the operator. Despite the current judicial uncertainty as to the precise rights and obligations between operators and nonoperators, careful drafting and inclusion of protective language in creating instruments and the corresponding judicial implication of a fiduciary relationship will afford prudent nonoperators appropriate protection of their interests.

*Sharon K. Schooley*

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109. See *id.* at 627; *McClintock*, *supra* note 21, at 154. *McClintock* says, "The question of whether a fiduciary relationship exists does not seem too important and the real purpose of the court is to determine the intention of the parties." *Id.*