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NOTES AND COMMENTS

PROTECTING THE RIGHTS OF THE NONPARTICIPATING MINERAL OWNER

I. INTRODUCTION

Traditionally, the mineral rights to a particular piece of property are owned by more than one person. It is not uncommon for one of these owners to have the exclusive right to enter into and execute a lease of the minerals for the benefit of all the parties. Unfortunately, the owner holding the executive rights may favor himself over the other owners with respect to the terms of a lease that he may enter into with a lessee of the minerals. Clearly, the potential for the executive owner to favor himself over the nonexecutive owner creates an inherent conflict of interest between the executive and the nonexecutive owners.

The courts in Texas and Oklahoma have developed different approaches in attempting to address this situation. Under the Texas approach, the interests created in a lease of the minerals by the executive owner and the lessee are defined as either a royalty or a bonus, and the nonexecutive owner is allowed to participate in one or the other. The Oklahoma approach, on the other hand, examines the intent of the parties to ascertain whether the nonexecutive should be allowed to participate in the created interests.

This Comment will first discuss the nature and characteristics of executive versus nonexecutive ownership. Next, the strengths and weaknesses of the various approaches utilized by the courts to handle this conflict of interest problem will be analyzed in relation to several important competing policy concerns. Finally, an alternative approach will be proposed and analyzed as to its strengths and weaknesses in relation to the same competing policies.

1. The exclusive right to enter into and execute mineral leases is referred to as the "executive right." See H. WILLIAMS & C. MEYERS, MANUAL OF OIL AND GAS TERMS 250 (5th ed. 1981); Jones, Non-Participating Royalty, 26 TEx. L. Rev. 569 (1948).
2. See Griffith v. Taylor, 156 Tex. 1, 291 S.W.2d 673 (1956).
II. CHARACTERISTICS OF EXECUTIVE, NONEXECUTIVE, AND
NONPARTICIPATING OWNERSHIP

In order to understand the inherent conflict of interest between an executive owner and a nonexecutive owner of the same minerals, it is first necessary to understand the nature of each type of ownership. Ownership of a mineral interest involves much more than just the ownership of the minerals themselves. Basically, the ownership of a mineral interest involves three rights:

1. The right to reasonably use the surface of the land under which the minerals lay in order to search for, develop, and produce the minerals.

2. The right to bonus, rental, or royalty benefits under an oil and gas lease.

\[\text{Vol. 20:433}\]
3. The right to lease or sell the mineral interest.\textsuperscript{12}

When a fraction of the mineral interest owned by one mineral owner is transferred to another, then the grantee of the fractional mineral interest also owns a proportionate share of these three rights. For example, should the sole mineral owner subsequently convey a one-half mineral interest by mineral deed to another party, then both parties would own one-half of each of the three rights of mineral ownership.

Additionally, the mineral interest owner may want to sever some of the rights of mineral ownership\textsuperscript{13} and reserve to himself the exclusive right to lease the minerals. The party with the exclusive right to lease the minerals is called the executive owner while the party without this right is called the nonexecutive owner.\textsuperscript{14} Although both the executive and nonexecutive owners may share equally in the lease benefits,\textsuperscript{15} only the executive owner can execute a lease on the property or develop the minerals himself.\textsuperscript{16}

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\textsuperscript{12} The right to lease is more commonly known as the executive right. \textit{See id. § 2022.}


\textsuperscript{14} The Texas Court of Civil Appeals has explained the concept as follows:

The owner of a mineral estate possesses a bundle of interests which can be separately conveyed or reserved; these include the rights to execute oil, gas and mineral leases, and the right to receive bonuses, rental and royalties. As indicated, each can be severed into a separate interest, and each is a property right. . . .


\textsuperscript{15} There are some cases which hold that the severance of the executive right from the mineral estate creates a nonleasing interest which is in essence a perpetual royalty interest violating the Rule Against Perpetuities. \textit{See} Dallapi v. Campbell, 45 Cal. App. 2d 541, 114 P.2d 646 (1941); Cosgrove v. Young, 230 Kan. 705, 642 P.2d 75 (1982); Lathrop v. Eyestone, 170 Kan. 419, 227 P.2d 136 (1951). However, there is substantial case law to the contrary holding that the severance of the executive right does not violate the Rule. \textit{See} Hanson v. Ware, 224 Ark. 430, 274 S.W.2d 359 (1955); Keville v. Hollister Co., 29 Cal. App. 3d 203, 105 Cal. Rptr. 238 (1972); Price v. Atlantic Refining Co., 79 N.M. 629, 447 P.2d 509 (1968); J.M. Huber Corp. v. Square Enter., Inc., 645 S.W.2d 410 (Tenn. Ct. App. 1982).

The more recent view as evidenced by the latter set of cases is that the severance of the executive right does not violate the Rule. For purposes of this Comment it will be assumed that such view is correct.

\textsuperscript{16} Theoretically, the mere grant or reservation of the executive right does not deprive the nonexecutive owner of the right to participate in lease benefits. Houston v. Moore Inv. Co., 559 S.W.2d 850, 852 (Tex. Civ. App. 1977). The court in Houston stated that “[a] grantor who reserves half of the minerals retains half of all the incidents [rights] of ownership inherent in the minerals except those specifically granted.” \textit{Id.}

The mere grant or reservation of one of the rights of mineral ownership should have no effect on the other rights of mineral ownership. \textit{See supra} note 11. However, there is a school of thought which holds that when an individual owns the executive rights it is presumed that he alone will be permitted to develop the property, either by leasing the minerals to another or by producing the minerals himself. \textit{See} Hudgins v. Lincoln Nat’l Life Ins. Co., 144 F. Supp. 192 (E.D. Tex. 1956). This view is also advocated by Williams and Meyers:

The right to lease and the right to develop are correlative. Ownership of land carries with it the right to use the land, including the exploitation of the minerals. The right to
Furthermore, it is also possible to divide the lease benefits between the parties. When the nonexecutive owner does not participate in revenues generated by one or more of the lease benefits, then the nonexecutive owner is referred to as a nonparticipating nonexecutive mineral interest owner.\textsuperscript{17} For example, this could be accomplished by the following clause in the instrument granting the mineral interest: "Grantor grants to Grantee one-half of the oil, gas and other minerals in and under the Subject Property, but Grantor reserves all right to bonus and rentals and the exclusive right to execute leases of the minerals in and under the Subject Property."\textsuperscript{18}

Although stated in simplistic language, the clause not only provides for the grantee to become the nonexecutive owner by virtue of the grantor’s reservation of the exclusive right to lease the minerals, but it also prevents the grantee from participating in revenues generated by a lessee’s payment of bonus and delay rentals. Consequently, the grantee has become a nonparticipating nonexecutive mineral interest owner and is dependent upon the grantor as to the lease benefit terms negotiated with a prospective lessee. Since the grantee will only share in royalty proceeds, the grantor could attempt to negotiate a lease that would minimize the royalty interest and maximize the bonus, thus allowing the grantor to keep most of the revenues generated by leasing the minerals.\textsuperscript{19}

It is apparent that without some protection being afforded the grantee, the grantor could enter into a lease that would be detrimental to the grantee’s interest.

The problem with the self-interest of the executive owner is also

\textsuperscript{17} The term "nonparticipating" simply means that the nonexecutive will not share in the revenues generated by bonus and rental payments. \textit{See generally} Jones, \textit{Exercise of Executive Rights in Connection with Non-Participating Royalty and Non-Executive Mineral Interests}, 15 \textit{Inst. on Oil \& Gas L. \& Tax'n} 35 (1964) (discussing the definitions of and distinctions among executive, nonexecutive, and nonparticipating interests).

\textsuperscript{18} \textit{See H. Williams \& C. Meyers, supra} note 1, § 327.3.

\textsuperscript{19} It is assumed in this illustration that the grantor’s financial position is such that tax considerations do not require him to elect to receive more revenue in the form of royalty payments even though he would have to share such revenue with the grantee.
present when there is a nonparticipating royalty interest owner. The owner of a nonparticipating royalty interest only owns the right to participate in the royalty revenues derived from a lease of the minerals. A nonparticipating royalty interest has a well-understood meaning in the oil and gas industry and has been defined as,

an interest in the gross production of oil, gas, and other minerals carved out of the mineral estate as a free royalty, which does not carry with it the right to participate in the execution of, the bonus payable for, or the delay rentals to accrue under, oil, gas, and mineral leases executed by the owner of the mineral fee estate.

The language in the conveying instrument necessary to create a nonparticipating royalty interest owner may be worded similarly to one of the two following clauses:

1. Grantor grants to Grantee an undivided 1/16th interest in any and all Royalty on oil, gas, and other minerals produced from the Subject Property:

2. Grantor grants to Grantee an undivided 1/16th interest in and to all the oil, gas, and other minerals that may be produced and saved from the Subject Property.

Should the instrument containing the second clause fail to contain other clauses normally associated with mineral deeds and contain clauses normally associated with royalty deeds, then most authorities would

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20. The owner of a nonparticipating royalty interest, like the owner of a nonparticipating nonexecutive mineral interest, does not have the right to enter into a lease of the minerals nor the right to enter upon the land for the purpose of exploring for or producing oil, natural gas, or other minerals. See Meyers & Ray, Perpetual Royalty and Other Non-Executive Interests in Minerals, 29 Rocky Mt. Min. Min. L. Inst. 651, 656 (1983) (wherein the authors set forth a theory that a nonexecutive mineral interest is simply another type of royalty interest).


22. See Jones, supra note 1, at 569.

23. See H. Williams & C. Meyers, supra note 1, § 327.2.

24. Id. § 327.1.

25. Typical clauses usually found in deeds meant to convey an interest in minerals are:

1) a specific grant of a right to ingress and egress at all times for the purpose of exploring for minerals and developing the property.

2) a specific grant of the right to receive bonuses and rents which may accrue under the terms of any lease that may then or thereafter cover the property.

Cf. H. Williams & C. Meyers, supra note 1, §§ 303.2-303.4.

Basically, if the instrument involved attempts to grant an interest that has the distinguishing characteristics of a mineral interest, such as the right to reasonable use of the surface to produce the minerals, the right to lease the mineral interest, and the right to participate in lease benefits, then it should be considered a mineral deed. See supra notes 6-12 and accompanying text.

26. An instrument which lacks the clauses referred to in note 25 and which references the fact that the interest conveyed is meant to be free of costs of production should generally be considered a royalty deed. See Maxwell, The Mineral-Royalty Distinction and the Expense of Production, 33 Tex. L. Rev. 463 (1955) (discussing the problems of distinguishing mineral and royalty grants).
agree that such instrument would be construed to convey a fixed-fraction royalty.\textsuperscript{27} If the interest conveyed is a fixed-fraction or fractional royalty, then the nonparticipating royalty interest owner is entitled to 1/16th (6.25\%) of all the minerals produced regardless of the terms of the lease between the executive owner and the lessee.\textsuperscript{28} Therefore, there is no opportunity for the executive owner to favor himself over this type of royalty interest owner in a leasing arrangement.

Should the instrument contain the first clause, however, then the grantee would instead own a fraction of the royalty interest applicable to the lease that the grantor negotiates with the lessee.\textsuperscript{29} It is in this situation that the grantee, as the nonparticipating royalty interest owner, needs some protection from the self-interest of the executive owner. Without any protection, the executive owner would undoubtedly favor himself over the nonparticipating owners in a leasing arrangement. It is evident that an owner of either a nonparticipating nonexecutive mineral interest or a nonparticipating royalty interest has the same need for protection from the self-interest of the executive owner when that executive owner is negotiating a lease with a prospective lessee.\textsuperscript{30} In both situations, there is a substantial need for some kind of standard of care or duty to be imposed upon the executive owner when he is in a position to affect the financial interests of the nonparticipating owners.\textsuperscript{31}

The next portion of this Comment will focus on the approaches taken by the courts in Texas and Oklahoma to decide to what extent the executive owner may be able to favor himself over a nonparticipating owner when negotiating the size and nature of the benefit terms in an oil and gas lease.

\textsuperscript{27} See Meyers & Ray, supra note 20, at 664.

\textsuperscript{28} Id.

\textsuperscript{29} This means that the grantee will receive a certain fraction of the mineral owner royalty revenues generated by the lease that the grantor negotiates with the lessee. In this case the grantee will receive 1/16th of all such royalty revenues.

\textsuperscript{30} Whether a nonparticipating nonexecutive mineral interest and a nonparticipating royalty interest are actually the same is the subject of some debate. Meyers and Ray argue that a nonexecutive mineral interest is simply another type of royalty interest. See supra note 19 and accompanying text. Professor Williams is also in accord with this view. See H. Williams \& C. Meyers, supra note 5, § 338. However, Lee Jones contrasts the two interests and finds that, although they may contain certain common attributes, they are, nonetheless, two distinct types of interests. See Jones, Exercise of Executive Rights in Connection with Non-Participating Royalty and Non-Executive Mineral Interests, 15 Inst. on Oil \& Gas L. \& Tax’n 35, 61-82 (1964).

\textsuperscript{31} For the remainder of this Comment both the nonparticipating nonexecutive mineral interest owner and the nonparticipating royalty interest owner will be referred to together as simply a nonparticipating owner.
III. CURRENT APPROACHES OF THE TEXAS AND OKLAHOMA COURTS

A. Introduction

Naturally, if a well drilled on the premises is a good producing well, generating substantial revenues, then everyone who owns an interest in the minerals being extracted will want to receive as great a share of the proceeds from the sale of those minerals as possible. The classic manner in which the executive owner attempts to favor himself over the nonparticipating owner is for the executive owner to lease the minerals involved for a certain specified royalty interest, certain specified bonus and rental payments, and then attempt to create and reserve, solely for himself, an additional interest in the lease. Generally, the executive owner will want the additional interest characterized as a bonus payment so that the nonparticipating owner will be precluded from receiving any of the proceeds attributable to the additionally created interest. Undoubtedly, a nonparticipating owner, who because of the nature of his interest will only share in the royalty proceeds, will want to have the additional interest that the executive owner has reserved solely for his own benefit characterized as a royalty interest, thereby entitling him to receive a share of the proceeds generated by that interest.

B. The Texas Approaches

There have been several approaches taken by the courts in Texas to determine whether a certain additionally created interest should be designated as a royalty interest or a bonus. The earliest approach by a Texas court is evidenced by the case of State National Bank v. Morgan. In Morgan, the court construed whether an oil payment of $48,000 provided for in a lease was a royalty interest in which the nonparticipating owner would share, or a bonus payment that would enure entirely to the benefit of the executive owner. The court decided that all payments in excess of the standard royalty are bonus payments as a matter of law.

33. 135 Tex. 509, 143 S.W.2d 757 (1940).
34. See supra note 10 and accompanying text.
35. Morgan, 135 Tex. at —, 143 S.W.2d at 759.
36. The court noted that "[t]he fact . . . that the usual royalty in oil and gas leases is 1/6, is in...
of law.\textsuperscript{37} Therefore, the executive owner was allowed to keep all proceeds from the oil payments.\textsuperscript{38}

This approach has since been repudiated by the Texas Supreme Court in \textit{Griffith v. Taylor}.\textsuperscript{39} In \textit{Griffith}, the executive owner leased the minerals in question for a \(\frac{1}{6}\)th royalty and "as additional consideration . . ., an equal one-sixteenth (1/16th) part of all oil [and gas] which may be produced and saved by Lessee. . . ."\textsuperscript{40} Again, the vital question was whether "this 1/16th 'bonus royalty' which is the subject of this controversy . . . is 'bonus' or 'royalty?'"\textsuperscript{41} In deciding this question, the court developed a definitional test\textsuperscript{42} defining bonus as "a sum certain to be paid in cash or out of production . . .,"\textsuperscript{43} and royalty as "a reservation or a payment of a part or percentage of production under a lease which is to continue throughout the life of the lease . . . ."\textsuperscript{44} Therefore, under \textit{Griffith}, a royalty interest continues in existence for the life of the lease and the revenue generated from a royalty interest depends upon the relative productivity of the lease. Alternatively, a bonus is an exact amount of money to be paid and once it is paid the bonus interest no longer exists. As a result, the court held that the interest created by the executive owner in this particular instance fit the definition of a royalty,\textsuperscript{45} thus the nonparticipating owner was entitled to receive his proportionate share of the revenues generated by the interest.\textsuperscript{46}

This definitional approach, as set forth in \textit{Griffith}, is the dominant approach in Texas today.\textsuperscript{47} Under \textit{Griffith}, it is apparent that any interest created by an executive owner in a lease in addition to the standard lessor's royalty will be considered a royalty if it bears the characteristics

\begin{itemize}
\item \textsuperscript{37} \textit{Id.} at —, 143 S.W.2d at 761.
\item \textsuperscript{38} \textit{Id.} at —, 143 S.W.2d at 762.
\item \textsuperscript{39} \textit{Id.} at —, 143 S.W.2d at 763.
\item \textsuperscript{40} \textit{156 Tex.} 1, 291 S.W.2d 673 (1956).
\item \textsuperscript{41} \textit{Id.} at —, 291 S.W.2d at 675.
\item \textsuperscript{42} \textit{Id.}
\item \textsuperscript{43} \textit{Id.}
\item \textsuperscript{44} \textit{Id.}
\item \textsuperscript{45} \textit{Id.}
\item \textsuperscript{46} \textit{Id.}
\item \textsuperscript{47} The following Texas cases are in accord with the \textit{Griffith} approach: Delta Drilling Co. v. Simmons, 161 Tex. 122, 338 S.W.2d 143 (1960); Portwood v. Buckalew, 521 S.W.2d 904 (Tex. Civ. App. 1975); Lane v. Elkins, 441 S.W.2d 871 (Tex. Civ. App. 1969).
\end{itemize}
of a royalty, or a bonus if it bears the characteristics of a bonus, regardless of how the executive owner intended the interest to be considered.

C. The Oklahoma Approach

The Oklahoma courts have not followed the definitional approach created in Griffith. Instead, Oklahoma has developed an approach based on the intent of the parties. This approach was first manifested in Sykes v. Dillingham. 49 In Sykes, Mr. Dillingham conveyed to Mr. Sykes his undivided 1/4th mineral interest in a certain tract of land, reserving 1/2 of any bonus money derived from a future lessee. 50 Eventually Mr. Sykes leased the minerals for a cash bonus of $1,125 51 and a royalty of 46/256ths, 52 which was actually 14/256ths more than the standard royalty at that time of 1/6th. 53 Subsequently, a dispute arose over whether Mr. Dillingham was entitled to 1/2 of the excess 14/256ths royalty interest. Mr. Dillingham claimed that the excess royalty was actually a bonus payment and since he was entitled to share in 1/2 of any bonus, then he should be entitled to 1/2 of the $1,125 and 1/2 of the 14/256ths excess royalty. 54 Again, the principal question was whether a nonparticipating owner was entitled to share in the revenues generated by a certain additional interest created by an executive owner. 55

The Supreme Court of Oklahoma held that Mr. Dillingham was entitled to 1/2 of the cash bonus and to 1/2 of the excess royalty. 56 Rather than looking to the characteristics and nature of the interest created, as in the Griffith approach, 57 the court examined the intent of the parties to the lease. 58

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48. See H. Williams & C. Meyers, supra note 5, § 328 (noting that other cases, except Sykes, are in accord with the Griffith view).
49. 318 P.2d 416 (Okla. 1957).
50. Id. at 417. Although not discussed in the case, Mr. Sykes, as grantee in this case, received the right to execute leases and, therefore, would be deemed the executive owner. Mr. Dillingham, as grantor, retained only the right to participate in half of the bonus. Mr. Dillingham was, therefore, the nonparticipating owner, but was nonparticipating as to royalty revenue instead of bonus revenue as opposed to the usual case where the nonparticipating owner is nonparticipating as to bonus revenues.
51. Id. at 418.
52. Id.
53. Id.
54. Id.
55. Id. at 417. "The problem is to determine whether Dillingham is entitled to one-half of the 'bonus money' received by Sykes on a lease executed by him in 1952 and, if so whether the 'bonus money' would include a portion of the 'excess royalty' under the 1952 lease." Id.
56. Id. at 419.
57. See supra text accompanying notes 39-47.
58. See Sykes, 318 P.2d at 419-20.
Where there is ambiguity or uncertainty as to the meaning of the terms used in a written contract between the parties, usages and customs may be resorted to for the purpose of interpreting them and to fix and explain the meaning of the expressions and words of doubtful and various meanings. The court concluded that the parties must have contemplated that Mr. Sykes would be entitled to the usual and customary 1/6th royalty and that both Mr. Sykes and Mr. Dillingham would share equally in the excess royalty as bonus money derived from the lease. Apparently, the Sykes approach is to construe the lease in question to determine the intent of the parties as to how they contemplated certain additionally created interests to be treated.

The Sykes approach has recently been upheld and followed in Gungoll v. Bierig. The plaintiffs in Gungoll were the executive owners of one-half of the minerals in a certain tract of land and the defendants were the nonexecutive owners of the other half of the minerals, but were nonparticipating as to bonuses and rentals. The executive owners negotiated an oil and gas lease for a 1/6th royalty and “an additional 1/16th of 7/8ths of Oil and Gas Production.” Again, the executive owners claimed that the extra interest created was a bonus to which they alone were entitled, while the nonparticipating owners claimed the additionally created interest was actually a royalty interest from which they were entitled to receive revenues. After examining the Sykes case, the court construed the terms in the lease to determine the intent of the parties to the lease and concluded that the terms clearly expressed an intent that the additionally created interest was to be considered a royalty interest, entitling the nonparticipating owners to 1/2 of the revenues it generated.

59. Id. at 419 (citing Cleveland v. Mascho, 95 Okla. 22, 222 P. 1008 (1923)).
60. Id. at 419-20.
62. Id. at 971.
63. Id.
64. Id.
65. Id. at 972.
66. Id. at 972-73.
67. Id. at 973. The court stated with respect to the intention of the parties that the rider containing the additional interest:

[W]hen construed against lessee clearly expresses an intent that the 1/16th of 7/8ths override should be considered a royalty and not a bonus. The meaning of the clause is aided by the use of the words “In addition to” and “additional.” These words suggest that the 1/16th of 7/8ths was intended to be additional royalty—an overriding royalty. The emphasized words in context read: “In addition to the 1/6 Royalty provided herein, lessor shall receive an additional 1/16th of 7/8ths of Oil and Gas Production [royalty].”

Id.
68. Id.
Although the court appears to agree with several Texas cases that state that an executive owner has a duty to exact every benefit for the nonparticipating owner that he exacts for himself,69 the court nevertheless left the door open for an executive owner to favor himself over the nonparticipating owner: "[H]ad the 1/16 of 7% overriding royalty been intended by the executive to be a bonus, he could have easily specified this in the lease."70

From the Sykes and Gungoll cases, it can be seen that the Oklahoma approach determines the intent of the parties to a lease by construing the intended nature of an interest created in the lease. It would appear that under this approach, an executive owner would be allowed to create an interest in addition to the traditional lessor's royalty and reserve the additional interest solely for himself, so long as the lease clearly expressed an intention on the part of the executive owner that the interest was to be considered as a bonus instead of a royalty interest.

D. Contrasting the Griffith and Oklahoma Approaches

In the process of developing a legal methodology designed to address and solve the problem of protecting the interests of the nonparticipating owner from the executive owner, several competing policy concerns necessarily arise. Specifically, courts should consider (1) the certainty of outcome in any given situation, (2) flexibility in contracting, and (3) protection of the interests of the nonparticipating owners.

Certainty of outcome should be a key policy concern in any legal test because it affords individuals the notice necessary for making decisions. No legal test should be so ambiguous and uncertain that an individual cannot ascertain with reasonable certainty what the legal consequences of his actions will be. Therefore, if the executive owner is able to predict how a particular type of interest will be treated in the event of a dispute, his ability to plan will naturally be enhanced. On the

69. The court noted that "the participating owner generally has a duty to exact for the nonexecutive owner every benefit that he exacts for himself." Id. (citing Portwood v. Buckalew, 521 S.W.2d 904 (Tex. Civ. App. 1975) (emphasis added). In Portwood the Texas court, when faced with the same question of whether the nonparticipating owner was to be allowed to participate in a certain additionally created interest, stated that:

Generally, where a party having executive leasing privileges enters into a transaction in which he and the non-executive mineral holders are both interested and the executive is authorized to act for both parties, he must exact for the non-executives every benefit that he exacts for himself. If he could obtain overriding royalties or cash bonuses for the non-executives and himself, it was his duty to have done so.

Portwood, 521 S.W.2d at 911.

70. Gungoll, 55 OKLA. B.J. at 973.
other hand, without some kind of assurance that a particular type of interest will be treated in a certain manner, the executive owner is relegated to guessing how that interest may be treated by a court. Lack of certainty of outcome also promotes unnecessary litigation, a result that neither parties to a lawsuit nor the courts can afford.

The right to contract freely for the terms and conditions that an individual desires is one of the most highly valued rights recognized in American society. Flexibility in contracting, as used in this context, affords the executive owner the opportunity to contract with a lessee for the terms that will be most beneficial to the executive's financial position and needs. If one type of interest, be it either bonus, royalty, production payment, net profits interest, or some other type of interest, will be the most financially beneficial to the executive owner, then he should be allowed to contract for that type of interest without having his decision influenced by whether he will have to share the revenues generated by the interest with the nonparticipating owner. Of course, if the executive owner is given unfettered flexibility in contracting with a lessee it will enable him to always favor himself over the nonparticipating owner by contracting around the rights of the nonparticipating owner. Specifically, the executive owner could create an additional interest in a lease in which only he would be entitled to receive the revenues generated from the interest. Disregard for the interests of the nonparticipating owner under this scenario gives rise to the third major policy concern: protection of the interests of the nonparticipating owner.

As discussed previously, without a mechanism to protect the interests of the nonparticipating owner, the executive owner could control the nonparticipating owner's benefits under any lease that the executive owner enters into with a lessee. It is imperative, therefore, that a legal approach concerned with the conflict of interest between the executive owner and the nonparticipating owner should also address the question of how to adequately protect the interests of the nonparticipating owner.

While these three compelling policy concerns may not be the only considerations that a court would or should examine when attempting to develop an approach to this problem, they are certainly the most important concerns to be taken into account. Thus, this portion of the Comment will examine the ways in which the Oklahoma approach and the

71. See supra note 10 (discussing the definition of a production payment).
72. See supra note 10 (discussing the definition of a net profits interest).
73. See supra text accompanying notes 13-19 (discussing the conflict of interest between the executive and nonparticipating owners).
Griffith approach address or fail to address the three important policy concerns.

The Griffith approach promotes certainty of outcome in any given situation because an executive owner will be able to ascertain with relative certainty how a particular additional interest will be interpreted by a Texas court. If the interest bears the characteristic nature of a royalty as defined in Griffith, then it will certainly be deemed a royalty interest. Similarly, if the interest bears the characteristic nature of a bonus as defined in Griffith, then it will be considered a bonus.

The Griffith approach does not, however, promote flexibility in contracting. It does not allow the executive owner to contract for the type of additional interest that will benefit him the most financially; rather it forces the executive owner, if he wants to keep all of the revenues generated by an additional interest, to contract for an additional interest in whatever lease benefit the nonparticipating owner is not permitted to share in. Therefore, even in instances where a lessee is amenable to giving either more royalty for less bonus or less royalty for more bonus, the executive owner will be forced to choose an alternative not on the basis of what would most benefit him financially, but on the basis of whether he will have to share the revenues generated with the nonparticipating owner.

While the Griffith approach may appear to protect the interests of the nonparticipating owner to some degree by not permitting the executive owner to contract around the nonparticipating owner's interests, its protection of the nonparticipating owner is far from total. For even though the executive owner will have to share the revenues generated by an interest in which the nonparticipating owner shares, there is nothing to keep the executive owner from structuring an additional interest resembling another interest in which the nonparticipating owner does not share, thus preventing the nonparticipating owner from receiving any of the revenues generated by that interest.

In relation to the three competing policy concerns, the Oklahoma approach is strong in some areas and weak in others. With regards to certainty of outcome, the Oklahoma approach is much weaker than the Griffith approach. Under the Oklahoma approach, an executive owner will usually be unable to forecast how a court will construe the lease he is
entering into and, more importantly, whether the additional interest sought to be created will be interpreted as a bonus or a royalty. The executive owner can only hope that the language used by the individual drafting the lease (typically, the lessee), will be sufficiently unambiguous for a court to decide that it was intended to create the type of interest that the executive owner actually intended to create.

Although flexibility in contracting was a major flaw in the Griffith approach, it appears to be present in the Oklahoma approach. Clearly, the Oklahoma approach at least gives the executive owner the opportunity to designate how a particular additionally created interest should be considered, so long as he has properly manifested his intent in the lease creating the additional interest. This affords the executive owner the flexibility to create an interest that will be the most beneficial to his particular financial position.

Unfortunately, the Oklahoma approach does very little to protect the interests of the nonparticipating owner because it forces the court to interpret an oil and gas lease to determine the intentions of individuals who did not have the best interests of the nonparticipating owner in mind when the lease was being negotiated. Certainly, the lessee has no interest in protecting the nonparticipating owner and it is the self-interest of the executive owner/lessor which creates the problem of protecting the interests of the nonparticipating owner in the first place. Actually, this approach could even encourage the executive owner to contract around the interests of the nonparticipating owner by properly evidencing his intent to have an additionally created interest treated in a manner that would preclude the nonparticipating owner from sharing in certain benefits. Therefore, the Oklahoma approach does not adequately protect the interests of the nonparticipating owner.

Both the Griffith approach and the Oklahoma approach inadequately address the three important policy concerns of certainty of outcome, flexibility in contracting, and protection of the interests of the nonparticipating owner.

Probst, 373 P.2d at 62 (typewritten terms control over printed terms); Sykes, 318 P.2d at 419 (usage and custom).

78. See Gungoll, 55 Okla. B.J. at 973 (noting in dictum that had the additionally created overriding royalty interest "been intended by the executive to be a bonus, he could have easily specified this in the lease.")

79. See Kimsey v. Fore, 593 S.W.2d 107 (Tex. Civ. App. 1979). In Kimsey, the lessee was found to have aided and abetted the executive owners in breaching a duty found to be owed to the nonexecutive owners and was thereby impliedly found to have breached the duty himself. Id. at 111-13.

80. See Gungoll, 55 Okla. B.J. at 973.
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nonparticipating owner. However, an alternative approach that can satisfy all three competing policy concerns can be formulated. This alternative is the subject of the remainder of this Comment.

IV. AN ALTERNATIVE APPROACH

A. Introduction

Ideally, an alternative approach to the Oklahoma and Griffith approaches should combine the strengths of both approaches, while satisfying all three of the previously discussed policy concerns.

B. The Three Steps of the Alternative Approach

The alternative approach to be proposed and discussed involves the following three steps which a court should take when attempting to ascertain whether an executive owner should be permitted to favor himself over a nonparticipating owner:

1. Check for a clearly expressed unequivocal statement in the lease that the additionally created interest, regardless of whether it is called a bonus or royalty, is intended to enure solely to the benefit of the executive owner.
2. If such a statement appears in the lease, then it should be given the effect intended by the executive owner and the interest should enure solely to the benefit of the executive owner, unless, under the circumstances, it would appear that to do so the executive owner would violate a duty of good faith and utmost fair dealing owed to the nonparticipating owner.
3. Absent a clearly expressed unequivocal statement that the additionally created interest is intended to enure solely to the benefit of the executive owner, then it should be irrebuttably presumed that the executive owner intended to benefit both himself and the nonparticipating owner by creating the additional interest in the lease and, therefore, both the executive and nonparticipating owners should be permitted to share in the revenues generated by the interest.

The proposed alternative approach attempts to combine the strengths of both the Oklahoma and Griffith approaches while adding a duty of good faith and utmost fair dealing on the part of the executive owner to more fully protect the interests of the nonparticipating owner.

C. The Duty of Good Faith and Utmost Fair Dealing

The idea of the executive owner owing a duty to the nonparticipat-
The concept of a duty on the part of the executive owner arose in Texas in *Schlittler v. Smith.* In *Schlittler,* the owner of a fraction of royalty interest claimed that the executive owner was required to lease the minerals involved for a minimum $\frac{1}{16}$ royalty. Although the court refused to force the executive to obtain a minimum $\frac{1}{6}$th royalty when he leased the minerals, it did state, in dictum, that “[i]f course, there should be the utmost fair dealing on the part of the grantee [executive owner] in this regard.” Implicitly, the court recognized a duty of “utmost fair dealing” by the executive owner on the behalf of the nonparticipating owner when the executive negotiates a royalty interest with a lessee.

In *Federal Land Bank v. United States,* the owner of a term royalty interest sued the executive owner for failure to exercise the exclu-

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82. Some of the areas where an executive may owe a duty to the nonexecutive include:
   1. The duty to drill wells on the land.
   2. The duty to lease the minerals.
   3. The duty to lease within a reasonable time.
   4. The duty to enforce implied lease covenants for the benefit of the nonexecutive.
   See H. WILLIAMS & C. MEYERS, supra note 5, § 339.3 (wherein appears a complete discussion of these various areas of duty as well as others).

83. Schlittler v. Smith, 128 Tex. 628, —, 101 S.W.2d 543, 545 (1937).


88. Id. at —, 101 S.W.2d at 544.

89. Id. at —, 101 S.W.2d at 545. The court stated “we think that self-interest on the part of the grantee [executive owner] may be trusted to protect the grantor [nonparticipating owner] as to the amount of royalty reserved.” Id. at —, 101 S.W.2d at 545.

90. Id.

91. Id.


93. A “term royalty interest” is one of less than perpetual duration. Most are created to last for
sive leasing rights within a reasonable time. The Court of Claims found that the term royalty owner was entitled to recover and stated: "We believe as between the mineral fee owner and the royalty owner there is an implied covenant in the deed that the mineral fee owner will use the utmost fair dealing and diligence in obtaining lease agreements in order to protect the royalty owner's interest."

*Kimsey v. Fore* is another case that deals with the question of the duty of the executive owner to lease the minerals within a reasonable time so as not to harm the financial interests of the nonparticipating owner. In *Kimsey*, the plaintiffs were owners of a term royalty interest in the minerals. The executive owners negotiated a lease whereby the primary term of the lease extended beyond the expiration date of the plaintiff's term royalty interest and the lessees of the minerals purposely waited until after the plaintiff's term royalty interest had expired before commencing drilling operations on the lease. The court stated that "the test of utmost fair dealing is an implied covenant arising from the royalty deed which is imposed upon the owners of the executive right to lease." Ultimately, the court not only held the executive owners liable for the breach of such duty, but also found the lessees guilty of a breach of the same duty.

In *Portwood v. Buckalew* the executive owners leased interests in a fixed period of time and so long thereafter as oil, gas, or other minerals are produced. See H. Williams & C. Meyers, supra note 1, at 765-66.

There is an obligation on the part of the Government [the executive owner] to lease for drilling if the facts show that wells on the adjacent land are producing oil and possibly depleting the oil in place and recoverable from the land in question. This obligation arises as we have said because the Government owes a duty to act with reasonable diligence and discretion.

*Id.* at 791.

96. *Id.*


98. *Id.* at 112.

99. *Id.* at 108.

100. The primary term of an oil and gas lease is the period of time during which a lease may be kept alive even though there is no production in paying quantities by virtue of drilling operations on the leased premises or by the payment of a certain specified rental. After the expiration of the primary term, the lease generally can be kept alive only by production of oil and gas in commercially paying quantities. See H. Williams & C. Meyers, supra note 1, at 570.

101. Instructions to the operator of the lease read "DO NOT DRILL UNTIL MARCH, 1974 (Outstanding Royalty [for Plaintiffs] Expires 2/74)." *Kimsey*, 593 S.W.2d at 109.

102. *Id.* at 111.

103. *Id.* at 114.

104. *Id.* See supra note 79 and accompanying text.

the minerals for specified bonus payments and a set $\frac{3}{8}$th royalty; they then attempted to reserve solely for themselves excess royalty interests ranging from 17.5% to 25%.\textsuperscript{106} Allegedly, these excess royalty interests were reserved to compensate the executive owners for surface damages.\textsuperscript{107} The nonexecutive owners brought suit to recover their respective shares of the excess royalty interest revenues. The court held that the executive owners did not act with utmost fairness in dealing with the interests of the nonexecutive owners\textsuperscript{108} and refused to allow the executive owners to reserve the excess royalty interests solely for themselves.\textsuperscript{109}

While the \textit{Portwood} case may appear to set forth an approach similar to the proposed alternative approach, such is not the case since the nonexecutive owners were not also nonparticipating owners. They had full right to participate in bonus or royalty interest revenues.\textsuperscript{110} The court even stated that the case did not involve a decision whether the additionally created interest was a bonus or a royalty because the interest was defined by \textit{Griffith} to be a royalty as a matter of law.\textsuperscript{111} Consequently, it appears from this statement that had the question been whether the additionally reserved interest was either a bonus or a royalty, the court would have used the \textit{Griffith} approach and determined it to be a royalty. The case is important, however, because it is the only case that has imposed a duty on the executive when reserving an additional interest solely for himself without regard for the interests of a nonexecutive owner.

Fairness and the rationale in \textit{Portwood} dictates that the duty of good faith owed by the executive owner to the nonexecutive owner should be expanded beyond the traditional boundaries\textsuperscript{112} to include the situation where the executive owner attempts to exact additional lease benefits

\begin{itemize}
  \item \textsuperscript{106} \textit{Id.} at 911, 914, 917.
  \item \textsuperscript{107} \textit{Id.} at 916.
  \item \textsuperscript{108} \textit{Id.} at 914, 916, 918.
  \item \textsuperscript{109} The court felt it was unreasonable to reserve a 25% royalty to compensate for fifty to one hundred dollars in surface damages. However, the court did note in dictum "[w]e are not to be understood as holding that surface owners such as appellants may never demand and accept a reasonable amount of surface damages solely for themselves. We are of the opinion that they may." \textit{Id.} at 918.
  \item \textsuperscript{110} \textit{Id.} at 909.
  \item \textsuperscript{111} \textit{Id.} at 912-13.
  \item \textsuperscript{112} \textit{See also} Manges v. Guerra, 673 S.W.2d 180 (Tex. 1984) (the Texas Supreme Court recognized a duty of fair dealing, but upheld the validity of the self-leasing arrangement of the executive owner as not breaching such a duty); Morriss v. First Nat'l Bank, 249 S.W.2d 269 (Tex. Civ. App. 1952) (the court determined that since the executive owner owed the nonparticipating royalty owner a duty of utmost good faith, the "minimum royalties" should be treated as royalties payable to the nonparticipating owner).
\end{itemize}
solely for himself. It is largely an exercise in semantics whether the duty is expressed in terms of “good faith,” “utmost good faith,” “utmost good faith and fair dealing,” “due diligence,” or some other standard. What is important is that the duty should adequately protect the interests of the nonparticipating owner by not allowing the executive owner to reserve an additionally created interest solely for his benefit unless, under the circumstances of the particular situation, it would be fair and reasonable to allow the executive owner to do so.

D. Analysis of the Alternative Approach in Relation to the Three Competing Policy Concerns

The alternative approach attempts to address the three important competing policy concerns discussed in relation to the Oklahoma and Griffith approaches. The first step of the alternative approach permits an executive owner to create an interest in addition to the bonus and standard royalty interest and to reserve such additional interest solely for himself, provided his intent is unequivocally expressed in the lease. The purpose of this step is to provide the executive owner the needed flexibility in contracting with the lessee; it allows him to exact from the lessee whatever he is able to exact. Should the executive owner prefer to own one type of interest over another, then this approach would allow him to contract for the particular type of interest and reserve it solely for himself, as opposed to the Griffith approach where an executive is absolutely prohibited from reserving, solely for himself, an interest in which the nonparticipating owner is entitled to share. Furthermore, this approach does not involve defining whether a certain interest is a royalty or a bonus as does Griffith; rather, it permits the executive owner to reserve an additional interest solely for himself, regardless of whether it is a bonus or a royalty. Of course, this approach is conditional on the executive owner clearly expressing the requisite intent and, as will be discussed later, not violating his duty to protect the interests of the nonparticipating owner.

Clearly, the alternative approach effectively promotes flexibility in contracting by allowing the executive owner to contract for whatever

113. See supra notes 73-80 and accompanying text.
114. The first step of the proposed alternative approach requires a court to check for a clearly expressed statement in the lease that the additionally created interest is intended to enure solely to the benefit of the executive owner, regardless of whether it is called a bonus or a royalty.
115. See supra notes 39-47 and accompanying text.
terms and lease benefits the lessee is willing to agree to. This result, in turn, furthers the fundamental right of freedom to contract.

Although the alternative approach does promote some degree of certainty of outcome, it does not provide as much certainty as the Griffith approach. Concededly, there are several areas in which uncertainty will be manifested using the alternative approach. First, the alternative approach requires the executive owner to clearly and unequivocally express his intention to reserve an additionally created interest solely for himself in the lease. While the precise language necessary for expressing a clear and unequivocal intent is currently unestablished, in most instances it should be obvious to an executive owner whether the language he has chosen to affect his intent will be sufficiently clear and unequivocal. Thus, the level of uncertainty existing within this area should be regarded as de minimis.

The next area of uncertainty arises in the second step of the alternative approach. In this step, a court must decide whether the executive owner has breached the duty to protect the interests of the nonparticipating owner by reserving for himself an additional interest. When a duty is expressed in terms of “good faith,” it may be difficult for the executive owner to know, at the time he creates the interest, whether a court would hold that he has violated the standard. However, the basic underlying purpose of imposing a duty on the executive owner is to insure that an executive owner be allowed to reserve an interest solely for his own benefit only in those cases where it is fair and reasonable. The executive owner should therefore be aware that in only a few narrow situations will he ever be allowed to prevent the nonparticipating owner from sharing in the revenues generated by an additionally created interest.

The policy concern of certainty of outcome cannot be totally effectuated in this area. However, because total certainty of outcome would obviate the executive owner's right to contract freely for the terms he wishes to include in the contract, some uncertainty is probably the preferred state of affairs. Although there will always be some uncertainty as to how each situation will be resolved by a court, the use of an objective standard and the corresponding generation of case law should help to reduce the uncertainty of outcome.

116. Id.
117. The second step of the proposed alternative approach requires a court to give effect to an executive owner's intent to only benefit himself at the expense of the nonparticipating owner, when to do so would not violate the duty of good faith and utmost fair dealing owed to the nonparticipating owner by the executive owner.
The alternative approach goes much further toward protecting the interests of the nonparticipating owner than either the Griffith or the Oklahoma approach. As discussed previously, the Griffith approach attempts to protect the nonparticipating owner by prohibiting the executive owner from contracting for the type of interest that the nonparticipating owner would normally share in without sharing the revenues generated by that interest with the nonparticipating owner.\textsuperscript{118} For example, if the nonparticipating owner shares in royalty revenues, then the executive owner may never reserve a royalty interest solely for himself. However, in this situation the executive owner could simply seek a higher bonus payment and less royalty or no royalty at all. Technically, the Griffith approach could not prevent this arrangement since the money received by the executive owner would be characterized as a bonus, not a royalty.

The Oklahoma approach determines the intentions of the executive owner when he reserved the additional interest.\textsuperscript{119} If the executive owner intended to create an interest in which the nonparticipating owner could not share and reserved that interest solely for himself, then the executive owner should be allowed to carry out that intent.\textsuperscript{120} Unfortunately, this result leaves the nonparticipating owner without any recourse against the executive owner for such action.

The second step of the alternative approach attempts to avoid the problems created by the Oklahoma and Griffith approaches by permitting an executive owner to reserve an additional interest solely for his own benefit only in situations where it would not constitute a breach of the duty imposed upon him to protect the interests of the nonparticipating owner. Although each case will turn upon its own particular set of circumstances, there are several situations where an executive owner might be able to reserve an additionally created interest for himself. Examples include those situations in which the additionally created interest is intended to reasonably compensate the executive owner for surface damages,\textsuperscript{121} or when the nonparticipating owner either expressly consents to the exclusive reservation of an additionally created interest by the executive owner, or misleads the executive owner into reasonably believing that his consent has been given. These examples are far from

\textsuperscript{118.} See supra notes 39-47 and accompanying text.
\textsuperscript{119.} See supra notes 49-70 and accompanying text.
\textsuperscript{120.} See supra notes 61-70 and accompanying text.
\textsuperscript{121.} See supra notes 105-11 and accompanying text.
inclusive and it must be stressed that each case should be decided upon what is fair and reasonable based upon the particular circumstances.

Finally, the third step of the alternative approach protects the interests of the nonparticipating owner by creating an irrebuttable presumption that the executive owner intended to benefit both himself and the nonparticipating owner by his creation of the additional interest in the lease, unless a contrary intention is clearly and unequivocally expressed in the lease as required by step one. The alternative approach, therefore, affords the executive owner the opportunity to favor himself over the nonparticipating owner. Conversely, if he fails to clearly and unequivocally express his intention to reserve the additionally created interest only for himself, the nonparticipating owner will be completely protected by this presumption.

The alternative approach is a viable alternative to the Oklahoma and Griffith approaches because it satisfactorily addresses the competing policy concerns of certainty of outcome, flexibility in contracting, and protection of the interests of the nonparticipating owner. It attempts to provide an equitable balance among these competing concerns by assuring the nonparticipating owner that he really does receive adequate protection from the self-interest of the executive owner.

V. CONCLUSION

In the process of negotiating lease benefit terms there exists the potential for the executive owner to favor himself over the nonparticipating owner. Accordingly, a judicial approach is needed which adequately protects the interests of the nonparticipating owner while also permitting the executive owner to contract for the terms he desires. At the same time, this approach must provide sufficient notice to the executive owner as to whether he may reserve a certain interest solely for himself in a particular situation. The current approaches taken by the Texas and Oklahoma courts are inadequate to effectuate these three important concerns.

The alternative approach set forth in this Comment squarely addresses these three competing policy concerns and attempts to strike a fair and equitable balance between them. Specifically, it affords the executive owner the flexibility necessary to enable him to freely contract for

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122. The third step of the proposed alternative approach requires a court to presume that the executive always intends to benefit both himself and the nonparticipating owner by his reservation of an additional interest, absent a clearly expressed intent to the contrary.
lease benefit terms which complement his own particular financial situation, provides the executive owner with sufficient certainty as to whether he would be permitted to reserve an additional interest solely for his own benefit, and finally, imposes upon the executive owner a duty to protect the interests of the nonparticipating owner.

C. Randall Hill