# **CASE NOTE: Oil and Gas: Use of Landlord-Tenant Concepts in Construction of Leases: Remedy For Failure To Pay Royalties.**

April, 1957

**Reporter**

4 UCLA L. Rev. 485 \*

**Length:** 7781 words

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**Text**

**[\*485]**Defendant lessee obtained production during the primary term of an ***oil*** and gas lease. The lessee paid no royalty for the period of production [[1]](#footnote-2)1and the plaintiff lessor sued to cancel the lease. The trial court ordered cancellation and the Supreme Court of Louisiana affirmed on the ground that, ***oil*** and gas royalties being analagous to rents under an ordinary lease, the statute under which an ordinary lessee could be expelled for non-payment of rent gave the ***oil*** and gas lessor the right to terminate when royalties were not paid. *Melancon v. Texas Co.*, 89 So.2d 135 (La. 1956).

The use of landlord-tenant theories to resolve cases involving ***oil*** and gas leases is primarily due to the lack of suitable common law property concepts on which to base the decisions, [[2]](#footnote-3)2but in applying ordinary leasehold law to ***oil*** and gas leases the courts have failed to recognize the basic differences between these two types of leases. The purpose of the ordinary lease is to give the lessee temporary possession and *use* of the property [[3]](#footnote-4)3whereas the purpose of the ***oil*** lease is to *remove* part of the property, not merely to use it. [[4]](#footnote-5)4Moreover, the ordinary lessee's possession gives the same return to the landlord regardless of how he uses the land while the ***oil*** and gas lessee has the obligation to develop the land to realize potential wealth in which the lessor will share. [[5]](#footnote-6)5In contrast to the ordinary lease which creates a term of years, the ***oil*** and gas lease creates a fee simple deter minable [[6]](#footnote-7)6which terminates unless the lessee is producing ***oil*** or gas at the end of a fixed primary term. The special limitation on the fee provides that the lessee's interest shall last for "so long thereafter as ***oil*** and gas are produced in paying quantities." This potential permanency of the ***oil*** lessee's estate is a necessary inducement for his large capital investment **[\*486]**and the limitation protects the lessor by providing for the automatic termination [[7]](#footnote-8)7of the lease when ***oil*** and gas production no longer meets the requirement of paying production. Obviously such a relationship requires a different set of concepts than those applicable to the ordinary leasehold situation. Yet the superficial similarity of the transactions and the designation of both types of documents as "leases" coupled with the courts' tenacious adherence to traditional property concepts have resulted in the frequent application of landlord-tenant concepts and statutes to ***oil*** and gas leases.

It is here contended that the usual though certainly not the inevitable consequence [[8]](#footnote-9)8of this misapplication of ordinary leasehold law to an ***oil*** **[\*487]**and gas lease is that the court is led to an improper result. An example is the use of the landlord-tenant doctrine of "holding over" [[9]](#footnote-10)9in a case where an ***oil*** and gas lessee remains in possession after the termination of the lease. In *Renner v. Huntington-Hawthorne* ***Oil*** *and Gas Co.*, [[10]](#footnote-11)10the plaintiff lessor sought to cancel the lease for failure of the lessee to comply with the required standards of production. [[11]](#footnote-12)11The court analogized the lessor's acceptance of monthly royalty payments after the termination of the lease to a landlord's acceptance of rent after the term, and held that a tenancy from month to month was created which the lessor could not terminate without giving the required statutory notice. [[12]](#footnote-13)12Applying this holdover doctrine to an ***oil*** and gas lease violates the provisions of the lease that only production of ***oil*** and gas can extend the lease beyond the primary term [[13]](#footnote-14)13and frustrates the lessor's intent to create an interest that would terminate automatically upon the failure of the lessee to produce.

The initial reaction to the theory used in the *Renner* case is to approve it as one which, though erroneous, imposes no real hardship on either party. Under this theory, the lessee, by defending against cancellation, merely obtains a renewal of the lease for one month and is saved from **[\*488]**possible liablility of a trespasser's measure of damages from the time the lease terminated, [[14]](#footnote-15)14while the lessor apparently loses only one month's use of his property. What the court perhaps overlooked is the danger of this theory as precedent. In applying the holdover doctrine, as codified in California, [[15]](#footnote-16)15the new tenancy is presumed to be under the same terms as the original lease. [[16]](#footnote-17)16If during the one month extension the lessee in the *Renner* situation brings production up to the standard required by the lease it is at least arguable that the lease, by the terms of the "thereafter" clause, has again attained the status of a determinable fee and the lessor could not terminate by giving the statutory notice so long as production continued. An extension of this theory could result in a lessee who has never produced being given a full year extension by virtue of the lessor's inadvertent acceptance of a yearly delay rental after the primary term during which time the lessee could secure a permanent interest by bringing in a producing well.

The wording of the holdover statute limits the "presumed renewal" to one year. [[17]](#footnote-18)17This would seem to preclude the lessee's claim to an interest of fee simple duration. However, this conflict could be resolved by holding that as applied to an ***oil*** and gas lease the one year limitation only applies to periodic renewals, during the primary term and not to the indefinite term since the statute seems to comprehend the extension of a fixed term of years and is arguably inapplicable to interests in the nature of a fee.

Frequently the lessee grants his interest in a particular lease reserving an overriding royalty with the stipulation that the royalty shall continue during any extensions or renewals of the lease. What will be the effect of the *Renner* extension on these outstanding royalty interests? It would seem that this is not the type of extension the lessee or his assignee contemplated.

In another misapplication of landlord-tenant law the summary remedy of unlawful detainer [[18]](#footnote-19)18was allowed in *Martin v. Pacific Southwest Royalties, Inc.* [[19]](#footnote-20)19to force an ***oil*** and gas lessee to quit the premises. The unlawful **[\*489]**detainer statute was intended to apply solely to the conventional landlord-tenant relationship [[20]](#footnote-21)20and the language of the statute refers to a tenant for a term of years less than life. [[21]](#footnote-22)21To permit a lessor such a strict remedy is obviously reasonable in the case of an ordinary tenant because he has usually acquired a relatively small interest in the property as compared to that of the lessor, but the application of this remedy to the holder of a fee simple, even though it is determinable, is clearly erroneous.

In *Hamblen v. Placid* ***Oil*** *Co.* [[22]](#footnote-23)22the traditional distinction between sublease and assignment [[23]](#footnote-24)23was applied to an ***oil*** and gas lease to prevent the lessor from holding a sublessee to the obligations of the original lease. [[24]](#footnote-25)24In landlord-tenant law if the lessee retains a reversion when he transfers the lease a sublease is created. It was held in the *Hamblen* case that the reservation of an overriding royalty by the transferor of an ***oil*** and gas lease is sufficient to constitute such a reversion. There is however consider able authority that in order to create a sublease the lessee must also reserve a right of entry, and that the reservation of an override is not enough to prevent the transfer from being an outright assignment. [[25]](#footnote-26)25Technically, if the transfer is found to have resulted in a sublease the lessor cannot hold the sublessee for the express or implied covenants in the original lease since there is no privity of estate. [[26]](#footnote-27)26As a result, if an implied covenant such as the covenant to protect against drainage has been breached by the sublessee and the original lessee is unavailable for suit, the lessor is theoretically left without an effective remedy. This unfortunate use of landlord-tenant concepts has created an obstacle that the courts must circumvent to avoid an obvious injustice. For this reason, even though a court may have made the distinction between sublease and assignment, in order to avoid injustice **[\*490]**the lessor will usually be given a direct remedy against the sublessee on some theory other than on the lease. [[27]](#footnote-28)27

In the instant case [[28]](#footnote-29)28the court ordered cancellation of the lease for non-payment of royalty although the conditions for termination were expressly set out in the lease [[29]](#footnote-30)29and non-payment of royalties was not one of these conditions. The court relied on the statutory right of the landlord to evict his tenant for non-payment of rent, [[30]](#footnote-31)30despite the fact that it is fairly well settled in other jurisdictions that non-payment of royalties is not grounds for the termination of an ***oil*** and gas lease. [[31]](#footnote-32)31Royalties of course cannot accrue until production is obtained, and once the lessee is producing, the lease becomes determinable only upon *non-production*--not non-payment of royalties. Until non-production occurs the lessee has an interest that is potentially indefinite and the fact that a debt has accrued against him should have no bearing on the continuance of that interest.

A number of jurisdictions have statutes giving a landlord the right to evict a tenant for non-payment of rent. Wherever these statutes are applied to ***oil*** and gas royalties, as in the instant case, and at the same time the distinction between assignments and subleases is recognized, the ability of a lessee to evict his transferee for non-payment of an overriding royalty **[\*491]**would depend on the tenuous distinction as to whether the override created a sublease or an assignment. The ***oil*** and gas lessee could conceivably evict a *sublessee* who fails to pay the overriding royalty, but not an *assignee* who fails to pay because there is no landlord-tenant relationship in the case of an assignment thus the landlord's rent-eviction statute is inapplicable. In both of these cases it would seem much sounder to put aside technical distinctions and recognize that when overriding royalties are not paid the lessee has an action for money due and that eviction is not a proper remedy unless the lessee has specifically reserved a right of re-entry to enforce the payment of royalties.

In individual cases the use of landlord-tenant law has caused little harm but these cases have established precedent which is both unworkable and illogical. Just how illogical may be shown by an example: An ***oil*** and gas lessee has no cause of action for damages against his lessor when the lessor drills a well on his own adjacent tract and begins to drain ***oil*** from the leased land. The basic rule is that if the lessee wants to protect his land from drainage--he must drill. The ordinary lessee on the other hand can sue his lessor for breach of covenant when the landlord interferes with his quiet enjoyment of the premises. It is not seriously contended that any court would torture the covenant for quiet enjoyment into an implied covenant by the ***oil*** and gas lessor to refrain from operations by which his wells would drain the leased premises but neither can it be denied that this is the logical end to which the illogical analogy leads us.

The use of landlord-tenant concepts may have been justified when the ***oil*** and gas industry first developed because of the lack of understanding of the subject matter and the absence of a body of law suitable to the ***oil*** and gas cases which arose. But by now the courts should have become sufficiently sophisticated to recognize that ***oil*** and gas problems are *sui generis* and that the law must advance to meet the exigencies of this somewhat unorthodox property transaction.

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1. 1 The court found that the well, though capped after only two months, was a producing well and production royalties for the period of production must be paid. Lessee's payment of shut-in royalties did not discharge the obligation to pay production royalty. [↑](#footnote-ref-2)
2. 2 "There is no complete analogy between ***oil*** and gas and any of the other physical substances found over, on, or under the surface of land. They *are* a unique species of property and property rights in them must be determined upon the basis of their own peculiarities." Walker, *Nature of Landowner's Interest in* ***Oil*** *and Gas*, 17 MONTANA L. REV. 22, 24 (1955). [↑](#footnote-ref-3)
3. 3 CAL. CIV. CODE § 1925 (West 1954). [↑](#footnote-ref-4)
4. 4 Although considering the point that the ***oil*** lessee removes part of the land rather than merely using it, the ***oil*** and gas lease has been held to be a "lease" within the generic use of the term "hiring" in the code. Reclamation District 108 v. Gibson, 63 Cal. App.2d 311, 147 P.2d 80 (1944). [↑](#footnote-ref-5)
5. 5 For this reason the ***oil*** and gas lease is strictly construed against the lessee. Beatty v. Baxter, 208 Okla. 686, 258 P.2d 626, 2 ***Oil*** *and Gas Reporter* 1284 (1953). [↑](#footnote-ref-6)
6. 6 *E.g.*, Dabney v. Edwards, 5 Cal.2d 1, 53 P.2d 962 (1935); see also Adsit, ***Oil*** *Estates*, 9 SO. CALIF. L. REV. 299, 302 (1936). To protect the investment of the lessee the lease is potentially indefinate (fee simple) and to protect the lessor's interest in having a productive tenant he can terminate the lease (determinable). [↑](#footnote-ref-7)
7. 7 The courts have recognized the power of the parties to provide for the automatic termination of the lease. Caswell v. Gardner, 12 Cal. App.2d 597, 55 P.2d 1222 (1936). They have also held that the prejudice against forfeitures does not apply to ***oil*** and gas leases. Banks v. Calstar Petroleum Co., 82 Cal. App.2d 789, 187 P.2d 127 (1947); Caswell v. Gardner, *supra*. This enlightened view has not pro tected the lessor, however, since the doctrine of "waiver of forfeiture" by acceptance of overdue rental applies to ***oil*** and gas leases in California. ***Kern*** Sunset ***Oil*** Co. v. Good Roads ***Oil*** Co., 214 Cal. 435, 6 P.2d 71 (1931). This doctrine is most incongruous when applied to an "unless" lease where the lease *ends automatically by its own terms. Cf.*, Renner v. Huntington-Hawthorne ***Oil*** and Gas Co., 39 Cal.2d 93, 244 P.2d 895 (1952); Richfield ***Oil*** Corp. v. Bloomfield, 103 Cal. App.2d 589, 229 P.2d 838 (1951). See also 2 SUMMERS, ***OIL*** AND GAS § 337, p. 212 (Penn. ed. 1938) (hereinafter cited as SUMMERS). Yet the courts have held that the lessor loses his right to insist on the termination of an "unless" lease where he accepts overdue delay rentals. 2 AMERICAN LAW OF PROPERTY § 10.53 (Casner ed. 1952), reprinted in KULP, ***OIL*** AND GAS RIGHTS (1954). Perhaps recognizing waiver of forfeiture inapplicable, some courts have resorted to estoppel to prevent the lessor from claiming that the lease had terminated. Mitchell v. Simms, 63 S.W.2d 371 (Tex. Corn. App. 1933). The use of either "waiver" or "estoppel" in effect overrules the self-operating feature of the delay rental clause in an "unless" lease. [↑](#footnote-ref-8)
8. 8 In some cases this faulty reasoning has not led to an unfavorable result. The customary concepts of abandonment and surrender are applied to ***oil*** and gas leases. See generally 51 C.J.S., *Landlord and Tenant* §§ 120.125 (1947); 3 SUMMERS §§ 522-525. Abandonment will be more readily found in ***oil*** and gas leases. *E.g.*, Banks v. Calstar Petroleum Co., 82 Cal. App.2d 789, 187 P.2d 127 (1947). To constitute an abandonment, non-user alone is not enough. There must be a physical relinquishment of the land plus an intent to abandon, Banks v. Calstar Petroleum Co., *supra*; Kunc v. Harper-Turner ***Oil*** Co., 5 ***Oil*** *and Gas Reporter* 1028 (Okla. 1956). An ***oil*** and gas lessee has been held liable in damages for breach of the covenant to protect against drainage when said drainage occurred between the time of the lessee's acts of abondonment and the lessor's termination of the lease. Mitchell v. Union Drilling and Petroleum Co., 1 Cal.2d 56, 32 P.2d 1069 (1934). This indicates that the mere abandonment by the lessee does not exonerate him from the burdens of the lease in the absence of an express "surrender" clause which, incidentally, is quite common in "or" leases. See 3 SUMMERS § 522. The ordinary lessee is likewise subject to the obligations of the lease until the lessor accepts the lessee's abandonment and a surrender is affected. Kulawitz v. Pacific Woodenware and Paper Co., 25 Cal.2d 664, 155 P.2d 24 (1944). The concept of surrender requires an abandonment by the lessee *and* an acceptance by the lessor. This is mechanically analagous to the termination of an "or" lease but is repugnant to the theory of an "unless" lease; yet it is quite conceivable that the courts will apply the theory of damages applicable to "surrender" when dealing with an " *unless*" lease since they have applied the even more incongruous Landlord-Tenant doctrine of Waiver of Forfeiture. See *supra* note 7. See also 1 AMERICAN LAW OF PROPERTY § 3.95 (Casner ed. 1952). In Tyson v. Surf ***Oil*** Co., 195 La. 247, 196 So. 336 (1940), the Louisiana Supreme Court gave the ***oil*** and gas lessor a conventional landlord's lien to secure the payment of accrued royalties. There appears to be no reason why the landowner should not be given this additional security especially since royalties are his prime motive for the lease. An alternative form of security for the lessor, where the landlord-tenant theories are recognized as inapplicable, is to consider the accrued royalty as part of the unpaid purchase price for the leasehold estate and to give the lessor an implied vendor's lien in Equity. See Walker, *The Nature of the Property Interests Created by an* ***Oil*** *and Gas Lease in Texas*, 10 TEXAS L. REV. 291, 301 (1932). Professor Walker recognizes this as a rather tenuous argument and the court in the *Tyson* case negates this argument by saying that the royalties are not payments of part of the price for ***oil*** and gas rights. [↑](#footnote-ref-9)
9. 9 1 AMERICAN LAW OF PROPERTY § 3.32 (Casner ed. 1952). [↑](#footnote-ref-10)
10. 10 39 Cal.2d 93, 244 P.2d 895 (1952). [↑](#footnote-ref-11)
11. 11 The *lease required* production by the lessee "in paying quantities" and this was defined as an average of fifty barrels of ***oil*** per day for thirty consecutive days. *Id.* at 96, 244 P.2d at 897. [↑](#footnote-ref-12)
12. 12 CAL. CIV. CODE § 1946 (West 1954): "A hiring of real property, for a term not specified by the parties, *is deemed to be renewed* . . . at the end of the *term implied by law* unless one of the parties gives written notice to the other of his intention to terminate the same, . . ." (Emphasis added.) [↑](#footnote-ref-13)
13. 13 Macco Construction Co. v. Fickert, 76 Cal. App.2d 295, 172 P.2d 951 (1996); 2 SUMMERS § 293, p. 128. [↑](#footnote-ref-14)
14. 14 From the facts of the *Renner* case it is not clear who had possession of the land during the pendency of the litigation. Therefore one can not tell whether the lessee's legitimate possession ended one month after notice or one month after the final judgment in the Supreme Court. The difference might well be more than three years. [↑](#footnote-ref-15)
15. 15 CAL. CIV. CODE § 1945 (West 1954): "If a lessee of real property remains in possession thereof after the expiration of the hiring, and the lessor accepts rent from him, the parties are presumed to have renewed the hiring *on the same terms* and for the same time, not exceeding one month when the rent is payable monthly, nor in any case one year." (Emphasis added.) [↑](#footnote-ref-16)
16. 16 *Ibid.; cf.*, Stetson v. Orland ***Oil*** Syndicate, 42 Cal. App.2d 139, 108 P.2d 463 (1940). [↑](#footnote-ref-17)
17. 17 CAL. CIV. CODE § 1945, fully reprinted *supra* note 15. [↑](#footnote-ref-18)
18. 18 CAL. CODE CIV. PROC. §§ 1159.1179a (West 1955). [↑](#footnote-ref-19)
19. 19 41 Cal. App.2d 161, 106 P.2d 443 (1940). [↑](#footnote-ref-20)
20. 20 Klein v. Loeffler, 96 Cal. App. 383, 274 Pac. 373 (1929). [↑](#footnote-ref-21)
21. 21 CAL. CODE CIV. PROC. § 1161 (West 1955): "A tenant of real property, for a term less than life . . . is guilty of unlawful detainer . . . ." [↑](#footnote-ref-22)
22. 22 279 S.W.2d 127, 4 ***Oil*** *and Gas Reporter* 1370 (1955), *rev'd on different grounds sub nom*. Mecom v. Hamblen, 289 S.W.2d 553 (Tex. 1956). [↑](#footnote-ref-23)
23. 23 See generally 51 C.J.S., *Landlord and Tenant* §§ 42-49 (1947). [↑](#footnote-ref-24)
24. 24 The true facts in the *Hamblen* case are as follows: *A* leased to *B, B* assigned the lease to *C* and *C* transferred to *D* retaining an overriding royalty. *B* attempted to hold *D* to the obligations of the assignment from *B* to *C*. The facts stated in the text omit *A* for clarity thus making *B* analogous to an original lessor with *D* as the sublessee. [↑](#footnote-ref-25)
25. 25 Chase v. Trimble, 69 Cal. App.2d 44, 158 P.2d 247 (1945). [↑](#footnote-ref-26)
26. 26 There is a scholarly split of authority on this point. It is contended on one side that both the assignee and the sublessee are bound by the covenants contained in the original lease. Hightower, *The* ***Oil*** *and Gas Lease in California*, 3 U.C.L.A. L. REV. 424, 442 (1956), Others strongly urge the lessor to draft his lease with care so as to prevent subleases because these transfers destroy the privity necessary for the lessor to hold the transferee. Merrill, *The Partial Assignee--Done in* ***Oil***, 20 TEXAS L. REV. 298, 322 (1942). See also 3 SUMMERS § 553, p. 309, Supp. 1956 p. 102. [↑](#footnote-ref-27)
27. 27 *Cf.*, Hartman Ranch Co. v. Associated ***Oil*** Co., 10 Cal.2d 232, 248, 73 P.2d 1163, 1171 (1937), where the court comments obiter that the lessor may have a direct right against the sublessee on the theory of conversion. The lessor has a property interest in the ***oil*** produced and the lessee cannot, by means of a sublease, deprive the lessor of his rights against the party producing the ***oil***. [↑](#footnote-ref-28)
28. 28 Melancon v. Texas Co., 89 So.2d 135 (La. 1956). [↑](#footnote-ref-29)
29. 29 There was a strong protest that the court was rewriting the judicial ascertainment clause. Dissent, *id.* at 148. The judicial ascertainment clause provides that once production is secured, the lease shall not be subject to forfeiture until a reasonable time after the lessee's breach has been judicially ascertained. This in effect dictates to the court that its decree shall not take the form of an absolute cancellation. The court in the *Melancon* case assumes the validity of the clause although there may be a valid argument that these clauses are against public policy because they tell the court the form its decree shall take. As yet this argument has not been tested. [↑](#footnote-ref-30)
30. 30 At common law the landlord did not enjoy this right due to the interpretation of the lease covenants as independent. [↑](#footnote-ref-31)
31. 31 *E.g.*, Davis v. Chataqua ***Oil*** & Gas Co., 78 Kan. 97, 96 Pac. 47 (1908). Courts commonly equate rents and royalties. For a recent example of this see Dishman v. Union ***Oil*** Company of California, 302 P.2d 326 (Cal. App. 1956). The owner of minerals under a tract of land agreed to pay ***oil*** royalty to surface owners. The right to receive the royalty was made an appurtenance to the land and was apportioned to each parcel in the tract. One parcel was subdivided into two lots and in this case the court applied section 1467 of the Civil Code to appoint the royalty to each lot. By analogizing royalties to ordinary rents the court applied this codification of the common law doctrine of rent apportionment to ***oil*** and gas royalties. The statute in question had never before been applied in California yet the court took this opportunity to apply another landlord-tenant concept to an ***oil*** and gas problem. [↑](#footnote-ref-32)