The Canadian Institute of
Resources Law

CLASSIFYING NON-OPERATING INTERESTS IN OIL AND GAS

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Presented at a seminar
sponsored by the
Faculty of Law
and the
Canadian Institute of Resources Law
The University of Calgary

April 7, 1988

Discussion Paper

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BACKGROUND

NEED FOR NON-OPERATING INTERESTS

Persons who invest or participate in an oil and gas operation engage in a high risk enterprise. Most of the risks to which they are exposed are unavoidable, but some of the risks should be unnecessary.

First, there are unavoidable risks involved in selecting a prospect to explore and to develop, because the methods used in geological and geophysical exploration are subject to error in performance and in interpretation. Next, there are unavoidable risks in drilling and completing wells, because unforeseen conditions may be encountered and costly mistakes may occur. Even if the usual mechanical risks have been avoided and the operation has been a complete success up to point of production, a further unavoidable risk of loss can be expected because of the volatile nature of the market for oil and gas.

The investor or operator may attempt to limit the financial loss which could result from mechanical and market risks by attempting to remove the risk of losing more than the amount originally invested. This may be attempted by using one of the non-operating interests. Unfortunately, the use of a non-operating interest may expose the investor or operator to a different risk that should be an avoidable risk. The risk is that the non-operating interest will not be recognized as a property interest and the expected rewards of a successful operation may be lost because the investor or operator did not acquire a property interest and any enforceable contractual rights are against a party who is having financial difficulty.

The law cannot remove all risks of loss of the rewards of an otherwise successful operation, but it should provide a framework within which informed parties may structure their transactions to remove unnecessary risks. That framework should make possible a selection of devices and arrangements suitable for reducing risks and protecting rewards incident to exploring for and producing oil and gas, and if the arrangements are properly used, the results should be predictable.

DEVELOPMENT OF NON-OPERATING INTERESTS

The selection of appropriate arrangements for sharing the risks and rewards in exploring for and producing oil and gas must have presented a true challenge to the pioneers in the industry. The conventional business practices apparently did not meet the requirements of those engaged in such activities. New devices were required and were forthcoming.

When a landowner was willing to contribute land to be explored and developed and another party was willing to provide the resources required for the operation, it is apparent that the conventional practice of entering into a partnership did not satisfy the requirements of the parties. To meet the respective requirements of the landowner and the operator, a new device which is now called the oil and gas lease was developed and continues to be developed. Many features of the existing devices used in land and mineral development were utilized, but the oil and gas lease emerged as a unique instrument creating a special relation.[1] Similarly, new devices were required to meet the growing requirements of operators in dealing with one another. The conventional devices of partnership or mining partnership did not meet their requirements, and the non-operating interest[2] evolved in apparent response to the need.

One can only speculate as to the early business objectives that must have influenced various stages of the evolution of non-operating interests. From later developments in the last several decades and from the present use of such interests, however, it is apparent that persons now create and use non-operating interests to make the sharing of the benefits of mineral ownership definite and certain, to minimize income taxes, to make a clear delegation of operating rights, and to make a proper allocation of the risks and rewards of an operation without invoking many objectionable features associated with creating a conventional business association. Non-operating interests proved to be effective, flexible devices for achieving such objectives.

PRESENT USE OF NON-OPERATING INTERESTS

Today, non-operating interests are commonly used in sharing the benefits of ownership and in acquiring, exploring, developing, and operating mineral properties. When used in acquiring an oil and gas lease from the mineral owner,

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1. See Eugene Kuntz, A Treatise on the Law of Oil and Gas, vol.2 (Cincinnati, Ohio: W.H. Anderson, 1962 -) §§ 18.1 and 18.2 [hereinafter Kuntz].
2. The term "non-operating interest" is used herein as a general term to identify a right to a share of minerals that are produced without the right to explore for and produce such minerals. The interest may exist as to any combination of minerals, but references herein to the substances involved will be restricted to oil and gas.

they may be used to increase the lessor's benefits under the lease. They may also be used to compensate personnel for services performed in connection with the acquisition or transfer of a lease or leases. Further, when used in acquiring, exploring, developing, and operating an existing oil and gas lease, they are commonly used in connection with farmouts and operating agreements.

When a non-operating interest is used to increase the lessor's benefits, it may be included in the lease as royalty in addition to the fractional royalty provided for in a printed lease form.[3] It is, of course, also possible for the lessor to retain a production payment as additional compensation in lieu of or in addition to the provisions for royalty.[4]

When a non-operating interest is used to compensate personnel for services to be performed in connection with the acquisition of a lease or leases, a contractual arrangement may be entered into in advance with possible provisions for current payments of salary and expenses plus a non-operating interest in properties acquired. For example, this arrangement may be made in retaining a geologist,[5] a geophysicist, a landman or other personnel to render special services in acquiring a lease or leases. When used to compensate employees whose services have been particularly valuable in the past in acquiring and developing specific properties, a non-operating interest in such properties may either be granted directly to such personnel or be granted in trust for their benefit.

In all of the foregoing situations, it is of great importance to the party acquiring such an interest that it be classified as a property interest and not as a mere contractual right. This is important to guard against the consequences of possible financial difficulties of the granting party and to protect the interest against the rights of third persons generally.

When a non-operating interest is used in connection with a farmout agreement, it is ordinarily retained by the farmor upon the transfer of the lease and may also be convertible to an operating interest upon payout. Similarly, an operating agreement may utilize non-operating interests in making provision for subsequent nonconsent operations. In those situations, it is also important to the person owning the non-operating interest that it be classified as a property

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3. See Kuntz, supra, note 1, vol.3, §39.1.
4. See Kuntz, supra, note 1, vol.5, §63.3.
5. See, e.g., Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd. (1970), 15 D.L.R. (3d) 256 (S.C.C.), aff'g (1969) 3 D.L.R. (3d) 630 (Alta. S.C., A.D.).

interest in order to be protected against the rights of third parties, including a possible trustee in bankruptcy.

NON-OPERATING INTERESTS DESCRIBED

ROYALTY INTEREST

A non-operating interest that is used more frequently in personal transactions than in commercial transactions is the royalty interest, sometimes referred to as a "nonparticipating royalty interest". The owner of a royalty interest is entitled to a share of oil or gas produced from a described tract of land, free and clear of costs, but such owner does not have the right to explore for and produce oil or gas. Not having such operating rights, the owner of such interest cannot confer them on another by granting an oil and gas lease.[6]

There may be a problem in construing a grant or reservation of a royalty interest to determine whether the fractional interest is of total production from the land or is of the royalty payable under any oil and gas lease covering such land.[7] There may also be a problem of construction as to whether the interest applies only to royalty under an existing lease or applies to all leases that may be granted in the future.[8]

OVERRIDING ROYALTY INTEREST

Although the term "overriding royalty" has been used to describe a royalty in excess of the "usual" royalty provided for in an oil and gas lease, an overriding royalty interest is generally understood to be a non-operating interest that is carved out of the working interest of an oil and gas lease by the lessee.[9] The owner of an oil and gas lease may create such interest by grant or by reservation upon the transfer of an interest in the lease. The owner of the overriding royalty does not share any of the lessee's rights to explore for and produce oil or gas, but is entitled to a specified share of oil and gas produced under the terms of the

6. See Kuntz, supra, note 1, vol.1, §15.4.
7. See Kuntz, supra, note 1, vol.1, at 497.
8. See Kuntz, supra, note 1, vol.1, §15.8, at 354. See also N.D. Bankes, "Case Comment: Guaranty Trust Company of Canada v. Hetherington" (1987) 50 Alta. L.R. (2d) 350.
9. See Kuntz, supra, note 1, vol.5, §63.2.

lease, free and clear of drilling, completing, and operating costs. It is possible that the word "overriding" is intended to be descriptive of the intention that the interest is to "override" or to be free of the burdens normally incident to the working interest out of which it is created.[10]

PRODUCTION PAYMENT

The production payment may be created by grant or reservation out of a mineral interest, a royalty interest, a royalty pool, an oil and gas lease, an overriding royalty interest, another production payment, or any interest that is greater than the production payment created.[11] Depending upon the language used in granting or reserving such interest, the owner is either entitled to a specified share of production free and clear of costs until a certain volume or value of production has been received, or the owner is entitled to payment of a specified amount of money, contingent on production attributable to the interest out of which it is carved.[12] The owner has no right to explore for or produce oil or gas.

NET PROFITS INTEREST

The net profits interest may be granted or reserved from any greater interest. The owner of a net profits interest is entitled to a specified share of profits from the operation of a described property, without exposure to personal liability for costs or for losses. Such owner has no right to explore for or to produce oil or gas. The deductions allowed in computing net profits are a matter of expressed intention in the grant or reservation, but they usually include all costs of exploring, drilling, well completion and operation.[13] If the costs to be taken into account in computing profits are restricted to operating costs, such an interest may be called a "net operating profits interest".

10. See Kuntz, supra, note 1, vol.5, §63.2.
11. See Kuntz, supra, note 1, vol.5, §63.3.
12. See Kuntz, supra, note 1, vol.5, §63.3.
13. See Kuntz, supra, note 1, vol.5, §63.5.

CARRIED INTEREST

"Carried interest" is a term that is applied to a wide variety of arrangements used in the acquisition, exploration, development, and operation of oil and gas properties.[14] It is unfortunate that the frequent use of the term has created an illusion of certainty as to its meaning. To a degree, the term is certain, in that there is a party to carry and another party to be carried, the carrying party and carried party each owns or acquires an interest in the commonly owned property, and the carrying party pays the costs attributable to both the carrying party's interest and the carried party's interest. There ceases to be certainty, however, when the subject of recovery of costs by the carrying party is considered. It may then become apparent that the details of the transaction are not supplied by the simple term "carried interest".

The carrying party may or may not be entitled to recoup from the production attributable to the carried interest the costs advanced on behalf of such interest.[15] In addition to recovering such costs, the carrying party may also be entitled to recover more than the total costs as a reward for undertaking the risk. The right to recover more than total costs is frequently referred to as a "penalty". Those matters as well as other matters pertaining to future rights of the parties must be determined from the expressed intention of the parties. If the carried interest is perpetual, pertaining to all future operations, and the carrying party is entitled to recoupment, the interest would be described better as a net profits interest.

POSSIBLE CLASSIFICATION OF NON-OPERATING INTERESTS

NEED FOR CLASSIFICATION

It may become necessary to determine if a non-operating interest is an interest in land for any one of a number of reasons. Thus, it may be necessary to

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14. See Kuntz, supra, note 1, vol.5, §63.4.
15. See Pine Pass Oil & Gas Ltd. v. Pacific Petroleums Ltd. (1968), 70 D.L.R. (2d) 196 (B.C.S.C.), for conflicting opinions of expert witnesses. See also Byrd v. Smyth, 590 S.W.2d 772 at 775, 64 Oil & Gas Rptr. 530 (Tex. App. 1979), wherein the court paradoxically held that the term "carried interest" is unambiguous but that parol evidence is admissible to explain it, observing that "[a]s used in the oil industry, the holder of a carried interest of a working interest has no personal obligation for operating costs while the co-owners who advance such costs are entitled to reimburse themselves first from the future production."

make such classification in order to determine the devolution of such interest, its tax situs, the applicable law, the application of a real estate mortgage, or the possible application of an area of mutual interest agreement. More importantly for the purpose of achieving the objectives of the parties, such classification is required to establish the right to oil or gas produced and to determine the applicability of statutes prescribing the formalities required for a transfer of the interest or providing for registration or recording of title to interests in land.

The purpose for which the classification of an interest must be made is, of course, an important consideration. For example, if the interest must be classified to determine if it is subject to the provisions of a statute, the question may be one of statutory construction to determine if the interest in question is of the type intended to come within the provisions of the statute. The question may not be solved by definition and simple substitution of terms, but may require a more profound inquiry into the purpose of the statute to determine if the interest in question is of the type intended to be affected by the statute. Nevertheless, in making such determination, there must be a starting point, and an initial classification may be required.

METHODS OF CLASSIFICATION

TRADITIONAL

One method of classifying an interest as an interest in land is the traditional method which recognizes the importance of maintaining stability in the law and, accordingly, looks to the past when classifying an interest. When properly applied, it involves a recognition that the development of the law represents a constant adjustment between the need for stability and the need for flexibility. Stability is certainly needed so that people may plan their affairs intelligently on the basis of existing law, with some assurance that the rules will remain the same in the future. On the other hand, the genius of the common law is that it permits changes in the law when changes are required to meet the needs of a dynamic society. This salutary process of balancing stability and flexibility permits change by social evolution as the preferred alternative to social revolution.

Maintaining a balance between stability and flexibility requires a preliminary appraisal of any new idea. Each time an innovation is proposed, it must be compared with existing law in order to ascertain if it truly represents a change. If it does not represent a change and the existing law has worked well, there is little reason to inquire further. If it does represent a change, then it becomes necessary to compare the social values that support the old and the values that appear to support the new. If the innovation does not appear at all in existing law, then the social values supporting the proposal must be appraised before it can be accepted. The traditional method of classification is an application of this process.

As applied to interests in oil and gas, the traditional method of classifying an interest involves a preliminary search for its existence and classification in English common law. If that search is successful, the present classification is automatic. If that search is unsuccessful, then a further search is made for the existence and classification of a counterpart in English common law with which the interest in question might be identified. If an identification is made but it is not exact, there is a tendency to identify the present right as "in the nature of" some right found to exist in early English land law, and the classification problem is solved. Undoubtedly, "in the nature of" means "approximating", "analogous to", or "resembling in all material respects", and accordingly the characteristics of the interest that existed at early English common law may fairly be applied to the new interest.

If neither the same interest nor a counterpart can be found in English common law, it should not automatically preclude classifying the interest as an interest in land. An appraisal of social values is necessary and the problem should not be solved mechanically by the use of historical definitions.[16] The traditional method of classification of interests is easy to apply when the interest or a counterpart can be found in early common law and classification as an interest in land results automatically, but it leaves much to be desired if it is applied without further critical analysis when classification is not dictated by early common law.

INCIDENTS OF OWNERSHIP

A method that should supplement the traditional method would make it possible to classify an interest in oil or gas as an interest in land even though it

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16. For a scholarly application of the traditional method of classification, see G.J. Davies, "The Legal Characterization of Overriding Royalty Interests in Oil and Gas" (1972) 10 Alta. L. Rev. 232, and W.H. Ellis, "Property Status of Royalties in Canadian Oil and Gas Law" (1984) 22 Alta. L. Rev. 1.

cannot be so classified immediately by reference to early common law. Such method might be identified as an "incidents of ownership" method.

Under an incidents of ownership method, the landowner or the owner of a severed mineral interest should be regarded as owning the total of all rights in and to the oil, gas, and any other minerals. The rights that exist because of ownership are incidents of ownership and should be regarded as interests in land.

The rights of the owner of the minerals include, among many incidents of ownership, the very valuable right to enter upon the land to explore for and extract oil and gas. Because of the great risk and expense involved in extracting oil and gas, the mineral owner rarely undertakes such an operation. Instead, the mineral owner confers such right upon another by granting an oil and gas lease. The common benefits retained by the mineral owner upon granting an oil and gas lease consist of the bonus received upon granting the lease and the right to delay rentals and royalty in the future. There may be other benefits such as oil or gas payments, shut-in gas royalty, and minimum guaranteed royalty, but such benefits are combinations or variations of the common benefits mentioned. The right to receive such benefits exists because of the reversionary interest or other ownership retained upon granting the oil and gas lease.[17]

Although the right to the payments under an oil and gas lease may be described as being incident to the reversion, the pattern of the payments under an oil and gas lease has become sufficiently standardized that the right to such payments is commonly regarded as being incident to the mineral interest whether or not there is an existing oil and gas lease.[18] Thus, even before an oil and gas lease is granted, creating a duty to make payments, the owner of the mineral interest is recognized as having distinct incidents of ownership which include the right to receive such payments when a duty to make them is created in the future. It is further recognized that such owner may alienate such incidents of ownership in whole or in part.[19] The incidents of ownership commonly recognized may be identified as the power to lease, the right to receive bonuses, the right to receive delay rentals, and the right to receive royalties.[20]

Similarly, the oil and gas lessee is regarded as being the owner of all rights

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17. See Kuntz, supra, note 1, vol.1, §15.1.
18. See Kuntz, supra, note 1, vol.1, §15.1.
19. See Kuntz, supra, note 1, vol.1, §15.1. For a clear statement and application of this principle, see Schlittler v. Smith, 128 Tex. 628, 101 S.W.2d 543 (Tex. Civ. App. 1937).
20. See Kuntz, supra, note 1, vol.1, c.15.

granted by and incident to the oil and gas lease. Further, any one of such rights that is exclusive should be separately alienable. For example, in a jurisdiction in which it is held that the oil and gas lease grants a profit a prendre, the lessee acquires an interest in land; the lessee's incidental rights are also interests in land. Where such rights are exclusive, they are divisible and may be separately alienated, if such a transfer does not increase the burden on the land.[21] Moreover, the practice of creating non-operating interests is commonplace as a means of dividing and transferring the right to oil and gas produced under an oil and gas lease which is incident to ownership of the lease.

To summarize, the incidents of mineral ownership are the rights which a mineral owner has in the land, and each of such incidents should constitute an interest in the land whether it is owned as a sole interest in the land or is owned in conjunction with other rights. Similarly, each of the rights of the oil and gas lessee conferred by the mineral owner is an incident of ownership and should constitute an interest in land whether it is owned as a sole interest in the land or is owned in conjunction with other rights. The idea that each of such rights should constitute an interest in land is not new, and it fits into the definitions introduced more than half a century ago by the American Law Institute in the Restatement of the Law of Property.

The American Law Institute's Committee on Property that was responsible for the material published was keenly aware of the need for precision in expression and adopted terminology attributable to Wesley Newcomb Hohfeld.[22] Such terminology was utilized to describe property interests as consisting of one or more of four types of relationships between persons. That is, property does not have an objective existence but, in legal contemplation, consists of legal relations between persons. The possible legal relations were described as "right"[23] with its

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21. This analysis was made in Hinds v. Phillips Petroleum Co., 591 P.2d 697, 62 Oil & Gas Rptr. 532 (Okla. Sup. Ct. 1979), wherein it was held that the right to lay pipelines conferred by the lease may be assigned to a purchaser of gas produced under the lease where it does not impose a greater burden than authorized by the lease.
22. For a description of the work of Hohfeld on legal analysis, see Walter Wheeler Cook, ed., Introduction to Hohfeld, Fundamental Legal Conceptions as Applied in Judicial Reasoning (New Haven: Yale University Press, 1923). For an application of Hohfeld terminology, see Richard R. Powell, The Law of Real Property, vol.1 (New York: Matthew Bender, 1949-) c.5.
23. Restatement of the Law of Property §1 (1936) [hereinafter Property Restatement].

correlative "duty", "privilege"[24] with its correlative "no right", "power"[25] with its correlative "liability", and "immunity"[26] with its correlative "disability".

According to the Property Restatement, an "interest" is defined as follows:

> The word "interest" is used in this Restatement both generically to include varying aggregates of rights, privileges, powers and immunities and distributively to mean any one of them.[27]

The definition is applied to describe an interest in land as follows:

> c. Interest in land or other thing. There are rights, privileges, powers and immunities with regard to specific land, or with regard to a thing other than land, which exist only in a particular person. By virtue of the fact that a person has these special interests, other than and in addition to those possessed by members of society in general, he occupies a peculiar and individual position with regard thereto. Interests of this type constitute the chief subject matter of this Restatement, and, when the affected thing is land, are designated herein as "interests in land".[28]

JUDICIAL CLASSIFICATION OF NON-OPERATING INTERESTS IN THE UNITED STATES

ROYALTY INTEREST

The courts in many of the states were called upon many years ago to make an initial classification of some non-operating interests in oil and gas. Three of the early cases that involved classification of the royalty interest may be singled out as leading or landmark cases that applied in varying degrees the methods of classification described herein.

In an early California case,[29] the court was required to classify a nonparticipating royalty interest in order to determine if it passed by a conveyance of the land and was subject to the recording statutes. The traditional method of classification was used to solve the problem. The court observed that "real property" was defined by statute as "coextensive with lands, tenements, and

24. Id., §2.
25. Id., §3.
26. Id., §4.
27. Id., §5.
28. Id., §5, "comment c".
29. Callahan v. Martin, 3 Cal.2d 110, 43 P.2d 788 (1935).

hereditaments".[30] The court then observed that the statutory definition corresponded to Blackstone's definition of "things real" which included "lands, tenements, and hereditaments". The court also referred to contemporary writers such as Hohfeld and Tiffany. The reasoning of the court was more than a mere substitution of terms, however, as it finally concluded that a nonparticipating royalty interest is an interest in land that passes with a conveyance of the land and is subject to the recording statutes.

In an early Texas case, the court classified the lessor's royalty and a severed nonparticipating royalty interest as real estate for purposes of ad valorem taxation.[31] The court had at its disposal many earlier Texas decisions and opinions of contemporary commentators as to the nature of the oil and gas lease and the nature of ownership of oil and gas and did not find it necessary to resort to early English commentators for a classification of such interests. The court did, however, make a resounding statement of policy that justifies repetition here.

> The oil industry in Texas is largely dependent for development, growth, or prosperity, on the doctrine that the interests we are considering - such as the lessee's and the lessor's estates under contracts which are in customary use in Texas - are interests in land; and hence are not subject to parol sale, but have the protection of the statute of frauds, the statutes regulating conveyances and mortgages of real estate, and the statutes requiring the record of instruments affecting title to or liens on land, so that purchasers can rely on deed and lien records and can execute and receive transfers and conveyances in reliance on true abstracts of title and lawyers' correct opinions thereon. Were the stability furnished by these rules withdrawn and the fundamental contracts on which the oil business so largely rests, be adjudged by the Supreme Court to create mere rights in personalty at some uncertain date in the future, the structure of the business would be seriously, if not fatally, jeopardized.[32]

Considering the immediate result of the decision, this statement of policy was probably viewed by the industry as a paternal declaration that "this is for your own good".

In an early Wyoming case, the court had the benefit of the opinions in the California and Texas cases but, nevertheless, made its own thorough analysis in determining if a nonparticipating royalty interest is an interest in land and

30. Id., P.2d at 792.
31. Sheffield v. Hogg, 124 Tex. 290, 77 S.W.2d 1021 (1934).
32. Id., S.W.2d at 1024.

therefore subject to a real estate mortgage on the land.[33] The court began with the traditional method of classification by quoting and referring to Coke, Blackstone, Kent, as well as contemporary commentators such as Hohfeld, Tiffany, and Summers. The traditional method did not persuade the court completely. After quoting from Coke to the effect that land consists of the profits thereof, the court pensively observed:

> While this statement of this luminary of the law may not light the way exactly as does a sun, it may, nevertheless, be accepted as a morning star, at least dimly indicating the path along which we must travel.[34]

The court referred to Hohfeld and other contemporary writers and applied the concept that ownership consists of "rights ... including claims, powers, immunities, and privileges ...."[35] The court then referred to the prior California and Texas cases and repeated a portion of the policy statement, quoted above, that was made by the Texas court.

Finally, in an apparent response to the argument that the right to receive royalty must be personalty because it does not attach until the oil is severed and has become personal property, the court made the following statement:

> The right to a royalty interest in oil does not merely attach after the oil has been severed from the ground and become personal property. It is not merely rent issuing out of the annual produce of the land. It goes further than that. The right, extending as it does to oil which is to come from particular land, extends to and is necessarily connected with the corpus of the land, and is, accordingly, a right which exists in the oil which still is in place, inchoate though it may be, follows it as it comes from the ground and still is attached after it has become personal property. To call it personal property is but emphasizing a particular stage of the right on its way to fulfillment. It ignores that it is a right which necessarily extends to a part of the corpus of the land.[36]

Consistent with the results reached in the cases just mentioned, a perpetual royalty interest may be created as an interest in land in every state with a decision on the subject, except Kansas and Colorado. Such property interest entitles the owner to a share of production, free and clear of costs, whether or not there was an outstanding oil and gas lease providing for a royalty at the time the

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33. Denver Joint Stock Land Bank v. Dixon, 57 Wyo. 524, 122 P.2d 842 (1942).
34. Id., P.2d at 846.
35. Id.
36. Id., P.2d at 849.

royalty interest was created.[37] The exception in Kansas deserves special attention, because it represents a substantial difference in concept.

In Kansas, the grant of a right to receive royalties is treated as a valid covenant to pay royalties which become payable to a lessor by a lessee under an oil and gas lease. If the covenant pertains to royalties payable under an existing lease, the covenant is enforceable.[38] If, however, the covenant applies to all leases granted in the future, it is invalid as a violation of the rule against perpetuities.[39]

OVERRIDING ROYALTY

If the overriding royalty is an additional royalty provided for in an oil and gas lease, it should have the same classification as the royalty interest and should be classified as an interest in land. Where, as is commonly the case, the overriding royalty is created out of an oil and gas lease, it cannot be an interest of greater dignity that the lease out of which it is created. Thus, in California and Indiana, where an oil and gas lease creates an incorporeal hereditament, the overriding royalty is held to be an incorporeal hereditament.[40] In Texas, where the oil and gas lease creates a determinable fee in the minerals in place, an overriding royalty retained on a transfer of the lease is similar to the royalty retained by a lessor on leasing.[41] Whereas in Kansas, where it is frequently stated that the oil and gas lease conveys no interest in land, an overriding royalty is not "land" within the meaning of that term in a statute providing for constructive service.[42]

Where the lease is treated as an interest in land, as it is in an overwhelming majority of the states with a decision on the subject, the overriding royalty is also treated as an interest in land. Thus, it has been held that a conveyance[43] and an agreement to grant[44] an overriding royalty is within the statute of frauds, that

37. See Kuntz, supra, note 1, vol.1, §15.4.
38. Miller v. Sooy, 120 Kan. 81, 242 P. 140 (1926).
39. Lathrop v. Eyestone, 170 Kan. 419, 227 P.2d 136 (1951).
40. La Laguna Ranch Co. v. Dodge, 18 C.2d 132, 114 P.2d 351 (1941); Halbert v. Hendrix, 121 Ind.App. 43, 95 N.E.2d 221 (1950).
41. Frost v. Standard Oil Co. of Kansas, 107 S.W.2d 1037 (Tex. Civ. App. 1937).
42. Connell v. Kanwa Oil Co., 161 Kan. 649, 170 P.2d 631 (1946).
43. Gaddis v. McDonald, 633 P.2d 1102, 70 Oil & Gas Rptr. 227 (Colo. App. 1981).
44. Danciger Oil & Ref. Co. v. Burroughs, 75 F.2d 855 (10th Cir. 1935); Duncan

any transfer or surrender of the interest requires the same formality as required of a transfer of a lease,[45] that it is an interest in land for purposes of the recording statutes[46] and venue,[47] that it is an interest in realty for purposes of quieting title[48] and specific performance,[49] and that it is "land", "real property", or "real estate", as those terms are used in a statute providing for attachment.[50]

PRODUCTION PAYMENT

There is a theoretical difference in the types of production payments, depending upon the language used.[51] The instrument may transfer a right to receive a share of production free of costs until a certain volume of production or amount of money has been received. This type is essentially an overriding royalty interest that is terminable and should theoretically have the same classification as the overriding royalty interest. The instrument may also be worded as a covenant to pay a certain amount of money out of a certain described portion of production.

Despite the theoretical difference in production payments, they have been classified as interests in land, with rare exception. Thus, it has been held or stated that the production payment is a real property interest and not personal property,[52] that it is an incorporeal hereditament,[53] that an agreement to exchange a production payment for services is within the statute of frauds,[54] that it is an interest in land subject to the recording statutes,[55] that it is an interest in

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v. Paragon Resources, Inc., 417 S.2d 850, 76 Oil & Gas Rptr. 57 (La. App. 1982).

45. Homestake Exploration Corp. v. Schoregge, 81 Mont. 604, 264 P. 388 (1928).
46. Dame v. Mileski, 80 Wyo. 156, 340 P.2d 205, 10 Oil & Gas Rptr. 853 (1959).
47. Heath v. Gray, 58 N.Mex. 665, 274 P.2d 620, 4 Oil & Gas Rptr. 44 (1954); Frost v. Standard Oil Co. of Kansas, 107 S.W.2d 1037 (Tex. Civ. App. 1937).
48. Christy v. Petrol Resources Corp., 691 P.2d 59, 82 Oil & Gas Rptr. 555 (N. Mex. App. 1984).
49. Globe Drilling Co. v. Cramer, 562 P.2d 762, 57 Oil & Gas Rptr. 185 (Colo. App. 1977).
50. Halbert v. Hendrix, 121 Ind.App. 43, 95 N.E.2d 221 (1950).
51. See Kuntz, supra, note 1, vol.5, §63.3.
52. Beshara v. Goldberg, 221 Cal.App.2d 392, 34 Cal. Rptr. 501, 19 Oil & Gas Rptr. 633 (1963), in which the type of production payment was not indicated.
53. Standard Oil Co. of Texas v. Marshall, 265 F.2d 46, 11 Oil & Gas Rptr. 379 (5th Cir. 1959), cert. denied 361 U.S. 915, which involved a title type of production payment, but the court did not decide on that basis.
54. See Dille v. Carter Oil Co., 192 F.2d 791, 1 Oil & Gas Rptr. 24 (10th Cir. 1951), in which there was no indication of the type of production payment involved.
55. Elliot v. Sioux Oil Co., 191 F.Supp. 847, 14 Oil & Gas Rptr. 443 (Wyo. D.

land under a statute providing for actionable fraud in real estate transactions,[56] that it is an interest in land and not just a mortgage,[57] and that it is taxable as an interest in land.[58] In Kansas, however, it has been held that the production payment does not constitute a present interest in the oil in the ground and that an oral agreement to transfer a production payment as compensation for services is not within the statute of frauds.[59] This is consistent with the position taken in that state regarding the nonparticipating royalty interest and the overriding royalty interest as previously mentioned herein.

NET PROFITS INTEREST

There is no body of law clearly defining the net profits interest and describing its incidents. Thus, it has been observed:

> In deciding whether plaintiff's "net profits interest" is an interest in the title to real property, we proceed on the following basis: (1) the phrase "net profits interest" has no independent meaning, and (2) the nature of plaintiff's interest must be determined from the provisions of the instrument which created plaintiff's interest.[60]

Depending upon the provisions of the instrument, the net profits interest could be any one of many things. It could be nothing more than a contractual arrangement to share the profits, but not the losses, from operating a described mineral property. It has been held that such an arrangement does not create an

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1960), wherein a lien type production payment was held not to be an account receivable but an interest in real property; Davis v. Lewis, 187 Okla. 91, 100 P.2d 994 (1940), wherein a lien type production payment was held to create an equitable lien and an assignment thereof was held to be an instrument relating to real estate; Tennant v. Dunn, 130 Tex. 285, 110 S.W.2d 53 at 55 (Tex. Civ. App. 1937), in which an assignment of a lease "insofar as it covers and only covers Twenty Five thousand dollars ($25,000) worth of oil" out of 5/48ths of 7/8ths was analyzed by the court as a conveyance of the grantor's interest in oil and gas and not as a covenant to pay.

56. Cockburn v. Mercantile Petroleum, Inc., 296 S.W.2d 316, 7 Oil & Gas Rptr. 306 (Tex. Civ. App. 1956), wherein the provisions of the production payment were not reported.
57. Prince Bros. Drilling Co., v. Fuhrman Pet. Corp., 150 S.W.2d 314 (Tex. Civ. App. 1941), wherein a title type production payment was analyzed.
58. Id.
59. McRae v. Bradley Oil Co., 148 Kan. 911, 84 P.2d 866 (1938).
60. Christy v. Petrol Resources Corp., 691 P.2d 59 at 62, 82 Oil & Gas Rptr. 555 at 559 (N. Mex. App. 1984).

interest in the property to be operated, and does not create a partnership.[61] If a net profits interest is retained on the assignment of a lease, it could create a sublease under local law with a resultant rights and duties incident to that relation. The retention of a net profits interest on the assignment of a lease could also impose an encumbrance or charge on the lease,[62] or create a covenant running with the lease.[63] It is also theoretically possible for the net profits interest to be an identifiable property interest with its own described incidents.[64] It has been held that a present interest in future profits to be realized from ownership of oil and gas leases is an interest in real estate for purposes of the statute of frauds and the Texas Trust Act.[65]

CARRIED INTEREST

Because of the various forms in which the carried interest can be cast,[66] a single classification is difficult. If it is a perpetually carried interest without penalty, then its classification should be the same as net profits interest. If it is not a perpetually carried interest and the carrying party is entitled to recoup its costs from production, a theoretical problem of classification may exist because of the substance or form of the provision for recovering costs. It should be classified as an interest in land, however, regardless of the substance or form of the provision for recoupment. Thus, it should be an interest in land whether it involves an assignment of a lease with a retained reversionary interest, resembles the grant of a production payment from a retained lease, or is in substance the grant of a mortgage upon a retained lease.

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61. Garfield v. True Oil Co., 667 F.2d 942, 74 Oil & Gas Rptr. 394 (10th Cir. 1982); LeBus v. LeBus, 269 S.W.2d 506, 3 Oil & Gas Rptr. 1762 (Tex. Civ. App. 1954).
62. See Kumberg v. Kumberg, 659 P.2d 823, 79 Oil & Gas Rptr. 534 (Kan. Sup. Ct. 1983), wherein a testamentary disposition of "net profits" from land created an incorporeal interest that constituted a charge on the land.
63. See Greenleaf v. S.A. Camp Ginning Co., 150 C.2d 385, 309 P.2d 943, 7 Oil & Gas Rptr. 551 (1957), where such a transaction was involved and the question decided had to do with the running of the benefit of the covenant.
64. See Carlock v. National Co-operative Ref. Ass'n., 424 F.2d 148, 36 Oil & Gas Rptr. 228 (10th Cir. 1970).
65. LaRue v. Wiggins, 277 S.W.2d 808, 4 Oil & Gas Rptr. 1171 (Tex. Civ. App. 1955).
66. See Kuntz, supra, note 1, vol.5, §63.4.

In those instances where a judicial classification has been made, the carried interest has been held to be an interest in real estate for purposes of the statute of frauds[67] and the Texas Trust Act.[68]

IN CANADA

ROYALTY INTEREST

With exception of an early Ontario High Court case,[69] the Canadian decisions are consistent with the incidents of ownership theory in that it has either been held or assumed that a royalty interest can be created as a separate property interest. In the Ontario case, the court held that the grantee of an "Assignment of Royalty" by a landowner who had previously granted an oil and gas lease acquired only contractual rights and that such contractual rights were enforceable only against persons liable by contract to him. The position taken in that case is the same as the position taken in Kansas, as described above. Further, in the light of subsequent cases in other provinces, it is similar to the Kansas situation in that it is a minority position.

In Berkheiser v. Berkheiser,[70] the Supreme Court of Canada used the traditional method of classification to hold that the oil and gas lease creates a profit a prendre and to hold that the lessor retained legal title to the oil and gas which included the right to receive royalties under the lease. The traditional method worked well because the rights granted under the oil and gas lease could be identified with the profit a prendre as it was recognized at common law. Having classified the lease, it was not necessary for the court to classify the right to receive royalty beyond holding that it remained with the owner of the minerals and passed to such owner's devisee. Such holding is certainly consistent with the theory that the right to receive royalty is one of the incidents of mineral ownership, although it was unnecessary for the court to determine if such incident of ownership could be severed from mineral ownership and owned as a naked property right.

67. Paine v. Moore, 464 S.W.2d 477, 38 Oil & Gas Rptr. 483 (Tex. Civ. App. 1971).
68. See LaRue v. Wiggins, 277 S.W.2d 808, 4 Oil & Gas Rptr. 1171 (Tex. Civ. App. 1955).
69. Fuller v. Howell, [1942] 1 D.L.R. 462 (Ont. H.C.).
70. Berkheiser v. Berkheiser (1957), 7 D.L.R. (2d) 721 (S.C.C.).

It later became necessary to classify the right to receive royalty for purposes of the Land Titles Act, when such right has been severed from the title to the minerals. In making the classification, the courts have used the traditional method of classification very sparingly. Thus, in Bensette v. Reece,[71] the Saskatchewan Court of Appeal did search the cases for the meaning of "royalty" and concluded that it is not a term of art. The court then made the valid assumption that a right to royalty can either be an interest in land or a contractual right, depending upon the expressed intention. The court analyzed the provisions of the instrument and concluded that, for purposes of the Land Titles Act, the grantee acquired an interest in the minerals under a grant of "a six per cent (6%) royalty in all the ... minerals ... which may be found in, under or upon the said lands."

In Vanguard Petroleums, Ltd. v. Vermont Oil & Gas Ltd.,[72] an Alberta court also made the valid assumption that a right to royalty can either be an interest in land or a contractual right. After analyzing the agreement, the court put emphasis upon the language "will pay" and concluded that an agreement to pay a specified percentage of the current market value of oil, of the current value of gas, and of the amount actually received on products from the land after they are produced did not create an interest in land in the payee. The traditional method of classification was then applied to determine that the contractual right to receive such payments was not "rent".

In Guaranty Trust Co. of Canada v. Hetherington,[73] the court had under consideration several "Gross Royalty Trust Agreements" and was required to decide, among other things, if the assignments of royalty created interests in land. The court did not employ the traditional method of classifying the interest, because it assumed on the basis of Canadian cases that the right to royalty created by the instruments under consideration could be either an interest in land or a contractual right, depending upon the expressed intention of the parties.

> I am prepared to assume, without deciding, that a lessor may also assign a royalty interest in his mines and minerals in gross, that is, unaccompanied by a conveyance of a fractional interest in his fee simple title, in such a manner as to create

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71. Bensette v. Reece, [1973] 2 W.W.R. 497 at 500, 34 D.L.R. (3d) 723 at 726 (Sask. C.A.).
72. Vanguard Petroleums, Ltd. v. Vermont Oil & Gas Ltd., [1977] 2 W.W.R. 66 (Alta. S.C., T.D.), 72 D.L.R. (3d) 734, 4 A.R. 251.
73. Guaranty Trust Co. of Canada v. Hetherington (1987), 50 Alta. L.R. (2d) 193 (Q.B.).

> an interest in land in the assignee. It seems clear from the authorities that the characterization of the royalty interest granted or assigned in a given case depends upon the intention of the parties as expressed in the wording of the instrument.[74]

The instruments under consideration were executed in 1952, a very early date in the development of oil and gas law in Canada, and were not as artfully drafted as they undoubtedly would be drafted today. The court construed the instruments in question as creating contractual rights and not interests in land. Although reasonable minds might differ as to the proper construction to be placed on those instruments,[75] there should be little doubt that the difficult task of construction was an unnecessary and futile exercise if a royalty interest cannot be created as a property interest when the intention to do so is clearly expressed.

Despite the fact that the number of cases is small, it is reasonable to conclude from the few cases that the situation is similar to that in the United States in that, in the provinces with a decision on the point, the majority recognizes that a royalty interest can be created as an interest in land if words of grant are used instead of words of contract, while a minority takes a contrary view.

OVERRIDING ROYALTY

In determining how a gross overriding royalty should be calculated, the Alberta Court of Appeal repeated, with apparent acquiescence, various definitions from cases in the United States and made the following observation:

> It is to be noted that in drawing the distinction between "royalty" and "overriding royalty" in each of these cases the court treats the first as the lessor's or the landowner's royalty while the second is treated as a share of the lessee's interest, a working interest. The language most commonly used in respect of the overriding royalty is "a percentage

74. Id., Alta. L.R. (2d) at 216, per O'Leary J.
75. See Voyager Petroleums Ltd. v. Vanguard Petroleums Ltd., [1983] 5 W.W.R. 622 (Alta. C.A.), 27 Alta. L.R. (2d) 1, 47 A.R. 1, aff'g [1982] 2 W.W.R. 36 (Alta. Q.B.), 17 Alta. L.R. (2d) 212, 47 A.R. 14, wherein it is apparent that Stratton J. would have reached a contrary conclusion. The language of the gross royalty trust agreement was not reported or analyzed and the nature of the grant was not at issue, but Stratton J. observed that the royalty "was tied to the leased substances themselves and was not merely dependent on the earlier expired lease." (47 A.R. 14 at 15)

carved out of the lessee's working interest" ... or a "charge on that working interest"....[76]

If the foregoing statement were applied for purposes of classifying the overriding royalty, it would be possible for the overriding royalty to be an interest in land if the lease is an interest in land, because it is a part of the lessee's interest. The instrument under consideration in the case in which the statement was made would also justify such conclusion, because it provided:

> The Grantor does hereby grant and assign to the Royalty Owners a Three (3%) per cent gross overriding royalty out of the 94.4% interest of the Grantor in all petroleum substances found within, upon or under the lands ...[77]

Unfortunately, when the question of whether or not the overriding royalty is an interest in land was considered, it arose in a case that is remarkable for its complexity, but not for providing a clear answer to the question. The answer given is that the nature of the overriding royalty interest depends upon the provisions of the instrument creating such interest and upon the nature of the lease out of which it is created. Thus, in Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd.,[78] a geologist asserted that, pursuant to a contract for his services, he was entitled to an overriding royalty on all oil and gas projects entered into by defendant. The classification of the overriding royalty was required for two reasons.

The first need for a classification arose with respect to overriding royalty interests that defendant had acquired prior to the date of the employment contract. Plaintiff claimed that a "new" contract was entered into that would apply to such overriding royalty interests and that plaintiff would be entitled to an overriding royalty on those overriding royalties. The issue of the nature of an overriding royalty arose because the defendant raised the defence of the statute of frauds, asserting that the interests were interests in land and that the new contract was not in writing. The court examined the provisions of the grant to defendant of such interests, demonstrated an inclination not to classify them as interests in land, but pointed out that classification was not possible because there was no evidence as to the nature of the leases from which they were carved.

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76. Telstar Resources Ltd. v. Coseka Resources Ltd. (1980), 12 Alta. L.R. (2d) 187 at 191 (C.A.).
77. Id., at 189.
78. See, e.g., Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd. (1970), 15 D.L.R. (3d) 256 (S.C.C.), aff'g (1969) 3 D.L.R. (3d) 630 (Alta. S.C., A.D.).

The second need to classify the interest arose in connection with the remedy of specific performance as to interests that were acquired after the date of employment under a contract that met the requirements of the statute of frauds. Here, again, the court observed that there was no evidence as to the nature of the leases out of which the interests were carved and accordingly a classification of the interests could not be made.

It should be pointed out that the court did comment very strongly that the overriding royalty would not constitute an interest in land if the right accrues only in the oil or gas after it is produced. This should not, however, preclude the creation of an overriding royalty as an interest in land if it is described in terms of a grant of an interest in the lease. Thus, the right to production, whether or not it is free of costs, should be capable of being alienated as an incident of ownership of the lease.

It might be observed that it should be possible to remove all doubt as to whether the overriding royalty is an interest in land if the grantor assigns an undivided interest in the lease and the parties enter into a contemporaneous agreement as co-tenants. The agreement would be that the grantor will pay all costs of drilling, completing, and operating any well drilled on the leased premises. Unfortunately, achieving the objective of conveying an interest in land would be at the expense of assuming another risk, that is, the risk that the agreement might not be enforceable against a future owner of the grantor's interest.

PRODUCTION PAYMENT

There has been no development of the law in Canada as to the nature of the production payment. Undoubtedly the classification of the production payment will be governed by the nature of the interest out of which it is created and by the wording of the instrument by which it is created.

NET PROFITS INTEREST

The net profits interest has not been classified in Canada except for purposes of determining the application of the Mines and Minerals Act. In

St. Lawrence Petroleum Ltd. v. Bailey Selburn Oil & Gas Ltd.,[79] a party with rights under a farmout agreement with the owner of Crown leases agreed to grant a net profits interest to a grantee if such grantee would participate in drilling the well required by the farmout agreement. From the language of the agreement quoted below, it is apparent that the parties made a deliberate effort to create an interest in the minerals:

> [T]he Company hereby assigns to the Participant such an undivided interest in the petroleum and natural gas and related hydrocarbons other than coal within upon or under said lands as will ... yield to the Participant the percentage of net proceeds of production as herein defined specified in numerical paragraph 5 hereof.[80]

Such an effort may or may not have been successful in creating an interest in land for other purposes, but it was not successful for purposes of the Mines and Minerals Act, because it must have been a transfer of "a specified undivided interest". The obvious difficulty was in describing a "specified undivided interest" in a lease in terms of the net proceeds from production. The Supreme Court of Canada held that the interest granted was not an undivided interest in the leases as contemplated by the Alberta Mines and Minerals Act and accordingly was not capable of registration. The court also held that the owner of such interest was not entitled to take production in kind.[81]

With the advantage of hindsight, one might suggest that the objective of creating an interest in a Crown lease that is capable of being registered could have been achieved if an undivided interest in the lease had been granted with an accompanying agreement between the grantor and grantee who are now co-tenants in the lease. According to the accompanying agreement, the grantor would agree not only to account for profits, as a co-tenant is required by law to do, but also to cause the properties to be operated and to advance the costs required. Such an arrangement might remove the risk of losing the interest to a third person, but it would create another risk, that is, the uncertainty of enforcing the duty to operate against a new co-tenant who became such by a subsequent purchase of the grantor's interest.

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79. St. Lawrence Petroleum Ltd. v. Bailey Selburn Oil & Gas Ltd., [1963] S.C.R. 482.
80. Id., at 487.
81. Id.

CARRIED INTEREST

The carried interest has not been classified in Canada. It has been the subject of inquiry regarding the relation of the parties, and testimony of experts has been considered to the effect that there is no "standard" carried interest agreement.[82] Because of the lack of uniformity in the arrangements, it can only be said that a carried interest may or may not be an interest in land, depending upon the form that it takes. If it is a perpetually carried interest, then it should be given the same classification that is given to a net profits interest. Otherwise, classification may require a consideration of the form or substance of the transaction in the light of the provisions for recoupment of costs.

If there are no provisions for the carrying party to recover costs, the form or substance of the transaction may be that the carried interest is a working interest and that the carrying party has assumed an obligation to pay certain costs. Such obligation may be personal, or the parties may attempt to make the obligation a charge on the interest of the carrying party. In either event, the interest of the carried party is a working interest and should be classified as an interest in land.

If the carrying party is entitled to recover costs, the form or substance of the transaction may vary, but the carried interest should still be classified as an interest in land. Thus, if the form or substance of the transaction is that the carrying party will own the working interests of the carried party during payout, at which time it will revert to the carried party, the carried interest should be classified as an interest in land because it is a reversionary interest during payout and is a working interest after payout. If the form or substance of the transaction is that the carried interest owner has granted a production payment to the carrying party in the amount of the costs to be recovered, the carried interest should be classified as an interest in land because it is a working interest that is subject to a production payment. If the form or substance of the transaction is that an encumbrance has been created in favour of the carrying party and has been imposed on the interest of the carried party, the carried interest should be classified as an interest in land because it is a working interest that is burdened by an encumbrance.

In all of the foregoing situations, when the expenditure has been made and

82. Pine Pass Oil & Gas Ltd. v. Pacific Petroleums Ltd. (1968), 70 D.L.R. (2d) 196 (B.C.S.C.).

the carry is occurring, the carried interest should be classified as an interest in land. If the need arises to classify a carried interest before the expenditure has been made, it should be classified as an interest in land, because it is a working interest and the arrangement for the expenditure and recovery from production could theoretically be indentified either as a covenant between co-tenants or as creating new incidents of ownership to benefit the working interest of the carried party and to burden the working interest of the carrying party.

CONCLUSIONS

It should first be reiterated that a general classification of a non-operating interest as an interest in land may only be a starting point for the solution of a classification problem. For example, if the purpose of the classification is to determine the application of a statute, there remains a problem of statutory construction. Nevertheless, an initial classification is not a wasted effort, because it may be effective for many purposes.

From the Canadian cases to which reference has been made herein, it can be concluded that the classification of non-operating interests is a problem of construction of instruments and that the parties can either restrict their rights to personal contractual rights or create an interest in land. The problem is one of arriving at the intention of the parties.

Thus, a landowner or mineral owner can convey a present interest in the oil and gas as a royalty interest. Such owner can also contract to deliver a share of any oil or gas produced from the land or pay its value to the other party as a personal contractual obligation which would not be an interest in land. Similarly, instead of granting an interest in an oil and gas lease as an overriding royalty interest, a lessee can contract to deliver to the other party or to pay to such party the value of a share of the oil or gas produced under the lease. The same thing can also be said of entering into contracts instead of creating a net profits interest or a carried interest. The difference is more than academic, because if it is a contractual arrangement, there is an uncertainty of performance and a lack of effective remedies to require performance.

Even though a party can create a non-operating interest as an interest in land, it is not at all clear how the intention to do so must be expressed. Obviously, a simple declaration that "the interest hereby granted (or retained) is intended to be an interest in land" will not have its intended effect if the interest is not capable of being an interest in land.[83] Certain words, such as "interest" and "property" are important, however, as observed in Bensette v. Reece,[84] but "safe harbor" language has not yet evolved. This is so, because the identifying characteristics of the various non-operating interests that may be created as interests in land have not yet been established. Using the fundamental concept applied in Bensette, a starting place is in using words of grant of oil and gas rights in land rather than in using words of promise to pay the value of oil or gas after it is produced, as was done in Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd.[85] The remaining step is judicial recognition that the rights in oil and gas described are capable of being created as interests in land.

It is at this point that the "incidents of ownership" method of classifying non-operating interests becomes important. In all of the non-operating interests under discussion, the fundamental right is the right to produce oil and gas, or the right to share in production, if the right to produce is conferred on another. The various non-operating interests represent variations of those rights. It is submitted that the incidents of ownership method of classification will support the conclusion that each of the non-operating interests described herein is capable of being an interest in land. All that is required is a recognition that the particular right granted or retained is a right incident to mineral ownership that can be severed and owned as a separate interest in land.

Until a particular non-operating interest has received judicial recognition, it may be possible to use other recognized principles to protect such an interest. Thus, a "sublease alternative" has been described as a means of protecting a retained overriding royalty interest.[86] An application of the rules governing the sublease of a conventional lease to a transfer of an interest in an oil and gas lease could remove much of the uncertainty that exists in reserving a non-operating interest. It could not only be applied to the reservation of an overridng royalty

83. Vanguard Petroleums, Ltd. v. Vermont Oil & Gas Ltd., [1977] 2 W.W.R. 66 at 69 (Alta. S.C., T.D.), wherein an attempt to grant "the continuing right to file and maintain a caveat against the said lands in respect of the said gross royalty hereby granted" did not have its intended effect.
84. Bensette v. Reece (1973), 34 D.L.R. (3d) 723 at 726 (Sask. C.A.).
85. Vanguard Petroleums, Ltd. v. Vermont Oil & Gas Ltd., [1977] 2 W.W.R. 66 (Alta. S.C., T.D.), 72 D.L.R. (3d) 734, 4 A.R. 251.
86. For a thorough analysis of the sublease alternative, see Edward Evans, F. Neuman, & K. Smith, "Overriding Royalties and Subleases as Interests in Land" in Papers Presented at the Mid-Winter Meeting of the Alberta Branch, Canadian Bar Association (Calgary, 1988) 406 at 433.

interest, but could be applied to the reservation of a carried interest or net profits interest as well.

One important feature of applying sublease principles is that the requirement of privity can be met in order to pass on the benefits and burdens of convenants to successive owners. For example, the objectives of a net profits interest could be achieved by transferring an interest in the lease, retaining a reversionary interest, and including covenants on the part of the grantee to develop property and to account to the grantor for a specified share of the profits. Such device could also be employed to achieve the objectives of other non-operating interests by modifying the covenants intended to run with the interest granted and the interest retained. Although a true landlord-tenant relation may not be created, the relation between the parties provides the required privity of estate.[87]

While the sublease alternative is a possible device for achieving certainty for the reserved non-operating interest, it does not solve the problem of the granted non-operating interest, unless the archaic artifice of a grant and regrant is revived. It is not recommended that any such practice be revived and used indiscriminately, however, because of the risks of subjecting the lease to unknown claims such as judgement liens against the party who briefly owned the lease before regranting it with a reserved non-operating interest.

It is submitted that the sublease alternative or any other artificial device is useful primarily as a precautionary measure. It will not satisfy an important function of the law to provide a framework that will permit arrangements suitable for reducing unnecessary risks and protecting the rewards of exploring for oil and gas. That framework could be provided by a recognition that all exclusive rights incident to the ownership of oil and gas are alienable and that each such incident of ownership may be separately owned as an interest in land.

87. See Berkheiser v. Berkheiser (1957), 7 D.L.R. (2d) 721 (S.C.C.), wherein the court quoted from Martyn v. Williams (1857), 1 H.& N. 817, 156 E.R. 1430 at 1436 (Ex. Ct.), regarding the relation between the owner of a profit and the owner of the land. "There is in reality the relation of reversioner and ownership of particular estates between them; there is exactly the same privity of estate as exists between reversioner and tenant properly so called, and upon the determination of the term the entire interest in the land reverted to the plaintiff, as upon the expiration of an ordinary lease."

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