

THE EMERGING “DUTY OF FAIR DEALING” IN
CONTRACT INTERPRETATION:

[*REYNOLDS-REXWINKLE OIL, INC. V. PETEX, INC.*, 1
P.3D 909 (KAN. 2000)]

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I. INTRODUCTION

What is a “duty of fair dealing” among parties to a contract? Is it merely an interpretive tool or is it a substantive right? The duty of fair dealing, in the context of oil and gas contracts, was described as an “emerging” concept in 1965.¹ It appears the concept is continuing to emerge with the Kansas Supreme Court’s decision in *Reynolds-Rexwinkle Oil, Inc. v. Petex, Inc.*,² where the court had the opportunity to contrast the “duty of fair dealing” with the “bad faith” analysis employed by the Court of Appeals, and rejected by the Kansas Supreme Court.³ The concept is again addressed in the context of an oil and gas contract: the assignment of oil and gas lease rights and the creation, by an exception to the grant, of an overriding royalty in the grantor. The court’s analysis is also conducted against the backdrop of two very different approaches to the issues by the Texas courts and the Oklahoma courts. The Texas courts refuse to apply any sort of relational duty on the parties, while the Oklahoma courts are willing to apply the ultimate relational obligation of a fiduciary.⁴

This comment will provide practitioners and students, even those not familiar with oil and gas law, with a better understanding of the importance of the Kansas Supreme Court decision in *Reynolds-*

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1. See *Campbell v. Nako Corp.*, 402 P.2d 771, 777 (Kan. 1965). “[T]here seems clearly emerging a duty of fair dealing required on the part of the lessee . . .” *Id.*

2. 1 P.3d 909 (Kan. 2000).

3. Compare *Reynolds-Rexwinkle Oil, Inc. v. Petex, Inc.*, 1 P.3d 909, 920 (Kan. 2000) with *Reynolds-Rexwinkle Oil, Inc. v. Petex, Inc.*, 969 P.2d 906, 913 (Kan. App. 1998).

4. See discussion *infra* Parts III.A, III.B., 7-17.

*Rexwinkle Oil, Inc., v. Petex, Inc.*⁵ In its decision, the Kansas Supreme Court took a step in protecting parties' economic interests in an oil and gas lease by applying a broader contractual interpretation more in keeping with the probable intent and expectations of the parties.

This ruling provides the overriding royalty interest owner in an oil and gas lease greater protection from being terminated by the operating interest. In its decision, the court distinguished a Tenth Circuit case, *Lillibridge v. Mesa Petroleum Co.*⁶ By refusing to follow *Lillibridge*, *Reynolds* took a step in the right direction towards the protection of overriding royalty interests.

While taking a big step, *Reynolds* is not without limitations. To fully protect overriding royalty interests, the Kansas courts must continue to move away from *Lillibridge* and Texas jurisprudence, and continue to enforce the practical effect of an extension and renewal clause through the observance of a duty of fair dealing between the overriding royalty interest and the operating interest. Only then will the courts secure the spirit of the contract between the parties.

This comment will explore the interesting questions that remain after the *Reynolds* decision, and why the court's analysis was appropriate in light of existing Kansas jurisprudence on the subject. Specifically to be discussed is: (1) the scope and importance of the "duty of fair dealing" between the assignor and assignee of an oil and gas lease, specifically, to what extent must the court focus on the "intent" or "motive" of the lessee to evaluate whether its decision to permit a lease to terminate was a breach of the duty of fair dealing; (2) the amount of protection the "extension and renewal" clause provides nonoperating interests, and possible drafting solutions for more protection; and (3) why the Supreme Court of Kansas must continue to move away from *Lillibridge* and more towards a duty of fair dealing.

II. CASE DESCRIPTION

The key to a thorough analysis of *Reynolds* and to understanding oil and gas assignment provisions is realizing that the oil and gas lease is a business transaction.⁷ Oil and gas developers enter into oil and gas leases to obtain the right to explore for, develop, and produce oil and gas.⁸ Frequently, the person that obtains the lease will sell their leasehold rights to someone else, but retain a right to receive a share of production that may be obtained if the lease is developed. This is called an overriding royalty.⁹ Because the overriding royalty is a "royalty

5. 1 P.3d 909 (Kan. 2000).

6. 907 F.2d 1031 (10th Cir. 1990).

7. See EUGENE O. KUNTZ ET AL., OIL AND GAS LAW 125 (3d ed. 1998).

8. See KUNTZ ET AL, *supra* note 7, at 125.

9. See KUNTZ ET AL, *supra* note 7, at 354. "An overriding royalty is an interest carved out of

interest carved out of the working interest created by an oil and gas lease,"¹⁰ if the lease from which the overriding royalty is carved terminates, the overriding royalty will also terminate.¹¹

In *Reynolds*, on February 5, 1992, Hess, Inc. entered into an oil and gas lease with the Schippers (landowners).¹² Hess, Inc., assigned the original oil and gas lease to Reynolds who paid the Schippers \$1,000 in order to extend the term of the lease to February 5, 1994.¹³ On May 14, 1993, Reynolds assigned the oil and gas lease to Petex for \$1,000.¹⁴ However, Reynolds did not transfer all of its rights in the lease. In the assignment used to convey its lease rights, Reynolds created the following overriding royalty by providing:

The Assignor [Reynolds] herein hereby expressly excepts, reserves, and retains title to an undivided 1.5% of 8/8ths of all oil, gas, and casinghead gas produced, saved, and marketed from the described land under the provisions of the aforesaid lease, *or any extension or renewal thereof*, as an overriding royalty, free and clear of any cost and expense of the development and operation thereof, excepting taxes applicable to said interest and the production therefrom.¹⁵

The lease would terminate on February 5, 1994, unless there was actual production from the leased land.¹⁶ On August 30, 1993, Petex obtained a new lease from the Schippers covering the same land, which would not take effect until February 6, 1994.¹⁷ This new lease (hereinafter "second lease") obtained by Petex is what is known as a "top lease" because it takes effect only when the existing bottom lease terminates.¹⁸

No development took place on the original lease, and it terminated on February 5, 1994.¹⁹ On January 6, 1995, Petex completed a producing well under its second lease, which was extended by production.²⁰ In

the lessee's interest in the lease." *Id.* The interest can be sold out of the leasehold rights as well as excepted. *See id.*

10. *Reynolds*, 1 P.3d at 914.

11. *See id.* "An overriding royalty interest is . . . an interest in oil and gas produced at the surface free of the expense of production and its outstanding characteristic is that its duration is limited by the duration of the lease under which it is created." *Id.* (citing *Campbell v. Nako Corp.*, 402 P.2d 771 (Kan. 1965)).

12. *See Reynolds*, 1 P.3d at 912.

13. *See id.*

14. *See id.*

15. *Id.* (emphasis added).

16. *See id.*

17. *See id.*

18. *See* 2 HOWARD R. WILLIAMS AND CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 839, 1285 (8th ed. 1991) [hereinafter OIL & GAS TERMS]. A "top lease," such as the one at issue in *Reynolds*, is an oil and gas lease "granted by a landowner during the existence of a recorded mineral lease which is to become effective if and when the existing lease expires or is terminated." *Id.* at 1377.

19. *See Reynolds*, 1 P.3d at 912.

20. *See id.*

March 1995, Reynolds claimed the right to payment of 1.5% overriding royalty on production from Schippers' land.²¹ Petex refused to acknowledge Reynolds' claim.²²

Reynolds sought recovery from Petex on the grounds that the second lease was an extension of the original lease, Petex had breached the terms of the assignment of the initial oil and gas lease it received, and Petex had breached its duty of good faith and fair dealing.²³ The trial court in granting summary judgment held: "(1) there was no fiduciary duty or confidential relationship between the parties and that the parties dealt at arms length; (2) the two leases had no real differences; (3) [Lillibridge] was distinguishable . . .; (4) the retained overriding royalty was part of the consideration for the assignment and it would be 'wrong' to allow Petex to unilaterally terminate the bargained-for consideration simply by negotiating a top lease; and (5) the top lease was an extension or renewal of the original lease and Reynolds was, therefore, entitled to an overriding royalty."²⁴

The Court of Appeals reversed and remanded to address the factual issue of bad faith, and the effect of the extension and renewal clause of the assignment.²⁵ In doing so, the Court of Appeals held in favor of Petex, stating:

Absent a contract provision that an overriding royalty interest in an oil and gas lease survives a subsequent top lease, a top lease extinguishes the overriding royalty interest, unless the holder of the overriding royalty interest proves a breach of duty of fair dealing by showing that the lessor committed fraud, collusion, or bad faith in granting the top lease.²⁶

The Kansas Supreme Court granted certiorari to determine this issue.²⁷

III. BACKGROUND

The nature of the relationship between operating and nonoperating interests in oil and gas leases has evolved over many years. Presently, with the oil and gas industry experiencing deeper, and therefore more expensive, drilling, overriding royalty interests are likely to become more numerous.²⁸ In order to avoid the risks and expenses of this deeper

21. *See id.* at 913.

22. *See id.*

23. *See id.*

24. *Id.*

25. *See id.* at 913. *See also* Reynolds-Rexwinkle Oil, Inc. v. Petex, Inc., 969 P.2d 906, 913 (Kan.App. 1998).

26. *Reynolds*, 1 P.3d at 914 (citing *Reynolds*, 969 P.2d at 913).

27. *See id.*

28. *See* EARL A. BROWN, THE LAW OF OIL AND GAS LEASES, §17.01, 17-23 (2d ed. 1967) (Supp. 1999).

Many lessees will desire to avoid the hazards and increased expense of

production, an increased number of lessees will assign leases to others and retain an override.²⁹ The overriding royalty interest is also used as a financing device in that it is “frequently used to compensate landmen, lawyers, geologists or others who have helped to structure a drilling venture.”³⁰

Ordinarily, an assignment of a lease where the assignor retains an overriding royalty interest without further provision does not create a fiduciary relationship between the assignor and assignee.³¹ However, there is some difference of opinion in situations where there is an “extension or renewal” clause associated with the grant or reservation of an overriding royalty interest.³² By looking at the jurisprudence, a spectrum can be seen on how courts have decided this issue. On one end, there is Texas jurisprudence that has offered the overriding royalty interest little protection.³³ On the other end, there is Oklahoma jurisprudence offering substantial protection.³⁴ Until *Reynolds*, it was difficult to place Kansas jurisprudence on the spectrum. By understanding Texas and Oklahoma jurisprudence, it becomes easier to recognize where Kansas and the *Reynolds* decision fit in this jurisprudence.

finding deep production by assigning leases to others and retaining an override. Unitization programs are also due to increase in number, because of economic and conservation factors. So in the future we may expect to see more leases and assignments of leases carrying overriding royalties contributed to unitization programs.

Id.

29. See BROWN, *supra* note 28, at 17-23.

30. JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL, 43 (3d ed. 1995).

31. See 24 AM. JUR. GAS AND OIL, §82 at 590. “[T]he transfer of a lease does not ordinarily create any confidential relationship between the parties.” *Id.* See also Gordon v. Empire Gas & Fuel Co., 63 F.2d 487 (5th Cir. 1933); Robinson v. Eagle-Picher Lead Co., 132 Kan. 860, 860 (1931).

32. Compare Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798, 805 (Tex. 1967) (finding an extension and renewal clause alone does not create a fiduciary relationship), and Exploration Co. v. Vega Oil & Gas Co., 843 S.W.2d 123, 126 (Tex. Ct. App. 1992) (finding that extension and renewal language is not sufficient to impose a fiduciary obligation on the assignee), with Indep. Gas & Oil Producers, Inc. v. Union Oil Co. of Cal., 669 F.2d 624, 627 (10th Cir. 1982) (stating that when an assignment contains extension and renewal language, the assignee stands as “quasi-trustee” and must exercise good faith in protecting the assignor’s interest) and Probst v. Hughes, 286 P. 875, 878 (Okla. 1930) (finding when overriding royalty applies to renewal and extension of the lease, the assignee occupies a position of trustee toward the assignor and is obligated to exercise good faith in obtaining an extension of the lease).

33. See Sunac, 416 S.W.2d 798, 805 (Tex. 1967) (refusing to hold extension and renewal clause to be a basis for a confidential or fiduciary relationship); see also Sasser v. Dantex Oil & Gas, Inc., 906 S.W.2d 599, 607 (Tex. Ct. App. 1995) (stating that assignees could not have acted in bad faith because there was no good faith obligation); Exploration, 843 S.W.2d at 126 (Tex. Ct. App. 1992) (finding extension and renewal language is not sufficient to impose a fiduciary obligation).

34. See Indep. Gas, 669 F.2d at 627 (stating that when an assignment contains extension and renewal language, the assignee stands as “quasi-trustee” and must exercise good faith in protecting the assignor’s interest); Rees v. Briscoe, 315 P.2d 758, 763 (Okla. 1957) (finding a confidential relationship existed between the parties); Probst, 286 P. at 878 (finding when overriding royalty applies to renewal and extension of the lease, the assignee occupies a position of trust toward the assignor and is obligated to exercise good faith in obtaining an extension of the lease).

A. Texas Jurisprudence

As a general rule, Texas cases are likely to interpret the scope of extension or renewal clauses narrowly, thereby affording the overriding royalty interest little protection.³⁵ The case of *Sunac Petroleum Corporation v. Parkes*³⁶ exemplifies Texas jurisprudence on this issue.

In *Sunac*, the plaintiff, Parkes, was granted an oil and gas lease that he subsequently assigned to Puckett, reserving an overriding royalty interest in the lease as well as “any extension or renewal thereof.”³⁷ After several more assignments, Sunac became the assignee of the lease.³⁸ The lessee pooled the 160 acres covered by the lease into a 640-acre unit.³⁹ The pooling was only for gas purposes and not oil.⁴⁰ On April 17, 1958, when the primary term of the lease ended, there was no production or operations for production from the lease.⁴¹ However, over two months after the expiration of the primary term on the original lease, Sunac had completed two producing wells.⁴²

Approximately one year after completion of the two wells, the lessor questioned whether the lease was still in effect.⁴³ The basis for the lessor’s complaint stemmed from the pooling agreement.⁴⁴ The first producing well completed after the primary term was on the pooled 640-acre unit, but not on the original 160 acres.⁴⁵ However, the well was an “oil” well instead of a “gas” well.⁴⁶ Since the well was not completed as a gas well under the pooling agreement, it would not have held the original lease to continue by production because the pooling clause only applied to “gas” wells.⁴⁷ If the original lease had terminated, Sunac would have had no authority to drill the second producing well on the

35. See generally *Sunac*, 416 S.W.2d 798; see also Edward M. Fenk, Note & Comment, Are Overriding Royalty Interests Becoming The Clay Pigeons Of The Texas Oil And Gas Industry? The Assignor-Assignee Relationship After *Sasser v. Dantex Oil & Gas*, 5 TEX. WESLEYAN L. REV. 231 (1999). Texas courts are limiting the use of extension and renewal clauses by narrowly interpreting situations in which a subsequent lease will be treated as an extension or renewal. See *id.* at 232.

Perhaps the most formidable obstacle to attempts in Texas courts to protect overriding royalty interests through the use of extension or renewal clauses has been the trend – established in *Sunac*, and followed in post-*Sunac* decisions – to narrowly construe the terms “extension” and “renewal” to find that a subsequent lease is not an extension or renewal of the former lease, but is instead a “new” lease, free of the burden of the overriding royalty reserved under the old lease.

Id. at 236.

36. 416 S.W.2d 798 (Tex. 1967).

37. *Id.* at 799.

38. *See id.*

39. *See id.* at 799-800.

40. *See id.* at 799.

41. *See id.* at 799-800.

42. *See id.* at 800.

43. *See id.*

44. *See id.*

45. *See id.* at 799-800.

46. *See id.* at 800.

47. *See id.* at 799.

original 160 acres.⁴⁸ In response to the lessor's claim, Sunac and the lessor entered into a new lease.⁴⁹ Thus, two of the issues in the case were: (1) whether the new lease taken by Sunac was an extension or renewal of the original lease; and (2) whether Parkes' overriding royalty interest extended to the new lease between the lessor and Sunac due to the existence of a confidential relationship.⁵⁰

The court stated that the new lease was not an extension of the original lease because it was not a "prolongation or continuation of the term of the existing lease."⁵¹ The court also found that the new lease was not a renewal of the original lease because although on the same land, "the new lease was executed under different circumstances, for a new consideration, upon different terms, and over a year after the expiration of the old lease."⁵² Thus, unless the court was to find a fiduciary relationship, the overriding royalty would terminate according to the general rule that the overriding royalty terminates along with the lease from which it was carved.⁵³

Accordingly, the court found that there was no fiduciary relationship between Sunac and Parkes.⁵⁴ The court reached this conclusion by first noting that "[t]here is no evidence that Sunac occupied a position of trust with Parkes other than the clause relating to extensions or renewals."⁵⁵ This statement admits that with the extension or renewal clause in the assignment, there is evidence of a position of confidence or trust between the parties. However, the assignment also contained a clause that stated there was no obligation to drill on the part of the assignee.⁵⁶ The Texas Supreme Court construed the "renewal or extension" clause, together with the lack of any obligation to drill, as relieving the lessee of any duty to perpetuate the overriding royalty interest.⁵⁷ Therefore, the court negated the evidence of a position of trust or confidence stemming from the extension or renewal language with the clause relieving the lessee of the obligation to develop, and refused to impose a constructive trust⁵⁸ in favor of Parkes' overriding royalty interest.⁵⁹

48. *See id.*

49. *See id.* at 800.

50. *See id.* at 802-04.

51. *Id.* at 802 (citing *Mutual Paper Co. v. Hoague-Sprague Corp.*, 8 N.E.2d 802 (Mass. 1937)).

52. *Sunac*, 416 S.W.2d at 803.

53. *See id.* at 804.

54. *See id.* at 805.

55. *Id.* at 804.

56. *Id.*

57. *See id.*

58. *See id.* at 805. "A constructive trust is an equitable remedy created by the courts to prevent unjust enrichment. To justify imposing a constructive trust, fraud, either actual or constructive, must be present." *Exploration Co. v. Vega Oil & Gas Co.*, 843 S.W.2d 123, 127 (Tex. Ct. App. 1992) (citing *Allen v. Allen*, 751 S.W.2d 567, 577 (Tex. Ct. App. 1988)).

59. *See Sunac*, 416 S.W.2d at 805.

Sunac is foundational to the Texas approach of determining whether a fiduciary relationship exists between the lessee and the overriding royalty owner and whether a new lease is considered an extension or renewal. Post-*Sunac* cases have narrowly interpreted what subsequent leases fall under the extension or renewal clauses and have refused to impose a fiduciary relationship due to the presence of an extension or renewal provision in an assignment.⁶⁰

An example of this more narrow interpretation is *Exploration Company v. Vega Oil & Gas Company*,⁶¹ in which the Texas Court of Appeals refused to impose a fiduciary relationship between the overriding royalty owner and the lessee despite the extension and renewal provision in the assignment, and a further provision requiring the lessee to give the assignor notice prior to letting the lease terminate.⁶² The court also used the restrictive *Sunac* contract analysis to determine whether the new lease obtained by the lessee was an extension or renewal.⁶³

In its interpretation of the *Sunac* decision, *Exploration* noted that “the Texas Supreme Court declined to impose a fiduciary relationship between the lessee and the overriding royalty interest owner based on the renewal and extension clause.”⁶⁴ However, as was noted earlier, the *Sunac* court refused to impose a fiduciary relationship based on the extension and renewal provision construed along with the provision relieving the lessee of a duty to develop.⁶⁵ The *Sunac* decision actually stated that there was “no evidence that *Sunac* occupied a position of confidence or trust with Parkes *other than the clause relating to extensions or renewals.*”⁶⁶ The Texas Court of Appeals in *Exploration* decided that it was not necessary to have a provision relieving the lessee of the duty to develop in order to negate any position of trust created by the extension or renewal clause.⁶⁷ *Exploration* stated that “[m]erely because this language is not in the lease in this case does not mean that a fiduciary relationship exists.”⁶⁸

To facilitate the above analysis, *Exploration* relied on a Texas

60. See *Exploration*, 843 S.W.2d at 127 (extension and renewal language is not sufficient to impose a fiduciary obligation on the assignee); *Sasser v. Dantex Oil & Gas, Inc.*, 906 S.W.2d 599, 607 (Tex. Ct. App. 1995) (holding that lessee did not owe overriding royalty interest owner “a duty of good faith and fair dealing or any other fiduciary-type duty”).

61. 843 S.W.2d 123 (Tex. Ct. App. 1992).

62. See *Exploration*, 843 S.W.2d at 126-27.

63. See *id.* at 125-26. The *Sunac* Court interpreted whether the new lease was an “extension or renewal” of the original lease by first applying a literal definition to the terms. See *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 803 (Tex. 1967). Then, the court considered the factors of when the new lease was executed, if different terms applied, and how much time had passed since the expiration of the original lease. See *id.*

64. *Exploration*, 843 S.W.2d at 126.

65. See *Sunac*, 416 S.W.2d at 804.

66. *Id.* (emphasis added).

67. See *Exploration*, 843 S.W.2d at 126.

68. *Id.*

Supreme Court case that noted, a “constructive trust arises if the evidence establishes ‘a fiduciary relationship before, and apart from, the agreement made the basis of the suit.’”⁶⁹ Thus, to justify the equitable remedy of a constructive trust, “fraud, either actual or constructive, must be present.”⁷⁰ Although this language is relevant as to when to impose a constructive trust, it fails to support the court’s conclusion that an extension and renewal provision in an assignment does not create a fiduciary relationship between the parties. Instead, a more detailed analysis could have explained why the extension and renewal clause alone does not represent the intent of the parties to create a relationship of trust.

Texas courts have continued to hold that an extension and renewal provision does not create a fiduciary relationship between the assignor and assignee.⁷¹ Instead, an overriding royalty owner must prove fraud or collusion on the part of the lessee in order to have the overriding royalty interest attach to a new lease.⁷²

Although fraud or collusion may justify imposing a constructive trust, arguing bad faith on the part of the lessee may be futile before a Texas court.⁷³ In the recent case of *Sasser v. Dantex Oil & Gas, Incorporated*,⁷⁴ the overriding royalty owner argued that the lessee owed a duty of good faith not to intentionally “washout” the overriding royalty interest.⁷⁵ A “wash out” transaction occurs when the lessee allows the original lease to expire while obtaining a new lease on the same land free of any overriding royalty interest carved out of the original lease.⁷⁶ In *Sasser*, the overriding royalty owner had not included in the assignment a provision that called for the royalty to attach to any extension or renewal of the lease.⁷⁷ Also, there were no additional facts found by the court that warranted imposing a fiduciary relationship on the lessee.⁷⁸ Nonetheless, the overriding royalty owner argued that a constructive trust should be imposed because the lessee terminated the

69. *Id.* (citing *Consol. Gas & Equip. Co. v. Thompson*, 405 S.W.2d 333, 336 (Tex. 1966)).

70. *Id.* (citing *Allen v. Allen*, 751 S.W.2d 567, 577 (Tex. Ct. App. 1988)).

71. See generally *Sasser v. Dantex Oil & Gas, Inc.*, 906 S.W.2d 599 (Tex. Ct. App. 1995); *Grimes v. Walsh & Watts, Inc.*, 649 S.W.2d 724 (Tex. Ct. App. 1983); *GHR Energy Corp. v. Transamerican Natural Gas Corp.*, 927 F.2d 96 (5th Cir. 1992).

72. See *Exploration*, 843 S.W.2d at 127.

73. See *Sasser*, 906 S.W.2d at 607.

74. 906 S.W.2d 599 (Tex. Ct. App. 1995).

75. See *Sasser*, 906 S.W.2d at 605-06.

76. OIL & GAS TERMS, *supra* note 18, at 1340. See also David E. Pierce, *An Analytical Approach to Drafting Assignments*, 44 Sw. L.J. 943, 968 (1990). “Washout” tactics include an operator intentionally terminating a lease and obtaining “a new lease on the same property in order to destroy the nonoperating interest.” *Id.* See also Bruce A. Ney, Note, *Protecting Overriding Royalty Interests In Oil And Gas Leases: Are The Courts Moving To Washout Extension Or Renewal Clauses?*, 31 WASHBURN L.J. 544, 546-47 (1992) (holding washout may be achieved by the operator obtaining “a top lease prior to the expiration of the primary ‘term’ of the bottom lease covering the same acreage.”).

77. See *Sasser*, 906 S.W.2d at 606.

78. See *id.* at 607.

original lease “in bad faith.”⁷⁹ The court deemed this argument circular because the lessee could have only acted in bad faith if there was a duty of good faith.⁸⁰ Thus, “the method by which a lease is terminated – so long as it is contractually permitted – is a distinction without a difference.”⁸¹

It is evident after a review of Texas jurisprudence that the overriding royalty interest is offered little protection.⁸² Texas courts, in essence, will do a two-step analysis in determining whether an overriding royalty interest should attach to a subsequent lease. First, the courts will narrowly interpret whether the subsequent lease is an “extension or renewal” of the original, and if the terms of the second lease are substantially different, it will not be considered as such.⁸³ Second, the court will look at the surrounding circumstances to determine whether there is a fiduciary relationship between the parties in order to impose a constructive trust.⁸⁴ An “extension or renewal” provision in the assignment will not impose a duty of good faith on the lessee.⁸⁵

B. Oklahoma Jurisprudence

At the opposite end of the spectrum from the Texas approach is that taken by Oklahoma courts. Oklahoma courts are more prone to find that a fiduciary obligation exists requiring protection of the nonoperating interest.⁸⁶ When analyzing the jurisprudence, *Probst v. Hughes*,⁸⁷ like *Sunac*⁸⁸ in Texas, is foundational to the Oklahoma approach.

In *Probst*, the landowner, Payne, made an oil and gas lease to a party named Williams.⁸⁹ Williams subsequently assigned the lease to the plaintiff, Probst, who then assigned the lease to the defendant, Hughes.⁹⁰

79. *See id.*

80. *See id.* This rationale is based on Texas jurisprudence, which finds no duty of good faith arising from ordinary contracts. *See English v. Fisher*, 660 S.W.2d 521, 522 (Tex. 1983); *David McDavid Nissan, Inc. v. Subaru of Am., Inc.*, 10 S.W.3d 56, 70 (Tex. Ct. App. 1999).

81. *Sasser*, 906 S.W.2d at 607.

82. *See generally Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 803 (Tex. 1967); *Exploration Co. v. Vega Oil & Gas Co.*, 843 S.W.2d 123, 127 (Tex. Ct. App. 1992); *Sasser*, 906 S.W.2d 599.

83. *See generally Sunac*, 416 S.W.2d 798; *Exploration*, 843 S.W.2d 123. Even if the leases are identical, timing will impact whether it is “new” or a “renewal” lease. *See Sunac*, 416 S.W.2d at 803.

84. *See generally Sunac*, 416 S.W.2d 798; *Exploration*, 843 S.W.2d 123; *Sasser*, 907 S.W.2d 599. Although the Texas courts refuse to impose a fiduciary relationship based on the extension and renewal language in an assignment, they give little discussion as to what would create a fiduciary relationship between the assignor and assignee.

85. *See Exploration*, 843 S.W.2d at 126.

86. *See generally Probst v. Hughes*, 286 P. 875 (Okla. 1930); *Rees v. Briscoe*, 315 P.2d 758 (Okla. 1957); *Pierce*, *supra* note 76, at 968.

87. 286 P. 875 (Okla. 1930).

88. 416 S.W.2d 798 (Tex. 1967).

89. *See Probst*, 286 P. at 875.

90. *See id.*

The assignment from Probst to Hughes reserved an overriding royalty interest and provided that the “reservation shall likewise apply as to all modifications, renewals of such lease or extensions that the assignee, his successors or assigns may secure.”⁹¹ During the original lease, the lessee completed a producing well.⁹² However, the well ceased producing, causing the lessee to pay a gas rental while the well was deepened.⁹³ The deepened well also ceased producing, but instead of paying a gas rental again while deepening the well, the lessee considered the original lease terminated.⁹⁴ After failing to get production again at a lower depth, the lessee plugged the well and negotiated a second lease with the landowners.⁹⁵

The court found that this second lease “varied in several of its terms from the old lease.”⁹⁶ Because of this finding, the lessee argued that the new lease was not an extension or renewal of the old lease.⁹⁷ In response, the court noted that because the lessee did not treat the lease as having terminated at the time the well first ceased producing, instead paying the gas rental, it was inconsistent to say that the lease terminated the second time it ceased producing.⁹⁸ The court then proceeded to explain the general principles of fiduciary relationships, and in applying those principles to lease transactions stated, “[i]t is thus to be seen that a trusteeship may arise by virtue of any relationship of the parties in which it may be said that the one occupying the position of trustee is in duty bound to act in the utmost good faith for the benefit of the other.”⁹⁹

Thus, the court found that the lessee was “under the obligation to exercise the utmost good faith to secure a renewal or an extension of the lease.”¹⁰⁰ Accordingly, the court held that “the new lease constitutes a renewal or an extension of the original lease within the meaning of the assignment, and is charged with the overriding royalty interest of the plaintiff.”¹⁰¹

The *Probst* result is completely opposite of what would likely happen in Texas.¹⁰² Based on precedent, the Texas Supreme Court first would have found that the second lease in *Probst* was substantially different from the original lease, and thus, not an extension or renewal

91. *Id.* at 876.

92. *See id.*

93. *See id.*

94. *See id.*

95. *See id.* at 877.

96. *Id.*

97. *See id.*

98. *See id.*

99. *Id.* at 878.

100. *Id.*

101. *Id.* at 879.

102. *See generally* Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798 (Tex. 1967).

of the original.¹⁰³ Then, regardless of the extension and renewal clause in the assignment, the court would have held there was no fiduciary relationship, and thus, no reason for imposing a constructive trust by which the overriding royalty would have attached to the second lease.¹⁰⁴ Instead, the Oklahoma Supreme Court construed the second lease to be an extension or renewal of the original lease because of the extension and renewal clause in the assignment, which was found to impose a duty of good faith.¹⁰⁵

Oklahoma courts have continued to follow the *Probst* approach.¹⁰⁶ Furthermore, the Tenth Circuit, in *Independent Gas & Oil Producers, Incorporated v. Union Oil Company of California*,¹⁰⁷ found that the “parties’ lease assignment expressly subjects renewals and extensions of [the original lease] to the overriding royalty interest held by [the assignor] and thus triggers operation of the fiduciary rule.”¹⁰⁸ In the recent case of *Goodall v. Trigg Drilling Company, Incorporated*,¹⁰⁹ the concurring opinion described the relationship between the overriding royalty interest owner and lessee as “quasi-fiduciary.”¹¹⁰

Another example of the substantial protection offered in Oklahoma jurisprudence is *Rees v. Briscoe*.¹¹¹ There, Rees assigned leases to Briscoe covering three eighty-acre tracts of land.¹¹² The assignment covering the third tract of land involved three leases and was given for only the consideration of an overriding royalty interest.¹¹³ The assignment contained no extension or renewal clause and was given for no consideration other than the reserved override, because Briscoe had agreed to drill one well on each of the tracts of land.¹¹⁴ However, about a month before the three leases expired on the third tract of land, Briscoe

103. *See id.*

104. *See generally Sunac*, 416 S.W.2d 798; *Exploration Co. v. Vega Oil & Gas Co.*, 843 S.W.2d 123 (Tex. Ct. App. 1992).

105. *See Probst*, 286 P. at 879.

106. *See generally Rees v. Briscoe*, 315 P.2d 758 (Okla. 1957); *Hivick v. Urschel*, 40 P.2d 1077 (Okla. 1935); *Independent Gas & Oil Producers, Inc. v. Union Oil Co. of Ca.*, 669 F.2d 624 (10th Cir. 1982).

107. 669 F.2d 624 (10th Cir. 1982).

108. *Independent*, 669 F.2d at 627.

109. 944 P.2d 292 (Okla. 1997).

110. *See Goodall v. Trigg Drilling Co.*, 944 P.2d 292, 296-97 (Okla. 1997).

Rather than as a true fiduciary relationship, I would describe the relationship between an operator and royalty interest owner as quasi-fiduciary. . . [A] quasi-fiduciary relationship is created ‘when a special relationship of trust and confidence has been developed between the parties, where one party is relying upon the superior specialized knowledge and experience of the other, where a [party] has knowledge of a material fact not easily discoverable by the [other party], and where there exists a statutory duty to disclose.’ Unlike in a true fiduciary relationship, a quasi-fiduciary is not forbidden from personal dealings, nor forbidden from maximizing profits for both parties; rather, the duty is dependent upon the facts and circumstances of each case.

Id. (Summers, J., Concurring, citations omitted).

111. 315 P.2d 758 (Okla. 1957).

112. *See Rees v. Briscoe*, 315 P.2d 758, 760 (Okla. 1957).

113. *See id.*

114. *See id.* at 761.

secured renewals of the leases.¹¹⁵ Briscoe then allowed the original leases to expire, and after achieving production on the tract under the new leases, he refused to recognize Rees' overriding royalty interest.¹¹⁶ On these facts, the court found a confidential relationship existed between the parties, imposed a constructive trust, and awarded Rees the overriding royalty.¹¹⁷

The *Rees* case is a good example of how the Oklahoma courts are willing to find the existence of a fiduciary relationship and impose a constructive trust in order to protect the overriding royalty interest.¹¹⁸ In accomplishing this, the Oklahoma courts offer a broader contractual interpretation than found in Texas jurisprudence, and a greater degree of protection for the overriding royalty interest.

C. Kansas Jurisprudence

In Kansas, prior to *Reynolds*, the courts found that "there seems clearly emerging a duty of fair dealing required on the part of the lessee."¹¹⁹ After *Reynolds*, it is apparent that this duty of fair dealing has emerged. However, the scope of this duty still remains undefined in Kansas.

In *Reynolds*, the Kansas Supreme Court distinguished the Tenth Circuit case of *Lillibridge v. Mesa Petroleum Company*.¹²⁰ *Lillibridge* has been viewed as severely limiting the protection afforded by an extension or renewal clause.¹²¹

In *Lillibridge*, the original "lease covered 800 acres, had a primary term of ten years, and provided" for a 1/8th landowner's royalty.¹²² When the original lease was assigned, the assignor "reserved an overriding royalty of 1/16th of all oil and gas produced under the lease or any extension or renewal thereof."¹²³ Prior to the end of the primary term of the original lease, the assignee leased the same property with "five separate leases, covering 160 acres each," to take effect at the expiration of the original lease.¹²⁴

115. *See id.*

116. *See id.*

117. *See id.* at 763-64.

118. *See id.* at 758.

119. *Campbell v. Nako Corp.*, 402 P.2d 771, 777 (Kan. 1965).

120. 907 F.2d 1031 (10th Cir. 1990). *See Reynolds-Rexwinkle Oil, Inc. v. Petex*, 1 P.3d 909, 920 (2000)(finding "*Lillibridge* factually different . . .").

121. *See Ney*, supra note 76, at 563.

Lillibridge greatly narrows the scope of protection provided by an express extension or renewal clause, at least in the Tenth Circuit. Unless the terms and conditions of the second lease are essentially the same as those of the original lease, the Tenth Circuit Court of Appeals will not give effect to an extension or renewal clause.

Id.

122. *Lillibridge*, 907 F.2d at 1032.

123. *Id.*

124. *Id.*

In determining whether the new leases were an extension or renewal of the original lease, the district court used a definitional approach by applying accepted legal distinctions to determine whether a subsequent lease constituted an “extension or renewal” or a “new” lease.¹²⁵ The district court found that to constitute an extension or renewal, a subsequent lease must be a “prolongation or continuation of the relationship” on essentially the same terms and conditions as the original lease.¹²⁶ Then, in order to make this determination, the district court articulated a test where the court considered: “(1) the circumstances surrounding the execution of the leases; (2) the relationship of the parties; (3) whether new consideration was given for the subsequent lease; and (4) the significant similarities and differences in the terms and conditions of the lease.”¹²⁷ The circuit court accepted this analysis, an analysis very similar to the Texas approach discussed previously, and affirmed that the subsequent leases were “new” leases, and not “extensions or renewals” of the original lease.¹²⁸

The Court of Appeals affirmed the district court in its decision, and in so doing, distinguished the Kansas Supreme Court cases of *Howell v. Cooperative Refinery Association*,¹²⁹ and *Campbell v. Nako Corporation*.¹³⁰

In *Howell*, the plaintiff, a petroleum geologist, entered an agreement with the defendant in which the plaintiff agreed to obtain a lease on a certain tract of land and to then assign the lease to the defendant.¹³¹ The assignment of the original lease reserved to the plaintiff an overriding royalty interest that was to apply to any extension or renewal of the original lease.¹³² In connection with the above transaction, the plaintiff had also prepared valuable geological information for the defendants.¹³³ The plaintiff obtained the lease and then assigned it to the defendants.¹³⁴ However, the defendant/lessee failed to obtain production on the lease, and allowed the original lease to expire.¹³⁵ The defendant, with the assistance of the plaintiff, then

125. *See id.* *See also* Ney, *supra* note 76, at 560.

126. Ney, *supra* note 76, at 560 (citing *Lillibridge v. Mesa Petroleum Co.*, No. 85-6037, slip op. at 3 (D. Kan. 1987)).

127. *Lillibridge v. Mesa Petroleum Co.*, 907 F.2d 1031, 1033 (10th Cir. 1990).

128. *See id.* The substantial differences that the court found constituted a “new” lease were the following: “three-year rather than ten-year primary term, five leases covering 160 acres each compared to one 800-acre lease, and a landowners’ royalty of three-sixteenths instead of one-eighth. The court also found it significant that the defendants paid new consideration in the amount of \$130,200 for the [new] leases.” *Id.*

129. 271 P.2d 271 (Kan. 1954).

130. 402 P.2d 771 (Kan. 1965).

131. *See Howell v. Coop. Refinery Ass’n*, 271 P.2d 271, 272 (Kan. 1954).

132. *See id.* at 275.

133. *See id.* at 273.

134. *See id.*

135. *See id.*

secured a second lease on the same land over a year later.¹³⁶ After completing two producing wells on the land, the defendants refused to acknowledge the plaintiff's overriding royalty interest on the second lease.¹³⁷

In deciding the issue of whether there existed a confidential relationship between the parties, the court found that when the assignment contains an extension or renewal clause, a new lease taken by the assignee will be subject to the overriding royalty, even though the new lease is not granted until production under the original lease ends.¹³⁸

The court also took note of the contract between the parties and found that its language was "susceptible of interpretation as providing for at least a form of joint interest and joint ownership."¹³⁹ This was because according to the contract, "the parties" were to attempt to secure a lease, and then, if a lease was secured, the parties decided what was to be done with the lease.¹⁴⁰ The court found these facts sufficient to find a confidential relationship between the parties.¹⁴¹ Thus, the defendants were "under [an] obligation to keep the lease in force by development, or if it did not do so and the lease was renewed or extended, Howell's right to the overriding royalty continued."¹⁴²

The defendants in *Howell* argued that because the second lease had different terms than the original lease, and was taken over a year after the original lease had expired, it was not by definition an "extension or renewal," and should not be subject to the overriding royalty interest that terminated with the original lease.¹⁴³ This argument would likely prove effective in Texas or before the *Lillibridge* court where the courts take the more narrow technical approach to interpreting an "extension or renewal."¹⁴⁴ However, the Kansas Supreme Court rejected these

136. *See id.*

137. *See id.*

138. *See id.* (citing 24 AM. JUR. ,*Gas and Oil*, §82, 590 (1939)).

Thus, when an assignment expressly provides that any extension or renewal of the lease shall be subject to the overriding royalty therein agreed upon, the courts will regard a new lease procured by the assignee as an extension or renewal of the old one and charge it with the royalty so reserved, even though it was not granted until production under the former lease had come to an end.

24 AM. JUR. ,*Gas and Oil*, §82, 590 (1939). The *Lillibridge* court only emphasized and cited from this quote certain language: "the transfer of a lease does not ordinarily create any confidential relationship" between the parties. *Lillibridge v. Mesa Petroleum Co.*, 907 F.2d 1031, 1034 (10th Cir. 1990). However, this is read out of context. The full sentence reads, "[w]hile the transfer of a lease . . . , this is not, of course, always the case." 24 AM. JUR. ,*Gas and Oil*, §82, 590 (1939).

139. *Howell v. Co-op Refinery Ass'n*, 271 P.2d 271, 275 (Kan. 1954).

140. *See id.*

141. *See id.*

142. *Id.*

143. *See id.*

144. *See generally* *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798 (Tex. 1967); *Exploration Co. v. Vega Oil & Gas Co.*, 843 S.W.2d 123 (Tex. Ct. App. 1992); *Sasser v. Dantex Oil & Gas, Inc.*, 906 S.W.2d 599 (Tex. Ct. App. 1995).

arguments by noting that the rule of strict construction had no application, and by refusing to “place any undue weight on the length of time elapsing between expiration of the first leases and execution of the last lease.”¹⁴⁵ Rather, the court construed the second lease as an extension or renewal due to the confidential relationship owed between the parties, and held that Howell’s overriding royalty interest continued to the second lease.¹⁴⁶

The *Lillibridge* court’s analysis of *Howell* construed the joint interest as the only evidence of the confidential relationship, not the assignment.¹⁴⁷ The court also highlighted that *Howell* cited the general rule from 24 AM. JUR. *Gas and Oil*, section 82, 590, that the relationship between the assignor/assignee is non-fiduciary.¹⁴⁸ However, the *Lillibridge* court failed to provide the rest of the *Howell* court’s citation, which explained that although the general rule is that the transfer of a lease does not generally create a confidential relationship, this is not always the case.¹⁴⁹ The significance of the *Lillibridge* interpretation is that it trivializes the “extension or renewal clause.” By including the entire citation, *Howell* emphasizes “[t]he terms of the conveyance may be such as to impose upon the assignee or sublessee the duty of protecting the interests of the assignor . . . and he must comply with the general rules that govern the conduct of persons occupying a trust status.”¹⁵⁰ The purpose of the “extension or renewal” clause is not only to lengthen the economic benefit created by reserving an overriding royalty, but it is also used to offer the overriding royalty interest owner greater protection from being “washed-out.”¹⁵¹

Thus, when an assignment expressly provides that any extension or renewal of the lease shall be subject to the overriding royalty therein agreed upon, the courts will regard a new lease procured by the assignee as an extension or renewal of the old one and charge it with the royalty so reserved, even though it was not granted until production under the former lease has come to an end.¹⁵²

145. *Howell*, 271 P.2d at 275.

146. *See id.*

147. *See Lillibridge v. Mesa Petroleum Co.*, 907 F.2d 1031, 1034 (10th Cir. 1990).

[T]he Supreme Court of Kansas predicated its decision upon the existence of a confidential business relationship. The court held that the original contract between Howell and the defendants, by which ‘the parties [were] to attempt to secure the lease, provid[ed] for at least a form of joint interest and joint ownership.’ Thus, it was this contract, not any subsequent transfer of lease interests, that created a confidential relationship involving mutual duties.

Id. (citations omitted) (emphasis in original).

148. *See id.*

149. *See Howell*, 271 P.2d at 274.

150. *Id.* (citing 24 AM. JUR.5, *Gas and Oil*, §82, 590 (1939)).

151. *See id.* at 271.

152. *Id.* at 274 (citing 24 AM. JUR.5, *Gas and Oil*, §82, 590 (1939)).

In essence, the *Lillibridge* interpretation of *Howell* requires a previous confidential or fiduciary relationship before the “extension or renewal” clause can operate to effectively protect the overriding royalty owner’s interest.

Just as the Texas case of *Exploration* skewed the interpretation of *Sunac*,¹⁵³ *Lillibridge* skewed the interpretation of *Howell*. *Howell* first noted that the “proper conclusion” to be drawn from the case law is that if the assignment contains an extension or renewal clause, then the overriding royalty will extend to a new lease taken by the assignee.¹⁵⁴ However, even without the extension and renewal language, the court found the existence of a confidential relationship in the contract the parties entered into before the assignment.¹⁵⁵ Thus, although the court may have based its findings on the joint interest between the parties, it did not disregard, and in fact found proper, the rule as stated by 24 AM. JUR., *Gas and Oil*, Section 82, 590.¹⁵⁶

In *Campbell v. Nako Corporation*,¹⁵⁷ the second case distinguished by *Lillibridge*, the Supreme Court of Kansas considered a petition to reopen a judgment terminating a lease where the overriding royalty owner alleged fraud and collusion between a landowner and a lessee engaged in a scheme to wash-out the overriding royalty interest.¹⁵⁸ The court held that:

[O]n bona fide forfeiture or surrender of a lease, the overriding royalty created thereunder falls with the lease. But if such forfeiture or surrender is obtained by fraud or collusion between the landowner and the lessee for the purpose of avoiding or cutting out the overriding royalty interest holder and the substitution of a new lease directly to the lessee, then a court of equity may grant relief to the overriding royalty holder against such forfeiture or surrender.¹⁵⁹

Campbell is distinguishable from *Howell*, *Lillibridge*, and *Reynolds*, in that the assignment at issue did not contain an express provision imposing the overriding royalty interest on any extension or renewal of the original lease.¹⁶⁰ Without an extension or renewal clause in the assignment, the overriding royalty owner will need to prove fraud or collusion on the part of the lessee and the lessor in order to prevent

153. See generally *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798 (Tex. 1967); *Exploration Co. v. Vega Oil & Gas Co.*, 843 S.W.2d 123 (Tex. Ct. App. 1992). See also the discussion under Texas Jurisprudence, *supra* Part. III.A.. Although *Sunac* said that the extension and renewal clause construed with a clause stating that there was no obligation to drill equated to no confidential relationship, *Exploration* said that the extension and renewal clause alone, without a clause stating that there is no obligation to drill, equaled no confidential relationship.

154. See *Howell*, 271 P.2d at 274.

155. See *id.* at 274-75.

156. See *id.*

157. 402 P.2d 771 (Kan. 1965).

158. See *Campbell v. Nako Corp.*, 402 P.2d 771,772-73 (Kan. 1965).

159. *Id.* at 779.

160. See *id.* at 771.

termination of the overriding royalty interest.¹⁶¹ The court did not address whether the inclusion of an extension or renewal clause in the assignment creates a heightened duty between the lessee/assignee and the overriding royalty owner. Significantly, however, the court did note “there seems clearly emerging a duty of fair dealing required on the part of the lessee to which doctrine this court has definitely inclined.”¹⁶² This “duty of fair dealing,” as stated by *Campbell*, seems to be emerging with or without an extension or renewal clause.¹⁶³

Although the *Lillibridge* court noted that *Campbell* “acknowledged a ‘clearly emerging . . . duty of fair dealing required on the part of the lessee,’” it attempted to limit *Campbell* to cases involving fraud and collusion.¹⁶⁴ This is what the Court of Appeals did in *Reynolds*.¹⁶⁵ *Lillibridge* also hampers the protection an “extension or renewal” clause is able to provide overriding royalty interest owners by forcing the assignor to prove fraud, collusion, or bad faith on the part of the assignee and the landowner, in spite of having contracted for the inclusion of the “extension or renewal” clause.¹⁶⁶ The more appropriate application of *Howell* and *Campbell* comes to light in the case of *Reynolds-Rexwinkle Oil, Incorporation v. Petex Incorporation*.¹⁶⁷

IV. ANALYSIS

A. *Reynolds-Rexwinkle*

The question presented in *Reynolds* was “whether an overriding royalty interest held by Reynolds-Rexwinkle in an oil and gas lease terminated” upon expiration of the original lease or whether it applied to a second lease on the same acreage, obtained by the assignee of the original lease, while the original lease was still in effect.¹⁶⁸

Petex, the assignee, argued that under *Campbell*, “the duration of an overriding royalty [was] limited by the oil and gas lease under which

161. See *id.* at 779. Collusion was defined by the court as:

[A]n agreement between two or more persons to defraud a person of his rights by the forms of law, or to obtain an object forbidden by law. It implies the existence of fraud of some kind, the employment of fraudulent means, or of lawful means for the accomplishment of an unlawful purpose . . . and a secret arrangement between two or more persons, whose interests are apparently conflicting, to make use of the forms and proceedings of law in order to defraud a third person, or to obtain that which justice would not give them, by deceiving a court or its officers.

Id. at 776 (citing BLACK’S LAW DICTIONARY 331 (4th ed. 1957)).

162. *Campbell*, 402 P.2d at 777 (citing 2 WILLIAMS AND MEYERS, OIL AND GAS LAW, § 420.2 (1959); *Howell v. Coop. Refinery Ass’n*, 271 P.2d 271, 275 (Kan. 1965)).

163. *Campbell*, 402 P.2d at 777.

164. *Lillibridge v. Mesa Petroleum Co.*, 907 F.2d 1031, 1035 (10th Cir. 1990) (citing *Campbell v. Nako Corp.*, 402 P.2d 771, 777 (Kan. 1965)).

165. See *Reynolds-Rexwinkle Oil, Inc. v. Petex, Inc.*, 969 P.3d 906, 908 (Kan. App. 1998).

166. See generally *Lillibridge*, 907 F.2d 1031; *Campbell*, 402 P.2d 771.

167. 1 P.3d 909 (Kan. 2000).

168. See *Reynolds-Rexwinkle Oil, Inc. v. Petex, Inc.*, 1 P.3d 909, 911 (Kan. 2000).

it was created.”¹⁶⁹ Petex also contended that, under *Howell*, there were no previous agreements between the parties that created a confidential relationship or joint interest that would prevent termination of the overriding royalty interest under *Campbell*.¹⁷⁰ Further, under *Campbell*, there was no allegation of bad faith, fraud, or collusion between Petex and the landowner that would prevent termination of the overriding royalty interest.¹⁷¹ Finally, the top lease Petex obtained was similar to the situation in *Lillibridge* in that the top lease was substantially different from the original lease; thus, it should be considered a “new” lease.¹⁷²

Relying on the holding in *Campbell*, Reynolds argued that a duty of fair dealing exists between an assignee and an overriding royalty owner.¹⁷³ Also, using *Campbell*, Reynolds argued “there does not have to be fraud or collusion in order for a duty of fair dealing to exist between the parties.”¹⁷⁴ Further, under *Howell*, there is a “duty of good faith and fair dealing [that] an operator-assignee owes the overriding royalty interest-assignor.”¹⁷⁵

The court found that the top lease between Petex and the landowner was substantially similar to the original lease.¹⁷⁶ With this finding, and after a careful analysis of the treatises and precedent, the Kansas Supreme Court held:

[T]he Court of Appeals erroneously reversed and remanded to require Reynolds to prove either fraud, collusion, or bad faith. The undisputed facts do not show that Petex was guilty of fraud, collusion, or bad faith. Nevertheless, the fact Petex took the second lease while the original lease it held was still in full force and effect requires a ruling that the overriding royalty of Reynolds attaches to the later lease. But, this is because of the extension and renewal language in the assignment and not due to any finding of bad faith on Petex’s part.¹⁷⁷

In reaching this holding, the court cited *Howell* as helpful precedent.¹⁷⁸

169. *See id.* at 915.

170. *See id.*

171. *See id.*

172. *See id.*

173. *See id.*

174. *See id.*

175. *See id.* at 915-16.

176. *See id.* at 912.

The original lease was for a 1-year term; consideration was \$1,000; the lease reserved a 1/8th royalty interest and an additional overriding royalty of 1/32nd of 7/8ths; and an attached option allowed the lease to be extended for an additional term of 1-year by paying a delay rental of \$6.25 multiplied by the number of net mineral acres owned by the lessors.

Id. Similarly, the second lease contained a “1/8th royalty interest and 1/32nd of 7/8ths overriding royalty interest was reserved by the [landowners], the second lease provided for an additional years’ term upon payment of a \$800 delay rental, and the sum of \$800 was paid as consideration for the lease.” *Id.* at 912.

177. *Id.* at 920.

178. *See id.* “We view *Howell* as most helpful to the result we reach.” *Id.* The court also gave a

The court noted that although the ultimate decision in *Howell* was based on the confidential relationship in the form of a joint enterprise between the assignor and the assignee obtaining the second lease, the extremely important language from the decision stated, “when an assignment expressly provides that any extension or renewal of the lease shall be subject to the overriding royalty therein agreed upon, the courts will regard a new lease procured by the assignee as an extension or renewal of the old one and charge it with the royalty so reserved.”¹⁷⁹ The court in *Reynolds* found the above language “clearly precedent to require that the overriding royalty of Reynolds attach to the second lease that was obtained by Petex during the time the first lease was in full force and effect.”¹⁸⁰

Unlike *Lillibridge*, where a previous confidential relationship was required to exist before the “extension or renewal” clause would impose a heightened duty upon the assignee, under *Reynolds*, an assignment containing the “extension or renewal” clause itself imposes a duty of fair dealing.¹⁸¹ The nature of that duty stems from the language in *Campbell*, which stated, “there seems clearly emerging a duty of fair dealing required on the part of the lessee . . . to which doctrine this court has definitely inclined.”¹⁸² Consistent with this language, *Reynolds* took what was an “emerging duty of fair dealing” and created a more concrete aspect of Kansas oil and gas law, further clarifying the relationship between the overriding royalty interest/assignor and the working interest/assignee. Accordingly, “[t]his duty, coupled with the ‘extension or renewal’ wording of the assignment, and the taking of the subsequent lease while the first one was in full force and effect compels a ruling, as a matter of law, that the overriding royalty interest . . . applies to and burdens the second oil and gas lease.”¹⁸³

Although *Reynolds* is correctly decided, there are still questions remaining as to the law in its present state. As one commentator noted, “it seems clear that the ‘duty of fair dealing’ was not an essential basis for the court’s holding. Instead, this statement seems to suggest an additional basis for a court to protect an overriding royalty owner.”¹⁸⁴ The basis of the holding in *Reynolds* was the existence of an “extension or renewal” clause in the assignment and a “substantially identical” new lease taken while the original was still in full force and effect.¹⁸⁵

more appropriate analysis of *Howell* than *Lillibridge*.

179. *Id.* at 920 (quoting *Howell v. Coop. Refinery Ass’n*, 271 P.2d 271, 274 (Kan. 1954)).

180. *Id.*

181. *See id.* at 921.

182. *Id.* at 920.

183. *Id.* at 921.

184. David E. Pierce, *Kansas-Oil & Gas*, ROCKY MOUNTAIN MINERAL INST. 1 (2000) (forthcoming article).

185. *See Reynolds*, 1 P.3d at 920-21.

However, the court stated that it was the duty of fair dealing “coupled with the extension and renewal clause and the taking of a subsequent lease while the first one was in full force and effect that compelled the ruling.”¹⁸⁶

Thus, an interesting question remaining concerns the scope of this duty of fair dealing. According to *Reynolds*, the assignor does not have to prove bad faith by the assignee in order for a duty of fair dealing to operate between the parties.¹⁸⁷ Still unclear is how an assignor may terminate a lease and subsequently acquire a new lease without being in violation of their duty of fair dealing to the overriding royalty interest owner. On one hand, the Kansas Supreme Court puts great weight in the language cited in *Howell*, which if applied literally, would impose trust status upon the relationship between assignor and assignee due to the extension or renewal clause.¹⁸⁸ As a result, the assignee would be required to put the interest of the assignor/overriding royalty interest owner above that of their own, which would entail seeking an extension or renewal of the existing lease rather than a new lease.¹⁸⁹ On the other hand, if the Kansas Supreme Court wanted to impose such a heightened relational duty on the assignee, this intention would have been more specifically stated in the holding. To better flesh out the limits of this duty of fair dealing, its application can be analyzed in the following factual scenarios.

CASE A:

Assume “B” obtains an oil and gas lease and subsequently assigns the lease to “C.” The assignment reserves an overriding royalty interest in B and also contains an extension or renewal clause. This first lease has terms of 1, 2, and 3. Two days before the expiration of the original lease, C obtains a new lease with terms 2, 3, 4, and 5. This second lease takes effect immediately after the original lease expires. The question presented is whether the second lease should be burdened by B’s overriding royalty interest.

186. *Id.* at 921.

187. *See id.* at 920.

188. *Id.* at 915-16 (citing *Howell v. Coop. Refinery Ass’n*, 271 P.2d 271, 274 (Kan. 1954)). 24 Am.Jur., *Gas and Oil*, § 82, 590 states:

The terms of the conveyance may be such as to impose upon the assignee or sublessee the duty of protecting the interests of the assignor or sublessor; and, whenever they are of such character, he must comply with the general rules that govern the conduct of persons occupying a trust status, and any effort on his part to procure from the lessor rights antagonistic to those of the assignor will be defeated. Thus, when an assignment expressly provides that any extension or renewal of the lease shall be subject to the overriding royalty therein agreed upon, the courts will regard a new lease procured by the assignee as an extension or renewal of the old one and charge it with the royalty so reserved, even though it was not granted until production under the former lease had come to an end. *Id.*

189. *See Reynolds*, 1 P.3d at 915-916.

This factual scenario is based on the facts from *Lillibridge*.¹⁹⁰ *Reynolds* distinguished *Lillibridge* on the fact that the second lease in that case was composed of substantially different terms.¹⁹¹ Thus, the question of whether the Kansas Supreme Court will follow *Lillibridge* in a case involving an “extension or renewal” clause and a substantially different top lease still remains.

The most appropriate course for the Kansas Supreme Court to follow is the path it is on presently. This “yet-to-be-defined”¹⁹² duty of fair dealing should play an important role in the next case involving terms of a top lease substantially different from the original lease. It has been said, “*Lillibridge* opens the door for those operators who can get their case into federal court to evade the obligations of an extension or renewal clause included in a lease assignment.”¹⁹³

When a court interprets a contract or clause within a contract, the purpose and primary function of the court is to ascertain the intent of the parties.¹⁹⁴ The Fifth Circuit Court of Appeals in *Otter Oil Company v. Exxon Company, United States of America*,¹⁹⁵ noted that the “purpose of the extension-and-renewal clause is to prevent a ‘washout’.”¹⁹⁶ When the courts apply a rigid, literal interpretation to the terms “extension” and “renewal,” they fail to recognize the parties’ intent in including the provision in the assignment.¹⁹⁷

As opposed to applying a rigid interpretation, by imposing a duty of fair dealing on assignees, the courts recognize the two-fold purpose and intent behind the inclusion of an extension or renewal clause. “First, the clause as a contract term represents the direct express intent of the parties to prevent washouts.”¹⁹⁸ Second, the parties intend to impose such a heightened relationship.¹⁹⁹ By recognizing the intent of the parties in using an extension or renewal clause, the courts, through this duty of fair dealing, are able to interpret the contract language

190. See generally *Lillibridge v. Mesa Petroleum Co.*, 907 F.2d 1031 (10th Cir. 1990). See discussion of *Lillibridge*, *supra* Part III.C..

191. See *Reynolds*, 1 P.3d at 920. “We find *Lillibridge* factually different and not authority to require the result that either party to this appeal champions.” *Id.*

192. Pierce, *supra* note 184.

193. Ney, *supra* note 76, at 563.

194. See Ney, *supra* note 76, at 559 (citing 4 SAMUEL WILLISTON, WILLISTON ON CONTRACTS § 601, at 303-04 (3d ed. 1961)). “The first duty of a court trying to interpret a conveyance is to give effect to the intent of the parties.” Lowe, *supra* note 30, at 111.

195. 834 F.2d 531 (5th Cir. 1987).

196. *Otter Oil Co. v. Exxon Co., U.S.A.*, 834 F.2d 531, 534 (5th Cir. 1987).

197. See generally *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798 (Tex. 1967) (applying a literal interpretation to the terms “extension” and “renewal”). See also *Lillibridge v. Mesa Petroleum Co.*, 907 F.2d 1031 (10th Cir. 1990). “[R]ecognized is the fact that while it is no doubt desirable that words have a fixed and ascertained meaning, precedent invariably attaching such a meaning often results in a rigidity which does violence to the intent of the parties . . . and even defeats the oft-iterated primary rule that ‘the intention of the parties’ is the ‘polestar’ of interpretation.” Ney, *supra* note 76, at 563 (citing WILLISTON, *supra* note 194, at 303-04).

198. Ney, *supra* note 76, at 571.

199. Ney, *supra* note 76, at 571.

broadly in order to encompass the spirit of the contract.

By applying *Reynolds* to the factual scenario above (“Case A”), it appears that the second lease should be burdened by B’s overriding royalty interest. This is because the assignment from B to C contained an extension or renewal clause, a duty of fair dealing exists between the parties, and the second lease was taken while the first lease was still in full force and effect. Thus, as a matter of law, the second lease should be burdened by B’s overriding royalty interest.²⁰⁰

In a case more factually similar to *Lillibridge*, this conclusion is appropriate in light of the Kansas Supreme Court’s outcome in *Howell v. Cooperative Refinery Association*.²⁰¹ *Howell* rejected the lessee’s argument that the second lease was substantially different from the original lease, and thus, should not be considered an extension or renewal.²⁰² The *Howell* court also gave little significance to the fact the second lease was taken after the original one had expired.²⁰³ It would appear, then, that the Kansas Supreme Court is moving away from the Texas approach as seen in *Lillibridge*, and more towards the approach taken in Oklahoma. This has the effect of providing more protection to an overriding royalty interest, by keeping or preventing it from being extinguished by a lessee taking a subsequent lease on the same acreage, at least while the original lease is still in full force and effect.

CASE B:

Assume B obtains an oil and gas lease and subsequently assigns it to C. The assignment reserves an overriding royalty interest to B and contains an extension or renewal clause. The terms of this first lease are 1, 2, and 3. C fails to execute an obligation under the terms of the first lease, and consequently, the first lease terminates. Three months after the termination of the first lease, C obtains a new lease with the terms 4, 5, and 6. The question presented is whether C’s second lease should be burdened with B’s overriding royalty interest.

This factual scenario illustrates the remaining questions after *Reynolds*. It is unclear what the scope of the duty of fair dealing is and to what extent this extension or renewal clause, which is form language used in thousands of existing assignments in the oil and gas industry,²⁰⁴ will impact contract interpretation. How broadly will the courts

200. See generally *Reynolds-Rexwinkle v. Petex*, 1 P.3d 909, 921 (Kan. 2000) (stating, “duty, coupled with the ‘extension or renewal’ wording of the assignment, and the taking of the subsequent lease while the first one was in full force and effect compels a ruling, as a matter of law, that the overriding royalty interest . . . applies to and burdens . . . the second oil and gas lease . . .”).

201. 271 P.2d 271 (Kan. 1954).

202. See *Howell v. Coop. Refinery Association*, 271 P.2d 271, 275-76 (Kan. 1954).

203. See *id.* at 275.

204. EUGENE O. KUNTZ ET AL., FORMS MANUEL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 104 (3rd ed. 1998).

interpret a new lease secured by the assignee to be an extension or renewal? Also, to what extent must the court focus on the “intent” or “motive” of the lessees to evaluate whether its decision to permit a lease to terminate was a breach of the duty of fair dealing?

In this factual scenario (“Case B”), there is no top lease, and the terms of the new lease are substantially different.²⁰⁵ One argument is that the language in *Howell*, literally applied, would require any new lease taken by the assignee to be burdened with the overriding royalty interest.²⁰⁶ This argument, basically the Oklahoma approach discussed previously, holds the assignee in a position of trust towards the assignor/overriding royalty interest owner. This position requires the assignee to refrain from seeking any interest contrary to the assignor, which means seeking to secure an extension or renewal of the original lease.²⁰⁷ By not seeking an extension or renewal, the assignee breaches this duty of fair dealing, and as a consequence, the overriding royalty attaches to the new lease.²⁰⁸

Another argument, and perhaps the most appropriate for the industry, is that in this situation, where the original lease has terminated and a substantially different new lease has been taken by the assignee, the only way the assignor/overriding royalty interest owner can burden the new lease with the overriding royalty interest is to show the assignee acted in bad faith. Thus, the question presented becomes what is bad faith in relation to this duty of fair dealing.

The beginning point of analysis in answering this question is an explanation of the duty of fair dealing. In Kansas, unlike Texas, there is an inherent contractual duty to act in good faith.²⁰⁹ In fact, the Kansas Supreme Court in *Bonanza, Incorporated v. McLean*²¹⁰ stated, “[t]he modern trend is to apply the duty of good faith and fair dealing in every contract.”²¹¹ The court also cited language from 17 Am.Jur.2d, Contracts, Section 256, stating:

Every contract implies good faith and fair dealing between the parties to it, and a duty of co-operation on the part of both parties. . . . Moreover, there is an implied undertaking in every contract on the part of

205. Finding the new lease “substantially different” would require a factual determination, as explained in “Case B,” prompted by the extension or renewal clause in the assignment.

206. See *Reynolds*, 1 P.3d at 915-16. See also *Howell*, 271 P.2d at 274.

207. See *Probst v. Hughes*, 286 P. 875, 878 (Okla. 1930) (finding when overriding royalty applies to renewal and extension of the lease, “the assignee occupies a position of trustee toward the assignor and is held with the duty to exercise good faith in obtaining an extension of the lease.”). See also *Howell v. Coop. Refinery Ass’n*, 271 P.2d 271, 274 (Kan. 1954).

208. See *Probst*, 286 P. at 878; *Howell*, 271 P.2d at 274.

209. Compare *Bonanza, Inc. v. McLean*, 747 P.2d 792, 801 (Kan. 1987), with *English v. Fisher*, 660 S.W.2d 521, 522 (Tex. 1983).

210. 747 P.2d 792 (Kan. 1987).

211. *Bonanza*, 747 P.2d at 801. “The duty imposes both affirmative and negative obligations.” *Id.*

each party that he will not . . . do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract. Ordinarily if one exacts a promise from another to perform an act, the law implies a counterpromise against arbitrary or unreasonable conduct on the part of the promisee.²¹²

According to the Restatement (Second) of Contracts, Section 205, “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”²¹³ Describing good faith, the Comments to the Restatement explain that “[g]ood faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the party; it excludes a variety of types of conduct characterized as involving ‘bad faith’ because they violate community standards of decency, fairness or reasonableness.”²¹⁴

Referring to the factual scenario above, as a matter of law, C’s taking of a new lease after the original has expired is not a breach of this duty of fair dealing. Therefore, the next step in analysis is a factual determination of whether C’s act of taking the new lease was a breach of the duty of fair dealing. Thus, B, the overriding royalty interest owner, must prove C, the lessee, acted in bad faith when allowing the original lease to terminate and when taking the second lease.

Bad faith encompasses a countless variety of actions.²¹⁵ The lessee in *Reynolds* argued, under their interpretation of *Campbell*, that the overriding royalty owner must prove fraud, collusion, or bad faith in order for the lessee to have breached the duty of fair dealing.²¹⁶ However, bad faith is not limited to intentional acts, such as fraud and collusion. Bad faith may encompass conduct that the actor believes is justified, as well as subterfuges and evasions of the spirit of the bargain.²¹⁷

In *Campbell*, the court required fraud to be proven for the

212. *Id.* (citing 17 AM. JUR. 2d *CONTRACTS* §256 (1964).

213. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

214. *Id.* at cmt. a.

215. *Id.* at cmt. d.

Subterfuges and evasions violate the obligation of good faith performance even though the actor believes his conduct is justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.

Id.

216. *See Reynolds-Rexwinkle Oil, Inc. v. Petex, Inc.*, 1 P.3d 909, 915 (Kan. 2000).

217. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1979).

overriding royalty interest to carry over to a new lease taken by the assignee when the assignment did not contain an extension or renewal clause.²¹⁸ This burden of proof is appropriate when the assignment does not contain an extension or renewal clause.²¹⁹ The lessee in *Reynolds* construed the holding of *Campbell* to mean the overriding royalty interest owner must prove fraud or collusion even with an extension or renewal clause in the assignment.²²⁰ This burden is not appropriate when the parties have expressly agreed on an extension or renewal clause.²²¹

In *Reynolds*, the court held that the overriding royalty interest owner did not have to prove fraud, collusion, or bad faith, and found that the lessee was not guilty of fraud, collusion, or bad faith.²²² When the *Reynolds* court used the triad of words, “fraud, collusion, or bad faith,” it was a product of a redundant legal phrase designed to identify various shades of fraud.²²³ Because collusion is a type of fraud, the court was in essence saying “fraud, fraud,” or bad faith.²²⁴ Thus, when the court said “fraud, collusion, or bad faith”, it most likely meant bad faith of the kind involving fraud. Pursuant to this rationale, when the court stated the overriding royalty interest of Reynolds attached to the second lease “because of the extension and renewal language in the assignment and not due to any finding of bad faith on Petex’s part,” the most reasonable explanation is that there was no finding of fraudulent behavior on the part of Petex, the lessee.²²⁵

Instead of making a factual finding that the lessee had intentionally defrauded the assignor, the court found that a substantially similar top lease fell within the intended scope of the extension or renewal clause as a matter of law.²²⁶ For the lessee to take a substantially similar top lease, but recognize the overriding royalty interest from the original lease, would fail to enforce the extension or renewal clause within its intended meaning. In other words, the lessee has not acted in good faith and fair dealing in performing the bargained-for extension or renewal clause.

218. See *Campbell v. Nako Corp.*, 402 P.2d 771, 779 (Kan. 1965).

219. See *id.*

220. See *Reynolds*, 1 P.3d at 915.

221. See *id.* at 920.

222. See *id.*

223. See *id.* See also RICHARD C. WYDICK, *Plain English for Lawyers* 19 (4th ed. 1998). “The phrase null and void is an example of coupled synonyms – a pair or string of words with the same or nearly the same meaning.” *Id.* Reynold’s use of the words “fraud, collusion, or bad faith” is analogous to how “[a]n occasional lawyer, perhaps believing that *null and void* looks naked by itself, will write *totally null and void, or perhaps totally null and void and of no further force or effect whatsoever.*” *Id.*

224. See *Reynolds*, 1 P.3d at 920. Collusion was defined in *Campbell* as an “agreement between two or more persons to defraud a person of his rights by the forms of law, or to obtain an object forbidden by law. It implies the existence of . . . fraudulent means . . .” *Campbell v. Nako Corp.*, 402 P.2d 771, 776 (Kan. 1965) (citing BLACK’S LAW DICTIONARY, 331 (4th ed. 1957)).

225. See *Reynolds*, 1 P. 3d at 920.

226. See *id.* at 921.

In applying this analysis to the “Case B” factual scenario, how does the assignor, B, show that the assignee, C, acted in bad faith in taking a substantially different new lease after the original lease was no longer in full force and effect? C’s actions have not been determined to be a breach of the duty of fair dealing as a matter of law, because the *Reynolds*’ holding is limited to substantially similar leases taken while the original is still in full force and effect.²²⁷ To do so, B will need to have a court make a factual determination that C acted in bad faith after an inquiry into the circumstances surrounding C’s taking of the new lease.

In its inquiry into the surrounding circumstances of C’s taking of the new lease, the court should look to the reasonable expectations of the parties when including the extension or renewal clause in the assignment to determine the scope of the clause.²²⁸ The reasonable expectation of the parties as to the scope of the extension or renewal clause can be determined by examining the common usage of the clause within the oil and gas industry.²²⁹

In Case B, if B thinks, after looking at the surrounding circumstances, that he has a reasonable expectation that his overriding royalty interest should carry to C’s new lease, then he should bring a contract action claiming C failed to enforce the extension or renewal clause with good faith and fair dealing. An example of when B might have a reasonable expectation is seen in the following facts that supplement Case B:

Two months before the expiration of the original lease assigned to C, C began negotiating with the landowners for a new lease. The negotiations continued but did not end until three months after the expiration of the original lease. Obviously, C’s interest in the property never ceased before or after the expiration of the original lease.

With these facts in mind, it is an appropriate conclusion that B, as would any overriding royalty interest owner in the industry, had a reasonable expectation that the extension or renewal clause would encompass a subsequent lease taken by the lessee under these circumstances. Thus, by not carrying the overriding royalty interest to the new lease in accordance with the extension or renewal clause, C breached the extension and renewal clause.

227. *See id.*

228. *See* RESTATEMENT (SECOND) OF CONTRACTS § 220 (1979). “An agreement is interpreted in accordance with a relevant usage if each party knew or had reason to know of the usage and neither party knew or had reason to know that the meaning attached by the other [party] was inconsistent with the usage.” *Id.*

229. *See id.* at § 222. “A usage of trade is a usage having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to a particular agreement.” *Id.* A usage must be reasonable, “but commercial acceptance by regular observance makes out a prima facie case that a usage of trade is reasonable.” *Id.* at cmt. d.

An example of when B would not have a reasonable expectation of his overriding royalty interest being carried over to C's new lease can be seen in the following facts supplementing Case B:

One month prior to the expiration of the original lease assigned to C, C learns of a dry hole drilled on adjacent property. Subsequently, C allows the original lease to expire. Three months later, C learns of a successful well drilled on adjacent property. C returns to the landowners and negotiates the new lease.

In this factual scenario, it is appropriate to find that B has no reasonable expectation that the extension or renewal clause would encompass C's new lease. Thus, the general rule that an overriding royalty interest dies with the lease from which it was carved would operate, and C would be found to have acted in good faith by allowing the original lease to expire and by subsequently acquiring a new lease.²³⁰

At this point, a situation could arise in which an overriding royalty owner has no reasonable expectation of having his interest contractually preserved by the extension or renewal clause; however, in light of the surrounding circumstances, he may still feel the royalty interest should attach to the new lease. Here, the overriding royalty interest owner could not rely on his contract claim. Instead, the remaining course of action would be to prove that the lessee acted fraudulently in taking the new lease and washing out the overriding royalty interest. Again, this course of action would seem incredibly difficult to prove.

With the varied resolutions to Case B, courts will continually determine on a case-by-case basis, both the scope of the extension or renewal clause, and how far the duty of fair dealing will be used to interpret that scope. Admittedly, this does not provide the practitioner with much assurance when trying to advise a lessee on whether or not a new lease can be taken without being burdened by a previously existing overriding royalty interest.

Unless the Kansas Supreme Court was – or is – going to impose upon the assignee a fiduciary obligation, which was doubtfully the court's intention, there must be some limit on how broadly the extension or renewal clause is interpreted. The Kansas Supreme Court's acknowledgement of this limit is illustrated in the following factual scenario.

CASE C:

Assume B obtains an oil and gas lease and subsequently assigns it to C. The assignment reserves an overriding royalty interest to B and contains an extension or renewal clause. C releases the first lease after the expiration of the primary term. Ten months after the expiration of

230. See *Campbell v. Nako Corp.*, 402 P.2d 771, 777 (Kan. 1965).

the first lease, D obtains a lease on the same acreage. D subsequently assigns an undivided one-third interest in the second lease to C. The question presented is whether C's interest in the second lease should be burdened by B's overriding royalty interest.

This factual scenario is based on the Kansas Supreme Court case of *K&E Drilling, Incorporated v. Warren*.²³¹ In *K&E*, the court held "the overriding royalty interest did not extend to an unrelated new lease subsequently acquired, in good faith, on the same property."²³² Even with the duty of fair dealing, there must be some limit on how broad it will be used to interpret what constitutes an extension or renewal.

It is a reasonable conclusion, in both *K&E* and the factual scenario above, that neither party intended such a far-reaching application of the extension and renewal clause. For a court to read into the form language of a typical extension or renewal clause such a broad application would be going beyond the spirit of the contract. Thus, in this factual scenario, C's interest in the new lease would most likely not be burdened by B's overriding royalty interest that would have terminated along with the original lease.²³³

V. FINAL ANALYSIS

In the end, when the spectrum of jurisprudence on this issue is viewed, Texas and Oklahoma are polar opposites. There are the Texas courts on one side, with no contractual obligation of good faith, and consequently little protection offered to the overriding royalty interest owner. Conversely, the Oklahoma courts on the other end, are willing to apply the ultimate relational obligation of a fiduciary.²³⁴ The Kansas Supreme Court has wisely taken the middle road.²³⁵

Rather than going to either extreme and finding a fiduciary obligation or nullifying the obligation of good faith and fair dealing, the Kansas Supreme Court in *Reynolds* logically applied the duty of fair dealing to keep the parties acting within the spirit of the bargained-for contract.²³⁶ Taking a substantially similar top lease, regardless of intent, is contrary to the spirit of the contract when the parties include an

231. 340 P.2d 919 (Kan. 1959).

232. *K&E Drilling, Inc. v. Warren*, 340 P.2d 919, 923 (Kan. 1959).

233. *See Campbell v. Nako Corp.*, 402 P.2d 771, 779 (Kan. 1965) (holding that "on bona fide forfeiture or surrender of a lease, the overriding royalty created thereunder falls with the lease.").

234. *Compare Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 805 (Tex. 1967) (finding an extension and renewal clause alone does not create a fiduciary relationship), *and Sasser v. Dantex Oil & Gas, Inc.*, 906 S.W.2d 599, 607 (Tex. Ct. App. 1995) (stating that assignees could not have acted in bad faith because there was no good faith obligation), *with Probst v. Hughes*, 286 P. 875, 878 (Okla. 1930) (finding assignee occupies a position of trustee toward the assignor when there is an extension or renewal clause in the assignment).

235. *See Reynolds-Rexwinkle Oil, Inc. v. Petex, Inc.*, 1 P.3d 909, 921 (Kan. 2000).

236. *See id.*

extension or renewal clause in the assignment.²³⁷ Nonetheless, there are arguments for narrowing this duty of fair dealing.

A strong policy argument for limiting both the scope of the duty of fair dealing and how broad the courts interpret an extension or renewal clause is the ability of the preexisting lessee and the overriding royalty owner to compete for a new lease after the termination of the original lease.²³⁸ It seems reasonable if the overriding royalty wants to continue possessing an economic interest in the lease, the overriding royalty owner should have to compete for the new lease after the original expires. Furthermore, it can be argued that the greater the scope of the extension or renewal clause, the more difficult it will be for lessees to acquire entirely new leases for fear of being subjected to a preexisting overriding royalty interest on the acreage. Also, if the courts were to ultimately apply a fiduciary obligation, an overriding royalty could conceivably run in perpetuity as to the particular assignee. Although limiting the scope of the duty of fair dealing is reasonable in cases such as *K&E*, taking the *Lillibridge* and Texas approach of not even recognizing a duty is extreme.

While there are strengths to the Texas approach, there are stronger policy arguments for imposing a duty of fair dealing between overriding royalty owner and lessees. Such a duty protects the overriding royalty owner from being washed out by a top lease. If an overriding royalty interest can be easily terminated by the lessee taking a substantially different top lease, the interest in obtaining and using an overriding royalty would likely decrease along with the economic value of the interest.

Although promoting competition for second leases is a worthy policy, promoting the protection of a bargained-for economic interest, such as the overriding royalty interest, is more compelling. One reason is the important role the overriding royalty interest serves for the oil and gas industry as a financing device.²³⁹ Rather than having to pay a large sum of cash in exchange for goods or services, a lessee (or assignee) may agree to pay with an overriding royalty interest, and a smaller sum of cash.²⁴⁰ Again, affording the overriding royalty little protection from washout transactions would lessen the incentive to receive such an interest as consideration. Furthermore, if the lessee is able to washout

237. *See id.*

238. *See Pierce, supra note 184.*

239. *See WILLIAMS AND MEYERS, supra note 18, at 750.1.*

240. *See WILLIAMS AND MEYERS, supra note 18, at 750-50.1.*

Thus the owner of a lease might offer to transfer the lease for a cash payment of \$100 per acre; this offer might produce a counter offer of an overriding royalty of one-eighth; the bargaining might result in an agreement upon a cash payment more modest than \$100 and a more modest overriding royalty, e.g., a cash payment of \$10 per acre and a one-sixteenth overriding royalty.

Id.

the overriding royalty interest that was given as part of the consideration for an assignment, the lessee actually receives the assigned lease for less than the consideration that was established in the bargain.

The *Reynolds* decision accomplishes two things that help prevent the previously mentioned unfavorable results, and benefit the overriding royalty interest. First, *Reynolds* offers more protection to the thousands of assignments already in existence containing an extension and renewal clause as was found in the assignment in *Reynolds*.²⁴¹ Second, the *Reynolds* decision acts as notice to future assignors that there is a need for better drafting in order to clarify the parties' intended relationship in the assignment.

To protect their economic interest from washout tactics, assignors should always include an extension or renewal provision in an assignment. Without this provision, the assignor is forced to prove fraud in order to carry the overriding royalty interest over to the new lease.²⁴² To avoid having a court interpret whether there is a duty of fair dealing between the parties, drafters should include express language in assignments clarifying the relationship.

One drafting solution, which could avoid the need to have a court interpret whether a second lease is an "extension" or "renewal", would read:

[t]he obligation to pay the overriding royalty required by this assignment will exist for the life of the oil and gas lease plus any extensions or renewals of the lease. For purposes of this Section, any leasehold interest acquired by assignee within _____ years following the termination, cancellation, or surrender of the oil and gas lease will be deemed an 'extension or renewal.'²⁴³

Another drafting solution would read:

The obligation to pay the overriding royalty required by this assignment will continue to any extensions or renewals of the lease, or any other new or subsequent lease(s) taken by the assignee within (21) years from the date of this assignment.²⁴⁴

As with many of the issues seen in the area of oil and gas law, most

241. See *Reynolds*, 1 P.3d at 912. "The Assignor herein hereby expressly excepts . . . title to an undivided 1.5% of 8/8ths of all oil . . . from the described land under the provisions of the aforesaid lease, or any extension or renewal thereof . . ." *Id.*

242. See generally *Campbell v. Nako Corp.*, 402 P.2d 771 (Kan. 1965).

243. *Pierce*, supra note 76, at 969. However, Professor *Pierce* notes there are arguably rule against perpetuities problems with the above drafting suggestion. To avoid this problem, an assignor could alternatively approach the problem using assignment language expressly imposing a duty of good faith on the lessee to protect the overriding royalty from any action or inaction that would terminate the overriding royalty rights under the assignment. See *id.*

244. This should avoid the rule of perpetuities problems.

of the uncertainty could be eliminated with careful drafting. Nonetheless, for those thousands of assignors that have taken an overriding royalty interest reserved with a basic "extension or renewal" clause, as found in *Reynolds*, the Kansas Supreme Court's opinion offers real protection.

VI. CONCLUSION

There is no doubt that *Reynolds* is an important case in Kansas' oil and gas law. The case was rightfully decided to protect the assignor's overriding royalty interest from being washed out by a substantially similar top lease executed between the assignee and the landowners. Although in a case factually similar to *Reynolds* the extension or renewal clause would offer protection, in a case more closely resembling *Lillibridge*, the same safeguards are not in place.

If overriding royalty interests are valuable to the industry, they should be protected from lessee actions that can destroy them. This is accomplished not by developing some newly "emerging" duty of fair dealing, but by simply observing the duty of fair dealing that is already inherent in contractual relationships in Kansas. It is in the best interest of the oil and gas industry that the courts continue to move away from *Lillibridge* and towards the course of protection of nonoperating interest in Kansas set in *Reynolds*.