RECENT CASES – THEIR PRACTICAL SIGNIFICANCE

Australian Energy Limited v. Lennard Oil N.L. and Others[1]

By M. Byrnes*

This paper is intended to identify and analyse the matters of practical significance to the mining and petroleum industry arising out of the decision of the Supreme Court of Queensland in *Australian Energy Limited v. Lennard Oil N.L. & Ors.* The case was heard at first instance before McPherson J., and subsequently appealed to the full court of the Supreme Court of Queensland. It was affirmed on appeal[2]. However the greatest significance arises from the judgment at first instance, and it is not proposed to deal at great length with the decision on appeal.

The Facts

Australian Energy Limited (A.E.L.) was the holder of Authority to Prospect 235P (Queensland). ATP 235P was granted on 1 January 1977, for a term of four years. It covered 653 blocks.

Through a series of farmouts described in greater detail shortly, ATP 235P came to be divided into three areas, called in this case Area 1, Area 2, and the Aquitaine Area. The Aquitaine Area was farmed out early in the life of ATP 235P, and was not involved in the subject matter of the dispute. Areas 1 and 2 became the subject of a farmout agreement between A.E.L. and Lennard Oil N.L., involving A.E.L. assigning the whole of its interest in Areas 1 and 2 to Lennard, with Lennard taking over A.E.L.'s exploration commitments and granting back to A.E.L. an overriding royalty interest.

A.E.L. had previously granted an overriding royalty interest of 3 percent to another company, International Oil Lease Service Corporation. Consequently it was envisaged that thereafter there would be two overriding royalty interests on the title, of 3 percent each. The agreement between A.E.L. and Lennard was in the form of a letter, signed on behalf of both companies. It is necessary to set out the letter in full, as follows:

> This letter will constitute an agreement between A.E.L., a wholly owned subsidiary of Lexicon Resources Corporation, and Lennard Oil, N.L. (L.O.N.L.) who agree to accept the following farmout proposal as regard to ATP 235P, Area 1, 7,557,800 acres in Queensland, Australia.
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> L.O.N.L. will be responsible for the remaining exploration commitments on the Authority to Prospect. 1979 – $150,000 (Australian) and 1980 – $250,000 (Australian). This will be solely managed and spent by L.O.N.L.

* LL.B. (Adel.) Solicitor S.A.

1 Unreported decision of McPherson J., Sup. Ct. Qld. No. 2948 of 1984.
2 [1986] 2 Qd. R. 216.

A.E.L. will contribute all geologic, seismic, aeromagnetic data they have in their files and will support the exploration efforts with all their geologic and executive staff whenever possible at the discretion of L.O.N.L.

A.E.L. will provide consulting geologic support to the program for a period of one year from the above date with expenses not to exceed $67,000.

L.O.N.L. will grant a 12.5% net profit revenue interest to be retained by A.E.L.

L.O.N.L. will solely outline a plan for continued exploration and select the best prospect for drilling.

The state of Queensland has retained a 10% royalty interest.

There is a 6% overriding royalty interest on the Authority. Three percent (3%) is held by International Oil Lease Service, Cisco, Texas. The remaining three percent (3%) is to be retained by A.E.L., which will convert to a 12.5% net profit revenue interest after payout.

L.O.N.L. will be assigned title to tenement as soon as possible. A.E.L. will apply for transfer upon acceptance of this letter.

A.E.L. warrants title and royalty as stated.

L.O.N.L. is to prepare an operating agreement for A.E.L. signature.

L.O.N.L. will provide A.E.L. and the Bureau of Mines an appropriate financial guarantee to meet the program commitment.

Enclosed is a copy of our original ATP 235P with Bureau of Mines, Brisbane, Australia.

This Agreement was dated 29 March 1979. The 'Area 1' referred to in the letter is in fact Areas 1 and 2 as they were defined in the case. There was an amendment to the agreement in October 1979, but the amendment is irrelevant to the case.

The Agreement contemplated that A.E.L. would assign the title to the tenement to Lennard. This was somewhat impractical, because the farmout related only to part of the area which was the subject of the tenement. There had at that stage been no assignment of or dealing with the title in relation to the earlier farmout of the Aquitaine Area. The parties contemplated an assignment of the whole of the tenement to Lennard, on the basis that Lennard would hold the title to the Aquitaine Area on trust for the Aquitaine farminees.

In correspondence between A.E.L. and Lennard in October 1979, the problem of the transfer was discussed. It was pointed out that if Lennard was to accept a transfer of the whole of the title, it would be responsible for performance of the conditions in respect of the whole area, and if the Aquitaine farminees defaulted in relation to their area, the whole of the ATP would become liable to forfeiture and cancellation.

Lennard was prepared for the title to remain in the name of A.E.L., on the basis of A.E.L. giving an undertaking that it would not surrender the title without Lennard's approval. This undertaking was given in October 1979, and that remained the state of affairs until the end of 1980.

In May 1980 A.E.L. wrote to Lennard notifying its intention to seek a renewal of the title, which was due to expire on 31 December 1980. Shortly thereafter, A.E.L. requested the Department of Mines to renew ATP 235P from 1 January 1981. It was at this stage that Lennard sought a transfer of the whole of the title to itself, to be held in part as trustee. A transfer to this effect was in fact prepared and executed and forwarded to the Mines Department, but was not formally approved by the Minister. The Department sought legal advice on the situation, and subsequently told A.E.L. that the transfer of the whole of the title to Lennard was

possible, but suggested as a better alternative that A.E.L. could make application for conditional surrender of ATP 235P, subject to the issue of separate ATPs over the two different areas (Areas 1 and 2, and the Aquitaine Area).

This proposal was advised to Lennard, which agreed. This was in September 1980, a few months before the expiry of the title. Shortly thereafter it was proposed that Lennard's area be divided into two, thus creating Areas 1 and 2. A.E.L. surrendered ATP 235P, and Lennard, and other companies with which it by now had farmout arrangements, submitted applications in respect of Areas 1 and 2. As a result new ATPs, 299P and 298P, were granted over Areas 1 and 2 respectively, each for four years commencing on 1 January 1981. Another ATP, 301P, was granted over the Aquitaine Area.

In December 1983, oil was discovered in commercial quantities in Tintaburra No. 1, situated in Area 1 (ATP299P). The wording of the letter agreement suddenly had much greater significance. Lennard denied that A.E.L. was now entitled to an overriding royalty, and this case was the result. By the time the case came to trial, some 17 companies had acquired interests in Areas 1 and 2, and consequently all were joined as third parties to bind them to the decision.

The Arguments

A.E.L. sought from the Supreme Court of Queensland orders and declarations that Lennard was bound to pay to A.E.L.

(i) 3 percent of the sale proceeds of any petroleum recovered from the area of ATP 235P free of the cost of exploration and production thereof; and

(ii) Upon recovery by Lennard of its costs of exploration and production of petroleum, 12.5 percent of the net proceeds of sales of petroleum recovered from the said area after deduction of cost of operation and sale of the said petroleum.

The Third Parties played an active role in the case, and put forward a number of arguments including:

(i) That the agreement was wholly or partly void for uncertainty, because the expressions 'overriding royalty interest', 'net profit revenue interest' and 'payout' did not have clear meanings, and could be capable of many different interpretations; and

(ii) That if enforceable, the agreement related only to oil discovered on the area the subject of ATP 235P prior to 1 January 1981, and not to oil discovered under a renewal of that title or under a different title granted in relation to the same area following a surrender of ATP 235P, as was the case here.

Before McPherson J., argument proceeded at some length on precisely what was the subject matter of the letter agreement. A.E.L. argued that the subject matter extended to the actual land covered by ATP 235P, Areas 1 and 2. The third parties argued that the subject matter was ATP 235P Areas 1 and 2, and nothing more.

The Judgment

In a long judgment which considered a number of matters of both practical and academic interest to petroleum lawyers, McPherson J. found that the agreement could be given meaning, and was enforceable by A.E.L. The precise orders made by him, after amendments made following further representations from the parties, were as follows:

> I consider that, as against [Lennard], [A.E.L.] is entitled to a declaration that [Lennard] is, pursuant to the agreement between the parties dated 29th March 1979 as varied, liable:
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> (1) until payout, to pay 3% of the wellhead value of petroleum recovered by virtue of any lease granted or to be granted by virtue of the *Petroleum Act*, 1923–1983, in consequence of an application by the holder or holders for the time being of authority to prospect no. 299P or no. 298P or either of them, or any renewal thereof, granted pursuant to the said Act; and –
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> (2) After payout to pay 12.5% of the difference between:
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> (i) accumulated revenue from sales of petroleum, and
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> (ii) accumulated costs including royalties, exploration expenses and normal operating costs and lifting expenses,
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> where:
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> (a) 'payout' means the time at which the total of accumulated revenue derived from sales of petroleum less royalties and less normal operating costs is equal to the total accumulated exploration expenses;
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> (b) 'wellhead value' means the sales value of petroleum less normal operating costs;
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> (c) 'normal operating costs' means normal operating costs incurred in the course of production and sale of petroleum including field gathering costs, pipeline tariffs, trucking costs and other transportation expenses, but not income tax or exploration expenses and in the case of well-head value not lifting expenses or royalty payments;
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> (d) 'exploration expenses' includes costs incurred in exploring and prospecting for petroleum and outlays on plant and other items of capital equipment required to produce petroleum from a well;
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> (e) 'petroleum' means hydrocarbon in gaseous, liquid or solid state, occurring naturally, and whether or not in the form of a mixture;
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> (f) 'royalties' means:
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> (i) royalties on petroleum payable to the State of Queensland;
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> (ii) the amounts payable to [A.E.L.] pursuant to paragraph (1); and
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> (iii) amounts (if any) payable to International Oil Lease Services pursuant to [the agreement creating the royalty in favour of that corporation].

When originally published, the order made no mention of royalties, and treated lifting expenses differently. After its publication, the parties went back to his Honour, seeking amendments to reflect more closely the evidence. He permitted some of the amendments sought, with the result set out above.

As mentioned, the judgment touched upon a number of matters of interest which I will deal with separately.

The Meaning of Industry Terms

The letter agreement between A.E.L. and Lennard is very brief, to say the least. It uses expressions such as 'net profit revenue interest', 'overriding royalty interest' and 'payout' with no explanation as to their intended meaning. In the face of an apparent ambiguity as to their meaning, McPherson J. admitted evidence of industry usage. The Third

Parties, who were arguing that the agreement was void for uncertainty because of these expressions, called as their witnesses Dr. C. J. Meyers and Mr. R. C. Nicholls. The former is a leading text writer and practising attorney in the United States in the field of oil and gas law, and the latter a solicitor in Sydney prominent in this industry and indeed in this Association. Both gave evidence that those terms were capable of a number of meanings, and therefore had no precise or ascertainably certain meaning. Their evidence was not accepted, on the basis that neither had, by active participation in the industry itself, acquired personal knowledge of the sense in which the terms in question are used and understood in the trade.

A.E.L. called as its witnesses two businessmen having extensive experience in the Australian petroleum exploration industry. Of their evidence, his Honour said the following[3]

> For both of them the terms 'royalty' and 'payout' have recognised meanings in industry circles. 'Royalty' means an interest in revenue from oil production and, when expressed as a percentage, means a percentage of the well head value of the petroleum (or gas) recovered. According to Mr. Allen, the well head value (a term used in s.40A of the Act) is the market or selling price of the petroleum or gas less the costs of transporting it to the refinery. Those costs include field gathering costs; that is, the costs of running the commodity from the wells into storage tanks and then into the pipeline; and pipeline tariffs or trucking costs to the refinery. Lifting expenses, being the costs of bringing the petroleum to the surface, are not brought into account in calculating well head value, nor are earlier exploration costs.
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> Both Mr. Allen and Mr. Siller agreed that 'payout' refers to the time at which the total revenue from the production well is sufficient to balance the expenditure in bringing the well into production; that is to say, the cumulative costs of exploration and outlays on plant and equipment are charged against accumulated revenue after allowing for normal operating costs associated with producing the oil or gas. Once equilibrium is reached between expenditure and gross revenue from sales of oil and gas payout has arrived. Thereafter the 'net profit interest' or 'net profit revenue interest' becomes payable. It represents a percentage (where so expressed) of the difference between accumulated revenue and accumulated costs. Revenue in this context is the gross sales value of the product; costs comprise all exploration costs, costs of plant and other capital items, and normal operating costs — in short, the same items of expenditure as are brought into account in determining whether payout has arrived. New items of capital expenditure are not amortized but are charged into the accumulated expenditure calculation as they arise.
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> The expression 'net profit revenue interest' is not one that Mr. Siller has encountered in its undefined form in any agreement. However, Mr. Allen, who, as well as being a practising accountant, is the commercial manager for the Moonie Oil group of companies, was conversant with the expression in its 'raw' state. One of those companies is a payer under an agreement for such an interest in favour of Australian Oil & Gas; and the group is also a recipient of royalties from various other companies in Australia. I have no hesitation in accepting Mr. Allen's evidence and in finding that each of the expressions referred to in the letter agreement does possess a definite meaning current in the industry.

On the basis of that evidence his Honour found himself able to make the orders which are set out above.

With respect to his Honour, A.E.L. might consider itself extremely lucky to have obtained these orders. Most lawyers familiar with the petroleum industry will have seen royalty or net profit interest agreements

3 McPherson J. judgment (unreported), 18–20.

where 'overriding royalties' and 'net profit interests' are calculated on a basis different to that set out in his Honour's order. Such different bases would of course produce different results in calculating amounts payable, which strongly suggests that the meaning of these terms without additional explanation is unclear, and that they are therefore uncertain. Indeed the evidence of Dr. Meyers and Mr. Nicholls, irrespective of whether or not it should have been admitted, made clear that there are different ways of calculating these interests. One of A.E.L.'s witnesses, Mr. Siller, conceded that although he was familiar with the expression 'net profit revenue interest', he had never seen it used without a precise definition.

An example of a common difference from his Honour's formulation relates to amortisation. In calculating the net profit revenue interest, later capital expenditure is not amortised but expensed in his Honour's formula. It is common in such agreements for capital expenditure to be amortised. This could make a substantial difference to what is paid and when.

The end result of his Honour's decision might be considered just, but a prudent lawyer would take no comfort from his Honour's ability to define with great precision the meaning of these terms. This case was almost a very expensive lesson for A.E.L., on the desirability of precise definition in the creation of interests involving mining and petroleum tenements. It is no doubt a common occurrence, particularly when no commercially exploitable discoveries have been made on an exploration tenement, for interests to be assigned or created with a minimum of documentation and precision. It is understandable, although not condonable, that in such circumstances executives of small companies do not perceive a need to resort to expensive lawyers. However, the evidence in this case, if not the result, shows that without precise definition of the intended meanings of the parties for such expressions, an agreement creating such an interest may well be uncertain and therefore void.

This case is not the first occasion in which a court has struggled against the odds to give meaning to a poorly expressed net profit interest obligation. In *Hammond v. Vam Limited*[4] the New South Wales Court of Appeal held that the expression 'an interest equal to 4 per centum (4%) in any or all mining operations conducted on the area or any part thereof resulting from the interest of Vam by virtue of this Agreement' was not so vague or indefinite as to be void for uncertainty. This was an even more extreme case than the one presently under review of a court going to extraordinary lengths to avoid a finding of uncertainty. The Court of Appeal held that the holder of the interest was entitled to 4 percent of Vam Limited's net profits from mining operations. It did not, however, define 'net profit'. Given the renowed skills of many accountants advising mining companies, one wonders how the parties ever managed to determine what was meant by 'net profit'. This leaves open the potential for enormous arguments about what should or should not be taken into account; for example depreciation and amortisation, and at what rate, write-offs of expenditures, *etc.* A thousand accountants could produce a thousand different results, each of them justifiable.

4 [1972] 2 NSWLR 16.

It has been pointed out in other reviews of this case that it is not a precedent raising those expressions to the state of terms of legal art, because their meaning was arrived at by reference to expert evidence, and that the meaning could be changed by different documentation or different expert evidence.[5] This must be correct, but the fact that one could contemplate different expert evidence leading to a different meaning for these terms itself suggests that they can have many meanings, and that without definition they are uncertain.

Nevertheless, if nothing else his Honour has provided us with a useful definition for use in future agreements.

The Expectation of Renewal of an ATP

His Honour's judgment considered at some length the practice of the Minister in renewing ITP's, and the legal nature of ATP's and expectations of renewal. During the case he received evidence as to the practice of the Minister in considering applications for renewal from the businessmen referred to earlier and from the senior petroleum engineer in the Queensland Department of Mines. He found that, although the matter of renewal of an ATP lies within the discretion of the Minister, the holder of an ATP, if he applies during its currency and if he has performed his exploration and other obligations imposed by its terms, can in practice confidently expect that it will be renewed.

His Honour was concerned as to the statutory authority for the Minister's practice in renewing ATP's. His precise reasoning is beyond the scope of this paper, but he held that, notwithstanding that there was no apparent authority in the Petroleum Act, the Minister's practice of renewing ATP's was authorised by statute.

McPherson J. analysed precisely what rights to renewal the holder of an ATP had. He noted that renewal of an ATP is clearly a matter for the discretion of the Minister, and that no right of renewal exists. He held that an applicant for renewal did, however, have the right to have this application considered on its merits.[6] This right, he held, is a right which is capable in appropriate circumstances of protection by injunction, or declaration. He characterised this as a right which might be likened to a right of first refusal. It gives to the holder of an ATP, he held, the ability to prevent the ATP or the area subject to the ATP from being opened to public tender, and thus to exclude others until his own application to renew is considered by the Minister on its merits. This, he found, is a valuable right, and one which falls within the description 'entitlements of the holder under this Act', which makes it a right which is capable with the Minister's consent of being transferred under the Act.

This finding is of importance to one of the main questions in the case, namely what was the subject matter of the letter agreement, but it is also important generally as a clear statement of the extent of the rights of renewal of the holder of an ATP.

5 J. R. Forbes 'AEL Appeal Dismissed, Interpretation Headaches Remain' (1986) 5 *AMPLA Bulletin* 42.

6 McPherson J. 15; and see *Wade v. New South Wales Rutile Mining Co.* (1967) 70 SR (N.S.W.) 227, 236 and on appeal 121 CLR 177, 199.

The Subject Matter of ATP Assignments

The agreement being considered by McPherson J. stated that it was a farmout proposal 'as regard to ATP 235P, Area 1, 7,557,800 acres in Queensland, Australia'. Counsel for A.E.L. argued that the true subject matter of the agreement was the area of land covered by the ATP. In support of this contention, he referred particularly to the reference to the number of acres in Queensland. As mentioned earlier, the third parties submitted that the subject matter of the agreement was nothing more than ATP 235P, which of course had come to an end on 31 December 1980.

McPherson J. held that neither approach was correct. He stated that the intention of the parties was not to farmout an instrument, nor the land itself. A.E.L. had no legal interest in the land, nor in the petroleum under it, and it could acquire no such interest until a lease was issued following a discovery of payable deposits of petroleum.

His Honour held that the subject matter of the assignment was the rights in respect of the land conferred by the ATP. The principal right conferred is of course the right to explore and prospect, coupled with the right to obtain a lease if payable deposits of petroleum are discovered. However, there were also secondary rights held by A.E.L., and in particular the right to have an application for renewal considered on its merits and the right analogous to a right of first refusal, referred to above. These rights, he held, were also the subject matter of the assignment.

The Parol Evidence Rule, and Expert and Extrinsic Evidence

It is not a matter of practical significance to mining and petroleum lawyers, rather a matter of academic significance to litigation lawyers generally, but McPherson J., and indeed the Full Court on appeal, considered in detail the role of the parol evidence rule and expert and extrinsic evidence. McPherson J. admitted into evidence a great deal of background evidence about the petroleum exploration industry, and in particular the time frames and cost of exploration activities. This evidence was important in his ultimate decision that the intention of the parties was that the overriding royalty obligation would continue beyond the exploration of ATP 235P.

The evidence admitted by his Honour concerned not only extrinsic or background evidence, but conduct of the parties and documents prepared by them subsequent to reaching the agreement. These were admitted for the purpose, which his Honour held was permissible, that it is possible for a party to make an admission that a contract exists, and that particular terms form part of it.[7] Thus he admitted subsequent evidence of what was in effect admissions of mixed fact and law, and held that Lennard knew at the time that the agreement was made that it was intended to extend to renewals of ATP 235P and not to be confined simply to the original term ending on 31 December 1980.

7 McPherson J. 33; and see *Lustre Hosiery v. York* (1935) 54 CLR 139–143, *Allen v. Roughley* (1955) 94 CLR 98, 141–142, *Grey v. Australian Motorists and General Insurance Co.* [1976] 1 NSWLR 669, 684–685 and *Jones v. Sutherland Shire Council* [1979] 2 NSWLR 206, 231–232.

Royalty Commitments Interpreted Through Industry Standards

The admission of evidence of subsequent conduct of Lennard was not the only method by which McPherson J. reached the conclusion that on the proper interpretation of the agreement it was intended to grant a royalty out of any petroleum discovered after the expiration of the ATP. At the time that the agreement was executed, it had just 20 months to run. It also specified a relatively modest level of exploration expenditure to be undertaken by Lennard.

His Honour heard extrinsic evidence as to the nature of petroleum exploration activities, the time frames in which they can be carried out, and their cost. The exploration commitments in the agreement were not nearly sufficient to drill even a single well, and although it was possible for a well to be drilled during the currency of ATP 235P, as in fact occurred, it was unlikely that the parties would reach a bargain providing for a royalty which was solely dependent upon one well which might or might not have been drilled before the expiration of the tenement.

Lennard was forced to concede that if oil had been discovered prior to 31 December 1980, but a lease not granted until after that date, a royalty would still have been payable, because upon discovery of a payable deposit of oil a right to be granted a lease came into existence. Having extracted that concession, McPherson J. then held that it was not logical to exclude other scenarios; for example, if oil was discovered on 2 January 1981 at the bottom of a well which was commenced during the currency of ATP 235P. He noted that on any view of the matter the royalty obligation required the issue of a further title, because petroleum could not be produced under an ATP: a lease was necessary.

His Honour held that, given the nature of the industry, the parties must have intended that the royalty was payable on petroleum discovered under a renewal of the ATP. This approach is undoubtedly more palatable to those familiar with the rules of evidence, than relying upon evidence of subsequent conduct constituting admissions as to the terms of a contract.

The Effect of the Surrender of the ATP

Lennard and the third parties also argued that, even if on the proper interpretation of the agreement the royalty was payable on petroleum discovered under a renewed ATP, the fact that in this case the ATP was actually surrendered broke the chain of title, and accordingly ATP's 299P and 298P were not renewals of ATP 235P, and no royalty was payable.

A.E.L. argued that by subsequent agreement the method of performance of the original agreement had been varied, and that the intention of the parties was that the royalty would apply equally to new ATPs granted after surrender. Lennard and the third parties pointed out that the two new ATPs were quite distinct from ATP 235P, in that they were in respect of different areas, different periods of time, contained different conditions, and involved different persons as the holders.

His Honour held that these facts flowed naturally from the agreement, and were foreseeable at the time, and therefore afforded no basis in law for concluding that Lennard was thereby freed of its obligation

to pay the royalty. He held that although the new titles were different, they nevertheless had their roots in ATP 235P.

Proprietary Nature of Royalties and NPIs

One very interesting and important issue which was touched upon by McPherson J. in his decision, but which has not yet been satisfactorily resolved, is the proprietary nature of a royalty or net profit interest.

The decision ultimately turned upon A.E.L.'s contractual rights against Lennard. However argument was put that the matter should be decided on the basis of equitable rather than contractual rights. This raises the question of whether or not a royalty or net profit interest is proprietary in nature, and whether the grant or transfer of such a right constitutes a dealing in the tenement which is void without Ministerial approval. This is a question which is of great importance to those drafting agreements which create such interests. There are both positive and negative aspects to either answer. If the creation of such an interest is not a dealing with the tenement, but merely the creation of a contractual obligation, then the agreement does not need to be submitted for Ministerial approval. If, however, it does constitute a dealing, and is accordingly submitted for approval and registered, then the right would appear to be proprietary in nature and to be enforceable against subsequent assignees.

McPherson J. agreed with the argument that a farmout agreement for an ATP constituted an assignment of fractions of the rights under the ATP, which gave rise to rights which are at least equitable in nature.

He then distinguished between rights under the ATP and the agreement for a royalty and net profit interest. He categorised the agreement for a royalty and net profit interest as an agreement for valuable consideration to assign a contingency in the form of the sales proceeds of petroleum if discovered in the future. Thus he was of the view that to some extent they were proprietary in nature. He stated:

> The expressions used in defining those interests in the latter agreement are 'grant' and 'retain', and the royalty interest is described as 'overriding': which tends to suggest an element of priority and therefore of proprietary rights: cf. *Clements* v. *Matthews* (1883) 11 Q.B.D. 808; *Re Trytel* [1952] 2 T.L.R. 32. On that footing, it operates in equity as an equitable assignment when the future property comprising proceeds of petroleum sales in fact come into existence: *Tailby* v. *Official Receiver* (1888) 13 App.Cas. 523, 550. At that point the royalty owner or assignee acquires an equitable charge on those proceeds, and to that extent the lessee (as the assignor will by then have become) under the petroleum lease becomes trustee for the assignee.

Thus his Honour characterised the royalty and net profit interest as an assignment of future property, creating a charge over the proceeds from sales of any petroleum discovered.

This approach has some definite attractions, in that it gives the holder of an overriding royalty some security for his interest. However this approach must be subject to two caveats: first, it could only arise in particular circumstances, and would not apply to every royalty; and secondly, it is submitted that his Honour's analysis requires far greater consideration and deliberation than was possible in this case.

On this latter point, the purpose of this analysis was to determine whether the principle of *Re Biss*[8] applied to the relationship between A.E.L. and Lennard. That principle, which applies where a fiduciary relationship exists and in other special relationships,[9] holds that a renewed lease or other addition to property is held on the same terms as the lease or property from which it is derived. His Honour noted that there were decisions in the United States to the effect that the holder of an exploration lease may be constructive trustee for a royalty holder of a renewal that he obtains[10], but decided that it was not necessary for him to decide this question in these proceedings.

It does not follow, however, that even if a royalty obligation creates equitable rights, they can attach to the title (as appears to have been assumed by his Honour). The English cases to which he referred might certainly stand for the proposition that the effect of the royalty and net profit interest agreement is to create a charge over sales proceeds when they come into existence, but those sales proceeds are rights or property which come into existence because of a subsequent contract of sale. They do not flow from the ATP or from a production lease.

His Honour apparently did not consider the more traditional form of royalty, where petroleum is taken in kind. Where this occurs, the property which would be subject to the charge arises not because of subsequent contractual rights, but from statutory rights. There is a stronger argument in such a circumstance that the royalty agreement is a dealing in the title.

The other reason why this decision could not have universal application is that it would depend upon the instrument which creates the overriding royalty using words which established an intention to create proprietary rights. It is easy to frame a royalty obligation in such a way that it is clear that the right is purely contractual, and therefore in no way subject to Ministerial approval. For example, the agreement could simply contain a covenant to pay a sum of money, equivalent to a percentage of the well head value of any petroleum discovered in commercial quantities and lifted and sold. Such a covenant, it is submitted, clearly does not of itself constitute a dealing with the tenement, and therefore does not need Ministerial approval.

An interesting recent development has been the use of a charge registered under the Companies Codes over the tenement in question and any future tenements granted in relation to the subject area of the tenement, securing the contractual obligation created by a covenant of the type just referred to. In this way the holder of the net profit interest seeks to attach the contractual covenant to the title and any subsequent titles, and thus to enforce it against subsequent holders of the titles.

This question of whether a royalty or net profit interest can be proprietary in nature and attached to the title remains unresolved, but it is

8 [1903] 2 Ch. 40.

9 *Chan v. Zacharia* (1984) 58 ALJR 353; *Rakestraw v. Brewer* (1728) 2 P. Wms. 511, 24 ER 839; and *Leigh v. Burnett* (1885) 29 Ch. D. 231.

10 *Oldland v. Gray* (1950) 179 F. 2d 408, 414; *Dabney-Johnston Oil Corporation v. Waldon* (1935) 52 Pac. 2d 237, 244–245.

interesting to note instances recently of the Department of Mines in South Australia accepting for Ministerial approval and registering an agreement which did no more than create a net profit interest. The Department was clearly of the view that the agreement constituted a dealing in the tenement.

Conclusion

In summary, this case is one of substantial interest to mining and petroleum lawyers, providing to some extent at least a judicial determination of concepts and expressions frequently encountered in this industry. However there remain unresolved issues concerning overriding royalties and net profit interest payments which could be of great significance in the future.