

THE SUSPENSE IS KILLING ME,
An Overview of the Law Applicable to the Suspense of
Oil and Gas Proceeds; Rights and Remedies of the
"Suspendor" and "Suspendee."

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I. Introduction

Article was originally written in 1991, about seven (7) years after the original Texas Division Order statute came into effect. At the time there was little interpretive caselaw. Most of what could be said about the statute was either based upon an analytical reading of its language or evaluation of its legislative history. The legislative history, in turn, was less than helpful given that the statute was born of so many compromises between two entrenched camps – the royalty owners on the one hand and producers and purchasers on the other.

Now, twenty-four (24) years after enactment, we still have only sparse interpretive case law and many of the conflicts and inconsistencies in the statute remain. Despite these facts, the most apocalyptic predictions of the issue advocates from two camps have failed to materialize. For the most part subsequent amendments of the statute have focused on expanding provisions intended to deal with the ever more pronounced problems resulting from fractionalization of minerals and royalties.

Since the development of the major pipeline systems, royalty owners and leasehold owners have been regularly embroiled in conflicts with oil and gas purchasers regarding oil and gas proceeds held in suspense. Likewise, non-operating working interest owners have waged wars against lease operators under the watchful but not always impartial scrutiny of third-party purchasers due to the suspense or setoff of oil and gas proceeds attributable to the non-operator's interest in an oil and gas lease. Surprisingly, there are very few reported cases documenting these battles. This paper addresses the rights and remedies of parties to various oil and gas relationships whose funds are placed in the limbo which is commonly known as "suspense." As many "suspendees" can attest, the frustration and hardships resulting from suspense of funds can often lead to irreconcilable conflicts between parties. The following materials will attempt to discuss the various statutory, contractual and common law doctrines relating to suspense of proceeds and the pitfalls for those in the position of determining whether to place funds in suspense.

¹ This article was originally written with the assistance of Raymond E. Galloway who was then an associate of my former law firm. Ray has gone on to now serve as general counsel of a San Antonio based independent producer. The updating of this article for publication at this seminar was accomplished with the able assistance of David Navarro, an associate with my present law firm, who is, likewise, destined for greater things.

II. Authority to Suspend Proceeds

A. Statutory Authority Under The Texas Division Order Statute

The Texas Division Order Statute² was originally enacted in 1983 to provide a statutory remedy for non-payment or late payment of oil and gas proceeds by a purchaser or operator. Under the statute as originally enacted, a "payor" (defined by the statute to be the party who undertakes to distribute oil and gas proceeds, whether as purchaser, operator or lessee) was and is obligated to make payments for production within certain time limits or become liable for interest and attorney's fees. The statute also identifies the circumstances in which a purchaser is authorized to withhold or suspend payments without incurring liability.

In 1991 the State of Texas substantially amended the statute and adopted statutory provisions governing the use of division orders. The 1991 provisions augmented the pre-existing 1983 statute that governed the obligations of payors, who could be either purchasers or producers, in making payments to royalty owners or payees in Texas. Under the 1991 amendments, a purchaser or payor became authorized to require execution of a Tex. Nat. Res. Code Ann. §§91.401-91.406 (Vernon 1999 and Supp. 2006) division order as a pre-condition for payment of proceeds from the sale of oil and gas. Prior Texas law regarding whether a division order could be required was confused at best, with most cases indicating that a division order could not be required. The division order which a purchaser can compel a payee to sign under the Code may either contain the provisions listed in §§91.402(c)(1)(A)-(G) or if it is an oil division order it may be substantially in the form set out in §91.402(d). The statute also legislatively defines "market value", "market price" and "prevailing price in the field" for purposes of clarifying the terms of royalty settlement under an oil and gas lease or division order.³

Under the Division Order Statute, as amended in 1991, in the absence of a statutorily prescribed excuse, a payor is required to distribute proceeds on or before 120 days after the end of the month of first sales of production from a well and thereafter subsequent distributions must be made no later than 60 days after the end of the calendar month in which subsequent oil production is sold or 90 days after the end of the calendar month in which subsequent gas production is sold.⁴ A payor is authorized to suspend or

² Tex. Nat. Code Ann. §§91.401-91.406 (Vernon Supp. 2006).

³ The extent to which this provision legislatively affects the Texas Supreme Court rulings in Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981) and Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968) is discussed in 1 E. Smith & J. Weaver, Texas Law of Oil & Gas, §6.5(C)(1992). Notably, however, the notional "division order shield" garnered from Middleton has been vitiated somewhat and an unjust enrichment exception has been carved out to allow revocation of a division order where: (a) an operator prepares erroneous division orders, (2) which error leads to underpayment to an interest owner, and (3) results in unjust enrichment of the operator who profits at the expense of the royalty holder. See Gavenda v. Strata Energy, 705 S.W.2d 690 (Tex. 1986); but see also Coastal Oil & Gas Corp. v. Roberts, 28 S.W.3d 759, 763 (Tex. App. – Corpus Christi 2000), reh'g granted in part (Mar. 21, 2002), judgment set aside (Mar. 21, 2002) (Note: The Texas Supreme Court accepted Coastal's Petition for Review, and the parties briefed the case, but settled it, leaving the Court of Appeals' decision standing.)

⁴ Tex. Nat. Res. Code Ann. §91.402(a)(Vernon Supp. 2006).

withhold proceeds beyond those time limits without becoming liable for interest when there is:

- (i) a dispute concerning title which would affect distribution of payments; or
- (ii) a reasonable doubt that the payee has sold or authorized sale of its share of oil and gas or that he has clear title to the interest in the oil and gas production; or
- (iii) a requirement in a title opinion that places in issue the title, identity or whereabouts of the payee and that has not been satisfied by the payee after a reasonable request for curative information; or
- (iv) a refusal by a payee to execute the statutorily prescribed form of division order.

In the event proceeds are not timely paid or are improperly withheld, the payee is entitled to recover the amount of delinquent proceeds plus interest at the rate of 2% above the rate charged to depository institutions by the New York Federal Reserve Bank plus reasonable attorney's fees. Unless a different rate of interest is specified in a written agreement between payor and payee. Thirty (30) days prior written notice is required before a payee may institute a suit to recover delinquent payments and the suit may be brought by a payee in the county where the well is located.⁵

A decision to suspend in light of any of the four statutorily defined circumstances should protect a first purchaser from liability for the statutory penalties. However, there may be other considerations such as penalty or termination provisions in the oil and gas lease or other ancillary agreements which may create liabilities separate and apart from statutory liabilities. It seems unlikely that the statute would negate an otherwise valid contractual provision and the relevant agreements should be consulted in any event before making a decision to suspend payment.

B. Contractual Authority - The Oil and Gas Lease

1. Express provisions

The royalty clause of an oil and gas lease may contain specific provisions concerning the payment of royalties which could bear upon the issue of whether to suspend payments. For instance, a lease may contain a provision authorizing suspense under various circumstances or, more likely, a deposit of disputed royalties into an interest-bearing account pending resolution of the issues giving rise to the payment issue. The decision regarding whether to suspend or pay is relatively easy when the circumstances authorizing suspense are sufficiently clear. More difficult questions arise surrounding lease clauses which mandate payment at specific times and place a purchaser

⁵ Tex. Nat. Res. Code Ann. §91.404 (Vernon Supp. 2006).

or operator in peril of breach of lease if payment is not made. It is fairly common to see a form of lease which requires that payments commence within thirty or sixty days of first production and also stipulates that the lessors are not required to execute division orders. Such a provision is obviously directly at odds with the provisions of the Texas Division Order Statute.⁶ The effectiveness of such a provision is subject to question and royalties may nonetheless be subject to suspense under the statute; however, it is also possible that the Courts would find the lease provision to be enforceable under §§91.402(c)(2) and (h) in spite of the conflicts with the statute. Additionally, some oil and gas lease royalty clauses may provide for automatic lease termination, or an election by the lessor to terminate a lease if royalty payments are withheld after written notice and a demand to cure the delinquent payments is issued by lessor. Failure to respond or the continuation of an unjustified suspense after demand from a lessor under a termination-for-breach provision in an oil and gas lease could prove to be very costly to a careless lessee.⁷

Coastal Oil & Gas Corp. v. Roberts⁸ construes a provision of a mineral lease which allows a lessor to terminate the lease for failure to pay royalties. Payment of royalties under the lease was expressly governed by a clause in the lease which provided that “Royalties and other payments for production shall be due and owing to Lessor within 120 days from the month following the month in which the production for which the royalties or payments are to be made are sold and delivered. If Lessee wrongfully or unreasonably withholds any such payment or payments due to Lessor for a period of thirty (3) days after written demand for payment is made by Lessor on Lessee at the above address..., at the election of Lessor this lease may be terminated.”

Coastal drilled a gas well on November 19, 1997. A few days later, Coastal sent division orders to all mineral interest owners with a letter that stated that Coastal would pay royalties to the interest owners upon receipt of the completed division order. Several of the lessors did not return a signed division order to Coastal. Under the terms of the lease, royalties were due on March 19, 1998 (which was 120 days from the date of first production). The non-signing lessors sent a demand letter to Coastal and when the demand letter was not satisfactorily responded to, the non-signing lessors terminated the lease. The trial court granted the non-signing lessors’ motion for summary judgment and Coastal appealed.

The Appeals Court affirmed the trial court’s judgment and held that the termination of an oil and gas lease could only occur if there was a breach of a special limitation or condition subsequent. Non-payment of royalties is usually considered a breach of a covenant which will subject a party to liability for damages, but not lease termination, unless the lease includes a clause which makes nonpayment of royalties a breach of a special limitation or condition subsequent. Coastal argued, in part, that it had withheld the payment of royalty pursuant to Section 91.402(c)(1) and therefore it was not wrongfully or unreasonably withholding payment and because the lease expressly stated

⁶ Tex. Nat. Res. Code Ann. §91.402(c)(1)(Vernon Supp. 2006).

⁷ Sowell v. Natural Gas Pipeline Co., 789 F.2d 1151, 1156 (5th Cir. 1986).

⁸ Coastal Oil & Gas Corp. v. Roberts, 28 S.W.3d 759, 763 (Tex. App. – Corpus Christi 2000), reh’g granted in part (Mar. 21, 2002), judgment set aside (Mar. 21, 2002)

that royalty payments that were withheld pursuant to any law, order directive or regulation of any government or regulatory body having jurisdiction would not be considered wrongful or unreasonable.

Under Section 92.402(e), if a division order contains provisions in addition to any statutorily permitted provisions, the lessee cannot withhold payment solely because the lessor refuses to sign the division order. The non-signing lessors asserted that they did not sign the division order because it contained an unauthorized provision regarding indemnification. Section 91.402(c)(1) permits lessees to require signed division orders from lessors, but only with certain standard provisions. One of the provisions a lessee may include is an agreement that the lessor will indemnify the lessee for payments made to the lessor, if the lessor does not have merchantable title to the production sold unless otherwise agreed. The lease was expressly made without warranty of title. Therefore, the non-signing lessors had otherwise agreed not to indemnify Coastal with respect to title. The Appeals Court ruled that Coastal's division order did not comply with Section 91.402(c)(1) and accordingly, Coastal could not withhold payments based on that statute.

2. Title defects

As discussed above, under the Texas Division Order Statute, a purchaser may suspend payments to a payee where there is "a dispute concerning title that would affect distribution of payments."⁹ A provision authorizing suspense of payment in the event of title disputes or deficiencies is generally also included in most forms of division order and suspense of payment has been the traditional response to title defects or disputes. Notwithstanding these provisions, a purchaser may not suspend payments in every ownership dispute, without subjecting itself to a possible claim for breach of the oil and gas lease contract, or a claim for interest under the statute.

Williamson v. Mobil Producing Texas & New Mexico, Inc.,¹⁰ was a lawsuit by the lessors under an oil and gas lease against their lessee for breach of contract for failure to pay royalties. The well in question was located on other lands owned by third parties and the Williamsons were owners of a non-site pooled tract. After production commenced, the Williamson lessors executed division orders to a separate unrelated corporation which was purchasing oil from a unit well. The payment question arose as a result of the filing of a separate bad faith pooling action by the drillsite lessors against Mobil and others. After suit was filed Mobil decided to place all royalties in suspense pending the outcome of the litigation and the Williamson lessors sued for unpaid royalty. In considering whether Mobil had the right to suspend payment the Court reviewed the nature of the dispute and found that with regard to the Williamson lessors, there was no "title dispute" because it was undisputed that the plaintiffs owned title to the lands covered by their lease. The royalty and pooling clauses of the Williamson lease were found to be determinative of Mobil's payment obligations regardless of the dispute regarding effectiveness of the pooled unit as to the drillsite owners. Further, the Court

⁹ Tex. Nat. Res. Code Ann. §91.402(b)(1)(Vernon Supp. 2006).

¹⁰ Williamson v. Mobil Producing Texas & New Mexico Inc., 737 S.W.2d 917 (Tex. App. – Beaumont 1987, writ denied).

held that the Williamsons' execution of the division orders to a separate corporation did not diminish the obligations and covenants of the lessee to pay royalties to the Williamsons from the pooled unit. Accordingly, the court held that there was a material fact issue concerning a possible breach of the express covenants and agreements in the lease which precluded the granting of a summary judgment in favor of the lessee. This case illustrates that a lessee or purchaser cannot unilaterally suspend royalties unless there is a title dispute which questions the title of the "suspendee" in the specific property through which the "suspendee" claims his interest, irrespective of any pooling or unitization.

A similar principal is illustrated in Northern Natural Gas Co. v. Vanderburg,¹¹ which was decided under the Texas Division Order Statute prior to the 1991 amendments. In the Vanderburg case, the lessor under an oil and gas lease sued the purchaser of casinghead gas from the leased premises under the Division Order Statute for wrongfully withholding payments for casinghead gas produced from two oil wells located on the leased premises. The purchaser had suspended all payments due to a title dispute between the leasehold owner of the oil and casinghead gas rights and a separate leasehold owner of the gas rights under the lease. The court found that although there was a valid title dispute between the owners of the leasehold rights, there was no question that Vanderburg, as Lessor, was the legal owner of all of the royalty reserved under the oil and gas lease. Therefore, the purchaser was not entitled to suspend the lessor's royalty payments due to a "title dispute" which did not pertain to the lessor's title.

There are numerous other situations which a purchaser must face on a daily basis that are loosely characterized as title problems. For example, a purchaser will generally suspend payments to a deceased interest owner after receiving notification of the death from a representative of the decedent's estate. A purchaser will be entitled to suspend payments for some period of time due to uncertainty over the identity of the successors in interest, and will generally continue to suspend funds until an executor or administrator is appointed on behalf of the estate. The personal representative of the estate will then execute a new division order on behalf of the estate directing the manner in which future payments are to be disbursed.¹² Quite often, litigation involving an interest owner results in demands by an opposing party that a party's proceeds be placed in suspense. A purchaser should be authorized to suspend payments when notified of a lawsuit which questions the title or ownership of proceeds of an interest owner. But it would generally be inappropriate for a purchaser to suspend payments when the claim involved in the lawsuit is merely one for the recovery of money damages unless the purchaser were

¹¹ Northern Natural Gas Co. v. Vanderburg, 785 S.W.2d 415 (Tex. App. – Amarillo 1990, no writ). See also Browning Oil Company, Inc. v. Luecke, 38 S.W.3d 625 (Tex. App.—Austin 2000, no pet.) (holding that since there was no dispute with respect to the payees' *entitlement* to royalties, the Code did not excuse lessees from paying prejudgment interest where there is no legitimate title dispute, but rather a dispute as to *how* to calculate the payees' royalties).

¹² Tex. Prob. Code Ann. §370 (Vernon 2001).

somehow exposed to liability for making payment and in the absence of an injunction,¹³ pre-judgment attachment or other similar order.

III. Security Interests. Liens and Competing Lien Claims

A. Voluntary Liens and Security Interests Under Deeds of Trust. Mortgages and Other Security Instruments.

1. Deeds of Trust and Security Interests in Oil and Gas Financing Transactions

A deed of trust lien is generally created by the execution of a contract by a borrower in favor of a lender whereby the borrower pledges real property as collateral to secure payment of a note or other indebtedness owed to the lender. Most deeds of trust applicable to mineral financing also include a security agreement covering the equipment and other personal property of the borrower which is located on the pledged real property. This separate "security agreement" creates a security interest in the equipment and personal property of the borrower in favor of the lender and attaches to the property at such time as (i) the borrower has signed a security agreement which describes the collateral; (ii) value has been given; and (iii) the borrower has rights in the collateral.¹⁴ The deed of trust is then filed for record in the public records in the county in which the real property is located in order to perfect the deed of trust lien and give notice of the existence of the lien.¹⁵ The security interest in severed oil and gas production and production accounts is perfected by the filing of a financing statement in the office of the county clerk where a mortgage on real property would be filed.¹⁶ A financing statement gives notice of the name and address of the lender and borrower, describes the items of the collateral and the real property involved, and is thereafter executed by the debtor. The financing statement covering production and production accounts; in connection with financing, is sometimes included within a deed of trust.¹⁷ As a practical matter, a separate financing statement is also filed in the secretary of state's office in order to perfect the security interest in equipment and other personal property located on the pledged real property.¹⁸

Notice of the existence of a deed of trust, when given to a purchaser of production, would not necessarily authorize a suspense of proceeds since, in this day and age, the deed of trust is a very common form of security tool. In order to determine

¹³ Cf. Recon Exploration, Inc. v. Hodges, 798 S.W.2d 848, 851 (Tex. App. – Dallas 1990, no writ); Bank of the Southwest N.A. Brownsville v. Harlingen Nat. Bank, 662 S.W.2d 113, 116 (Tex. Civ. App. – Corpus Christi 1990, no writ).

¹⁴ Tex. Bus. & Com. Code Ann. §9.203 (Vernon 1991 & Supp. 2006).

¹⁵ Tex. Prop. Code Ann. §§11.001, 13.001, 13.002 (Vernon 1984 & Supp. 1993).

¹⁶ Tex. Bus. & Com. Code Ann. §9.501(a)(2)(Vernon 2006).

¹⁷ Accordingly, the security interest is probably perfected by filing the deed of trust in the real property records, without the need for a separate filing in the county UCC records. Tex. Bus. & Com. Code Ann. §§9.501(a), 9.502(e)(Vernon 2001).

¹⁸ For an excellent discussion of the requirements for creation, perfection, priorities and enforcement of deed of trust liens, security interests and other types of liens affecting oil and gas transactions, see Rodgers, Liens Affecting the Oilfield (Including Priorities and Enforcement), State Bar of Texas, Tenth Annual Advanced Oil, Gas and Mineral Law Course, Paper D (1992).

whether a deed of trust may authorize a purchaser to suspend oil and gas runs, it is necessary to examine the provisions of the instrument together with any demand made by the lender. The demand from a lender may request that payments be suspended, or that payments be made directly to the lender. Although uncommon, it is possible that a deed of trust may contain a provision appointing the lender, or a trustee for the lender, as attorney-in-fact on behalf of the borrower to direct suspense of proceeds or the manner in which proceeds should be disbursed. A purchaser must examine the deed of trust to determine the authority of the attorney-in-fact prior to suspending proceeds or making an alternative allocation, since powers of attorney are strictly construed.¹⁹

A more common provision contained in a deed of trust is an express assignment of production which is a separate right granted to a lender by the borrower as a further means to insure payment of the indebtedness. Such a provision will generally assign oil and gas production and the proceeds thereof to the lender, since severed oil and gas production is considered personal property, while minerals in place are considered real property.²⁰ The following provision is an example of an assignment of production clause in an oil and gas financing transaction:

ARTICLE III. ASSIGNMENT²¹

3.1 For the purpose of additionally securing the payment of all items of Indebtedness Secured by this Mortgage and to provide an additional means of paying said indebtedness and as cumulative of any and all rights and remedies herein provided for, Grantor hereby TRANSFERS, ASSIGNS, GRANTS, CONVEYS and SETS OVER unto Noteholder, its successors and assigns, all of the following:

(a) All oil, gas, casinghead gas, distillate and other minerals, and the proceeds therefrom, produced and to be produced from the interest of Grantor in the oil, gas and mineral leases, properties, processing plants and interests now or hereafter constituting a part of the Mongaged Properties from and after 7:00 o'clock a.m., on the first day of _____, 200___; and Grantor hereby authorizes and empowers said Noteholder to demand, collect and receive said oil, gas, casinghead gas, distillate and other minerals, and the proceeds therefrom, produced and to be produced from the interests of Grantor in said Mongaged Properties, and to execute any release, receipt, division order, transfer order and relinquishment or other instrument that may be required or necessary to collect and receive such production or the proceeds therefrom and Grantor hereby authorizes and directs all pipeline companies, gathering companies and others purchasing oil, gas or other mineral production from said properties of having in their possession any production from said properties or the proceeds therefrom, to pay and deliver to Noteholder all such production or proceeds therefrom accruing. The payment of proceeds of production to Noteholder by the purchaser

¹⁹ Montgomery v. Nevins, 270 S.W. 2d 427, 430 (Tex. Civ. App. – Austin 1954, writ ref'd n.r.e.); Bean v. Bean, 79 S.W.2d 652, 654 (Tex.Civ. App. – Texarkana 1935, writ ref'd).

²⁰ Lone Star Gas Co. v. Murchison, 353 S.W.2d 870, 879 (Tex. Civ. App. – Dallas, 1962, writ ref'd n.r.e.).

²¹ This form was generously contributed by and is published with permission of International Bank of Commerce, San Antonio, Texas.

of production shall constitute a full and complete release of such purchaser from any and all liability to Grantor to the full extent and amount of all such payments so made. Grantor agrees that all division orders, transfer orders, receipts and other instruments which Noteholder may from time to time execute and deliver for the purpose of collecting or receipting for such production or the proceeds therefrom may be relied upon in all respects, and that the same shall be binding upon Grantor, and Grantor's successors and assigns. Grantor agrees to execute and deliver all necessary, convenient and appropriate instruments, including transfer and division orders, which may be required by Noteholder in connection with the receipt by Noteholder of such production or the proceeds therefrom and to indemnify and keep and hold said Noteholder free and harmless from all parties whomsoever having or claiming an adverse interest in said leases, properties and interests and the production and proceeds therefrom, and in this respect agrees to pay all expenses, costs, charges and reasonable attorney's fees that may be incurred by Noteholder as to any of said matters.

(b) All amounts or proceeds hereafter payable to Grantor or to which Grantor is entitled under all gas sales contracts, all oil distillate or condensate sales contracts, all gas transportation contracts, and all gas processing contracts relating to or now or hereafter to become a part of the Mortgaged Properties.

(c) All amounts, sums, revenues and income which become payable to Grantor from any of the Mortgaged Properties (including after-acquired properties) or under any contract, present or future, relating to any gas pipeline system and processing plant or unit now or hereafter constituting a part of the Mortgaged Properties.

(d) All eminent domain or condemnation award monies which may hereafter be awarded or paid for the condemnation of the Mortgaged Properties, or any part thereof, or for any portion thereof which may be appropriated for any public or quasi-public use, or by virtue of private sale in lieu thereof, and any sums which may be awarded or become payable to Grantor for damages caused by public works or construction on or near the Mortgaged Properties.

3.2 Grantor agrees to execute such transfer orders, payment orders, division orders and other instruments as may be needed by Noteholder or requested by it incident to Noteholder having all assigned payments made direct to it. Grantor hereby authorizes and directs that all such pipeline companies, purchasers, transposers and other parties owing moneys to Grantor under contracts herein assigned, pay such amounts direct to Noteholder as follows:

International Bank of Commerce
Attention: Credit Department
130 E. Travis
San Antonio, Texas 78204

For the Account of _____

and such authorization shall continue until this Mortgage is released. Noteholder is authorized to collect, receive and receipt for all such amounts and no party making payment shall have any responsibility to see the application of any funds

paid to Noteholder but shall be fully protected in making such payment to Noteholder under the assignments herein contained. Should Noteholder bring suit against any third party for collection of any amounts or sums included within this assignment (and Noteholder shall have the right to bring any such suit) it may sue either in its own name or in the name of Grantor.

3.3 In the event that, for its convenience, Noteholder should elect with respect to particular properties or contracts not to exercise immediately its right to receive payment to it direct of the assigned proceeds, then the oil or gas purchasers or other persons obligated to make such payment shall continue to make payment of such proceeds or amounts to Grantor until such time as written demand has been made upon them by Noteholder or Trustee that payment be made direct to Noteholder. Such failure to notify shall not in any way waive the right of Noteholder to place such assignment into effect, as to any payments not theretofore paid out to Grantor before the giving of written notice. In this regard, in the event payments are made direct to Noteholder and then, at the request of Noteholder, payments are, for a period or periods of time, paid to Grantor, Noteholder shall nevertheless have the right, effective upon written notice, to require that future payments be again made to it.

3.4 Independent of the foregoing provisions and authorities herein granted, Grantor agrees to execute and deliver any and all transfer orders, division orders and other instruments that may be requested by Noteholder or that may be required by any purchaser of the production from or of gas or oil or products delivered through any of the Mortgaged Properties to effect payment of the proceeds thereof direct to Noteholder. If under any existing gas sales agreements or products, sales contracts, other than division orders or transfer orders, or under any gas transportation contract, any proceeds are required to be paid by the purchaser or transporter direct to Grantor so that under such existing agreements payment cannot be made for such proceeds of runs to Noteholder in the absence of foreclosure, then Grantor's interest in all proceeds under such sales agreement and in all other proceeds or payments which for any reason may be paid to Grantor shall, when received by Grantor, constitute trust funds in its hands and shall be immediately paid over to Noteholder, if Noteholder has requested that such payments be delivered to it under this assignment.

3.5 Noteholder and its successors and assigns are hereby absolved from all liability for failure to enforce collection of the proceeds and amounts assigned under 3.1 above and from all other responsibility in connection therewith, except the responsibility to account (by application upon the Indebtedness Secured or otherwise) for funds actually received. All monthly proceeds received by Noteholder under the assignment provisions of 3.1 above may be placed by Noteholder in a cash suspense account and credited upon the Indebtedness Secured on the monthly payment date next ensuing after the receipt of such proceeds. Grantor agrees to indemnify and hold harmless Trustee and Noteholder against any and all liabilities, actions, claims, judgments, costs, charges and attorneys' fees by reason of the assertion that they or either of them have received either before or after payment in full of the Indebtedness Secured hereby funds from the production of oil, gas, other hydrocarbons or other minerals claimed by third persons, and Trustee and Noteholder shall each have the right to defend against any such claims or actions employing attorneys of their own selection,

and if not furnished with indemnity satisfactory to each of them, they shall each have the right to compromise and adjust any such claims, actions and judgments, and in addition to the rights to be indemnified as herein provided, all amounts paid by Trustee or by Noteholder in compromise, satisfaction or discharge of any such claim, action or judgment, and all court costs, attorneys' fees and other expenses of every character incurred by Trustee or by Noteholder pursuant to the provisions of this section shall be a demand obligation owing by Grantor and shall bear interest at the maximum rate allowed by applicable law from the date of expenditure until paid and shall be secured by the liens evidenced by this Mortgage.

3.6 Nothing herein contained shall detract from or limit the absolute obligation of Grantor to make prompt payment of the Note, of all amounts owing thereon, and of all amounts owing hereunder at the time and in the manner provided in the Note or provided herein, regardless of whether the proceeds herein assigned are sufficient to pay the same, and the rights under this assignment shall be cumulative of all other security of any and every character now or hereafter existing to secure the payment of the Note and all other Indebtedness Secured hereby. Monies received under the assignments herein contained shall not be deemed applied to payment of the Indebtedness Secured by this Mortgage unless and until such funds are actually applied to the Indebtedness. Noteholder may, in its sole discretion permit funds received by it to be returned to Grantor (rather than applied to Grantor's indebtedness) by deposit to its account for use in Grantor's operations.

It is readily apparent from the language of Article 3.1 that the Borrower is actually transferring all of its interest in severed oil, gas and other substances, as well as all proceeds derived from the sale of those substances produced from the encumbered property. A purchaser, when presented with a deed of trust containing an assignment provision which includes only Article 3.1, should begin submitting proceeds directly to the lender only after securing a new division order or a transfer order executed by the borrower and the lender confirming direct payment of proceeds to the lender.

In addition to the absolute assignment of production and proceeds, a deed of trust will sometimes contain a provision which restricts the lender's right to demand direct payments to the happening of a specified event. Article 3.3 in the assignment provision noted above authorizes direct payment to the lender on demand after the receipt of written notice by purchaser requiring that future payments be made directly to the lender. Other variations of this provision may provide for assignment upon demand and notice to the debtor, or upon default by the borrower under any provision of the deed of trust.

As a further method to insure enforcement of the assignment provision, many lenders secure undated transfer orders, or letters in lieu of transfer orders at the time of execution of the deed of trust which can be sent to a purchaser to require that payments be made directly to the lender. This practice has become common since most borrowers are less cooperative when they begin having financial difficulties, and the last thing a borrower wants is to have production proceeds paid directly to a lender. All the foregoing aside, most lenders are reluctant to employ an assignment or revenues

provision absent some unique circumstances. There are obvious pitfalls that could be very costly to a lender if it were to be determined (in the rearview mirror) that the assignment was improperly implemented.

2. Deeds of Trust in Common Real Estate Financing Transactions

A survey of the various states' theories pertaining to real estate financing is beyond the scope of this paper, however, a general understanding as to the fundamental differences between a "lien theory" and "title theory" state may be useful to add context to this section.

Each type of theory has special considerations on who will hold title and how foreclosure proceedings would take place if they were to become necessary. In a "lien theory" state, such as Texas, Oklahoma, New Mexico, and a large majority of producer states the buyer holds title to the property during the mortgage term. The buyer promises to make all payments to the lender and the mortgage becomes a lien on the property, but title remains with the buyer. The lender's lien is removed once the payment of all loan payments have been completed. The lender has no immediate right of possession in the event of default, but must first exercise foreclosure rights in order to gain title to and possession of the collateral property. The lien theory of real property encumbrances is generally considered to be more reflective of the economic reality of mortgage or lien transactions.

In "title theory" states, such as Alabama, Tennessee and Illinois, the borrower does not actually hold title to the property during the loan term.²² The seller gives the buyer/borrower a deed to the property but when the borrower signs the mortgage for the loan the borrower gives the title back to the mortgage holder. The lender then holds title to the property, as security only, until all loan payments have been made. During that time the borrower has the right to possession of the property, and the lender delivers title back to the borrower only after the loan obligation has been satisfied.

Many former title theory states have adopted an intermediate or Deed of Trust theory mortgage doctrine. The intermediate theory, in fact, adapts most of the attributes of lien theory while retaining vestiges of title theory. In practice there remain only limited practical differences between lien, title and intermediate theories.

The foregoing discussion applies to situations in which a leasehold owner or lease operator mortgages its interest in oil and gas leases and/or mineral interests to secure payment of a debt. Situations also arise in which a royalty owner or lessor under an oil and gas lease will mortgage land either before or after execution of an oil and gas lease to secure payment of a debt. Many deed of trust forms, and indeed the State Bar of Texas form, contain provisions which assign "rent", "income" and "profits" from the property

²² The "title theory" of real property liens has been referred to as a "mere fiction, created to circumvent the ecclesiastical laws of Thirteenth Century England." *In re Young*, 22 Bkrptcy. Rep. 620 (N.D. Ill. 1982). About two thirds of all states have abandoned title theory in favor of lien theory.

either absolutely or as further security for a debt. The present State Bar of Texas form contains the following provision:

"Grantor assigns to Beneficiary absolutely, not only as collateral, all present and future rent and other income and receipts from the property. Leases are not assigned. Grantor warrants the validity and enforceability of the assignment. Grantor may as Beneficiary's licensee collect rent and other income and receipts as long as Grantor is not in default under the note or this deed of trust. Grantor will apply all rent and other income and receipts to payment of the note and performance of this deed of trust, but if the rent and other income and receipts exceed the amount due under the note and deed of trust, Grantor may retain the excess."

This assignment of rents provision goes on to provide further rights and remedies of the grantor and beneficiary under the deed of trust. If a purchaser is presented with a demand by a lender to suspend royalty payments or to make an alternate distribution of royalty payments under such an assignment clause, the question arises whether royalties are considered "rent and other income and receipts" from the encumbered property. In order to determine the proper application of proceeds, it is necessary to examine Texas law regarding the characterization of royalties.

Under Texas property law, a royalty is an interest in land reserved by the lessor as consideration for the grant of an oil and gas lease.²³ With regard to mortgages, Texas is a "lien theory" state which follows the rule that a mortgage or deed of trust grants equitable title to the mortgagee, with legal title remaining vested in the mortgagor. As such, the mortgagee is not the owner of the property and therefore is not entitled to possession of the property or the collection of rentals or profits, unless the mortgage or deed of trust grants an absolute assignment of rentals and profits to the mortgagee.²⁴ The assignment provision quoted above from the current State Bar of Texas deed of trust form does act as an absolute assignment of rents, incomes and receipts from the encumbered property. However, it is still necessary to determine whether a royalty interest would qualify as rent, income or profit from the encumbered property.

While there is little direct authority regarding whether royalties should be properly characterized as "rents", "income" or "profits" for purposes of a Deed of Trust assignment, general Texas property law principles suggest they should not. Under Texas law, royalties are deemed to be payments for the sale of the minerals underlying property.²⁵ Since royalties are considered payments for depletion of the minerals underlying the land, they are not considered "rents" or "income" or "profits."²⁶ Royalties, or the proceeds derived therefrom, are equivalent to a piecemeal sale of the mineral

²³ Texas Oil & Gas Corp. v. Moore, 630 S.W.2d 450, 452 (Tex. App. – Corpus Christi 1982, writ dismissed); Watkins v. Slaughter, 183 S.W.2d 474, 477 (Tex. Civ. App. – Amarillo 1944), aff'd, 189 S.W.2d 699 (1945).

²⁴ Taylor v. Brennan, 621 S.W.2d 592, 593 (Tex. 1981)

²⁵ Stephens v. Stephens, 292 S.W.2d 290, 293-94 (Tex. Civ. App. – Amarillo 1927, writ dismissed).

²⁶ White v. Blackman, 168 S.W. 2d 531, 534 (ex. Civ. App. – Texarkana 1942, writ refused w.o.m.).

estate, and therefore, the proceeds would not be considered rents or profits, but rather proceeds for the actual sale of the mineral property.²⁷ In Norris v. Vaughn, the issue before the Texas Supreme Court was the proper classification of oil and gas proceeds as community or separate property. Since the minerals in place were found to be the separate property of one spouse, the royalty proceeds were also found to continue to be separate property, rather than classified as community income, thus indicating that they should not be treated as income. Accordingly, an assignment of rents provision should have no effect upon royalties received by a mortgagor on oil and gas produced from the encumbered property.

These long standing principles of Texas law, however, are at odds to some extent with federal tax law. In Burnet v. Harmel, the United States Supreme Court rejected Texas law to the effect that an oil and gas lease is a present sale of the oil and gas in place. The court instead held that bonus and royalties constituted income to the lessor rather than a sale of the minerals, thereby depriving the taxpayer of a claim that the amount received as royalties would be eligible for taxation at a more favorable capital gains rate.²⁸ By following this interpretation, proceeds received under an oil and gas lease may actually be considered "income", and fall within the assignment of rents provision quoted above. It is the writer's suggestion that this latter interpretation would most likely be inapplicable to entitlement to royalties under a deed of trust.

Based upon the conflicting interpretations, should a purchaser suspend royalties to a lessor based upon a demand from a lender under an assignment of rents provision such as that quoted above? The answer is unclear particularly given the conflicting authorities. A purchaser will probably need to follow Texas property law and continue to pay royalties to the borrower under such a deed of trust if the borrower insists that payments be made in that manner. Title to the royalties is really not an issue since royalties are not properly characterized as "rents" or "income" under Texas property law and the borrower has not effectively assigned the royalties to the lender. In such case the most prudent course will be for the purchaser or operator to seek joint execution of a division order or other agreement which dictates the manner in which proceeds are to be paid.

B. Statutory, Constitutional and Involuntary Liens

1. §9.343 of The Texas Business and Commerce Code - Oil and Gas Security Interests; Security Interest Perfected without Filing; Statutory Lien

Under §9.343 of the Texas Business and Commerce Code (the Texas UCC)²⁹ an interest owner (as a secured party) is given a statutory security interest to secure the obligation of the first purchaser of oil and gas production to pay the purchase price. An interest owner is defined as:

²⁷ Norris v. Vaughn, 260 S.W.2d 676, 679 (Tex. 1953).

²⁸ Burnett v. Harmel, 287 U.S. 103, 108-09 (1932); see also Estate of Johnston v. United States, 586 F.Supp.500 (N.D. Tex. 1984).

²⁹ Tex. Bus. & Com. Code Ann. §9.343 (Vernon 2001)(formerly §9.319 et seq.).

"A person owning an entire or fractional interest of any kind or nature in oil or gas production at the time of severance, or a person who has an express, implied, or constructive right to receive monetary payment determined by the value of oil or gas production or by the amount of production."³⁰

First purchaser is defined as:

"The first person that purchases oil or gas production from an operator or interest owner after the production is severed, or an operator that receives production proceeds from a third-party purchaser who acts in good faith under a division order or other agreement signed by the operator under which the operator collects proceeds of production on behalf of other interest owners...."³¹

Under the statute, the signed writing giving the interest owner his or her interest under real estate law is treated as the security agreement which, when recorded in the Real Estate Records of the county in which the oil or gas well is located, is effective as a filed financing statement for purposes of the Texas Business and Commerce Code. For purposes of establishing the lien's priority under the Act, the security interest is treated as a purchase money security interest.³²

A purchaser making 100% distribution³³ to an operator, when faced with a claimed security interest by an interest owner may be required to either suspend or interplead proceeds in those instances in which the interest owners' security interest may be superior to the operator's rights. Unless the purchaser avails itself of the "safe harbor" provisions of the statute, the proceeds in the hands of the purchaser and the production in the purchaser's system are subject to the lien. Under the statute a first purchaser, acting in good faith, may terminate the interest owner's security interest or statutory lien by paying or making a tender of the amount the first purchaser believes to be due the interest owner:

- (i) if the owner's rights are to oil or gas production or to its proceeds, to the operator alone, in which case the operator will be determined to be the first purchaser; or

³⁰ Id. at §9.343(r)(3).

³¹ Id. at §9.343(r)(3).

³² Id. at §9.343(f)(2). The priority of this lien with regard to other Chapter 9 security interests not arising under this section is set out in §9.324 of the Code. The relative priorities of the security interests and liens arising under this section are set out in §9.343 of the Code.

³³ A 100% distribution occurs when a purchaser pays all proceeds to the operator, usually under an indemnifying division order, and the operator undertakes the obligation to distribute proceeds to non-operators and royalty owners pursuant to the affected leases.

(ii) whatever the nature of production, to any person that the interest owner has agreed to or acquiesced in; or in the event of litigation or bankruptcy to a court of competent jurisdiction .³⁴

Under the foregoing section, the implied security interest does not impair an operator's right to setoff or withhold funds from an interest owner as security for or in satisfaction of a debt to or security interest of the operator. In the case of a dispute between the operator and interest owner, a good faith tender by the one holding the funds to a court of competent jurisdiction in the event of litigation or bankruptcy is considered to be a tender to both parties.³⁵

An operator or a purchaser who makes distribution to a party in the face of a claim by an interest owner may incur liability through a number of theories. Although the effectiveness of the statute has been questioned in a bankruptcy context³⁶ the statute should be considered as creating a valid lien under Texas law for purposes of determining payment obligations. Obviously under the statute when faced by competing lien claims, the purchaser will readily either seek protection under the safe harbor provisions of the statute or interplead the proceeds to avoid liability for the competing claims.

2. Mechanic's and Materialman's Liens

"Mineral Contractors" and "Mineral Subcontractors" may be entitled to a lien against mineral property to secure payment of the value of labor performed or materials furnished by complying with the provisions of Chapter 56 of the Texas Property Code.³⁷ A mechanic's and materialman's mineral lien can be created by furnishing the appropriate information in an affidavit regarding ownership of the property, amounts due and the dates of performance, and by filing the affidavit not later than six months after the date the indebtedness accrues.³⁸ However, this type of lien attaches only to the property described in §56.003, including machinery, equipment, pipelines, rights-of-way and the oil and gas leasehold estate, but does not attach to the mineral fee, the surface estate or oil and gas extracted from the ground or proceeds thereof.³⁹ Accordingly, if a purchaser is merely presented with a recorded copy of a mechanic's and materialman's lien affidavit, the purchaser has no authority to suspend payments or to make an alternate distribution of proceeds based upon a request received with the affidavit. The purchaser should only suspend proceeds or make an alternate distribution after receiving certified copies of the

³⁴ Tex. Bus. & Com. Code Ann. §9.343(Vernon 2001).

³⁵ Id.

³⁶ In re Prudential Energy Co., 58 Bankr. 857, 862 (Bankr. S.D.N.Y. 1986). The result reached in the Prudential Energy Co. case was effectively legislatively "overruled" when the Texas legislature subsequently amended Tex. Bus. & Comm. Code Ann. §9.306(d) to expressly extend the security interest in oil and gas sales proceeds granted under §9.343 to all of debtors cash and deposit accounts in which proceeds have been commingled.

³⁷ Tex. Prop. Code Ann. §§56.001-56.045 (Vernon 1984).

³⁸ Tex. Prop. Code Ann. §§56.021, 56.022 (Vernon 1984).

³⁹ See Wilkins v. Fecht, 356 S.W.2d 855 (Tex. Civ. App. – San Antonio 1962, writ ref'd); Croley v. Adams Bros. & Prince, 262 S.W. 883, 885 (Tex. Civ.App. – Amarillo 1924, no writ).

judicial proceedings foreclosing the mineral lien and granting title to the party who has purchased the mineral interest at the sale of the property.

The Texas Constitution gives a lien to certain individuals to secure the value of labor done or materials furnished without the need for the individuals to take any action.⁴⁰ This provision is frequently utilized by oil and gas contractors and materialmen when filing a mineral lien affidavit under Chapter 56 of the Texas Property Code. A contractor or materialman is not required to take any action because, the lien arises automatically. However, a mineral contractor or materialman may not have a basis for claiming a constitutional lien since the drilling of an oil well is not considered the erection or repair of a "building", nor is the setting of casing an "article made" within the constitutional provisions.⁴¹

3. Abstract of Judgment Liens

An abstract of judgment is the document used to create a lien against a debtor's property by giving notice of a judgment rendered against the debtor and by filing the abstract of judgment in a county in which the debtor owns real property. After a judgment is obtained, a party must follow the provisions of Chapter 52 of the Texas Property Code to secure an abstract of that judgment, and must also follow the recording provisions in that statute to insure that a lien is fixed upon property of the judgment debtor.⁴² However, like a mechanic's and materialman's mineral lien, an abstract of judgment attaches only to real property of a debtor located in a county in which the abstract of judgment is recorded.⁴³ The judgment lien does not attach to oil and gas after it is severed from the ground, or to proceeds from the sale of the oil and gas.⁴⁴ Accordingly, although a judgment lien will attach to all real property of a debtor, such as leasehold interests, royalty interests and mineral fee interests, the lien does not attach to proceeds derived from extracted oil and gas. Only after the foreclosure of the judgment lien by a court of competent jurisdiction, and the subsequent sale of the encumbered interest will a purchaser of the real property interest become entitled to oil and gas proceeds.

A judgment creditor may, however, utilize the statutory garnishment procedures we its case is pending against a debtor, or after judgment, in order to recover funds in the hands of a garnishee, such as an oil and gas purchaser.⁴⁵ Such an action may also be used against an operator who may be holding funds of one of its non-operators. The procedural

⁴⁰ Article XVI, §37 of the Texas Constitution provides: "Mechanics, artisans and material men, of every class, shall have a lien upon buildings and articles made or repaired by them for the value of their labor done thereon, or material furnished therefore; and the legislature shall provide by law for the speedy and efficient enforcement of said liens."

⁴¹ Ball v. Davis, 18 S.W.2d 1063, 1066 (Tex. 1929); In re Mid-American Petroleum, Inc., 83 Bankr. 937, 943 (Bankr. N.D. Tex. 1998)

⁴² Tex. Prop. Code Ann. §§52.001, 52.025 (Vernon 2006).

⁴³ Id. at 52.001.

⁴⁴ Onyx Refining Co. v. Evans Prod. Corp., 182 F. Supp. 253, 257 (N.D. Tex. 1959); Donley v. Youngstown Sheet & Tube Co., 328 S.W.2d 192, 196 (Tex. Civ. App. – Eastland 1959, writ ref'd n.r.e.).

⁴⁵ Tex. Civ. Prac. & Rem. Code Ann. §§63.001-63.005 (Vernon 1986)

requirements for the filing of a garnishment action, and obtaining a writ of garnishment are set forth in the Texas Rules of Civil Procedure.⁴⁶ After a garnishee, such as an oil or gas purchaser is served with a writ of garnishment, the purchaser is authorized to suspend, and indeed is prohibited from paying any funds to the defendant in the underlying case (such as an interest owner) until further directions or orders are received from the court in which the garnishment action is pending.⁴⁷ The purchaser/garnishee is then required to inform the court, under oath, the amount of funds being held for the benefit of the judgment debtor in the underlying case.⁴⁸ Accordingly, although an abstract of judgment lien will not attach directly to oil and gas proceeds, the ancillary remedy of garnishment can be utilized by a judgment debtor in an appropriate case to receive oil and gas proceeds, or to cause an immediate suspense of such proceeds.

4. Federal Tax Liens

A federal tax lien may be created encumbering all of the property and "rights to property, whether real or personal," belonging to a taxpayer if the taxpayer neglects or refuses to pay any federal tax after notice and demand for payment.⁴⁹ This provision of the Internal Revenue Code (the I.R.C.) applies to the payment of all federal taxes including income taxes, estate taxes, gift taxes, and employment taxes. The tax lien established, after notice of an assessment and demand for payment, applies to real and personal property, including severed oil and gas and the proceeds from the sale thereof.⁵⁰ The Bigheart Pipeline Corp. case, decided under Oklahoma law, addressed the priority of a federal tax lien filed after an assignment was made, but before the assignment was recorded in the real property records. In this case, the Court found that the federal tax lien had been filed by the Internal Revenue Service and attached to an undeveloped oil and gas lease owned by the taxpayer. The taxpayer had already sold the lease, although the assignment was not recorded until after the Notice of Federal Tax Lien was filed. The lease was subsequently developed by the taxpayer's assignee, and the United States claimed a prior interest in all of the proceeds on oil and gas produced from the lease. Since the assignment was not filed for record until after the government filed its notice of tax lien, the purchaser was not entitled to protected purchaser status. The Court found that the severed oil and gas, and the proceeds thereof, were a "right to property" within the meaning of §6321 of the I.R.C., and therefore the United States was entitled to the proceeds under its notice of levy on the oil purchaser.

A federal tax lien arises when an assessment is made by the government and relates back to the date of the assessment, even though the notice of tax lien is filed later. Generally, an assessment occurs when the I.R.S. sends notice and demand for payment to the taxpayer, and the taxpayer neglects or refuses to pay the assessment within ten days.⁵¹ Since the federal tax lien relates back to the date of assessment, a purchaser of oil and gas

⁴⁶ Tex. R. Civ. P. 657-679.

⁴⁷ Tex. Civ. Prac. & Rem. Code Ann. §63.003(a)(Vernon 1986).

⁴⁸ Tex. R. Civ. P. 661.

⁴⁹ 26 U.S.C.A. §6321 (West 1989).

⁵⁰ See Bigheart Pipeline Corp. v. United States, 835 F.2d 766, 768-69 (10th Cir. 1987)

⁵¹ 26 U.S.C.A. §6322 (West 1989).

is well advised to suspend payments to a taxpayer upon receiving notice of a federal tax lien, and to institute an interpleader action to determine the proper party entitled to receive payments. The suspense of proceeds and subsequent filing of an interpleader should relieve the purchaser of the burden of determining the proper party to whom proceeds should be paid under the complex priority scheme under the I.R.C.⁵²

C. Joint Operating Agreements - Operators and Non-Operators Liens

An Operating Agreement is a contract setting forth the rights and duties of leasehold co-tenants in connection with the exploration and development of an oil and gas mineral property. The most commonly encountered type of operating agreement is the AAPL Form 610 Model Form Operating Agreement.⁵³ Two of the more commonly used forms are the 1977 Model Form and the 1982 Model Form, both of which have very similar provisions. The 1977 and 1982 forms make provision for liens to secure payment of joint interest expenses, but make only limited provision for their implementation and execution. The most recent form, the 1989 Model Form, has the most detailed provisions regarding operator and non-operator liability for expenses and reciprocal liens to secure payment of those expenses. The principal functions of the operating agreement are to designate one of the parties as the operator, describe the scope of the operator's authority, provide a method of allocating costs and production proceeds among the parties, and provide remedies in the event of a default in any obligation by a party.⁵⁴

One of the significant remedies given in an operating agreement is the operator's lien which secures payment of sums owed by one party to another. In the operating agreement, all non-operators grant a lien on their "oil and gas rights" covered by the contract, and a security interest in all personal property and equipment in the contract area covered by the agreement to the operator.⁵⁵ The modern forms of operating agreement also grant the non-operator a lien and security interest to secure obligations owed by the operator. Additionally, the operating agreement will generally contain a contractual setoff provision granting the operator the right to collect proceeds from the sale of a defaulting non-operator's share of oil and gas and apply the proceeds to payment of outstanding debts owed by the non-operator. This provision is the most significant in determining whether to suspend oil and gas proceeds based upon a demand to suspend received by a purchaser from an operator.

⁵²See Bigheart Pipeline Corp. v. United States, 835 F.2d 766 (10th Cir. 1987); Transwestern Pipeline Co. v. Allied Bank of Texas, 89-1 T.C. 9173 (S.D. Tex. 1989). Although the intricacies of the federal tax laws are beyond the scope of this paper, an excellent discussion of federal tax liens including the enforcement and priorities of those liens, can be found in William D. Elliott, Federal Tax Collections. Liens and Levies, (1988 & Supp. 1992).

⁵³ The American Association of Petroleum Landmen ("AAPL") Form 610 Model Form Operating Agreement. The forms most commonly in use today (with respect to onshore properties) are like 1982 and 1989 iterations, though there are still many 1956 and 1977 versions still in effect in "heritage properties." There are other operating agreement forms, including forms customized by some of the larger oil and gas companies, but they are not in widespread use.

⁵⁴ E. Smith & J. Weaver, Texas Law of Oil and Gas §17.3(A)(1989).

⁵⁵ 1982 Model Form, Art. VII.B.

Oil and gas purchasers may be presented with demands by operators or non-operators to suspend payment to a party or to make an alternate distribution of proceeds based upon the provisions contained in an operating agreement. A purchaser may be concerned with these demands where it is making direct distributions to all of the leasehold owners. However, in many cases, a purchaser merely pays all proceeds to an operator under a 100% indemnifying division order, and the operator is responsible for further distribution of proceeds to its royalty owners and to all of the non-operators. If a purchaser is responsible for direct distribution of proceeds, and receives a demand to suspend or make an alternate distribution, the purchaser may be required to examine the terms of the applicable operating agreement prior to taking the requested action. The operator's lien on real property, unless foreclosed, cannot be relied upon to require suspension or an alternate distribution of proceeds. Additionally, the security interest in personal property, such as oil and gas proceeds, cannot readily be relied upon unless the security interest is foreclosed. However, the right of the operator to collect proceeds and apply the sums received against expenses must be carefully evaluated by a purchaser. Further, demands for direct payment from a non-operator should be carefully considered. Although the 1982 Model Form does not expressly waive any recourse by a non-operator against the purchaser, the 1989 Model Form does contain such a waiver. If a purchaser pays all proceeds directly, once the purchaser receives demand from an operator under the offset provision, the purchaser should require the following:

- (i) an indemnity agreement executed by the operator which indemnifies the purchaser from any liability resulting from its decision to release proceeds directly to the operator;
- (ii) a written summary of amounts owed by the non-operator, as well as continuing updates, on a monthly basis, in order that the purchaser can determine whether any additional debts have been incurred by the non-operator;
- (iii) written notice from the operator when the debt of the non-operator has been satisfied; and
- (iv) a new division order executed by the operator which directs the purchaser to distribute proceeds attributable to the interest of the operator and any defaulting non-operator, directly for the account of the operator.

After an oil and gas purchaser has received all of the foregoing, it will have protection against adverse claims by a non-operator whose funds have been diverted to the operator. However, it must be noted that an indemnity agreement is only as good as the party giving the indemnity. If there is some question as to the creditworthiness of the indemnitor, it may be necessary for a purchaser to file an interpleader action to have a court of competent jurisdiction determine the party to whom proceeds should be paid, without subjecting the purchaser to potential double liability.

In connection with a contractual setoff right granted in an operating agreement, a purchaser may be presented with conflicting claims to proceeds from the operator and from a third party claiming a lien or security interest in the proceeds under a separate agreement.⁵⁶ In Enduro Oil Co. v. Parish & Ellison, the assignee under an assignment of production provision contained in a deed of trust sued an oil and gas purchaser for conversion of certain suspense proceeds when the purchaser failed to pay the suspended funds to the assignee. The funds were placed in suspense due to a non-operator's failure to pay operating expenses and completion expenses under an operating agreement covering several oil and gas leases. The deed of trust and security agreement which contained the assignment of production clause was filed after the effective date of the operating agreement and was made subject to that operating agreement. The Court of Appeals found that the offset right of the operator to collect the non-operator's share of oil and gas proceeds was superior to the right of the third party lien claimant. The non-operator lacked authority to assign any interest in production to the lien claimant since operating expenses exceeded the production income. The lien claimant, as assignee, essentially acquired nothing and had no rights in the suspended funds. Therefore, based upon the superior right of the operator, the action for conversion could not be maintained.⁵⁷ This case illustrates the importance of giving notice of the operator's lien provisions and setoff rights contained in an operating agreement either by reference in assignments, or by recording the operating agreement or a memorandum thereof in the real property records where the oil and gas property is located.

In Hondo Oil & Gas Co. v. Texas Crude Operator, Inc.,⁵⁸ another case involving conflicting claims to production proceeds subject to an operating agreement, the successor to a non-operator filed suit against the operator to recover proceeds owed to the successor non-operator. In that case, a dispute arose between an operator and a non-operator regarding the proper method of computing overhead charges under an operating agreement. The non-operator began withholding amounts from its overhead payments as a means of recovering the perceived overcharges by the operator. The non-operator then sold its properties to Hondo Oil and Gas Company, and the operator retained Hondo's share of the proceeds to recoup the funds withheld by Hondo's predecessor in interest. Although the Court concluded that the operator had breached the operating agreement as to Hondo, the Court further found that the operator did not violate the provisions of the Texas Division Order Statute by withholding funds since it had a reasonable doubt as to whether Hondo was entitled to the withheld proceeds. Hondo was ultimately awarded damages for the breach of the operating agreement by the operator, but Hondo was not entitled to interest on the withheld funds due to the "reasonable doubt" created by the controversy. This case illustrates the power granted to an operator to withhold proceeds, but further illustrates that an operator can still be liable for its decision to withhold funds owed to a non-operator.

⁵⁶ See Enduro Oil Co. v. Parish & Ellison, 834 S.W.2d 547, 549 (Tex. App. – Houston [14th Dist.] 1992, writ denied).

⁵⁷ Id. at 549.

⁵⁸ Hondo Oil & Gas Co. v. Texas Crude Operator, Inc., 970 F.2d 1433, 1437 (5th Cir. 1992).

D. Liens under Purchase Contracts. Transportation Agreements and Other Contracts

While identification and discussion of all of the types of agreements and provisions which may provide for liens of one type or another is beyond the scope of this paper, many common oil and gas transportation and sales agreements provide for liens to secure delivery of oil and gas or proceeds from sales of oil and gas. When confronted by a claimed lien under such circumstances the contract itself must be examined in making a decision regarding whether and how much to suspend.

IV. Common Law Issues

A. Co-tenancy-Suspense of Non-Drilling Mineral Co-tenant Proceeds Where Operations Are Undertaken by Less Than All Co-tenants or Their Lessees

Novel issues arise regarding ownership of oil and gas where operations are undertaken by less than all of the owners of fractional interests in minerals. Texas common law authorizes any owner of a fractional interest in oil and gas in place to drill for and produce the oil and gas without first receiving the consent of his cotenants.⁵⁹ Likewise, one or more owners of fractional interest in oil and gas in place can execute oil and gas leases thereby authorizing their lessee to develop minerals for that co-tenant's account. A co-tenant or lessee that elects to develop in such an instance is under an obligation to account to a non-leasing/non-developing co-tenant for that owner's proportionate share of the net profits from the sale of production.⁶⁰ The non-participating co-tenant is not directly responsible for the costs of developing and drilling for or producing the minerals and as a general rule the operating co-tenant is authorized to take possession of and sell all of the production from a well subject to the obligation to account to the non-participating co-tenant.⁶¹

The non joining/non-consenting co-tenant/co-lessee situation is rife with potential disputes over ownership of oil and gas. For instance, there is substantial uncertainty as to what specific costs are and are not deductible. The non-consenting co-tenant may find direct expenses incurred by the operating co-tenant to be unreasonable and the accounting for proceeds may be questioned.⁶² Because the accounting procedure is, in effect, a recoupment, the operator takes possession of all of the runs and, after selling them to the purchaser, only remits to the non-consenting co-tenant the portion of runs which exceeds the operating expenses. Moreover, because the operating co-tenant is entitled to recover all of his drilling costs prior to remitting proceeds for any runs to the non-participating

⁵⁹Burnham v. Hardy Oil Co., 147 S.W. 330,335 (Tex. Civ. App. – San Antonio 1912), aff'd, 195 S.W. 1139 (1917).

⁶⁰ White v. Smyth, 147 Tex. 272, 214 S.W.2d 967, 975 (1948); see generally Smith, Methods for Facilitating the Development of Oil and Gas Lands Burdened with Outstanding Mineral Interest, 43 Tex. L. Rev. 129 (1964).

⁶¹ Mapco, Inc. v. Carter, 786 S.W.2d 368, 372 (Tex. App. – Beaumont 1989) rev'd on other grounds, 817 S.W.2d 686 (Tex. 1991); Bullard v. Broadwell, 588 S.W.2d 398 (Tex. Civ. App. – Eastland 1979, writ ref'd n.r.e.); quoting, Cox v. Davison, 397 S.W.2d 200, 201 (Tex. 1965).

⁶² See generally E. Smith and J. Weaver, Texas Law of Oil and Gas, §2.3(A)(1-3)(1990).

co-tenant, there is often substantial lapse of time before any runs can be disbursed to the non joining co-tenant. The latter circumstance one often creates substantial suspicion and conflict.

These ownership issues create a quandary for a purchaser who is faced with competing claims to proceeds among co-tenants. Title is not really in issue since, assuming the operating co-tenant does own a fractional interest in oil and gas in place in the lands on which the well is bottomed, he has the right to produce all of the oil and gas which he can lawfully produce through that wellbore subject only to an obligation to account to his non joining co-tenants. While no Texas cases directly in point were found, it does not appear that the non-operating co-tenant would have any right to demand possession of the oil and gas or proceeds since the operating co-tenant has the right to "capture" and take possession of the oil and gas. At most, the other non-consenting co-tenant has an after payout interest in the net proceeds from oil and gas production. On the other hand, the operating co-tenant does have a right to recoup from the net proceeds his operating expenses before remitting any money to the non-consenting co-tenant. This would imply a superior right of possession. Based upon these principles, it would not appear that a purchaser, at least at common law, would be under any obligation to remit proceeds to a non-operating working interest owner or even to suspend proceeds attributable to the non-operating working interest owners' interest based solely upon a demand by the non-consenting co-tenant for his share of production. If a purchaser were to suspend or pay based upon such a demand, it is at least conceivable that the operating co-tenant would have a cause of action against the purchaser for failing to remit the proceeds since he has the right to receive all the proceeds and to "net out" a non-consenting co-tenant's share of expenses. The non-consenting co-tenant's right in such case is not to possess and sell oil, but to be properly accounted to for proceeds.

The security interest statute discussed in a prior section of this paper places a new spin on this situation. Under §9.343 of the Texas Business and Commerce Code, an interest owner has a perfected security interest in the proceeds of oil and gas production based upon the recording of the instrument under which his interest devolves. Thus, at least superficially, if a first purchaser is placed on notice of the existence of the security interest by the non-consenting co-tenant a purchaser is at jeopardy due to the existence of the lien. Section 9.343(k) does create a safe harbor for the purchaser providing that "[t]his section does not impair an operator's right to set off or withhold funds from other interest owners as security for or in satisfaction of any debt or security interest...." Likewise, a purchaser is able to make the operator the statutory "first purchaser" by remitting the proceeds from the sale of oil and gas in good faith to the operator for distribution.⁶³ However, even in this instance, when a complaint has been raised by the owner of a record interest in minerals that the operator is not properly accounting to him, the most prudent course for the purchaser may be to seek protection of the interpleader provisions of the security interest statute rather than making the unilateral decision as to payment of the proceeds.

⁶³Tex. Bus. & Corn. Code Ann. §§9.343(e)(1) & 9.319(g)(3)(Vernon 2001).

B. Common Law Doctrines of Setoff and Recoupment

The common law doctrines of setoff, recoupment and counterclaim may also create issues regarding entitlement to receipt of proceeds from oil and gas production. In many instances, the purchaser itself may have a matured claim or right to payment from the party entitled to receive proceeds. In other situations the right to receive payment may be one owned by the operator against some non-operator or royalty owner. These situations arise in the context of prior overpayments of royalty, monies owed by operators to purchasers for "frac oil" or services or overpayments on other leases among other situations. Separate and apart from any co-tenancy principles, the doctrines of setoff, recoupment and counterclaim (generally referred to interchangeably by Texas courts) allow a party holding a matured claim against another party to set off or recoup the amount owed out of money which that party owes the other claimant. This doctrine is ancient, having its roots in the early English common law and is grounded on "the absurdity of making "A" pay "B" when "B" owes "A"."⁶⁴ The general rule is that where parties have cross demands against each other, the real indebtedness is the excess of one debt over the other.⁶⁵ The requirements for setoff (outside of the bankruptcy context which will be discussed later) are relatively few. The only strict requirements are that the cross claims must be mutual (i.e., between the same parties) and due in the same capacity or right.⁶⁶ Aside from these requirements there is no necessity that the cross-demands or claims be similar in nature or related to one another.

While these doctrines do not give rise to a true "suspense" issue, they do create circumstances in which a demand may be made for payment in which a purchaser or operator may be entitled to withhold payment. Obviously, if the purchaser or operator has a matured claim against the party seeking payment of royalties and there is not some legal impediment to its collection, the purchaser or operator may withhold payment and in the proper circumstances apply those proceeds to satisfaction of his debt.

V. Effect of Bankruptcy Laws on Payment/Suspense Decisions

A bankruptcy filing by an operator can cause significant problems for a purchaser of oil and gas production. If a purchaser distributes 100% of proceeds to an operator under an indemnifying division order, the non-operating working interest owners will immediately demand that they be paid directly for their share of oil and gas production. In many cases, the purchaser has no information as to the identity or interests of the non-operators. Demands for payment may also come from a variety of lien claimants. When an operator files bankruptcy, the indemnification given by the operator to the purchaser in a division order is worthless.⁶⁷ What should a purchaser do when faced with these problems? First, the purchaser should suspend payments to the non-operator claimants

⁶⁴Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913).

⁶⁵ See, Bandy v. First State Bank, 835 S.W.2d 609, 618 (Tex. 1992).

⁶⁶ See Greathouse v. Greathouse, 60 Tex. 597, 598 (1884); Dallas/Fort Worth Airport Bank v. Dallas Bank & Trust Co., 667 S.W.2d 572, 575 (Tex. Civ. App. – Dallas 1984, no writ).

⁶⁷ As a practical matter, the indemnification may have become worthless well in advance of the bankruptcy filing due to the financial troubles of the operator.

and lien claimants, since a dispute "which would affect distribution of payments" has been created. Additionally, if a purchaser receives notice of a bankruptcy filing by an operator, it would be well advised to suspend all payments due to the operator pending a determination of rightful ownership of the proceeds.

With respect to oil and gas proceeds held by a purchaser when an operator commences bankruptcy proceedings, the purchaser may file an interpleader action in the bankruptcy case due to its reasonable uncertainty as to the proper distribution of proceeds. Federal Rules of Bankruptcy Procedure Rule 7022 provides that Rule 22 (1) of the Federal Rules of Civil Procedure pertaining to interpleader actions "applies in adversary proceedings." An interpleader action filed under Rule 22 (1) of the Federal Rules of Civil Procedures is referred to as a rule interpleader, and can be used only by meeting certain jurisdictional requirements, i.e., the amount in controversy must exceed \$75,000.⁶⁸ If a "Rule" interpleader is available, a purchaser can interplead suspended funds and, in most cases, recover costs and attorneys fees. If the jurisdictional requirements cannot be met, it may be necessary for a purchaser to seek an order lifting the automatic stay created by the bankruptcy filing and to use the federal interpleader statutes (statutory interpleader) to determine rightful ownership.⁶⁹ Federal statutory interpleader requires diversity of citizenship between any two claimants and, an amount in controversy exceeding \$75,000.00. However, the availability of statutory interpleader in bankruptcy is uncertain due to the wording of Federal Rules of Bankruptcy Procedure Rule 7022. An interpleader action under state law may also be available at the discretion of the bankruptcy court.⁷⁰

A different problem arises when an operator is in possession of proceeds when the operator files for bankruptcy protection. As discussed in §III.C. of this paper, many operating agreements give the operator the authority to sell production to a purchaser, collect the proceeds and distribute the proceeds among the non-operators pursuant to their respective ownership interests. The debtor/operator may argue that the proceeds are part of the bankruptcy estate, thereby relegating the non-operators to unsecured creditor status. Conversely, the non-operators will typically argue that the operator may hold legal title, but the non-operators own an equitable right to the proceeds under an operating agreement, and the operator merely holds the proceeds in trust for the non-operators. As such, the proceeds would not become property of the bankruptcy estate.⁷¹

In an Oklahoma federal case, the Tenth Circuit Court of Appeals found that funds in the hands of the operator created a quasi fiduciary relationship similar to a constructive trust.⁷² Therefore, the operator had no rights in the proceeds, except possibly; the right to offset the non-operator's share of unpaid costs and expenses, but the non-operator was not merely an unsecured creditor. However, one Texas bankruptcy case has rejected the

⁶⁸ 28 U.S.C.A. §1332 (West 1966 & Supp. 1992).

⁶⁹ The federal interpleader statutes are found at 28 U.S.C.A. §§1335, 1397 and 2361.

⁷⁰ The bankruptcy court may, but is not required to, hear the state law action "arising in or related to" the bankruptcy case. 28 U.S.C.A. §§1334(6), 1334(c).

⁷¹ See, Wurts, Bankruptcy Issues in Oil & Gas Transactions: General Scope and Selected Problems, State Bar of Texas, Tenth Annual Advanced Oil, and Mineral Law Course, Paper J (1989).

⁷² Reserve Oil, Inc. v. Dixon, 711 F.2d 951 (10th Cir. 1983).

rationale in Reserve Oil. Inc. by refusing to find any type of trustee relationship between the operator and a non-operator.⁷³ Since an operator under Texas law would not occupy the status of a "quasi fiduciary" a non-operator may be required to stand at the back of the line as an unsecured creditor in trying to collect proceeds in the hands of the operator. A non-operator may, however, have some protection under the operator's (and non-operator's) lien provisions in a joint operating agreement if the agreement, or a memorandum thereof, has been properly recorded. A properly recorded operating agreement, or-memorandum thereof, perfects the operator's lien and security interest in proceeds granted in the operating agreement.⁷⁴ Likewise, with the enactment of §9.343 of the Texas Bus. & Comm. Code, an oil and gas interest owner has an automatically perfected statutory security interest which is perfected without the need for a filed financing statement (other than the recorded instrument giving rise to the interest). If the non-operator holds a perfected lien, it should be entitled to secured creditor status with respect to the proceeds. Such a result is consistent with statutory language and indicated by the legislative history behind §9.343 which was intended to provide mineral owners with a greater degree of protection in bankruptcy proceedings.

A purchaser must also face a separate problem of determining what to do with proceeds on the continuing production from the property of a bankrupt operator. If the mineral property is subject to an operating agreement, the non-operators may look to the terms of the agreement in an attempt to remove the operator and to appoint a successor.⁷⁵ Although the operating agreement may expressly provide for the replacement of a bankrupt operator, this provision is probably invalid.⁷⁶ The non-operators will essentially be in a state of limbo until the bankrupt operator elects to assume or reject the operating agreement since an operating agreement is considered an executory contract.⁷⁷ If the property subject to the operating agreement is considered valuable, the bankrupt operator (or bankruptcy trustee) may elect to assume the contract and remain as operator under the agreement. At this point, the non-operators may be forced to file an adversary proceeding in the bankruptcy court seeking an order from the court to remove the bankrupt operator, and authorizing the non-operators to appoint a successor operator. If successful, a purchaser may rely upon the court order and begin distributing proceeds to the new

⁷³ In Re Wilson, 69 Bankr. 960, 964-5 (N.D. Tex. 1987); see also, Texstar North America, Inc. v. Ladd Petroleum Corp., 809 S.W.2d 672 (Tex. App. – Corpus Christi 1991, writ denied) (parties to joint operating agreement do not owe a duty of good faith and fair dealing or a duty of mutual cooperation since the contract expressly sets forth the agreements and relationship between the parties); but cf. Johnston v. American Cometra, Inc., 837 S.W.2d 711, 716 (Tex. App. – Austin, 1992, no writ)(Operator may owe duties similar to those in principal – agent relationship to non-operators in connection with marketing of non-operators' gas).

⁷⁴ In re Wilson, 69 Bankr. 960 N.D. (Tex. 1987) (operator attempted to claim secured creditor status under the operator's lien provision of its operating agreement after a non-operator filed for bankruptcy protection).

⁷⁵ AAPL Form 610 – Model Form Operating Agreement 1982, Art. V.B.1. "Operator may be removed if it fails or refuses to carry out its duties hereunder, or becomes insolvent, bankrupt or is placed in receivership, by the affirmative vote of two (2) or more Non-Operators owning a majority interest based upon ownership as shown on Exhibit "A" remaining after excluding the voting interest of Operators."

⁷⁶ 11 U.S.C.A. §365(1).

⁷⁷ See In re Wilson, 69 Bankr. 960 N.D. (Tex. 1987)(operating agreement is an executory contract which may be assumed or rejected in bankruptcy)

operator after securing a new division order. If the operating agreement is rejected, the bankrupt operator would no longer be a party to the contract, and the non-operators would then be able to exercise the provisions of the operating agreement for selection of a new operator. However, the bankrupt party may then be treated as a leasehold co-tenant, and would need to be dealt with under the common law principals of mineral co-tenancy. This result could cause considerable headaches to the remaining parties to the operating agreement due to the potential for imposition of a fiduciary obligation which may be owed to this mineral co-tenant.⁷⁸

Of course, there are many other scenarios in which the filing of a bankruptcy proceeding may influence whether funds are placed in suspense or paid to a bankruptcy trustee or into the registry of the court in an interpleader action. Some additional situations which may occur are the effect on working interest owners and royalty owners of a bankruptcy filing by a purchaser or the effect of a bankruptcy filing on an operator by a non-operator or a royalty owner. Each situation must be evaluated carefully to determine the effect of the bankruptcy on the existing relationships between parties and the actions which may be taken notwithstanding requests or demands by parties affected by a bankruptcy proceeding.

VI. Judicial Remedies Related to Suspense or Non-Payment

A. Interest

Under Texas law the failure to pay royalties does not generally cause termination of a lease but is treated as a breach of lease covenant.⁷⁹ The unpaid interest, owner has cause of action against the operator for the unpaid royalties. Similarly, an unpaid co-tenant would have a cause of action under general co-tenancy principles for the amount which he is entitled to receive by accounting.

In addition, to payment of the actual royalties and/or mineral proceeds, the unpaid owner has the right to receive interest on proceeds which have not been timely paid. Prior to the enactment of §91.343 of the Texas Natural Resources Code, interest was imputed on unpaid royalties based upon the common law.⁸⁰ However, under the division order statute, a royalty owner is entitled to interest if payments are not made within the deadlines set out in the statute unless a statutory exception is satisfied.⁸¹

B. Contractual - Express Lease Clauses

⁷⁸ Rankin v. Naftalis, 557 S.W.2d 940, 946 (Tex. 1977)(the existence of a joint venture or mining partnership created a Fiduciary relationship, in the absence of a joint operating agreement).

⁷⁹ Morriss v. First Nat'l Bank of Mission, 249 S.W.2d 269, 279 (Tex. Civ. App. – San Antonio 1952, writ ref'd n.r.e.).

⁸⁰ Phillips Petroleum Co. v. Stahl Petroleum Co., 569 S.W.2d 480, 485-88 (Tex. 1978); Phillips Petroleum Co. v. Adams, 513 F.2d 355, 369, cert. denied, 423 U.S. 930 (1975).

⁸¹ Tex. Nat. Res. Code Ann. §91.343 (Vernon 2001).

Failure to account for and pay royalties due under an oil and gas lease constitutes a breach of an expressed obligation of the lease and may result in a claim for damages. If suit is filed and a damage claim is established, the royalty owner should also be entitled to recover reasonable attorney's fees in⁸² addition to interest on the unpaid amount. Special care must also be given with regard to specific lease clauses which may affect the validity of the lease or invoke a particular remedy if royalties are not timely paid. While the content of such provisions is beyond the scope of this paper, such provisions may range from liquidated damage provisions to punitive interest rates to lease termination. While the validity of such provisions may be in question in any given case, some seemingly very punitive express lease clauses have been upheld even in circumstances where the lessee's conduct would not seem that egregious.⁸³

C. Conversion Claims

Conversion is defined under Texas law as the wrongful exercise of dominion and control over other's property in denial of or inconsistent with such person's rights.⁸⁴ Conversion claims apply only to tangible personal property, not to real property.⁸⁵ Under Texas law, oil, gas and minerals in the ground are considered real property and only become personal property, subject to a conversion claim, after they are removed from the ground.⁸⁶ Accordingly, it is possible for an interest owner to maintain an action for conversion of severed oil and gas production.

It is possible that a claim for conversion may be defeated under the contractual provisions in an oil and gas lease or an operating agreement. An oil and gas lease is considered a conveyance of a fee simple determinable interest in all of the oil and gas (and other covered substances) underlying the land described in the lease.⁸⁷ Oil and gas leases typically provide that a lessor may receive the retained royalty either "in kind" or "in money."⁸⁸ If the royalty is payable "in money" the lease passes title to all of the covered substances and the lessor retains only the right to receive money, and no conversion claim can be maintained. A typical royalty clause in an oil and gas lease allows a lessor to take royalty on oil either "in kind" or "in money", but provides for

⁸² Tex. Civ. Proc. & Rem. Code Ann. §38.001 (Vernon 1995).

⁸³ Sowell v. Natural Gas Pipeline Company, 789 F.2d 1151 (5th Cir. 1986) (lease declared terminated pursuant to express lease clause for lessee's failure to properly pay royalties under lease after demand was made) citing Cole Petroleum Co. v. United States Gas & Oil Co., 121 Tex. 59, 41 S.W.2d 414, 416 (1936).

⁸³ Waisath v. Lack's Stores, Inc., 474 S.W.2d 444, 446 (Tex. 1971); Bandy v. First State Bank, 835 S.W.2d 609, 622 (Tex. 1992).

⁸⁴ Waisath v. Lack's Stores, Inc., 474 S.W.2d 444, 446 (Tex. 1971); Bandy v. First State Bank, 835 S.W.2d 609, 622 (Tex. 1992).

⁸⁵ See, Branham v. Prewitt, 636 S.W.2d 507, 512 (Tex. App. – San Antonio 1982), writ ref'd n.r.e., 643 S.W.2d 122 (Tex. 1982), Rodriguez v. DiDQ, 546 S.W.2d 655, 658 (Tex. Civ. App. – El Paso 1977, writ ref'd n.r.e.).

⁸⁶ Humble Oil & Refining Co. v. West, 508 S.W.2d 812, 817 (Tex. 1974).

⁸⁷ Cherokee Water Co. v. Forderhause, 641 S.W.2d 522, 525 (Tex. 1982); Stephens County v. Mid-Kansas Oil & Gas Co., 254 S.W.2d 290, 292 (Tex. 1923).

⁸⁸ Wilson v. United Texas Transmission Co., 797 S.W.2d 231, 233 (Tex. App. – Corpus Christi 1990, no writ); Morriss v. First Nat'l Bank, 249 S.W.2d 269, 278-79 (Tex. Civ. App. – San Antonio 1952, writ ref'd n.r.e.)

royalties only "in money" for gas produced from the leased premises.⁸⁹ Therefore, it is much more likely that an oil purchaser may be subject to a conversion claim by a lessor for suspending payments and refusing to disburse proceeds to the lessor.

A purchaser may also face a conversion claim for suspending proceeds owed to an operator if the suspense is considered "the wrongful exercise of dominion and control" over the operator's property. A similar claim may be asserted by a non-operator whose funds are placed in suspense, or whose funds continue to be distributed to an operator after demand for direct payment is given by the non-operator to the purchaser.⁹⁰ A purchaser may have some protection against claims for conversion asserted by a non-operator if there is an operating agreement granting the operator the contractual right to purchase or sell oil or gas for the benefit of a non-operator. The 1982 Model Form Operating Agreement provides "in the event any party shall fail to make the arrangements necessary to take in kind or separately dispose of its proportionate share of the oil and gas produced from the contract area, operator shall have the right, subject to the revocation at will by the party owning it, but not the obligation, to purchase such oil and gas or sell it to others at any time and from time to time, for the account of the non-taking party at the best price obtainable in the area for such production."⁹¹

In Enduro Oil Co. v. Parish & Ellison,⁹² a lienholder of a non-operator under a deed of trust, security agreement and assignment of production sued an operator and an oil purchaser for conversion, alleging wrongful suspense of the non-operator's proceeds and the improper application of these proceeds to operating expenses and completion expenses owed to the operator. The court examined the contractual offset provision contained in the operating agreement between the operator and non-operator and found that the non-operator lacked authority to assign its interest in production income because operating expenses exceeded the suspended income. Accordingly, there could be no conversion on the part of the operator or the oil purchaser because of the superior right of the operator to the proceeds under the contractual offset provision. This was further reinforced by the fact that the deed of trust, security agreement and assignment of

⁸⁹ For example, the Producer's 88 (7-69) with 640-Acres Pooling Provision, Pound Printing & Stationery Company, Houston, Texas form provides:

"As royalty, lessee covenants and agrees: (a) to deliver to the credit of lessor, in the pipe line to which lessee may connect its wells, the equal 1/8 part of all oil produced and saved by lessee from said land, or from time to time, at the option of lessee, to pay lessor the average posted market price of such 1/8 part of such oil at the wells as of the day it is run to the pipe line or storage tanks, lessor's interest in either case, to bear 1/8 of the cost of treating oil to render a marketable pipe line oil; (b) to pay lessor on gas and casinghead gas produced from said land (1) when sold by lessee, 1/8 of such gas and casinghead gas..."

⁹⁰ Enduro Oil Co. v. Parish & Ellison, 834 S.W.2d 547, 549 (Tex. App. – Houston [14th Dist.] 1992, writ denied).

⁹¹ AAPL Form 610 – Model Form Operating Agreement – 1982, Art. VI.C., page 8 alternate. It should be noted that the standard page 8 of the 1982 Model Form authorizes an operator to purchase or sell oil, but does not extend this right with regard to gas sales for the benefit of the non-operator. If the standard page 8 of the 1982 Model Form is used, then a gas balancing agreement is generally attached to the operating agreement and the gas balancing agreement must be consulted to determine the rights and liabilities of the parties and the potential for a conversion claim against a gas purchaser.

⁹² Enduro Oil Co. v. Parish & Ellison, 834 S.W.2d 547 (Tex. App. – Houston [14th Dist.] 1992, writ denied).

production was made expressly subject to the operating agreement. Since the operator proved that it had superior rights to the proceeds, the conversion action could not be maintained by the lienholder.⁹³

D. Tortious Interference Claims

An oil and gas purchaser should be aware of potential liability for tortious interference with business relations claims. Tortious interference claims may take one of two forms; interference with an existing contract, or interference with prospective contractual relations. The separate actions are generally referred to interchangeably as tortious interference with contracts. An action for tortious interference with contract is an intentional tort which results from actions by a person who is not a party to the contract which either induce a party to breach the contract or make performance of the contract more difficult.⁹⁴ In general, a failure of a purchaser to pay the producer or of an operator to pay a royalty owner should not give rise to an interference claim by the aggrieved party since one cannot "interfere" with a contract to which he is a party.⁹⁵ However, improper intentional actions by a third party which cause a purchaser or operator to suspend payment could subject the person causing the suspense to liability for interference generally attached to the operating agreement, and the gas balancing agreement must be consulted to determine the rights and liabilities of the parties, and the potential for a conversion claim against a gas purchaser.

Similarly, there are many other conceivable circumstances where an improper suspense of proceeds and an improper motive could give rise to an interference claim.

In a recent Texas case, the Supreme Court found that a gas purchaser was liable for tortious interference with contract when the purchaser intentionally breached its gas purchase contract with an operator containing "take or pay" provisions which, in turn, caused a breach of a gas balancing agreement between the operator and its non-operators.⁹⁶ In the Transco case, the Supreme Court found that "a knowing and intentional breach of one's direct contract may also be an act tortiously interfering with a third party's contract, if it is done with a purpose and effect of preventing the third party from performing its contract with another."⁹⁷ Under the rationale presented in the Transco case, there could be many other instances in which the intentional and wrongful suspense of proceeds by a purchaser could be found to tortiously interfere with the suspended party's contract with another party.

⁹³ Id. at 549 (citations omitted).

⁹⁴ Armendariz v. Mora, 553 S.W.2d 400 (Tex. Civ. App. – El Paso 1977, writ recd n.r.e.).

⁹⁵ Frost Nat. Bank v. Matthews, 713 S.W.2d 365, 369 (Tex. App. – Texarkana 1986, writ ref'd n.r.e.) citing Sakowitz, Inc. v. Steck, 669 S.W.2d 105 (Tex. 1984).

⁹⁶ American National Petro. Co. v. Transcontinental Gas Pipe Line Corp., 798 S.W.2d 274 (Tex. 1990).

⁹⁷ Id. at 279.

E. Injunctions

The remedy of injunction (either mandatory or prohibitory) may be available in those, circumstances where a purchaser or operator is threatening to either withhold proceeds or disburse proceeds through such circumstances as would cause irreparable harm to the person entitled to receive the proceeds. The circumstances in which: injunction would be proper under Rule 680 et set. of the Texas Rules of Civil Procedure are relatively limited since injunction is not available in circumstances where the claimant has an available adequate legal remedy. In most instances, mere failure to pay money owed or improper payment of money owed gives rise to a legal remedy which would be adequate i.e., suit for an accounting, action for debt or the like. Those situations in which injunction could become appropriate include when the party seeking to retain/receive proceeds is insolvent (unable to respond in damages)⁹⁸ or where disposal of the proceeds would constitute conversion. An argument might be fashioned under proper circumstances that suspension of proceeds could cause disruption of lease operations and irreparable economic harm, in which case injunction could become appropriate.

F. Interpleader

Interpleader is a remedy available to a party faced with multiple or conflicting claims to money or property within such party's possession. Interpleader was considered an equitable remedy at common law, but it may actually be used as a defense in a suit for wrongful suspense of proceeds. A party, such as a purchaser, holding proceeds to which it has no claim, but to which there is reasonable uncertainty as to the rightful owner, may institute an interpleader action and join the conflicting claimants. A court of competent jurisdiction will then decide which of the claimants is entitled to the proceeds. In an appropriate case, the plaintiff interpleader may also be able to recover costs and attorney's fees in connection with such an action.

The equitable remedy of interpleader has been given formal recognition and can be found in Rule 43 of the Texas Rules of Civil Procedure. The federal counterpart to this rule is found in Rule 22 of the Federal Rules of Civil Procedure. In addition, an interpleader proceeding may be brought, in appropriate situations, pursuant to the federal interpleader statutes.⁹⁹ The decision to institute an interpleader action under either state or federal law is determined based upon certain jurisdictional and venue requirements with respect to the stakeholder and the conflicting claimants.

In an interpleader action brought in Texas state court, a stakeholder may bring such an action if that person is or may be exposed to double or multiple liability. The potential multiple exposure must be based upon a reasonable doubt as to property ownership. The reasonableness requirement will generally be resolved in favor of the

⁹⁸ See, Bank of the Southwest, N.A. v. Harlingen Nat'l Bank, 662 S.W.2d 113, 116 (Tex. App. – Corpus Christi 1983, no writ).

⁹⁹ 28 U.S.C.A. §§1335, 1397, 2361.

stakeholder in order to allow the remedy of interpleader.¹⁰⁰ Interpleader is frequently used where there are conflicting claims to royalties on oil and gas produced from land, either due to a title dispute to the land itself, or conflicting claims to the royalty proceeds.

When a stakeholder, such as a purchaser of oil or gas, becomes aware of conflicting claims to specific property, the purchaser generally will place the funds in suspense. It is then necessary to evaluate the conflicting claims to determine whether each claimant has a reasonable claim to the proceeds. If the stakeholder/purchaser has reasonable doubt, then an original petition for interpleader can be filed joining the claimants and the disputed proceeds or funds should be tendered into the registry of the court. By instituting this action, the stakeholder/purchaser may actually be avoiding any claim for wrongful suspense of funds.

The stakeholder who is entirely disinterested in funds or property, and who interpleads the claim in good faith, is generally entitled to recovery of its attorney's fees out of the funds tendered to the court.¹⁰¹ A stakeholder/purchaser generally is also entitled to recover costs incurred in the interpleader action. However, a stakeholder who is not entirely disinterested, or who is found to be responsible for creating the conflicting claims to the property or proceeds, may not be entitled to recover its attorney's fees.¹⁰² Getty Reserve Oil Inc. involved conflicting claims by drillsite and non-drillsite non-participating royalty interest owners against a lessee in connection with a 640 acre gas unit with differing royalty ownership. Since the lessee had not sought prior ratification from all of the non-participating royalty owners, the Court found that there was some evidence that the lessee was responsible for creating the conflicting claims, and remanded that part of the judgment to the trial court for trial on the merits.¹⁰³ When a stakeholder/purchaser has a reasonable doubt as to payments to conflicting claimants, the remedy of interpleader should be used as soon as possible, so the stakeholder can recover its attorney's fees.¹⁰⁴

G. Indemnity Agreements

As a practical matter when there is any substantial issue regarding title or ownership, the decision of whether or not or who to pay often devolves to a credit evaluation, i.e., who is able to adequately reimburse you if you pay them and are wrong. Quite often suspense issues or competing claim issues are resolved by obtaining an

¹⁰⁰ Citizens Nat'l Bank of Emporia v. Socony Mobil Oil Co., 372 S.W.2d 718, 722-23 (Tex. Civ. App. – Amarillo 1963, writ ref'd n.r.e.).

¹⁰¹ United States v. Ray Thomas Gravel Co., 380 S.W.2d 576, 581 (Tex. 1964).

¹⁰² Brown v. Getty Reserve Oil, Inc., 626 S.W.2d 810, 815 (Tex. App. – Amarillo 9181, writ dismissed).

¹⁰³ Id.; cf. MCZ, Inc. v. TrioIQ, 708 S.W.2d 49, 56-57 (Tex. App. – Houston [1st Dist.] 1986, writ ref'd n.r.e.)(lessee allowed to recover attorney's fees based upon the fact that lessee did not create the controversy underlying the interpleader action and was paying royalties prior to the institution of the interpleader action as then prescribed by law.)

¹⁰⁴ See Verble v. Coffman, 680 S.W.2d 69, 71 (Tex. App. – Austin 1984, no writ)(defensive interpleader brought after the institution of suit to recover funds does not entitle a stakeholder to an award of attorney's fees).

indemnity from the recipient of the funds indemnifying the payor against all costs and expenses which may be incurred as a result of the payment including attorney's fees and costs. This is often the most practical solution for a purchaser who desires to maintain a relationship with the party selling him the oil or gas and at the same time avoid excess liability to an adverse claimant. The practical adverse consequences of indemnity are that indemnities are only as good as the indemnitor and if the party to whom funds are paid (the indemnitor) is unable to fully compensate the purchaser who releases money (the indemnitee), the purchaser may still be on the hook. In addition, if claims such as conversion or intentional interference with contract are involved which create potential for excess punitive and exemplary damages, an indemnity which might otherwise appear good on its face may prove inadequate.

H. Escheat

A purchaser or other party in the position of distributing mineral proceeds should also be familiar with the provisions and reporting requirements of the Texas Escheat Laws.¹⁰⁵ Chapter 75 of the Texas Property Code specifically applies to minerals and mineral proceeds and provides that all mineral proceeds that are held or owing by the holder and that have remained unclaimed by the owner for longer than three (3) years after they become payable or distributable are presumed abandoned.¹⁰⁶ Additionally, at the time an owner's underlying right to receive mineral proceeds is presumed abandoned, all proceeds then held for the owner or accruing thereafter are also presumed abandoned.¹⁰⁷ When mineral proceeds or an owner's underlying right to receive mineral proceeds is presumed abandoned, the holder of the proceeds is subject to the reporting provisions of Chapter 74 of the Texas Property Code.¹⁰⁸

Under Chapter 74 of the Texas Property Code, a party who on June 30th of a particular year holds property that is presumed abandoned under Chapter 75 of the Property Code, or under other chapters specified, is required to file a report of that property with the State Treasurer on or before the following November 1.¹⁰⁹ The holder of such property is then required to file successive reports each year thereafter regardless of whether the holder has any reportable property on June 30th of the year in which the report is filed. The reports to be filed with the State Treasurer must include certain detailed information as required by the statute, including a verification by the holder, on forms prescribed by the State Treasurer.¹¹⁰ A holder who willfully fails to file a report or violates other provisions of the Escheat Statutes can be liable for criminal penalties including a fine not to exceed \$2,000, confinement in jail for up to six (6) months, or both.¹¹¹ Additionally, a holder may be subject to a civil penalty equal to five percent (5%) of the value of the property if the holder fails to pay or deliver property within the

¹⁰⁵ Tex. Prop. Code Ann. §§71.001 – 75.102 (Vernon 2006).

¹⁰⁶ Tex. Prop. Code Ann. §75.101(a)(Vernon 2006).

¹⁰⁷ Tex. Prop. Code Ann. §75.101(b)(Vernon 2006).

¹⁰⁸ Tex. Prop. Code Ann. §74.101(c)(Vernon 2006).

¹⁰⁹ Tex. Prop. Code Ann. §74.101 (Vernon 2006).

¹¹⁰ Tex. Prop. Code Ann. §§74.101(c), 74.102 (Vernon 2006).

¹¹¹ Tex. Prop. Code Ann. §74.710 (Vernon 2006)(stating an offense under this section 74 is a Class B misdemeanor)

time prescribed by the Escheat Statutes and if a holder fails to pay or deliver property before the 31st day after the date the property is due, an additional penalty equal to five percent (5%) of the value of the property due shall be imposed.¹¹² Accordingly, a purchaser or other holder of mineral proceeds must be aware of the statutory provisions and comply with these provisions to avoid the criminal and civil penalties which may be imposed.

VII. Conclusion

As should be obvious from the above discussion, the decision of whether to pay or suspend payment is one which will require analysis of the specific facts and agreements. Not every dispute authorizes suspense nor does suspending payment automatically protect the purchaser from liability. The solution for the purchaser is on a pragmatic decision based as much on business considerations as legal ones.

¹¹² Tex. Prop. Code Ann. §74.705 (Vernon 2006).