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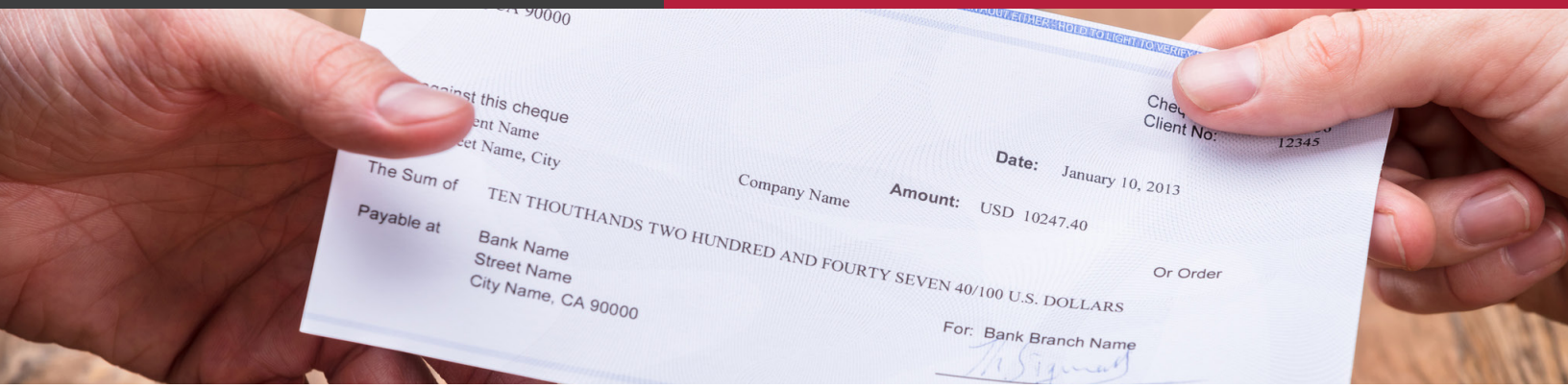
"SHOW ME THE MONEY!": WHO IS A "PAYOR" UNDER THE TEXAS NATURAL RESOURCES CODE?

DEVON ENERGY PRODUCTION CO., LP V. APACHE CORPORATION

by Paul Yale, Chance Decker and Ethan Wood
Gray Reed & McGraw Energy Industry Team
May 25, 2018



In a case of first impression, on April 30, 2018, the Eastland Court of Appeals held that Section 91.402 of the Texas Natural Resources Code (the "Division Order Statute") does not require an operator to pay lease royalties to mineral interest owners who have leased to a different working interest owner. But, the court stopped short of answering some additional questions surrounding issues that arise when multiple lessees are unable (or unwilling) to enter into a Joint Operating Agreement ("JOA").

The Facts

Norma Jean Hester leased her undivided one-third mineral interest in a tract of land in Glasscock County, Texas to Apache, reserving a 25 percent royalty. The remaining mineral owners leased their combined two-thirds mineral interest to Devon, also reserving a 25 percent royalty. These mineral interest owners are referred to herein as the "Devon Lessors". Devon and Apache were unable to agree on a JOA. Apache drilled seven producing oil and gas wells on the property and, after payout, paid Devon its two-thirds share of the production revenue net of Apache's costs. Apache left it to Devon to pay the Devon Lessors their quarter royalty.

The Dispute

The Devon Lessors sued Devon for failure to pay "all royalties due" under the terms of their leases and Apache for failure to pay royalties pursuant to the Division Order Statute. Devon filed a cross-claim against Apache seeking a declaratory judgment that the Division Order Statute required Apache to pay the Devon Lessors royalties under Devon's leases: (i) directly and (ii) before payout of Apache's wells. Devon alleged Apache was then to charge those royalty payments against Devon in determining the wells' payout point.

The Law

The court stated the rules of equitable accounting between mineral cotenants are well established. "A cotenant has the right to extract minerals from common property without first obtaining the consent of his cotenants; however, he must account to them on the basis of the value of any minerals taken, less necessary and reasonable costs of production and marketing." It was also clear that Devon and Apache, as lessees, were cotenants in the mineral estate. However, the question of which cotenant must pay royalties to the lessors of a non-participating working interest owner under the

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Division Order Statute has never been addressed by the Texas courts of appeal. The Statute provides as follows:

"The proceeds derived from the sale of oil or gas production from an oil or gas well located in this state must be paid to each payee by payor on or before 120 days after the end of the month of first sale of production from the well. After that time, payments must be made to each payee on a timely basis according to the frequency of payment specified in the lease or other written agreement between payee and payor."

The Ruling

Siding with Apache, the Eastland Court focused on the words "payor" and "payee" in the statute to determine Devon, not Apache, was obligated to pay the Devon Lessors. A "payor" is "the party who undertakes to distribute oil or gas proceeds to the payee, whether as the purchaser of the production of oil or gas generating such proceeds or as operator of the well from which such production was obtained or as lessee under the lease on which royalty is due." A "payee" is "any person legally entitled to payment from the proceeds derived from the sale of oil or gas from an oil or gas well located in this state."

The court held Apache could not be a "payor" under the Division Order Statute because it did not "undertake" to pay the Devon Lessors by entering into leases with them. Thus, even though Apache was the "operator of the well from which … production was obtained", it was not a "payor" under the Division Order Statute. Thus, paying the Devon Lessors their lease royalty was Devon's obligation.

The Unanswered Questions

The court's opinion did not expressly address the issue of when a mineral owner who has leased to a non-participating working interest owner is entitled to royalties pursuant to their lease—before or after payout. However, the court's opinion appears to have answered that question by implication. The Division Order Statute does not require an operator to pay royalties to mineral interest owners who have leased to a different working interest owner. And, Texas cotenancy law does not require the operator to pay net production revenues to a non-participating cotenant until after payout. Thus, arguably, absent special lease provisions, a mineral estate lessor is not entitled to lease royalties from the lessee of its cotenant until after payout of the well from which royalties are due[1]. Until that point, the operator is not required to pay net production revenue to the non-participating cotenant, and the non-participating cotenant has received no revenues on which royalties are due.

But if the non-participating working interest owner is not paying royalties—what is keeping the lease alive? Absent pooling of the leases or a JOA, the non-participating working interest owner cannot rely on the operator's actions to perpetuate its leases. A sly operator can obtain top leases from the non-participating working interest lessors and run out the clock on those leases (this option is especially promising if "payout" will not occur until after the expiration of the primary term of the non-participating working interest owner's lease).

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[1] *But see Eugene Kuntz, The Law of Oil and Gas § 5.6 at 155 (1987) ("It is also possible that such non-operating lessee should pay to his lessor the agreed royalty on the basis of the covenant in his lease, whether or not the expenses of the operating lessee have been recovered.")*

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So, what's a lessor to do when his lessee won't play ball with the operator? Arguably, his lessee has failed to develop the lease and protect against drainage. Devon and the Devon Lessors settled their claims prior to the trial court's final judgment, so we don't know what duties Devon had to pay royalties or drill their own wells on the leased lands.

The Takeaway

It's good to be the operator! Devon v. Apache gives operators additional leverage in JOA negotiations with potential non-operators: Do things our way or risk the ire of your lessors who will sit and stew for months or years waiting on royalty payments. And non-operators may be forced to sit in the dark[2] trying to figure out when—or if—payout will come and what actions they need to take to preserve their lease.

ABOUT THE AUTHORS

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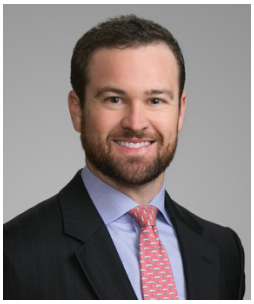

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An aggressive and results-driven litigator, Chance Decker focuses on resolving high-stakes disputes for businesses in a variety of industries, particularly oil and gas. His client list includes major players and growing businesses across the energy industry, from E&P companies, interstate pipeline companies, pipe and steel distributors, and oilfield services companies. As a reader of every oil and gas opinion issued by the appellate courts of Texas each week, Chance is a regular contributor to various industry publications, including Energy & The Law, the firm's blog focused on analyzing oil and gas issues and how they may impact clients from a legal and business standpoint.

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Ethan Wood has significant experience with natural resources law, lease and contract negotiations, title opinions, regulatory compliance, and environmental and surface use. He also has extensive knowledge and proficiency with oil and gas law in multiple jurisdictions, including Texas, New Mexico, Ohio, Pennsylvania, and Oklahoma. Before starting his law practice, Ethan was an independent petroleum landman.

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[2]*Devon waited over two and a half years for production, sales, and revenue information for the wells that had reached payout and still did not receive such information for wells that had not reached payout. Brief of Appellant Devon Energy Production Company, LP, 2016 WL 4251479 at *5*