REAL ESTATE CENTER

Minerals, Surface Rights and Royalty Payments

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Real Estate Center

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Summary

The exploration and production of minerals, especially oil and gas, have played an important role in the economic development of Texas. Because most of the oil and gas is privately owned, a body of law has evolved in the state that defines ownership rights.

One of the earliest and most significant cases decided by the Texas Supreme Court held that the mineral estate is dominant over the surface estate. The grant of the mineral lease gives the mineral lessee the implied right to use as much of the surface as is reasonably necessary for the exploration and development of the minerals. The surface owner's consent is not required for this right to be exercised. The mineral lessee is liable for surface damages only in limited situations.

Another significant precedent established by Texas courts held that the grant of an oil and gas lease gives the mineral lessee the exclusive right to conduct exploration tests on the property for the presence of oil and gas. Because an oil and gas lease is silent concerning how, when and under what circumstances the tests may be undertaken, the mineral owner may wish to address these issues when negotiating an oil and gas lease.

Finally, recent Texas case law has settled the issue concerning which document controls when the division order conflicts with the oil and gas lease. The division order supplants contradictory provisions in the lease until the division order is revoked.

This rule places mineral owners in a dilemma: if they sign the division order, they relinquish important lease provisions but if they do not sign, they cannot receive royalty checks. However, provisions in the oil and gas lease can be negotiated that avert this problem.

Surface Rights and Mineral Rights

Many Texans buy small tracts outside the city for residential purposes. Their primary concern is to use and enjoy the surface. They may give little or no thought to the inclusion or exclusion of the minerals at the time of purchase because the probability of mineral activity in the area appears nil. Later, however, not owning the minerals can create serious problems.

In Texas, the mineral estate is a separate interest in land that can be severed from the surface estate. The severance generally occurs in one of two ways. Either the landowner sells the minerals and retains the surface, or more commonly, the landowner sells the surface and retains the minerals. If the seller fails to reserve the minerals when selling the surface, the buyer automatically receives any mineral interest the grantor owned at the time of conveyance.

Whether the surface and mineral estates are severed or united, the rule in Texas is the same—the mineral estate dominates. The surface estate exists for the benefit and use of the mineral owner. Otherwise, the mineral estate would be worthless if the mineral owner could not enter on the surface to explore for and produce the minerals.

Mineral Agreements Grant Ownership Rights

This rule has serious implications for surface owners who are not mineral owners. Texas courts have held that mineral leases are not mere rental agreements as the name implies. Instead, they are actually deeds granting limited ownership rights to mineral lessees for as long as the lease continues. Thus, during the tenure of a lease, the mineral lessee enjoys the same rights to use the surface as any other mineral owner.

These property rights can be stated in the following way:

> Mineral lessees can use as much of the surface as is *reasonably necessary* for mineral exploration and production. This privilege springs from the executed mineral lease. Independent permission from the surface owner is not necessary. No responsibility exists for restoring the surface or for paying surface damages. Liability arises only when the lessee goes beyond what is reasonably necessary or negligently injures the surface.

The oil company or other entity leasing the minerals is the *lessee* and the mineral owner is the *lessor*.

Exceptions to the Rule on Surface Use

The general rule regarding surface use may be offset by negotiating specific lease provisions. For example, the lease terms could be altered to require the surface owner and mineral lessee to mutually agree on the location of wells, roads, pipelines and related activities. Likewise, the lease might require the surface to be restored and surface damages paid once drilling operations cease. On small tracts, the mineral lessee may waive all rights to use the surface. Most lease forms prohibit drilling activity within 200 feet of any dwelling on the property.

Another exception arises where the mineral activity occurs within the boundaries of a municipality. The mineral producer's activities must conform to any valid ordinances instituted under the police powers of the city or town.

And finally, a subdeveloper may impose certain deed restrictions on a subdivision to designate operation sites (drill sites) and the location of road and pipeline easements within the subdivision. The procedure is outlined in Chapter 92 of the Texas Natural Resources Code.

Court Cases Resolve Conflicts

Citizens who do not qualify for these exceptions and cannot negotiate a surface-use agreement with the producer can find recourse only through the judicial system.

The cases evolving from the conflict between surface owners and mineral lessees have concentrated in three areas: What is reasonable use? When does negligence occur? When do the minerals belong to the surface owner?

Texas courts have ruled that the following activities constitute **reasonable use:**

- To conduct geophysical explorations on the surface, such as seismic tests
- To select the best possible well sites
- To enter and leave the well sites and other facilities on the lease property
- To construct, maintain and use roads, bridges, canals and other passageways necessary to transport materials, personnel and equipment to and from the well sites and to other facilities
- To use caliche found on the leased premises to construct roads and passageways
- To install and use pipelines to transport hydrocarbons and waste products to points within or off the leased premises
- To house employees working on the leased premises
- To install necessary storage tanks, slush pits, structures, machinery and other appliances
- To use any water, either fresh or saline, found above or below the surface for use in drilling and waterflood operations
- To inject salt water in nonproductive wells located on the leased premises
- However, in 1939, a Texas appellate court held the mineral lessee liable for the destruction of movable personal property (sand) that was stored on the lessee's proposed drill site.

Texas courts have ruled that the following activities **do not constitute negligence:**

- Failing to restore the surface when operations cease
- Failing to fence the area of operations to restrict grazing livestock from any harmful substances existing thereon
- Completely draining underground aquifers serving as the sole source of the surface owner's domestic and agricultural water supply

- Causing subsidence because of drilling or extraction methods stemming from known commercial processes

The Texas Supreme Court has ruled, however, that subsidence caused by the negligent or excessive withdrawal of groundwater will create liability.

Several Texas appellate cases have found the mineral lessee negligent for polluting fresh water with salt water. One case found the mineral lessee liable for the negligent construction and maintenance of a cattleguard that caused injury to a horse.

In the early 1970s, the Texas courts departed slightly from the traditional tests of "reasonably necessary" and "negligence." The emerging standard introduces compromise between the surface owner and mineral lessee. It is sometimes referred to as the Accommodation of the Estates Doctrine or the concept of "due regards." The precedent was rendered by the Texas Supreme Court in the 1971 decision of *Getty Oil Co. v. Jones.*

The controversy between Jones (the landowner-farmer) and Getty Oil centered on a beam pump installed by Getty Oil on Jones' land. The height of the beam pump interfered with Jones' circular irrigation sprinkler system. Jones sued for damages and an injunction seeking either to have a shorter type of pump installed or alternatively to dig a pit to lower the height of the present pump.

The Texas high court ruled in favor of Jones. The court recognized the reasonably necessary doctrine but held that a use still may be unreasonable when a reasonable alternative exists. The surface owner is entitled to an accommodation of estates if the mineral lessee has a reasonable alternative that would serve the public policy of mineral development while also permitting use of the surface for productive agriculture.

Later refinement of the Getty decision limited the reasonable alternatives to other methods that can be used on the leased land and not elsewhere. Also, any injunctions issued based on the accommodation of the estate doctrine must identify the harm that will be suffered if the injunction is not issued. Simply citing the doctrine as the reason for the injunction is inadequate.

Minerals: Not All Substances in Ground

Regarding ownership of the minerals in the ground, the courts have recognized that property rights of the surface owner sometimes extend below the surface. Traditionally, under common law, all matter was divided into three categories—animals, vegetables and minerals (which included the soil and everything in it). Hence, if the surface and mineral estates were severed, the line of demarcation lay at the surface.

This long-standing rule was re-examined by the Texas courts in the cases of *Acker v. Guinn* and *Reed v. Wylie.* The latter occurred more recently and was heard twice by the Texas Supreme Court. Resolution of the issue took several years. It is the landmark decision in this state.

In 1949, Wylie owned the surface and three fourths of the minerals in 223 acres in Freestone County, Texas. That same year he executed a mineral lease for strip mining of coal and lignite. In 1950, Wylie sold the surface. Simultaneously, Wylie reserved an undivided one-fourth interest in "all oil, gas and other minerals. . . ." Later, Reed became the owner of the surface and brought an action against Wylie to determine whether the *undivided* one-fourth mineral interest reserved by Wylie included the coal and lignite.

The court held that Wylie's reservation did not include the coal and lignite. The decision was based, in part, on the earlier case of *Acker v. Guinn* involving iron ore. There the court had held that the unnamed substances included in the phrase *oil, gas and other minerals* must be ascertained from the intent of the parties. And, ". . . unless contrary intention is affirmatively and fairly expressed . . . the term 'minerals' or 'mineral rights' should not be construed to include a substance that must be removed by consuming or depleting the surface estate."

Reed v. Wylie clarified the *Acker v. Guinn* decision. The court held the term *minerals* meant the following where no express intent appears to the contrary. (1) Any coal or lignite found *at the surface* is not a mineral and thus belongs to the surface owner. The term at the surface basically means "on the surface." (2) Any coal or lignite found *near the surface* is not a mineral and belongs to the surface owner if any reasonable method of production will destroy, consume or deplete the surface. The term *near the surface* means within 200 feet of the surface. (3) Any coal or lignite situated both within and below 200 feet of the surface again belongs to the surface owner if production will destroy, consume or deplete the surface. (4) Reclamation or restoration of the surface after production is immaterial. (5) The value of the substance being removed is irrelevant.

Following the *Reed v. Wylie* decision, the Texas Supreme Court was asked to decide whether the phrase *oil, gas and other minerals* included uranium. In deciding *Moses v. U.S. Steel* on June 8, 1983, the Texas Supreme Court departed from the surface-destruction test set forth in *Acker v. Guinn* and *Reed v. Wylie.* Instead, the court held that the term *mineral* includes uranium as a matter of law regardless of its depth or how it was produced.

The court left intact the surface-destruction test for iron ore, coal and lignite but limited the test solely to these three substances in the future. However, in 1995, in *Plainsman Trading Co. v. Crews*, the Texas Supreme Court applied the surface-destruction test when asked to decide whether uranium was a mineral. As long as all the conveyances material to a dispute were executed before June 8, 1983, the test is not limited to iron ore, coal and lignite.

Finally, the court held that the term *mineral* does not include, as a matter of law, limestone, caliche, surface shale, building stone, sand and gravel. These substances belong to the surface owner along with fresh water, whether located on the surface or in the subsurface.

Other Surface Protection Measures

However, surface owners may pursue the following where they clearly own no rights to the minerals:

- Contact the mineral lessee in an attempt to work out a land-use agreement. Basically, the agreement would restrict the lessee's operations to a certain section of the land or restrict operations from the surface entirely. Of course, the lessee is not under any legal obligation to enter such an agreement.
- Contact the mineral owner and work out a land-use agreement or a comprehensive surface-use and surface-damage clause to be included in future leases. Again, the mineral owner has no legal obligation to respond to the request.
- Attempt to purchase all or a part of an undivided interest in the mineral estate. By doing so, future mineral lessees may have to negotiate with them when leasing the property.
- If all or a part of the minerals cannot be purchased from the mineral owners, surface owners may attempt to purchase the right of ingress and egress. This will require the lessee to make arrangements with the surface owners before entering to explore or produce on the property. At the same time, the mineral owners giving up this right are not deprived of any bonus, delay rentals or royalty payments.

In Texas, the mineral lessee has the implied right to use the surface estate for exploring and producing minerals. Such mineral rights are superior to the right of the surface owner to the extent that they are reasonably necessary for the development of the mineral property. The courts have moderated this rule somewhat. However, the surface owner still may wish to protect and preserve the surface by securing an independent contractual arrangement. Competent legal assistance when purchasing land is indispensable.

Negotiating Terms of Mineral Exploration

Mineral owners who anticipate extensive exploration of their property should negotiate lease provisions that will protect their interests.

Exploration Techniques

Oil companies use a geophysical survey to search for underground geological structures favorable for the accumulation of hydrocarbons. The survey is an attempt to locate structural traps formed by a dome-shaped impermeable rock layer covering a layer or layers of permeable sand. The survey may reveal the presence of a trap but not the presence of hydrocarbons.

Several devices are used to conduct geophysical surveys, including seismographs, magnetometers, gravity meters and a torsion-balance system. With the exception of the seismograph, these devices measure the gravitational pull of subsurface rocks to locate the structural trap. The seismograph is the most widely used device on shore.

A seismic test measures acoustic waves bounced off subterranean structures. Acoustic waves are generated in several ways: by blasting dynamite from a shot hole drilled several hundred feet in the ground; by dropping a heavy weight known as a *thumper* from a truck; or by shaking the ground with a device known as a *vibrasizer*.

The acoustic waves travel downward and outward; they are reflected back to the surface by underground structures. The reflected signals are monitored on the surface by seismometers (or *jugs*) connected to a line laid along a predetermined course. The line is connected to an oscillograph that records the signals.

With the advent of 3-D seismic in the 1990s, the lines and seismometers are more concentrated. Landowners may want more payment to consent to 3-D seismic tests and negotiate stronger surface-damage provisions.

Permission for Exploration

Before oil companies may conduct exploratory tests for potential drill sites, they must secure permission from the mineral owner. If the land is under lease, the mineral lessee's consent is needed. The surface owners and surface tenants may be contacted to avoid conflicts, but their permission is not required by Texas law. However, this section of this report is based on the assumptions that the mineral and surface estate are owned by the same person, and the minerals are not under lease.

Permission from the mineral owner may be granted in one of two forms. The oil company may acquire an oil and gas lease that, among other things, grants to the lessee the exclusive right to explore. Or, the oil company may acquire permission only to conduct geophysical tests. If the tests prove positive, an oil and gas lease may be sought.

Liability for Geophysical Trespass

But what happens if a geophysical trespass occurs? In other words, what are the legal consequences of a geophysical survey that is conducted without the company first securing proper consent?

The answer depends, in part, on whether the trespass was conducted in good faith or in bad faith.

A good faith or innocent trespass occurs when the surveyor honestly believes that permission to enter and conduct the tests has been secured. In such cases, the innocent trespasser is liable for all damages suffered by the surface and mineral owner. Damages are divided into four categories: (1) physical damages to the land caused by the trespass, such as damages to fences, water wells, crops, improvements and roads; (2) monetary value paid to the mineral owners in the area for permission to enter and survey. If the data collected from the survey are not kept confidential, the innocent trespasser also is liable for (3) lost value of leasing the minerals if the survey indicates no underground structural traps and (4) value of the sale if the data are sold.

A bad faith trespass occurs when the surveyor knowingly or maliciously enters to conduct tests. When a bad faith trespass occurs, the trespasser not only is liable for the same damages as the good faith trespasser but also is liable for punitive damages. Punitive damages may greatly exceed the actual damages in certain cases. However, no punitive damages may be awarded unless actual damages first can be proven.

Geophysical Explorations Under Lease

Texas has unique laws regarding geophysical surveys conducted pursuant to an oil and gas lease. Texas case law has held that the mineral lessee has the implied right to conduct geophysical surveys unless prohibited by the lease. Oil and gas leases generally do not prohibit such surveys but instead grant the lessee the exclusive right to conduct such tests.

Texas law also has held that the lessee has no legal obligation to restore the surface or pay surface damages for geophysical tests conducted pursuant to an oil and gas lease. However, liability for damages arises when the tests were not reasonably necessary or when they were conducted negligently.

Because the damages suffered from geophysical tests can outweigh any resulting monetary benefits, mineral owners should carefully consider geophysical operations when negotiating an oil and gas lease or when granting the right to conduct geophysical tests apart from the lease. There are two ways of approaching the issue when negotiating the lease. One is to prohibit geophysical operations without the mineral owner's prior written consent. This defers negotiating the seismic agreement. The other is to negotiate and include the terms of the seismic agreement in the oil and gas lease. The agreement should be tailored to the needs of the particular tract.

Lease Considerations

In the agreement, the mineral owner should specify who or what entity is liable for all surface and subsurface damages and how the payments will be apportioned among the mineral owner, the surface owner or the agricultural-surface lessee.

The mineral owner should determine how the monetary value of the damages will be ascertained and when damages must be paid. Many mineral owners require an adequate security deposit before the tests begin. The monetary value of damages may be assessed by a qualified appraiser.

The mineral owner should establish test site boundaries. This involves restricting the shot holes, or other means generating the waves for seismic operations, to a safe distance from water wells, dams, foundations of homes and other structures.

Vehicular travel should be disallowed when the ground is so saturated with moisture that ruts exceeding a specified depth will occur. Cables and seismometers still can be pulled or carried across the property for the tests.

Routes of egress and ingress the crews must use while conducting the survey should be established, and a map provided with the proposed route of the survey platted. The mineral owner can stipulate that if the surveyor deviates from the designated course, the permit will be terminated or liquidated damages imposed. Whether fences can be cut, how they must be braced before cutting and how they will be repaired are other considerations.

The agreement should describe how the land may be cleared prior to tests and how it must be cleaned and restored. Usually land is cleared when the crew lays the seismic line. Clearing also may be necessary when new roads are constructed. In any event, the mineral owner should require all brush to be stacked and burned; damaged or removed trees should be cut for firewood, with the limbs and stumps burned or removed. Rocks exceeding specific dimensions should be removed or placed in designated areas.

The agreement should specify that all holes and ruts be back-filled, all mounds leveled, topsoil replaced and, perhaps the area reseeded where surface damages are more extensive. In addition, the cut line should be back-dragged and the ground leveled as smooth or smoother than before the tests.

The agreement should address how much the mineral owner will be paid for allowing the survey. The mineral owner generally receives an amount customary in the area. This may range from a payment per shot hole to a fee for the length of line laid. A daily fee for the number of personnel and vehicles entering the land may be paid also.

In addition, the mineral owner should consider whether the seismic agreement may be assigned to a third party once the mineral owner has consented.

Possible damage to water wells should be addressed. The mineral owner may require the replacement of a damaged well with one of equal quantity and quality. If one cannot be located on the property, the mineral owner may ask for water to be piped in or for property damages because of diminished or lost water supply. The mineral owner may want water samples to be taken by a third party prior to and 15 to 30 days after the tests to preserve any evidence of damage to water wells.

Some mineral owners attempt to obtain copies of the survey results. This may be difficult. However, a copy of the data acquired from the tests may be a good substitute. Interpretation of the data may vary.

The following are other considerations:

- A requirement that gates be kept closed and possibly locked—liquidated damages can be imposed for each time gates are left open.
- Inclusion of an indemnity agreement holding the mineral owner harmless from judgments, attorney's fees or both arising from the surveyor's activities on the property
- Instructions for repairing the surface above the shot holes

Taxation of Payments

The fee paid the mineral owner for the right to enter and survey is sometimes called a *trespasser's fee.* It is a separate and distinct fee from the payment for surface and subsurface damages. Further, the two are taxed differently.

Payment for permission to enter and survey is taxed as ordinary income. Payment for damages to the land (as opposed to damages to growing crops) reduces the owner's basis in the property. The payments are not taxed until they exceed the property owner's basis in the land. After that, they are taxed as capital gains income if the land has been owned for more than six months. However, all payments received pursuant to geophysical tests are presumed to be for permission to enter and survey and not for damages to land.

The mineral owner may wish to require the lessee to prepare a written itemized account disclosing how the payments were computed. The itemized account would be indispensable in a tax audit.

Above all, parties to an agreement must remember to place all the terms and conditions in writing. Oral promises are difficult to prove in a court of law.

Division Orders and Royalty Checks

Mineral owners or their attorneys frequently fail to properly address the treatment of division orders and royalty checks when negotiating an oil and gas lease. If overlooked, the mineral owner could lose not only money but also many beneficial lease terms acquired during the negotiation process.

Division Orders

Not all mineral owners are familiar with division orders because they are not issued until production begins. Division orders are revocable agreements signed by the mineral owners directing the distribution of proceeds from the sale of oil, gas, casinghead gas or other related hydrocarbons. The division order becomes effective only after the oil or gas comes into the purchasers possession. It is not a sale of the oil or gas in the ground.

In addition to being a sales contract, division orders also insure that the proper parties (or owners) are paid the correct amounts. Division orders state (or declare) the fraction of production each party is entitled to receive. The precise figure is contained in a fraction carried out to a minimum of seven digits, though eight decimal points frequently are used. The specified ownership interest is derived from a title opinion rendered by an attorney working for either the purchaser or lessee (producer). Each interest owner will be asked to sign (or execute) the division order before the first royalty check is issued.

Division orders can do more than simply state each party's interest. Additional provisions may be included that may or may not comply with the original lease terms. Here is the dilemma faced by mineral owners who are sent a division order for execution. If they sign the division order containing terms contrary to the original lease, will the division order amend or supplant the lease? Is the execution of the division order a prerequisite for receiving the first royalty check? Is it necessary for all parties named in the division order to sign before any party gets paid?

Apart from any specific statutory law or case law that a particular state might have, the answers to these questions generally are held as follows.

First, a division order can never permanently amend or supplant the lease. If the terms of the division order differ from the lease, however, the division order controls until revoked by the mineral owner. The mineral owner has no recourse against the purchaser or lessee for any variances during the interim. See Sections 91.402(g) and (h) of the Texas Natural Resources Code.

Second, execution of the division order may be required as a condition for receiving a royalty payment. Section 91.402(c) (1) of the Texas Natural Resources Code provides that the mineral owner *must* sign the division order if it contains **ONLY** the following items:

(A) the effective date of the division order;

(B) a description of the property from which the oil or gas is being produced and the type of production;

(C) the fractional and/or decimal interest in production claimed by payee (royalty owner), type of interest, certification of title to the share of production claimed, and, unless otherwise agreed to by the parties, an agreement to notify payor at least one month in advance of the effective date of any change in the interest in production owned by payee and an agreement to indemnify the payor (purchaser) and to reimburse the payor for payments made if the payee does not have merchantable title to the production sold;

(D) the authorization to suspend payment to payee for production until the resolution of any title dispute or adverse claim asserted regarding the interest in production claimed by payee;

(E) the name, address and taxpayer identification number of payee;

(F) provisions for the valuation and timing of settlements of oil and gas production to the payee; and

(G) a notification to the payee that other statutory rights may be available to payee with regard to payments.

The purchaser may not withhold royalty payments solely because an owner refuses to sign a division order not in compliance with Section 91.402(c)(1). However, if the owner refuses to sign a division order consistent with the section, the purchaser may withhold royalty payments without interest.

Note: Section 91.402(c) *et seq.*, effective August 26, 1991, was added by the 72nd Texas Legislature to cure problems associated with division orders. However, it created others in at least two respects.

First, Section 91.402(c)(2) provides that a division order containing only the six enumerated items ". . . does not amend any lease. . . ." However, if such a division order did contain conflicting provisions, which instrument controls, the division or the lease?

Second, Section 91.402(i) provides that a division order may be used to clarify royalty settlement terms. As such, the terms *market value, market price, prevailing price in the field* or other such language is statutorily defined as "the amount realized at the mouth of the well by the seller of such production in an arms length transaction."

The problem is that the statutory definition of the terms alters Texas case law. The terms are not synonymous according to the Texas courts. Furthermore, the deductible costs from the royalty may vary with each term according to Texas case law.

And finally, all parties need not sign the division order before a single party is paid. However, the purchaser or lessee has sole discretion in the matter.

The mineral owner may encounter other questions and problems apart from the terms of the division order. For instance, how soon after production commences will the first royalty check be issued? After the first royalty check is received, how frequently will subsequent checks be rendered to the lessor? If a royalty check is delinquent or withheld, will the mineral owner receive interest on the unpaid balance?

The answers to these questions are governed both by the lease terms and Texas statutory law. Unless the lease contains terms to the contrary, Section 91.401 et seq. of the Texas Natural Resources Code provides that the first royalty payment must be tendered within 120 days after the end of the month in which the first sale of production occurs . Thereafter, subsequent royalty payments are to be tendered within 60 days after the end of the month oil production is sold and within 90 days after the end of the month gas production is sold.

If royalty payments are not forthcoming within the designated intervals, the royalty is to draw interest at a rate 2 percent above the rate charged on loans to depository institutions by the New York Federal Reserve Bank. A different interest rate will be charged if the lease so states.

As a prerequisite for royalty accruing interest under the Texas statute, the royalty owner must give the purchaser written notice by mail of the delinquency. The purchaser has 30 days after receipt either to pay the royalty or to explain the reason for delay.

Section 91.402(b) of the statute describes three circumstances when the purchaser is excused from paying interest. These are when (1) a dispute concerning title affects distribution of payments, (2) a reasonable doubt exists concerning the mineral owner’s entitlement to the royalty payments and (3) a title opinion places in issue the title, identity or whereabouts of the royalty owner that has not been satisfied after a reasonable request has been made.

Section 91.402(f) also provides that royalty payments may be remitted annually, not monthly, if the aggregate amount owed the royalty owner during the preceding 12 months does not exceed $100.

For the best protection, mineral owners should address these issues in the lease and not rely solely on the Texas statutes. Alternatives the mineral owner may negotiate regarding division orders include the following:

- A division order tendered to the mineral owner shall comply strictly with Section 91.402(c)(1) as illustrated in Section 91.402(d) of the Texas Natural Resources Code. However, the division order may not alter the leases valuation of the royalty nor change the Texas case law definition of the terms *market value, market price, prevailing price in the field, proceeds* or other such language.
- The execution of any division order containing provisions contrary to the lease terms will not temporarily nor permanently alter or amend the original lease terms. All such contrary terms may be stricken before executing the division order.
- Acceptance of any royalty payment pursuant to the division order shall not constitute a full or final settlement for any past royalties or interest payments that may be due the mineral owner.
- The division order shall be cancelable or revocable at all times. Section 91.402(g) provides division orders are revocable by either party on 30 days written notice.
- The mineral owner shall be paid on the execution of the division order. He or she need not wait for all parties specified in the division order to sign.
- The mineral owner shall not give any warranty of title in the division order beyond that contained in the lease.
- The division order shall not constitute a ratification of the oil and gas lease or any oil or gas purchase contract—whether revocable or not—or any other contract or agreement covering the leased premises or its production.
- The terms of the original lease contract cannot be altered or amended except by a separate written instrument clearly defining its purpose and effect. The written agreement shall describe the specific terms or provisions being altered and the proposed change or modification. It must be executed by the party against whom the amendment or alteration is sought to be enforced. Any memoranda or attachments to a royalty check shall be null and void and without legal significance for the purpose of altering the original lease contract.

Note: In light of the 1991 changes to Chapter 91 of the Texas Natural Resoucres Code, the effectiveness of some of the prior suggestions may be questionable until the Texas courts and legislators resolve some apparent contradictions.

Royalty Checks

Lease provisions dealing with royalty checks also may be negotiated. The following suggestions contain the essence, not the precise language, of lease clauses pertaining to royalty checks.

- The first royalty check shall be tendered to the mineral owner within 90 days after the end of the month the first production leaves the leased premises (or some reasonable time). (Generally, it takes 90 to 120 days for the title opinion to be secured by the purchaser or lessee. Sometimes it takes longer depending on the number of interest owners in the production unit.)
- If the first royalty check is not tendered within 90 days after the end of the month when the first production leaves the leased premises, interest shall accrue on the unpaid royalty at the highest rate allowed by state law. The first royalty check shall contain all accrued interest. (Some mineral owners tie the interest to the prime rate. Others designate a fixed rate such as 15 percent, but always less than a usurious rate.)
- If the first royalty check is not tendered within 180 days after the end of the month when the first production leaves the leased premises, the lease shall terminate. The only exception shall be when a valid division order title opinion has been rendered depicting serious title problems. However, all title problems must be cured within 30 days. Otherwise, the countdown toward the 180-day limit will continue.
- Once royalty checks have been tendered, the mineral owner will be paid within 60 days (or some reasonable time) after the end of the month when the production leaves the leased premises. If the payments are not forthcoming within the designated period, interest will again accrue on the unpaid balance. If more than six months transpire between royalty payments, the lease shall expire. An exception may be

included when the annual accrued royalty payments do not exceed $100.

A royalty interest is sometimes referred to as a cost-free interest because it bears no exploration and production costs. However, it does bear a pro rata share of post-production costs based on the size of the lease royalty. Post-production costs include items such as transportation, compression separating and so forth.

In the past, mineral owners who wanted to avoid post-production costs negotiated contractual provisions in the oil and gas lease. Basically, the lessee agreed to bear all the post-production costs in the mineal owners' behalf.

In 1996, the Texas Supreme Court reviewed the enforceability of these lease provisions. In *Heritage Resources Inc. v. NationsBank,* No. 95-015, 4/25/96, the court ruled that whenever the value of the royalty is set "at the well" or "the wellhead," the lease clauses freeing the royalty of post-production costs are surplusage as a matter of law, i.e., null and void, useless, unenforceable. A dissenting judge wrote, "The author is puzzled by the court's decision to ignore the unequivocal intent of sophisticated parties who negotiate contractual terms at arm's length."

To avoid the consequences of this decision, mineral owners may require the oil companies to reimburse royalty owners for the post-production. This allows the deduction in lieu of the *Heritage* decision but contractually requires their reimbursement.

Also, mineral owners may negotiate a lease provision holding the oil company, purchaser or both liable for the loss of oil or gas once it leaves the leased premises.

Mineral Owners' Options

If the oil company refuses to include any of the provisions in the lease, or if the mineral owner is presented a division order for execution without having addressed these issues in the lease, the mineral owner may want to proceed in the following manner.

First, the mineral owner may alter the division order so it conforms to the original lease terms. This can be done by striking all contradictory or questionable language and then initialing the margins where the deletions and changes occur.

Second, he or she could attach an addendum to the division order incorporating these suggested alternatives. Typically, the addendum would begin with wording similar to the following: "Notwithstanding anything to the contrary contained in the attached division order rendered by the XYZ Company, the following terms and provisions control. . . ."

Naturally, the purchaser or oil company is responsible for deciding whether to issue royalty checks based on such a revised or amended division order or one not in compliance with Section 91.402(c)(1) as illustrated in Section 91.402(d) of the Texas Natural Resources Code. However, it is a means by which the mineral owner may receive royalty payments yet preserve the rights stated or negotiated in the original lease form.

Successful negotiation of an oil and gas lease requires knowledge of the lease terms, common sense, foresight and diplomacy. Even with knowledge of lease provisions, a mineral owner easily can overlook the problems associated with division orders and royalty checks. Therefore, treatment of division orders and royalty checks should be on the agenda of every oil and gas leasing transaction.

This report is for information only and is not a substitute for legal counsel. It is a combination of three Real Estate Center publications: A Thin Layer of Rights, Negotiating Terms of Mineral Exploration and Division Orders and Royalty Checks.

The Real Estate Center offers additional publications related to mineral leasing:

Hints on Negotiating an Oil and Gas Lease, report 229, $4 out of state/$2.50 in Texas.

"Rights and Responsibilities of Mineral Cotenants," reprint 843, $5 out of state/$3 in Texas.

Termination of an Oil and Gas Lease, report 601, $5 out of state/$3 in Texas.

"Subdivision Drill Sites," reprint 690, $2.50 out of state/$2 in Texas.

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