

WHAT CAN I DO IF MY ROYALTIES ARE NOT BEING PAID?

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Introduction

This paper is intended to give general guidance to royalty owners who believe that they are owed royalties but are not receiving payment. It is not intended as legal advice, and royalty owners are encouraged to consult with their own legal counsel regarding their particular situations.

In order to enforce your rights as a royalty owner, it is necessary first that you understand how exploration companies pay their royalties.

Before a well is drilled, an exploration company obtains oil and gas leases covering the lands on which the well will be located. This may be as simple as obtaining one oil and gas lease from the single mineral owner of the tract, or it may involve obtaining multiple oil and gas leases from many mineral owners of several tracts. If the tracts are small, it may also require that the tracts be pooled together into a single pooled unit for drilling of the well. The company then obtains a "drilling title opinion" on the tract or unit where the well will be located. This is an opinion from a title attorney who has reviewed all of the recorded documents concerning the mineral title to the lands in question, stating the ownership of the mineral and leasehold estate. Its purpose is to assure the exploration company that the company has an oil and gas lease or leases covering all of the mineral interests in the tract or unit where the well will be drilled.

After the well is drilled and completed, the exploration company must determine how royalties should be paid on production. The company will then obtain a "division order title opinion," usually from the same attorney who did the drilling title opinion for the well. The purpose of the division order title opinion is to ascertain the ownership of royalties on production from the well. Again, this may be very simple, if there is only one royalty owner. Usually, however, there are multiple royalty owners. Royalty ownership may be different from mineral ownership.

Most title opinions make "requirements" for "title curative" steps that should be taken, based on the attorney's title examination. These could involve obtaining copies of probate records on the estate of a royalty owner who has died, or affidavits of facts necessary to ascertain ownership, such as family histories. Some documents in the title may be susceptible to more than one interpretation, and the title attorney may make a requirement that the parties execute a stipulation as to the meaning of the ambiguous instrument. Where a well has been drilled on a pooled unit, a common requirement is that the company obtain ratification of the pooled unit by royalty owners. Requirements can address myriad issues.

It is then the job of the land department of the exploration company to (1) obtain the documents necessary to satisfy the requirements in the division order title opinion and (2) prepare division orders (reflecting the royalty ownership shown in the title opinion) to send out to the royalty owners. A division order is a document that identifies the property and the royalty owner's interest. The royalty owner must sign and return a proper division order to confirm that he/she agrees that his/her interest is correct, and must provide an address for payment and his/her social security or taxpayer I.D. number for IRS purposes. Once the division order is returned, the company then sets up its "pay deck" for payment of royalties in its royalty payment system and places the royalty owner in line for payment.

Most royalties are paid by the operator of the well; the operator sells the production to oil and/or gas purchasers, collects 100% of the proceeds of sale, and disburses the royalty to the royalty owners in the well. Some purchasers of oil also agree to disburse oil royalties directly to the royalty owners as a part of their agreement with the operator. If a well produces both oil and gas, a royalty owner may therefore receive checks from two different companies – from the operator for gas production and from the oil purchaser for oil production. In some instances there may be multiple owners in the well who elect to separately sell their share of the production, and in such a case each owner may separately pay royalties on its share of production from the well. In those cases a royalty owner might receive production royalties on the same well from two different companies for oil or gas or both.

Depending on the complexity of the royalty title, it may take the operator several months after a well commences production to get the division order title opinion, perform the necessary curative work, and send out division orders, so that royalty payments can commence. Once payments have begun, royalties on oil production should be paid by the end of the month following the month in which production occurs, and royalties on gas production should be paid within two months after the end of the month in which production occurs. The payor, whether the purchaser or the operator, is required to provide with the payment certain information concerning the amount of production, the price for which it was sold, and any deductions being made from the payment.

Division Orders

In Texas, the party responsible for payment of royalties (the "Payor"), whether the operator or the oil purchaser, is entitled to receive a signed division order from a royalty owner before paying the royalty. This requirement is set forth in Chapter 91 of the Texas Natural Resources Code, known as the royalty payment statute. The statute sets forth the time within which royalties must be paid, the terms the Payor can require in division orders, and remedies for the royalty owner who is not timely paid. Section 91.402 provides that (1) royalties must commence to be paid "on or before 120 days after the end of the month of first sale of production from the well," and (2) thereafter, royalties on oil must be paid within 60 days after the end of the month in which production is sold, and royalties on gas must be paid within 90 days after the end of the month in which the gas is sold. These time limits may be modified by provisions in the oil and gas lease pursuant to which royalties are owed. If royalties are not paid by those due dates, the payor owes interest on unpaid royalties at the rate of 2% over the New York Federal Reserve Bank rate charged on loans to depository institutions. §91.403. The Payor may also be required to pay the royalty owner's legal fees incurred in collecting the royalty due. §91.406.

The royalty payment statute also provides excuses for non-payment of royalty. The Payor need not pay if the royalty owner has not returned a signed division order, or if there is a "reasonable doubt that the [royalty owner] ... has clear title to the interest," or if "a requirement in a title opinion that places in issue the title, identity, or whereabouts of the [royalty owner] ... that has not been satisfied by the [royalty owner] after a reasonable request for curative information has been made by the payor."

In order for a Payor to refuse payment for failure to return a division order, the Payor must have sent a division order to the royalty owner, and the division order can contain only those provisions authorized by the royalty payment statute. In general, a division order cannot include terms that purport to modify the payment terms of the applicable oil and gas lease.

If you believe you are entitled to royalties you are not being paid, you should answer the following questions:

1. Is there a producing well on property in which you have a royalty interest? The operator's name must be posted at the well, along with its Railroad Commission operator number. The operator must be registered with the Railroad Commission, and you can look up the address and phone number for the operator on the Railroad Commission's web site at <http://www.rrc.state.tx.us/data/operators/ogdirectory/index.php>. You can also research what production for the well has been reported by the operator to the Railroad Commission, at <http://www.rrc.state.tx.us/data/online/index.php>. Learn how to use the Railroad Commission's database to look up your wells.
2. Who is responsible for payment of the royalty? Contact the operator and ask why you have not been receiving royalties. Has the operator delegated royalty payment responsibilities to the purchaser of production? Who is the purchaser? Has the operator or purchaser changed recently? You can also ascertain who is purchasing the well's production from the Railroad Commission website.
3. Does the Payor have a division order signed by you? If the operator or purchaser has changed recently, does the new Payor require a new division order from you?
4. Under the royalty payment statute, a Payor need not pay royalties until the accrued royalty owed is at least \$100. Ask the operator how much has accrued for your account.
5. Ask the operator if there are title curative requirements that must be satisfied before you can be paid. If so, ask for a copy of the title requirement.

When you talk to the companies, take notes on your calls. Write down the names and ask for the direct numbers of the people you talk to, and ask them when they will call you back to answer your questions. Follow up, and be persistent.

Title Problems

If your royalty is not being paid because of a title problem or requirement, ascertain what you need to do to solve the problem. It may be as simple as providing an affidavit of relevant facts. The landman with the operator should be able to help you with this. If the problem is more complicated, it may be necessary to consult with an attorney to determine how the problem can be solved. Resolving the issue may require the filing of a suit.

If you are being asked to sign a lease or pooled unit ratification before being paid your royalty, beware. Signing the ratification may not be in your best interest, and the company may owe you royalties whether you sign the ratification or not. Consult with legal counsel before signing a ratification.

When a Payor is not paying royalties because of a potential title dispute or a title curative requirement, it is said that the royalty is placed "in suspense," or in a "suspense account." This term can be misleading. It does not mean that the Payor opens a separate bank account and deposits the money into the account. A suspense account is simply an internal account of the company that shows the amount as a liability of the company for an unpaid royalty. If funds placed in suspense are not claimed by the owner, under Texas escheat statutes the Payor must pay the monies to the Texas Comptroller's Office, into its Unclaimed Property Fund. The owner may claim the money from the Comptroller upon satisfactory proof of ownership. <http://www.window.state.tx.us/up/>

If the title problem is one of ascertaining to whom the royalty should be due, the Payor is a disinterested stakeholder. In other words, the Payor does not dispute that it owes the money to someone, but it faces potential conflicting claims to the funds. In such a circumstance, the Payor may elect to file what is known as an Interpleader action to determine the proper owner (or might be encouraged to do so). In an Interpleader, the stakeholder sues the parties who are asserting conflicting claims to the royalties due and deposits the royalties into the court. The Payor is then out of the case, and the claimants resolve their claims between themselves.

Remedies

If you have determined that oil or gas is being produced on which you should be paid royalty, and you have signed and returned a division order showing your interest, and there are no title problems preventing payment, then you have a cause of action against the Payor for failure to pay your royalty. Chapter 91 of the Natural Resources Code provides that a royalty owner may collect from the Payor the amount due, plus interest, plus attorneys' fees. If your royalty payment is due under an oil and gas lease you signed, you also have a claim against the lessee for breach of the oil and gas lease, entitling you to collect the amount due plus interest and attorneys' fees. Before bringing such a claim, you must give 30 days' written notice by mail of the Payor's failure to pay you. If the Payor does not respond within 30 days with a reasonable cause for nonpayment, you may sue the Payor in the county where the well is located. §91.404.

If the operator is the party responsible for payment, you may also wish to notify the company or companies purchasing the well's production of the operator's failure to pay and demand that the purchaser pay your share of production proceeds to you directly. This is not

likely to get you paid, but it may cause the purchaser to withhold payment to the operator of your share of proceeds, thus "trapping" the money with the purchaser. If the operator is potentially insolvent, this may be a good way to preserve your right to payment without having to fight with the operator's other creditors in the bankruptcy court. As discussed below, Texas Business & Commerce Code §9.343 grants you a security interest in proceeds of sale of production to secure the operator's obligation to pay you. You should assert your rights under this statute when you notify the operator's purchaser of your claim.

Finally, if the facts show that your operator/lessee is simply pocketing your royalties, you may be able to obtain assistance from your local district attorney. The operator's failure to pay you may be a crime for which the operator could be prosecuted. The prosecutor would have to show that the operator has taken and used the royalty funds as his own and intentionally deprived you of your royalties with no legitimate excuse.

Payor's Insolvency

In the 1980's oil prices declined to record lows and some companies sought protection from creditors by filing for bankruptcy. Royalty owners found that, if the bankrupt company owed them royalties, they were classified as unsecured creditors and had to fight with other unsecured creditors of the company over limited funds (if any) to recover their royalties. As a result, the Texas Legislature passed a new statute, now Section 9.343 of the Texas Business and Commerce Code, which grants to royalty owners a security interest in production from their well, and in the proceeds of sale of production, to secure the payment of their royalties. Royalty owners do not have to make any filings or do anything in advance in order to have the protections of this statute. Its effect is to make the royalty owners secured creditors in the bankruptcy case of the company that owes them royalties. If the company still has funds in its account that represent proceeds from the sale of production, you would have a claim against those funds superior to unsecured creditors of the company. The statute has been upheld and enforced in bankruptcy proceedings.

If the company that pays your royalties files for bankruptcy, you will receive a notice of that filing, as a creditor of the company. Typically, the notice will classify you as an unsecured creditor. In order to take advantage of the protection provided by Section 9.343, you will have to file a claim asserting your secured status. This will probably require the help of a bankruptcy attorney.

If you receive royalties from the purchaser rather than the operator, and if the purchaser enters into bankruptcy, you should claim that your lessee/operator still owes you the royalties due. In other words, the fact that you agreed to accept payment of your royalties from the lessee's purchaser should not relieve the lessee of the obligation to pay royalties if the purchaser fails to do so.