CHAPTER 16
RESOLVING DIVISION ORDER DISPUTES: A CONCEPTUAL APPROACH

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Synopsis

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§ 16.01 Introduction

Today oil and gas attorneys are attempting to resolve the same division order disputes that have plagued the industry since its inception.[1] For example, attorneys continue to be asked whether a lessor must sign a division order, what can be done if a lessor refuses to sign, and if signed, how it will impact the rights of the lessor, lessee, and purchaser. Although these issues have been addressed before,[2] it is difficult to predict how prior rulings will be applied to present and future disputes. This lack of predictability arises from lack of a consistent analytical framework for evaluating the legal nature and effect of the division order.[3]

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[1] *See, e.g.,* Childers v. Neely, 34 S.E. 828 (W. Va. 1899).

[2] *See* Lear, "First Purchaser Suspense Accounts," 33 *Rocky Mt. Min. L. Inst.* 17-1, 17-9 n.24 (1988) (collecting division order articles up to 1987). Since 1987, the following articles have chronicled division order problems: Bondurant, "Royalty Owner Rights Under Division Orders," *Mississippi Oil and Gas Law Seminar,* Section Four (April 21, 1989) (sponsored by the Mississippi Oil and Gas Lawyers Association and the Mississippi Association of Petroleum Landmen); Brannan, "Division Orders," 8 *E. Min. L. Inst.* 12-1 (1987); Cutbirth, "Division Orders... A False Sense of Security or a Useful Tool?" *The Landman,* Jan. 1987, at 44; Smith, "Royalty Issues: Take-Or-Pay Claims and Division Orders," 24 *Tulsa L. J.* 509 (1989).

[3] Professor Ernest E. Smith notes that division order jurisprudence suffers from "too many cases saying too many things without clearly articulating the legal theories used." Smith, "Royalty Issues: Take-Or-Pay Claims and Division Orders," 24 *Tulsa L. J.* 509, 535 (1989) [hereafter cited as Smith]. Si M. Bondurant expresses the problem as follows: "Division order cases are kind of the Am. Jur. of oil and gas law. Quotes can be found in the various cases to support most any proposition one desires." Bondurant, "Royalty Owner Rights Under Division Orders," *Mississippi Oil and Gas Law Seminar,* Section Four at 39 (April 21, 1989) (sponsored by the

There is general agreement in the legal community concerning the need for division orders: they provide the basis for distributing production proceeds and protect the disbursing party when payment is made in accordance with the division order.[4] However, there is little agreement about what should be contained in the division order and no consensus concerning the legal classification and effect of division orders. Although this article offers proposed analyses to address division order disputes, it also attempts to define the basic reason why courts have been reluctant to employ a consistent analysis.

Many courts have engaged in artful policing of the lessor/lessee relationship through selective enforcement of division order terms. Although clothed in such authoritative labels as "consideration," the courts have really been attempting to mitigate the basic rule of contract law that you are bound to what you sign; even if you don't read the document or fail to appreciate its legal effect.[5] The courts have waged a similar war against the oil and gas lease;[6] it is not surprising they are willing to resist lessee counterattacks under the guise of a division order. To effectively address division order disputes, and to avoid such disputes in the future, we must identify what predisposes courts to resist traditional legal analysis in favor of what they perceive to be an equitable result. Only then can the attorney effectively plan transactions for a client.

This article begins with a look at the basic division order issues and the existing analytical process used to resolve division order problems. The division order process is then evaluated by applying the legal principles of Article 2 of the

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Mississippi Oil and Gas Lawyers Association and the Mississippi Association of Petroleum Landmen) [hereafter cited as Bondurant].

[4] *See, e.g.*, R. Sullivan, *Handbook of Oil and Gas Law* § 72, at 140 (Prentice-Hall 1955).

[5] For a recent example of the lengths courts will go to preserve this basic element of the objective theory of contracts, *see* Silk v. Phillips Petroleum Co., 760 P.2d 174 (Okla. 1988).

[6] *See* Pierce, "Rethinking the Oil and Gas Lease," 22 *Tulsa L. J.* 445, 453–55 (1987) [hereafter cited as Pierce].

Uniform Commercial Code. This is followed by suggestions on how prospective division order disputes can be minimized or eliminated.

§ 16.02 Ownership of Production Under the Oil and Gas Lease

The rights and obligations of the lessor, lessee, and production purchaser are initially governed by the terms of the oil and gas lease. To illustrate how the oil and gas lease affects each party's rights, consider the following production sales scenario:

Fred Farmer owns the minerals in Section 30. Fred leases Section 30 to Acme Oil Company and Acme completes the Farmer 1-30 Well on the leased land. The well produces oil and gas. Acme has entered into a written agreement with Interstate Pipeline Company to sell the gas pursuant to a three-year gas sales contract. Acme has entered into an oral agreement with Crude Oil Purchasing Company to sell the oil. The royalty clause of the Farmer/Acme oil and gas lease provides:

> The royalties to be paid by lessee are:
>
> (a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected;
>
> (b) on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.

Each of the purchasers obtains a division order title opinion which indicates production from the Farmer 1-30 Well is owned as follows:

Fred Farmer	1/8th	royalty interest
Acme Oil Company	7/8ths	net revenue interest

Interstate Pipeline Company prepares a division order for Acme which indicates Acme is entitled to payment for 8/8ths of the gas produced from the Farmer 1-30 Well. This division order also contains a clause whereby Acme agrees to indemnify Interstate for any claim made against Interstate relating to its payment of production proceeds to Acme. Acme, in turn, prepares a division order for Fred Farmer's signature which indicates Fred is entitled to payment for 1/8th of the gas produced from the Farmer 1-30 Well.

Crude Oil Purchasing Company prepares a division order for Fred and Acme which credits each with their respective interests. The well was completed in February 1989; oil and gas sales commenced in March. The division order title opinions were completed in April, division orders were prepared in May and sent to Acme and Fred for their signatures. Acme sent Fred a gas division order in June. Acme signed the division orders presented by Interstate and Crude; Fred has refused, to date, to sign either the Acme or the Crude division order. The Farmer 1-30 Well continues to produce oil and gas which are delivered to Crude and Interstate. Crude has placed oil sale funds credited to Farmer in a suspense account; Acme refuses to pay Fred's share of the gas proceeds until Fred signs Acme's gas division order.

To define each party's rights, we must determine who has title to the produced oil and gas and evaluate the marketing authority conferred on the lessee by the oil and gas lease. Although the express terms of each lease must be carefully reviewed, our analysis will focus upon the commonly encountered Farmer/Acme royalty clause terminology.

[1] Ownership of Oil—Lessor's Right to Take in Kind

The Farmer/Acme royalty clause gives the lessor one-eighth of the oil produced and saved from the land. Therefore, after oil is extracted, the lessor has title to one-eighth of the oil.[7]

[7] Shreveport-El Dorado Pipe Line Co. v. Bennett, 172 Ark. 804, 290 S.W. 929 (1927).

The royalty clause requires the lessee to deliver this oil to the lessor at the well or, if the well is connected to a pipeline, to lessor's credit in the pipeline. Typically, the lessor's share of production is never segregated but instead is marketed with the lessee's share of production. The lessee contracts with a purchaser to sell the oil. Often the crude oil sales agreement is oral. The purchaser begins to take oil immediately upon making its purchasing agreement with the lessee or the operator of the well. However, no production proceeds will be distributed until the lessee signs the purchaser's division order. Similarly, oil sales proceeds credited to other interest owners in the well will be withheld until the purchaser's division order is signed.[8]

An initial question is whether the lessee has any obligation to market the lessor's oil. Arguably the lessee's marketing obligation ends when it *tenders* lessor's share of the oil at the well or pipeline. However, this would place the onerous burden of storage and marketing on the royalty owner. It is doubtful the lessor ever contemplated having to purchase tanks and engage in marketing efforts to obtain its royalty benefits. Absent express lease language negating any further lessee obligation, courts impose an implied obligation on the lessee to market oil as well as gas.[9] When the lessor elects to take its oil in kind, the lessee's implied marketing obligations will be suspended; the lessee discharges its lease obligations by delivering the oil to the lessor either at the well or to a pipeline connected to the well.[10]

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[8] *See generally* Wolfe v. Texas Co., 83 F.2d 425 (10th Cir.), *cert. denied,* 299 U.S. 553 (1936). *See also* Brief of Amici Curiae Koch Oil Company, Total Petroleum, Inc., The Permian Corporation, and Citgo Petroleum Corporation, Attachment A, Hull v. Sun Refining & Marketing Co., No. 71179 (pending before Okla. Sup. Ct.) (affidavits of industry personnel stating their crude oil purchasing practices).

[9] Wolfe v. Texas Co., 83 F.2d 425, 430 (10th Cir.), *cert. denied,* 299 U.S. 553 (1936); Cook v. Tompkins, 713 S.W.2d 417, 421 (Tex. App.—Eastland 1986).

[10] *Cook v. Tompkins,* 713 S.W.2d at 421 (upon delivering royalty oil to purchaser for lessor's account, lessee was not obligated to ensure purchaser actually paid lessor for the oil); *but cf.* Williams v. Baker Exploration Co., 767 S.W.2d 193 (Tex. App.-Waco 1989) (lessee remains obligated to lessor for payment of royalty even though lessor has signed a division order agreeing to sell royalty oil to the lease operator).

Problems arise when the lessor fails to make arrangements to take or market its share of the oil. This problem has been addressed by finding that the lessee in such cases has an implied right to sell the oil either as a matter of contract or agency.[11] The lessee's implied contract or agency authority arises out of three facts: (1) lease language imposing on the lessee the obligation to deliver royalty oil at the well or to a pipeline; (2) the lessor's failure to make arrangments to take or market the oil; (3) the need to dispose of royalty oil in order to efficiently operate the well.[12]

[a] Lessee as the Lessor's Marketing Agent

As soon as the word "agent" is used, you can bet the word "fiduciary" will not be far behind.[13] Therefore, it is unlikely lessees will embrace any sort of agency theory to support their marketing decisions. However, oil purchasers, who are not parties to the oil and gas lease, have embraced the agency theory.[14] The major authority supporting the agency theory is the trio of *Wolfe* cases decided in 1936 by the Court of Appeals for the Tenth Circuit.[15]

In *Wolfe v. Texas Co.*,[16] Wolfe leased land to Amerada; the royalty clause required Amerada to "deliver to the credit of lessor . . . in the pipe line to which he may connect his wells, . . . one-eighth part of all oil produced and saved from the leased premises."[17] Amerada completed a well on the

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[11] *Cook v. Tompkins*, 713 S.W.2d at 421 (implied contract); *Wolfe v. Texas Co.*, 83 F.2d at 439 (alternative theories of implied contract, agency, and ratification).

[12] If the lessee is unable to do something with the lessor's royalty oil, then the well will have to be shut in. This could result in drainage and, in some instances, waste.

[13] *Restatement (Second) of Agency* § 1(1) states: "Agency is the fiduciary relation . . . ."

[14] Hull v. Sun Refining & Marketing Co., No. 71179 (pending before Okla. Sup. Ct.) (litigation between royalty owners and non-lessee crude oil purchasers) [hereafter cited as Hull v. Sun].

[15] Wolfe v. Texas Co., 83 F.2d 425 (10th Cir. 1936); Wolfe v. Prairie Oil & Gas Co., 83 F.2d 434 (10th Cir. 1936); Wolfe v. Shell Petroleum Corp., 83 F.2d 438 (10th Cir.), *cert. denied*, 299 U.S. 553 (1936).

[16] 83 F.2d 425 (10th Cir.), *cert. denied*, 299 U.S. 553 (1936).

[17] 83 F.2d at 427.

leased land, Wolfe failed to make arrangements for his share of the oil, and Amerada commenced sales of all the oil production to Texas Co. Although Texas Co. purchased production from the leased land from December 1926 through February 1930, it refused to pay Wolfe for its royalty share because Wolfe's title was being challenged. In December 1931, Wolfe was ultimately held to own 7/12ths of the disputed land.[18] Wolfe thereupon demanded payment of 7/12ths of the royalty held in suspense—plus interest. Texas Co. defended, asserting Amerada had contracted with Texas Co. to sell Wolfe's royalty oil under the following terms: (1) the price would be the posted price, when produced, for oil in the area; (2) the sale would be made under the "usual and customary terms" which included: (a) the purchaser could withhold payment until an abstract was furnished showing a merchantable title and (b) Wolfe must execute a "division order" before the funds would be distributed.[19] The suspended royalty would not be "due" until Wolfe demonstrated merchantable title and signed a division order covering his interest. Therefore, no interest on the suspended royalty would accrue until Wolfe could meet these conditions of the oil sale made by Amerada on Wolfe's behalf.[20]

The court in *Wolfe* focuses upon the state of affairs when oil is being produced, but the royalty owner fails or is unable to store or market its share of the oil. First, the court acknowledges that "[t]he lease imposed upon the [sic] Amerada an implied duty to market the royalty oil." [21] Second, the court holds that "in order to perform that covenant o its lease, when Wolfe failed to sell his share of the royalty oil, it had to sell same as his agent." [22] Acting as Wolfe's agent, Amerada entered into a contract which contained terms permitting Texas Co. to suspend royalty payments, without liability for interest, until Wolfe could present an abstract showing he was

[18] *Id.* at 426.

[19] *Id.* at 430.

[20] *Id.* at 433.

[21] *Id.* at 430.

[22] *Id.* at 432.

entitled to payment.[23] As an alternative holding, the court found that Wolfe ratified the oil sales contracts Amerada made on Wolfe's behalf.[24]

Although purchasers have long embraced the *Wolfe* cases as vindicating their division order practices, the context of these cases must be carefully examined. First, the alternate holding that Wolfe affirmatively ratified the lessee's oil sales arrangements avoids difficult issues regarding limits on the lessee's agency authority, powers, and obligations. Second, Wolfe's title was in litigation and no purchaser could safely distribute sales proceeds until either a bond was posted or the litigation concluded. Third, the "division order" the court insisted upon was probably a much less elaborate and demanding document than those required by today's purchasers.

If the lessor's failure to act makes the lessee the lessor's agent to dispose of royalty oil, how should we define the scope of such an agency relationship? It appears any definition of the relationship must be based upon an interpretation of the oil and gas lease—a frightening thought for most lessees.[25] If the lessee is able to obtain a division order from the lessor, this could also create, expand, or contract the lessee's agency authority.[26] The lessee's authority to contract with a crude oil purchaser for the benefit of the lessor will usually be governed by the express and implied covenants of the oil and gas lease. It seems unlikely that the lessee's agency authority would include obligating the lessor to expand its contractual liability to a purchaser on terms dictated by the purchaser. Although the *Wolfe* cases focus upon the "usual and customary terms" required by a purchaser, the court also notes that Wolfe expressly ratified the purchaser's terms.

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[23] *Id.* at 433.

[24] *Id.* at 434.

[25] *See generally* Pierce, *supra* note 6, at 454-55.

[26] Although the agency relationship is created through consent of the principal and agent, there is generally no consideration requirement. *Restatement (Second) of Agency* § 16 (1958). However, "[w]here the agency relation is created without consideration, it can ordinarily be terminated without liability on the part of either party." *Id.* at § 16 comment b.

Once we determine an agency relationship has been created, we must evaluate each party's rights under agency law. First, as to the sale of the oil by the lessee, the lessee is the lessor's agent and acts as a fiduciary.[27] The lessor is a "disclosed principal." [28] Under the *Restatement (Second) of Agency,* the lessee's authority will be defined by section 50 which provides: "Unless otherwise agreed, authority to make a contract is inferred from authority to conduct a transaction, if the making of such a contract is incidental to the transaction, usually accompanies such a transaction, or is reasonably necessary to accomplish it." [29] Since the lessee must dispose of the royalty oil to produce the well, the lessee should be able to make a contract to dispose of the royalty oil. But this still doesn't address the terms of such a contract.

The *Restatement (Second) of Agency,* in the tradition of Article 2 of the Uniform Commercial Code, provides the following "gap fillers" to help define the agent's authority to contract:

(1) "[A]uthority to . . . sell with no price specified . . . includes authority to . . . sell at the market price if any; otherwise at a reasonable price." [30]

(2) "[A]uthority to . . . receive so much of the price as is payable at such time." [31]

(3) "[A]uthority to make such promises operating as warranties, and only such, as are usual in such a transaction. . . ."[32]

(4) "[A]n agent is authorized to comply with relevant usages of business if the principal has notice that usages of such a nature may exist." [33]

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[27] *Id.* at § 1.

[28] *Id.* at § 4.

[29] *Id.* at § 50.

[30] *Id.* at § 61(1).

[31] *Id.* at § 62.

[32] *Id.* at § 63(1).

[33] *Id.* at § 36.

(5) "[A]uthority to contract for a . . . sale includes authority to enter into negotiations for and to complete the . . . sale, including therein usual and other appropriate terms, and, if a writing is required or is usual, to execute such writing." [34]

However, each of the foregoing gap fillers begins with the condition "unless otherwise agreed." Therefore, as with a contract for the sale of goods, the presumptive provisions of the *Restatement* can operate only to the extent the oil and gas lease fails to address the matter.[35] However, unlike the sale of goods, the lessee, in conducting the sale, will be held to a fiduciary standard.

Although the limits on the lessee's authority can be expanded by estoppel,[36] acquiescence,[37] or ratification,[38] they can also be clarified and limited by the lessor's subsequent directions to the lessee.[39] If the lessor objects to the lessee's interpretation of its implied agency powers, the lessor should inform the lessee of the scope of its authority *and* give notice to the purchaser of the lessee's scope of authority.[40] The lessor must be careful, however, not to assert a limitation of authority which is inconsistent with a proper interpretation of the oil and gas lease.[41] The lessor must also be careful not to execute any document, such as the purchaser's division order,

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[34] *Id.* at § 55.

[35] The terms of the lease may restrict, for example, the ability of the lessee to receive payment for lessor's oil, or to offer a warranty of title on the lessor's behalf.

[36] *Restatement (Second) of Agency* § 141 (1958).

[37] *Id.* at § 43.

[38] *Id.* at §§ 82, 143.

[39] *Id.* at §§ 118, 119.

[40] *Restatement (Second) of Agency* § 125 (1958) provides:

Apparent authority, not otherwise terminated, terminates when the third person has notice of:

(a) the termination of the agent's authority;

(b) a manifestation by the principal that he no longer consents; or

(c) facts, the failure to reveal which, were the transaction with the principal in person, would be ground for rescission by the principal.

[41] Although the principal can revoke the agent's authority at any time, if the revocation is contrary to the terms of a contract between the principal and agent, the principal may be liable for breach of their contract. *See id.* at § 118.

that could be construed as acquiescence or a ratification, or give rise to an estoppel defense.[42]

If it is discovered that the oil sales contract made by the lessee was not authorized, *Restatement (Second) of Agency* § 164 (2) states:

> Where the only difference between the contract as authorized and the contract as made is a difference as to amount, or the inclusion or exclusion of a separable part, the principal is liable upon the contract as it was authorized to be made, provided that the other party seasonably manifests his willingness to accept the contract as it was authorized.[43]

This would seem to create the ironic requirement that the purchaser either accept the sales terms authorized by the lease or become liable for converting the lessor's oil.[44]

A case awaiting argument before the Oklahoma Supreme Court, *Hull v. Sun Refining & Marketing Co.*,[45] offers an opportunity to define whether the lessee has agency authority to sell royalty oil and, if so, the scope of such authority. Each party to the litigation concedes that the lessee is the lessor's agent for marketing royalty oil.[46] As might be expected, their

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[42] When the substance being sold is gas, the potential for an estoppel, acquiescence, or ratification claim is much greater since the lessor is contracting directly with its lessee. When the substance is oil, the analysis is different because the lessor is usually contracting with a third party purchaser instead of the lessee. However, it would seem difficult for a lessor to, for example, enter into a contract with a third party, agree to the deduction of transportation charges in calculating the amount due, and then seek to recoup such charges from the lessee under the oil and gas lease. If the lessor has title to the oil, and voluntarily enters into a contract to sell it under specified terms, how could the lessor assert the sale was contrary to the terms of the oil and gas lease? In such a case, the courts would probably find the lessee discharged its lease obligations when it delivered the oil to the third party purchaser designated by the lessor. Lessors, attempting to avoid such a result, often refuse to execute division orders.

[43] *Restatement (Second) of Agency* § 164(2) (1958).

[44] Without a contract authorizing the purchaser to take lessor's royalty oil, the purchaser will be subject to a conversion claim. *See* Rocket Oil & Gas Co. v. Conoco, Inc., 58 *Okla. B. J.* 2603, 2605 (Okla. App. 1987), *mandate issued,* 59 *Okla. B. J.* 210 (Jan. 14, 1988) (operator had implied authority to market lessors' oil to purchaser but lacked authority to permit purchaser to pay proceeds to operator instead of lessors).

[45] *Hull v. Sun, supra* note 14.

[46] Brief for Appellant at 6, *Hull v. Sun, supra* note 14 ("If a lessor fails to take his

interpretations of the scope of lessee's authority vary greatly. Sun, the purchaser, asserts the lessee has authority to enter into a contract to sell the lessor's royalty oil and agree, as one of the terms of the sale, that the lessor will sign the purchaser's division order.[47] Sun asserts that the oral oil purchase contract with Hull's lessee impliedly incorporated the customs and usages of the oil purchasing industry, to include the purchaser's right to withhold payment of royalty until the lessor signs the purchaser's division order.[48] Hull counters by arguing that the lessee lacks the agency authority to obligate the lessor to sign a division order which diminishes lessor's rights under its oil and gas lease.[49] Hull also argues that when it initially refused to execute Sun's division order, Sun, as to future purchases, was on notice that Hull objected to the lessee's interpretation of its implied agency authority.[50] The District Court's Findings of Fact and Conclusions of Law indicate that the lessee was acting as the lessor's agent to contract for the sale of royalty oil to Sun.[51] However, the lessee does not have the authority to require its lessor to sign an "unaltered, unnegotiated Division Order *on any terms*." [52] The district court concludes that the lessor must sign a division order to be entitled to payment—but such division order need

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oil in kind by obtaining his own purchaser and by providing adequate storage facilities, the lessor impliedly designates his lessee as the agent to market the royalty oil and the lessor will be bound by the terms of the sale."); Brief of Appellees at 21 ("There is no need for a separate contract between the purchaser and the royalty owners since the lessee, as the royalty owners' agent, has already entered into a contract with the purchaser on the royalty owners' behalf.") None of the parties to the *Hull* case are lessees; the amici curiae filing briefs in the case are all crude oil purchasers or royalty owners. See note 8 *supra*.

[47] Brief for Appellant at 17-18, *Hull v. Sun, supra* note 14.

[48] *Id.* at 18.

[49] Reply Brief for Appellees at 4, *Hull v. Sun, supra* note 14 ("Under the terms of its [Sun's] Division Order, the Defendant [Sun] can withhold royalties at its discretion, pay the price it chooses, deduct interest and receive full protection and indemnity from any and all liability.")

[50] *Id.* at 8.

[51] Findings of Fact and Conclusions of Law at 2, No. 7, *Hull v. Sun, supra* note 14.

[52] *Id.* at 2, No. 9 (emphasis in original).

only contain certain essential terms which the court enumerates.[53]

An agency theory is a tenuous basis for creating a functional relationship for the sale of the lessor's royalty oil. Although it may offer the purchaser some protection for runs prior to a dispute, once the lessee's agency authority is terminated we return to the basic problem: the lessor's oil is being produced by the lessee, delivered to a purchaser, and the purchaser is selling the oil and retaining the proceeds pending an agreement with the lessor. The situation is further complicated because the lessor typically does not object to the delivery of oil to the purchaser; only the *terms* of the sale are at issue.[54]

[b] Lessee's Contractual Right to Market Lessor's Oil

In the *Wolfe* trilogy of cases, the court suggests that the lessee had the contractual right to sell the lessor's royalty oil.[55]

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[53] *Id.* at 4-5, No. 23. In Finding No. 23, the district court states:

23. The essential or necessary terms that any Division Order, or similar form, must contain in order to "legally entitle" a royalty owner to payment from a purchaser are the following:

a. Purchaser's name and address

b. Effective date of purchase

c. Lease/unit/property name

d. Description of property

e. Warranty

f. Reference to payments in accordance with federal and state laws

g. Notice of change of ownership

h. Division of interest

i. Name, address and tax I.D. number of interest owner

j. Signature of interest owner

[54] See text accompanying notes 202-207 *infra*.

[55] In Wolfe v. Texas Co., 83 F.2d 425, 430 (10th Cir.), *cert. denied*, 299 U.S. 553 (1936), the court states:

Under the facts, the existing trade usage and its implied duty under the lease to market the oil, we think Amerada had implied authority to sell the Wolfe royalty oil, at the posted price and on the customary terms, as it was produced . . ..

But if Amerada did not have authority in the first instance to sell the royalty oil belonging to Wolfe, it undertook to sell it as Wolfe's agent, on the usual and customary terms and the question of ratification by Wolfe is presented.

Under this theory, the lessee, by implication from the express terms of the oil and gas lease, has the right to sell royalty oil at the posted price and on terms customary to the industry.[56] Although the scope of the lessee's authority will be governed by the oil and gas lease, it will not be subject to unilateral limitation by the lessor, nor will the lessee be held to a fiduciary standard of performance.

Arguably, if the lessor fails to take or market its oil, a court could find that the lessee has the contractual authority to do whatever a prudent operator would do to market the oil in pursuit of the mutual interests of the lessor and lessee. The following considerations are offered to help define the prudent operator in this situation:

(1) A prudent operator would *not* leave the oil in the ground. The lessee's obligations are defined by the traditional implied covenants of efficient operation, protection against drainage, and diligent production and marketing.

(2) The lessee has the authority to sell the lessor's royalty oil and thereby transfer title to the royalty oil to a purchaser.[57]

(3) The lessee has the authority, on its sole behalf, to enter into whatever sort of agreement it desires with third parties to effect a sale of royalty oil.[58]

Once a court confirms this basic authority, the purchaser could safely deal directly with the lessee and eliminate the need for a division order from the lessor. A court would have to adopt this theory before it could be safely relied upon by

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[56] *Id. See also* Cook v. Tompkins, 713 S.W.2d 417 (Tex. App. 1986) (lessee complied with implied covenant to market when it sold lessor's oil to purchaser at the current market price).

[57] For this approach to work, courts would have to hold there is a transfer of *title* to the oil, from the lessor to the lessee, when the lessor fails to take or market its royalty oil.

[58] This would take care of the lessor complaint that by signing a division order, they may be impairing their rights under the oil and gas lease. If the lessee is able to contract with the purchaser for the sale of royalty oil, the contractual relations between the lessor and lessee will not be affected.

purchasers.[59] However, even without judicial adoption of the theory, the lessor and lessee could, by contract, amend the oil and gas lease to clearly confer such authority on the lessee. Under this approach, the lessee would inquire whether the lessor intends to take or market its royalty oil. If the lessor indicates it will not take or market its oil, or says it will but fails to make the necessary arrangements, the lessee can enter into whatever sort of contract it desires to sell the oil.[60] Regardless of the oil sale contract terms, the oil and gas lease will govern the lessor's compensation for the sale of royalty oil. The purchaser will deal directly with the lessee and obtain whatever sort of division order and indemnity it can negotiate—from the lessee.

In lieu of fussing over division orders, it may be more workable for the lessee to obtain a one-time amendment of the oil and gas lease to clarify the marketing relationship.[61] The process might offer an opportunity to resolve some of the lurking problems which underlie the division order debate, such as deduction of marketing costs.[62] However, lessees

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[59] This is necessary to ensure that the lessee can effectively pass title to the oil.

[60] The problem with existing lease language is that it places title to royalty oil in the lessor, without stating what happens if the lessor fails to take or market its oil. A better approach would be to place title with the lessee initially, but give the lessor the power, upon notice to the lessee and any purchaser, to commence taking oil in kind or otherwise arrange for its marketing. To the extent the lessor fails to make arrangements to take or market its oil, the lessee retains title to the oil for marketing purposes. See text accompanying notes 211-214 *infra*.

[61] The basic problem with relying upon a negotiated division order framework is that in some states either party can revoke the division order at will. *See, e.g.*, Exxon Corp. v. Middleton, 613 S.W.2d 240, 250-51 (Tex. 1981). In many states, division order language which differs from the terms of the oil and gas lease will be ineffective. See N.D. Cent. Code § 47-16-39.3 (Supp. 1988); Okla. S.107, 42d Leg., 1st Reg. Sess. (1989), to be codified as Okla. Stat. tit. 52, § 540 B. (applies only to division orders executed on or after July 1, 1989); Wyo. S.67, 50th Leg., Gen. Sess. (1989), to be codified as Wyo. Stat. § 30-5-305(a); Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983), *cert. denied*, 106 S. Ct. 322 (1985).

[62] Often the debate between the lessor, lessee, and purchaser is not over the need to sign a division order, but instead whether the lessor's share of production will be calculated before or after certain marketing expenses are deducted from the gross value of production. The Wyoming legislature, attempting to address this root cause of division order disputes, has enacted Wyo. S.67, 50th Leg., Gen. Sess. (1989), to be

should resist the temptation to unilaterally dictate new terms. Instead, lessees should seek an agreement founded upon meaningful understanding and consent.[63] The contract approach has a number of advantages over the agency approach. First, we already have an established body of law defining the lessee's marketing obligations in this context under the gas royalty clause. Second, it coincides with the lessor's traditionally passive role under the oil and gas lease. Third, it eliminates imposition of a fiduciary role on the lessee, employing instead the more realistic role of a prudent operator. If the contract approach is adopted, oil sales practices would tend to parallel those of gas sales.

[2] Ownership of Gas—Lessor's Right to Production Proceeds

The Farmer/Acme royalty clause gives the lessor one-eighth of the market value or proceeds obtained from the sale of gas. Although the method of valuing production depends upon whether the gas sale occurs on or off the leased premises, the

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codified as Wyo. Stat. §§ 30-5-304 and 30-5-305 (Supp. 1989). Wyo. Stat. § 30-5-304(a)(vi) and (vii) (Supp. 1989) provides:

> (vi) "Costs of production" means all costs incurred for exploration, development, primary or enhanced recovery and abandonment operations including, but not limited to lease acquisition, drilling and completion, pumping or lifting, recycling, gathering, compressing, pressurizing, heater treating, dehydrating, separating, storing or transporting the oil to the storage tanks or the gas into the market pipeline. "Costs of production" does not include the reasonable and actual direct costs associated with transporting the oil from the storage tanks to market or the gas from the point of entry into the market pipeline or the processing of gas in a processing plant;
>
> (vii) "Royalty" means the mineral owner's share of production, free of the costs of production . . ..

This is followed by Wyo. Stat. § 30-5-305(a) (Supp. 1989) (emphasis added) which provides, in part:

> (a) Unless otherwise *expressly provided by specific language* in an executed written agreement, 'royalty', "overriding royalty" . . . shall be interpreted as defined in W.S. 30-5-304. A division order may not alter or amend the terms of an oil and gas lease or other contractual agreement.

[63] To avoid division order-related problems, the agreement should be carefully structured as a bilateral contract; supported by sufficient consideration and signed by both parties.

lessee has title to the entire gas stream.[64] Upon a sale of gas, the lessee incurs a contractual obligation to pay the lessor a one-eighth share of the production value or proceeds in accordance with the oil and gas lease.[65] Since the lessee has title to all the gas, the lessee can contract directly with the gas purchaser. The purchaser will usually obtain a division order from the lessee covering 8/8ths of the gas production and the lessee will receive 8/8ths of the sales proceeds.[66] Lessees often attempt to obtain division orders from their lessors as a condition to distributing the lessor's share of the gas sale proceeds.[67]

Traditionally, lessors contracted only for a share of the gas sale proceeds. In recent years, lessors have been demanding an option to take their royalty gas in kind. Depending upon the express wording of the option, the lessor may retain title to the gas. In such cases, sales of royalty gas would tend to follow the

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[64] Greenshields v. Warren Petroleum Corp., 248 F.2d 61, 67 (10th Cir.), *cert. denied*, 355 U.S. 907 (1957). In *Greenshields*, the lessor refused to sign a gas purchaser's "Stipulation of Interest" and then asserted that the purchaser converted the lessor's gas when delivered by the lessee to the purchaser's pipeline. Rejecting this claim, the court states:

> Whether or not title passes upon the occurrence of production must be determined from the language of the lease . . .. In the Producers 88 lease here under consideration, it is provided that the lessor shall receive a portion of the gross *proceeds* at the market rate of all gas, contrasting with the provision of his receipt of one-eighth *part of all oil produced*. It is well settled that the provision concerning the payment for gas operates to divest the lessor of his right to obtain title in himself by reduction to possession and that thereafter his claim must be based upon the contract with the one to whom he has granted that right. His claim can only be for a payment in money and not for the product itself.

Greenshields, 248 F.2d at 67 (emphasis in original).

[65] *Id. See also* Anschutz Corp. v. Natural Gas Pipeline Co., 632 F. Supp. 445, 451-52 (D. Utah 1986) and Tidewater Associated Oil Co. v. Clemens, 123 S.W.2d 780, 783-84 (Tex. App. 1938).

[66] The so-called "100-percent division order" is typically used for the sale of gas. The 100-percent division order will list only the working interest owners and their respective shares of production from the leased land. Each working interest owner will then make distributions to their lessors on the basis of their oil and gas lease, or a separate division order the lessee obtains from their lessor. *See* Brannan, "Division Orders," 8 *E. Min. L. Inst.* 12-1, 12-7 (1987) and Cutbirth, "Division Orders . . . A False Sense of Security or a Useful Tool?" *The Landman*, Jan. 1987, at 44, 45.

[67] *See, e.g.*, Lippert v. Angle, 211 Kan. 695, 508 P.2d 920 (1973).

oil sales framework.[68] However, the optional right to take in kind can be drafted to permit the lessee to market the gas, and pass title to the gas, for so long as the lessor fails to exercise its in-kind marketing rights. Similar language could be used with reference to oil.[69]

§ 16.03 The Perrenial Problems—An Update

During the past five years, a number of division order cases have been decided which touch on issues that have been debated by commentators and the courts for half a century. Each of the cases demonstrates the continuing tension between royalty owners, lessees, and purchasers. Perhaps the most fundamental issue in the debate is when, if ever, a lessor must sign a division order.

[1] Refusal to Sign a Division Order

To evaluate whether a lessor must sign a division order, we must first examine the royalty clause and then ask who is demanding the division order. Using the example posed in Section 16.02 *supra,* Fred Farmer, as the lessor, holds title to 1/8th of the oil produced from the leased land. Acme holds title to 7/8ths of the oil and 8/8ths of the gas. In our example, Crude Oil Purchasing Company, a third party purchaser, is demanding that Fred sign Crude's division order before Fred's oil sales proceeds will be released. Acme is demanding that

[68] See text accompanying notes 7-12, *supra.*

[69] See text accompanying notes 199-207, *infra.* The goal would be to permit the marketing party, whether lessor or lessee, to pass title to the royalty oil or gas. This could be accomplished by giving the lessee title to sell all production from the leased land *until* : (1) the lessor commences the actual taking of royalty production in kind; and (2) the lessor informs the lessee and the lessee's purchaser(s) of the actual diversion of royalty production. In the event the lessor fails to continue the actual taking of all or part of their royalty production, the lessee will have title to such production and can pass title to a purchaser in a sale arranged by the lessee.

Although the lessee could impose elaborate notice provisions on the lessor to commence or cease taking in kind, this doesn't address the basic problem of when the lessor says he is going to take in kind, but fails to separately market any or all of his royalty production. In such cases, the purchaser needs to be ensured that the lessee can pass title to the lessor's share of production.

Fred sign a division order before Fred's share of the gas sales proceeds are remitted by Acme.

Although most reported cases address the interpretation of an executed division order, there are two reported cases which address whether lessors are obligated to execute a division order. In *TXO Production Corp. v. Page Farms, Inc.*,[70] the Arkansas Supreme Court examines the issue from the perspective of a lessee demanding that its lessor sign a division order. In *Blausey v. Stein*,[71] the Ohio Supreme Court examines the issue from the perspective of a purchaser demanding that a lessor sign a division order. Currently pending before the Oklahoma Supreme Court is another case, *Hull v. Sun Refining & Marketing Co.*,[72] which involves a non-lessee purchaser and various lessors.

[a] Lessee Demand for a Division Order

When the lessee is functioning as the purchaser, or as a distributor of sales proceeds, a division order is unnecessary.[73] The common forms of oil and gas lease contain the terms

[70] 287 Ark. 304, 698 S.W.2d 791 (1985).

[71] 61 Ohio St. 2d 264, 400 N.E.2d 408 (1980).

[72] *Hull v. Sun, supra* note 14.

[73] Many commentators, and some courts, suggest that the virtue of the division order is its ability to specify how royalty should be calcuated. *See, e.g.*, Note, "A Suggested Analysis for Gas Division Orders," 13 *Tulsa L. J.* 534, 542 (1982) and Phillips Petroleum Co. v. Williams, 158 F.2d 723, 727 (5th Cir. 1946). However, too often the lessee's demand for a division order is a veiled attempt to amend the oil and gas lease. There is a significant practical difference between the lessee saying: "I want to enter into a long-term gas sales contract; will you sign this document to amend the royalty clause of our lease to accept 1/8th of the gas contract proceeds instead of 1/8th of the market value of the gas?" versus "I have $25,000 worth of gas proceeds in an account with your name on it, all you need to do is sign this division order to receive the $25,000 and your share of monthly production; if you don't sign, I can't pay you your money."

Most of these same courts and commentators suggest it is impractical to state the exact basis for determining royalty payments in the lease. This just isn't so. Most of the fussing over division orders concerns the costs that can be charged against the royalty interest. This can be easily stated in the lease. The state of Wyoming has addressed the matter by statute. See note 62 *supra*. Also, it is most interesting to find that many lessees, when acting in the capacity of a lessor, provide for revenue calculation in great detail. This suggests the failure is not an inability to address the issue, but rather a lack of sophistication on the part of the lessor.

required to protect the lessee in making royalty payments.[74] However, lessees routinely insist that their lessors sign a division order. As with the oil and gas lease, lessors usually sign—so they can get their money. When the lessor refuses to sign, it generally focuses on the oil and gas lease and asks where it says signing a division order is a predicate to the lessee honoring the royalty clause.

In *TXO Production Corp. v. Page Farms, Inc.*,[75] the Supreme Court of Arkansas addresses whether a lessor must sign a division order presented by its lessee. The Pages leased their land in 1964. TXO acquired the lease and completed a gas well on the land in February 1982. In September 1982, TXO's title opinion indicated that the Pages had conveyed their interest to Page Farms, Inc. In March 1983, TXO sent a division order to Page Farms.[76] Page Farms filed suit in July 1983 asserting TXO had violated Ark. Stat. Ann. § 53-525[77] which requires payment of royalty not later than six months following the first sale of production.[78] TXO defended, asserting: (1) Page Farms' title was not marketable; (2) Page Farms refused to sign TXO's division order; (3) the Pages failed to comply with the change of ownership clause of the oil and gas lease; and (4) under the lease, the Pages were required to give TXO notice of any TXO breach of the lease and 60 days to cure any breach.[79]

The court, under the facts of this case, summarily dismisses TXO's title and lease defenses. With regard to refusal to sign a division order, the court simply states:

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[74] The royalty clause states the ownership of production and the basis for valuing production. The pooling clause and proportionate reduction clause may adjust the lessor's share of production. The change of ownership clause will ensure that the lessee is informed of any transfers and that no transfer will be effective, as against the lessee, until the transferee complies with the lease terms. The typical lease form contains a warranty clause by which the lessor agrees to defend the lessee against claims adverse to the lessee's interests.

[75] 287 Ark. 304, 698 S.W.2d 791 (Ark. 1985).

[76] *Page Farms*, 698 S.W.2d at 792.

[77] Ark. Stat. Ann. § 53-525 (Supp. 1988).

[78] *Page Farms*, 698 S.W.2d at 792.

[79] *Id.* at 792-94.

> TXO also argues that the title was somehow rendered unmarketable by Page Farms's failure to sign the requested division order. To begin with, the oil and gas lease did not require the lessors to sign such an order . . .. Additionally, the proposed division order contained provisions, unfavorable to the lessors, that were not authorized by the lease. Page Farms was not at fault in failing to sign the division order . . ..[80]

TXO attempted to demonstrate that division orders are recognized by "custom and usage as being required in the oil and gas industry . . .." [81] However, the court refuses to bind the lessors to such custom and usage; there was no proof the Pages were sufficiently familiar with the oil and gas business to presume their knowledge and acceptance of its customs and usages.[82]

It seems unlikely that courts will require lessors to enter into a division order with their lessee before they can receive payments required by the oil and gas lease. The judicial attitude will probably be similar to that of the Kansas Supreme Court in *Chapple v. Kansas Vitrified Brick Co.*,[83] where the lessee attempted to pay delay rentals by check and to require the lessor to sign a receipt. In *Chapple,* the court stated:

> The terms of the lease were unequivocal; the lessee was to either pay or deposit the money. The plaintiffs [lessors] could not be compelled to accept the defendant's [lessee's] check if tendered within time. That was not the contract. They could not have been compelled to sign a receipt or voucher. That was not the contract. They were not compelled to institute inquiry to ascertain whether the defendant was seeking in some way not expressed in the lease to comply with or to evade a compliance with the terms of the lease.[84]

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[80] *Id.* at 792.

[81] *Id.*

[82] *Id.*

[83] 70 Kan. 723, 79 P. 666 (1905).

[84] Chapple v. Kansas Vitrified Brick Co., 70 Kan. 723, 729, 79 P. 666, 668 (1905).

When a lessor is presented with a demand to sign a division order before payment will be made, the lessor's response may simply be: "that is not the contract." However, lessors should be careful not to refuse to provide assurances required by the oil and gas lease. For example, if there has been a change of ownership, they should promptly provide the lessee with whatever information is required by the lease, and any additional information required to demonstrate marketable title in the royalty claimant.[85]

[b] Purchaser Demand for a Division Order

When the purchaser of production is not the lessee, and the lessor holds title to the production being tendered for sale, the purchaser has a legitimate right to require a division order—as a condition to the *purchase* of lessor's production. For discussion purposes, we will assume a lease form with a royalty clause similar to the Farmer/Acme lease discussed at Section 16.02, *supra*. Since the purchaser has no other contractual relation with the lessor, and the lessee's right to pass title to oil is nebulous,[86] the purchaser needs some sort of agreement with the lessor concerning the sale of royalty oil. If the lessor refuses to agree with the purchaser's terms, the purchaser should be able to *refuse to purchase oil from the lessor*. If the lessor is dissatisfied with the purchaser's terms, the lessor should be able to *refuse to sell oil to the purchaser*.

Just like any other sales transaction, if the buyer and seller cannot come to terms, they are free to go and make other arrangements. If this were the case, we wouldn't have any division order problems. Lessors would refuse to deal with purchasers who insisted upon the execution of division orders; purchasers would only buy from lessors who agree to sign the purchaser's division order. Although this seems quite elementary, this sequence of events never occurs when selling

[85] In addition to requirements imposed by the oil and gas lease, the lessor must also be careful to comply with any statutory requirements. *E.g.*, Okla. Stat. tit. 52, § 540 (Supp. 1988) (title must be "marketable" as determined by applying current title examination standards of the Oklahoma Bar Association).

[86] See text accompanying notes 11-63 *supra*.

production from a well. Instead, the oil continues to flow, the purchaser continues to take the oil and credits a portion to the recalcitrant lessor by making an entry in its "suspense account." [87]

In *Blausey v. Stein*,[88] the lessor Blausey sued lessee Stein asserting that the lease had terminated for failure to produce in paying quantities. The Ohio Supreme Court, concluding that the lease had produced in paying quantities, addresses Blausey's second claim "that she has an unqualified right under the lease to receive royalty payments, and that she is not required to sign division orders as a condition of payment." [89] It appears that Blausey had not received any royalty on production since 1975 because she refused to sign a division order and "[b]ecause of her refusal, the *purchaser* has not tendered payment for accrued royalties." [90] The court characterizes the division order as "a direction and authorization to the purchaser of oil to distribute the purchase price in a specified manner." [91] The court next notes that "[b]y signing the division order, the lessor is simply verifying that he has a right to royalty payments." [92] With these two premises established, the court holds: "[T]he requirement that appellant execute a division order prior to receiving her royalty payments does not contravene any specific provision of the lease, and is not such a burden that it can be considered an attempted modification of the agreement." [93]

The court in *Blausey* fails to offer any analysis for its conclusion that the lessor must sign the purchaser's division order. The court's opinion does not provide the terms of the division order, nor does it address the body of case law in other

[87] In other sales contexts, the Uniform Commercial Code provides special rules to define contractual relationships for parties who fail to agree on the terms of a sale but nevertheless consummate a sale. See text accompanying notes 199-207 *infra*.

[88] 61 Ohio St. 2d 264, 400 N.E.2d 408 (1980).

[89] Blausey v. Stein, 61 Ohio St. 2d 264, 400 N.E.2d 408, 410 (1980).

[90] 400 N.E.2d at 410 (emphasis added).

[91] *Id.*

[92] *Id.*

[93] *Id.* at 410-11.

jurisdictions where division orders have been successfully used to support estoppel and ratification defenses.[94] The court seems to imply that a division order is some sort of benign document where the lessor merely states what their interest is in the production. Very few division orders encountered today merely verify the lessor's interest.[95] Perhaps the message the court is really conveying is: "go ahead and sign the division order, we will protect you when the parties try to use it for something besides a verification of your fractional share of production";[96] not a very reassuring way to conduct business, or resolve disputes.

In *Hull v. Sun Refining & Marketing Co.*,[97] the Oklahoma Supreme Court has an opportunity to address the critical issues concerning a purchaser's right to insist that a lessor sign the purchaser's division order. Hull, the lessor, has marketable title to minerals which are leased to Andress. The royalty clause requires Andress, as lessee: "[T]o deliver to the credit of the LESSOR, free of cost, in the pipeline to which LESSEE may connect wells on said land, the equal One-fourth (1/4) part of all oil produced and saved from the leased premises." [98] Andress completed a producing oil well, the Reed #1-31 Well, on the leased land. Hull failed to take or market his one-fourth of the oil; Andress entered into an oral

[94] Recent examples include: Puckett v. First City Nat. Bank of Midland, 702 S.W.2d 232, 235 (Tex. App. 1985) (division order changed basis for calculating royalty from market value to proceeds); Pope v. Pennzoil Producing Co., 288 Ark. 10, 701 S.W.2d 366, 368-69 (1986) (the concept of estoppel, created by a party's ratification or revivor, may prevent a party from asserting their interest has not become subject to, e.g., a lease or pooling agreement).

[95] An attempt by lessors to merely "stipulate" or "verify" their interest was rejected by the purchaser, and the trial court, in *Hull v. Sun. See* Findings of Fact and Conclusions of Law, *Hull v. Sun, supra* note 14.

[96] The Kansas Supreme Court has provided lessors with this sort of protection. *See* Maddox v. Gulf Oil Corp., 222 Kan. 733, 567 P.2d 1326, 1328 (1977), *cert. denied,* 434 U.S. 1065 (1978) (neither the lessee nor a purchaser [dicta] can unilaterally impose on lessor division order terms which reduce the lessor's rights under the oil and gas lease); Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335, 1342 (1983), *cert. denied,* 474 U.S. 953 (1985) (court voids division order provision attempting to change basis for royalty accounting from market value to proceeds).

[97] No. 71179 (pending before Okla. Sup. Ct.).

[98] Findings of Fact and Conclusions of Law at 1, No. 2, *Hull v. Sun, supra* note 14.

agreement with Sun to sell all oil produced from the Reed #1-31 Well. Sun sent Hull a division order which Hull refused to sign. Hull responded by sending Sun a form of division order he would be willing to sign. Sun rejected Hull's form and attempted to satisfy some of Hull's concerns with a modified version of Sun's division order. Hull rejected Sun's modified division order.[99] As this "battle of the division order forms" raged, Sun continued to take all the oil produced by the Reed #1-31 Well and deposited an amount representing Hull's share in a "suspense account." [100] Hull brought suit seeking recovery under Okla. Stat. tit. 52, § 540 which requires the prompt payment of royalties.[101] Sun defends by asserting it is not obligated to pay funds to Hull until Hull signs Sun's division order.

The trial court in *Hull v. Sun* holds that a purchaser could insist upon execution of a division order before a lessor would be "legally entitled" to payment under section 540.[102] However, the court finds that Sun's division order asked for too much and Hull's proposed form offered too little.[103] The court then proceeds to identify the minimum elements of a "division order" which a purchaser can demand before they can be compelled to distribute production proceeds.[104] Although the court finds that Hull's lessee was the marketing "agent" for Hull,[105] the lessee could not obligate Hull to sign "an unaltered, unnegotiated Division Order *on any terms*." [106] However, the court implies the lessee could, in the oral contract with Sun, obligate Hull to sign a division order containing *the court's minimum terms*. Hull and Sun have each appealed from the trial court's ruling. Hull objects to the court's finding

[99] *Id.* at 4-5, Nos. 23-25.

[100] *Id.* at 2, No. 5.

[101] Okla. Stat. tit. 52, § 540 (Supp. 1988).

[102] Findings of Fact and Conclusions of Law at 4, Nos. 18, 19, and at 5, No. 27, *Hull v. Sun, supra* note 14.

[103] *Id.* at 5, Nos. 24 and 25.

[104] The trial court's division order provisions are set out in full at note 53 *supra*.

[105] Findings of Fact and Conclusions of Law at 2, No. 7, *Hull v. Sun, supra* note 14.

[106] *Id.* at 2, No. 9 (emphasis in original).

that an owner is not "legally entitled" to payment under section 540 when they have marketable title but refuse to sign a division order[107] Sun objects to the court's finding that Sun cannot insist upon Hull selling his oil on Sun's division order terms. Sun also objects to the court limiting the terms that can be contained in a division order, and asserts it may include any terms so long as they are lawful, conscionable, and consistent with standard industry practice.[108]

The trial court, consistent with the parties' stipulation, held that the lessee functions as the marketing "agent" of the lessor when the lessor fails to take or market royalty oil.[109] Without analyzing the scope of the lessee's agency authority, the court found Hull's lessee could not, in the oil sales contract with Sun, bind Hull to sign Sun's division order.[110] Under these facts, it appears that the Oklahoma Supreme Court can do one of three things: (1) address the lessee's agency authority; (2) treat the division order as a body of law unto itself; or (3) dodge the division order issue and focus on the "legally entitled" interpretation of section 540.[111] To be of any

[107] Brief for Appellees at 16, *Hull v. Sun, supra* note 14.

[108] Brief for Appellant at 16, 20, *Hull v. Sun, supra* note 14.

[109] Findings of Fact and Conclusions of Law at 2, Nos. 6, 7, *Hull v. Sun, supra* note 14.

[110] *Id.* at 2, No. 9.

[111] If the court addresses the agency issue, it will have to determine whether the lessee acts as the lessor's agent in selling royalty oil. If so, the court will have to determine the scope of the lessee's authority and the lessee's obligations in exercising such authority. See text accompanying notes 25–42 *supra*. The court could avoid the agency issue by finding that the lessee had the *contractual* authority to transfer title to the oil without the lessor's consent. See text accompanying notes 55-63 *supra*.

The court could follow the approach employed by many states and not worry about trying to "fit" division orders into any traditional analytical framework of contract or property law. Instead, they could pursue the legislative trend of creating "division order law" by trying to create a fair and workable system for all parties concerned.

Another alternative would be for the court to confine its review to whether Okla. Stat. tit. 52, § 540 (Supp. 1988) contemplates any reason other than a title defect for failing to promptly distribute production proceeds. If it limits § 540 to title defects, the lessors win and will not be required to sign anything to be entitled to payment. If § 540 is not limited to title defects, then the court must address the division order issues.

It is likely Utah may soon be addressing similar issues since its new payment

analytical value for resolving future disputes, the court will need to address the agency issue and evaluate the division order formation process under Article 2 of the Uniform Commercial Code.

In some states, statutes may play a role in determining whether a lessor must execute division orders. For example, a North Dakota statute provides, in part: "Royalty payments may not be withheld because an interest owner has not executed a division order." [112] Contrast this approach with a recent Utah statute which lists, as one of the excuses for a purchaser's failure to make prompt distribution of proceeds: "(d) the party entitled to payment has failed or refused to execute a division or transfer order acknowledging the proper interest to which the party claims to be entitled and setting forth the mailing address to which payment may be directed." [113] Although the recently enacted Oklahoma division order statute is silent regarding the obligation to execute a division order, the statute suggests what can be contained in a division order by providing, in part:

> B. A division order is an instrument for the purpose of directing the distribution of proceeds from the sale of oil, gas, casinghead gas or other related hydrocarbons which warrants in writing the division of interest and the name, address and tax identification number of each interest owner with a provision requiring notice of change of ownership.[114]

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statute provides: "(8) The penalty provisions of this chapter do not apply in the following instances: [T]he party entitled to payment has failed or refused to execute a division or transfer order acknowledging the proper interest to which the party claims to be entitled . . .." Surely there will be litigation over what the lessor must sign to constitute a "division . . .order acknowledging the proper interest . . .." Utah H.121, 1989 Gen. Sess. (1989), to be codified as Utah Code Ann. § 40-6-9(8)(d). Indiana has had a similar provision on the books for years. Ind. Code Ann. § 32-5-9-1 (Burns 1987) (entitled to payment "after purchasers have received executed division orders . . ..").

[112] N.D. Cent. Code § 47-16-39.3 (Supp. 1988).

[113] Utah H. 121, 1989 Gen. Sess. (1989), to be codified as Utah Code Ann. § 40-6-9(8)(d). Indiana has a similar type statute. Ind. Code. Ann. § 32-5-9-1 (Burns 1987).

[114] Okla. S. 107, 42d Leg., 1st Reg. Sess. (1989), to be codified as Okla. Stat. tit. 52, § 540 B. The final portion of § 540 B states: "This subsection shall only apply to

Purchasers will likely argue that such a provision makes signing a "division order," as defined by the statute, a prerequisite to the prompt payment obligations contained in other subsections of the statute. Lessors will argue that the statute creates a limit on the terms that a purchaser can include in a division order.

[2] Protection Offered by a Division Order

Once a division order is signed, the next problem is to evaluate its utility to the purchaser and the lessee. This section evaluates the benefits a third party purchaser can derive from the division order. Section 16.03 [3] evaluates the benefits a lessee can expect in the context of the division order's impact on the oil and gas lease.

[a] Errors in Payment

For the third party purchaser, the major function of the division order is to establish the sales terms between the seller and buyer of production. However, whether the purchaser is the lessee or a third party, another basic function of the division order is to protect the purchaser from an improper distribution of production proceeds.[115] The purchaser obtains a title opinion stating how proceeds should be distributed. Relying upon the title opinion, the purchaser prepares division orders for each interest owner to sign. In effect, each interest owner is saying: "If you pay me in accordance with the stated fraction, you will have discharged your obligations for my share of production from the lease." Usually the division order will state that if the purchaser pays the interest owner *more* than they are entitled to, the purchaser can recoup the overpayment.[116] What happens if the interest owner's stated fraction is *less* than the amount to which they are entitled?

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división orders executed on or after July 1, 1989." For third party purchasers, the division order serves an important "signature card" function to ensure the proper person is receiving the royalty payments.

[115] 4 Williams, *Oil and Gas Law* § 701, at 573 (1988).

[116] *Id.* at § 704.1, at 579-80 ("Breach of the warranty contained in the division or transfer order by reason of failure of the title of the parties thereto will support an

Until the division order is revoked, the purchaser will be protected from the underpaid interest owner's claim.[117] The underpaid interest owner can seek recovery against the overpaid interest owners; the division order will not protect the overpaid interest owners.[118] However, what happens when the overpaid interest owner is also the purchaser to which the division order is directed? This issue is addressed in *Gavenda v. Strata Energy, Inc.*,[119] where the Texas Supreme Court holds that the underpaid interest owner can recover against the overpaid purchaser.

The Gavendas owned a one-half term non-participating royalty interest in land owned by Blaha. Blaha leased the land and the lessee conveyed various overriding royalties before the working interest was ultimately acquired by Strata and Northstar. Wells were drilled and Strata was named as operator. Strata hired an attorney to prepare a division order title opinion. The lease provided for a one-eighth royalty and the examining attorney treated the Gavenda royalty as one-half *of* the one-eighth royalty, crediting Blaha and Gavenda each with a one-sixteenth royalty interest.[120]

Strata prepared a division order in which Gavenda warranted their interest as one-sixteenth of the oil and gas produced from the land.[121] After receiving payment under the division order for almost two years, Gavenda discovered the error, revoked the division order, and sued Strata to recover $2.4 million in underpaid royalties. The court stated: "[t]he only issue is whether under these facts division orders are binding

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action by the purchaser against his vendor in the event the purchaser is held liable in damages to the rightful owner of the products.").

[117] *See, e.g.*, Chicago Corp. v. Wall, 293 S.W.2d 844 (Tex. 1956).

[118] 4 Williams, *Oil and Gas Law* § 707, at 613 (1988).

[119] 705 S.W.2d 690 (Tex. 1986).

[120] *Id.* at 691.

[121] Strata also prepared, and Gavenda signed, transfer orders containing the same error. *Id.* Although the Texas Supreme Court's opinion is silent on the contents of the division and transfer orders, the Court of Appeals' opinion indicated they contained warranties of ownership. Gavenda v. Strata Energy, Inc., 683 S.W.2d 859, 861 (Tex. App. 1984), *rev'd*, 705 S.W.2d 690 (Tex. 1986).

until revoked."[122] Citing *Exxon Corp. v. Middleton,*[123] the court notes that the general rule in Texas "is that division and transfer orders bind underpaid royalty owners until revoked."[124] The court notes that one basis for the rule is detrimental reliance.[125] However, in *Middleton* the court did not apply a detrimental reliance analysis. The purchaser in *Middleton* entered into the long-term gas contract *before* it obtained the division orders calling for royalties based upon gas contract proceeds as opposed to market value.[126] Instead, the court in *Middleton* begins to fashion a body of division order law, cognizant of industry practices and designed to achieve fair and functional results. Commenting on the *Middleton* case, the court in *Gavenda* states: "To provide stability in the oil and gas industry, we held for the distributors of the proceeds because they had not profited from their error in preparing the division order—in short, because there was no unjust enrichment."[127] The *Gavenda* court ascribes an unjust enrichment theory as the legal rationale for its holding in *Middleton.*[128] Applying its unjust enrichment theory, the

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[122] Gavenda v. Strata Energy, Inc., 705 S.W.2d 690, 691 (Tex. 1986).

[123] 613 S.W.2d 240 (Tex. 1981).

[124] *Gavenda,* 705 S.W.2d at 691.

[125] *Id.* at 691-92. The court explains the detrimental reliance theory as follows:

> In the typical case, purchasers and operators following division orders pay out the correct total of proceeds owed, but err in the distribution, overpaying some royalty owners and underpaying others. If underpaid royalty owners' suits against purchasers and operators were not estopped, purchasers and operators would pay the amount of the overpayment twice—once to the overpaid royalty owner under the division order and again to the underpaid royalty owner through his suit. They would have double liability for the amount of the overpayment. *Chicago Corp. v. Wall,* 293 S.W.2d 844 (Tex. 1956). Exposing purchasers and operators to double liability is unfair, because they have relied upon the division order's representations and have not personally benefited from the errors.

Id. at 692.

[126] *Id.* Exxon Corp. v. Middleton, 613 S.W.2d 240, 250 (Tex. 1981).

[127] *Gavenda,* 705 S.W.2d at 692.

[128] *Id.* In *Middleton,* the court leaves open the possibility of further refinement to its division order jurisprudence, observing at footnote 8 to its opinion:

> We should not be understood as holding that the execution of division orders would prevent relief from fraud, accident or mistake or preclude the correction of mathematical calculations. Nor do we in any way indicate that relief could not be

court describes the protection offered by Gavenda's division order under the circumstances:

> Because of its error, Strata underpaid the Gavenda family by 7/16th royalty, retaining part of the 7/16th royalty for itself. It profited, unlike the operators in *Exxon v. Middleton,* at the royalty owner's expense. It retained for itself, unlike in *Chicago Corp. v. Wall,* part of the proceeds owed to the royalty owners. Therefore, Strata is liable to the Gavendas for whatever portion of their royalties it retained, although it is not liable to the Gavendas for any of their royalties it paid out to various overriding or other royalty owners.[129]

The court remanded the case to the trial court to determine the portion of the royalty underpayment retained by Strata and Northstar.

In *Strata Energy, Inc. v. Gavenda,*[130] the Texas Court of Appeals considers whether the trial court, on remand, properly applied the Texas Supreme Court's holding in *Gavenda.* Strata and Northstar assert the Gavenda division order should be given effect to the extent that the underpaid royalties were distributed to overriding royalty owners and working interest owners other than Strata and Northstar.[131] The court of appeals rejects Strata's interpretation, holding that the Ga-

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obtained from unusual or unfair provisions imposed by a party having a superior bargaining power or position.

Exxon Corp. v. Middleton, 613 S.W.2d 240, 251, n.8 (Tex. 1981). Instead of relying upon any of the *Middleton* exceptions, such as "accident or mistake" or "correction of mathematical calculations," the court in *Gavenda* embraces a more encompassing "fairness" standard under the rubric of unjust enrichment.

[129] *Gavenda,* 705 S.W.2d at 692-93. Professor Ernest E. Smith questions the court's attempt to distinguish the *Middleton* case, noting:

> In both cases the lessees had prepared the division orders; hence the only reason given for the difference in result was the presence or absence of benefit to the lessee from its own mistake. But a lessee that fails to make out-of-pocket payments owed to a royalty owner benefits from its mistake as fully as a lessee that keeps income that should have been paid to the royalty owner. The lessees in both instances are wealthier to the extent that the royalty owner has failed to receive moneys owed.

Smith, *supra* note 3, at 543.

[130] 753 S.W.2d 789 (Tex. App. 1988).

[131] *Id.* at 790.

venda division order would not be effective as to sums paid to working interest owners or overriding royalty interests carved out of the working interest.[132] The court's reasoning focuses on two principles. First, Strata did not detrimentally rely upon the division order.[133] Second, Strata would be enriched, at Gavenda's expense, by the error.[134] Therefore, the only offset against Gavenda authorized by the division order would be for the one-sixteenth royalty paid to Blaha, the lessor mineral owner.[135] Strata, however, may be able to recover against the attorney who prepared the division order title opinion.[136]

The lesson from *Gavenda* is clear: the division order does not fully protect the purchaser from an erroneous payment. To the extent any of the value or benefit of the underpayment

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[132] *Id.* at 791.

[133] *Id.* The court notes that the overriding royalty owners "were not even listed in the division or transfer orders upon which appellants argue they relied." *Id.* Although not mentioned by the court, the critical act of reliance would have been drilling the wells and creating the overriding royalties. All of these events preceded execution of the division and transfer orders. This highlights the importance of the *drill site title opinion.* Although for drill site title examinations, the attorney is interested primarily in who has the right to develop, any unusually large nonparticipating burdens must be noted since they directly impact the decision to develop. For all practical purposes, an owner of a one-half cost-free share of production must be treated as though they have a veto power over development. Unless you can come to some sort of agreement with the interest owner to reduce their cost-free share, the lessee will elect not to develop the lease.

[134] *Strata Energy,* 753 S.W.2d at 791. The court explains the nature of the unjust enrichment, stating:

> [A]*ppellants had profited at the royalty owner's expense* . . .. It seems clear, therefore, that the only credits appellants are entitled to are for those royalties *belonging to the Gavendas* that were paid to others and for which appellants *did not profit* at the Gavendas' expense . . ..
>
> [T]he overriding royalty interests were created out of the working interest . . ..
>
> Therefore, the royalty payments made to the seven overriding royalty interest owners were not to be paid out of royalties belonging to the Gavendas but were to be paid out of the working interest. Consequently, appellants are not entitled to a credit for these sums.

Strata Energy, 753 S.W.2d at 791 (emphasis in original).

[135] *Id.*

[136] *Gavenda,* 705 S.W.2d at 693. The Texas Supreme Court notes "that Strata and Northstar have filed a third party cross-action against the attorney." Where the purchaser is also the lessee, could they also bring an action against the attorney preparing the drill site title opinion? See note 133 *supra.*

flows to the purchaser, the underpaid interest owner can attack the binding effect of the division order—even for periods prior to its revocation. The practical lesson is also clear: use the most experienced title counsel available and, recognizing they can also make mistakes, use counsel that are adequately insured.[137]

[b] Purchaser Failure to Pay

Referring again to the Farmer/Acme situation posed in section 16.02 *supra,* suppose Acme delivers all the oil produced from the Farmer 1-30 Well to Crude Oil Purchasing Company. However, before Crude distributes any of the oil proceeds attributable to Farmer's interest, Crude files for bankruptcy. Farmer, unable to recover the amount due for oil royalty, brings suit against Acme asserting nonpayment of royalty under the Farmer/Acme oil and gas lease. Assuming Farmer signed Crude's division order, is Acme protected by the Farmer/Crude division order? Two recent Texas cases appear to arrive at opposite answers to this question.

In *Cook v. Tompkins,*[138] the lessee contracted to sell oil produced from the leased land to Basin. Since Basin did not have lessor Cook's address, it suspended oil royalty payments from the date of first production, 1979, to June 1982. In June 1982, Basin filed a Chapter 11 bankruptcy proceeding. In July 1983, Cook filed a claim in the Basin bankruptcy, executed a division order to Basin, and received partial payment of her royalty claim. Cook sought to recover the balance due from the working interest owners of the lease.[139]

The court holds the lessees fulfilled their obligations to Cook when they sold the production to Basin at the current market price. The lessee had no implied obligation to ensure Basin had

[137] Phillip Lear discusses the practical considerations, for both examining attorney and purchaser, in Lear, "First Purchaser Suspense Accounts," 33 *Rocky Mt. Min. L. Inst.* 17-1, 17-13 to 17-14 (1987).

[138] 713 S.W.2d 417 (Tex. App.-Eastland 1986).

[139] *Id.* at 421.

Cook's address.[140] "When the royalty oil was delivered to the purchaser for the lessor's account, the implied covenant to market was satisfied." [141] The working interest owners were not obligated to "warrant or guarantee payment to the lessor for the oil which was delivered and credited to the account of the lessor." [142]

Contrast the holding in *Cook v. Tompkins* with the approach of another Texas Court of Appeals panel in *Williams v. Baker Exploration Co.*[143] Baker Exploration had an oil and gas lease covering Williams' land. Oil production was obtained and Williams executed a division order directed to McMurrey Petroleum, the operator of the pooled unit.[144] McMurrey ceased making royalty payments to Williams and Williams sued McMurrey *and* Baker Exploration.

Baker Exploration's defense focused upon the Texas Supreme Court's holdings in *Cabot Corporation v. Brown* [145] and *Exxon Corp. v. Middleton*,[146] arguing Williams' division order to McMurrey relieved Baker from any oil royalty obligation so long as the division order remained unrevoked.[147] The court rejects Baker's argument and distinguishes *Brown* and *Middleton,* stating:

> In both *Brown* and *Middleton,* the royalty payments required in the division orders were paid. In our case, appellants seek royalty payments called for in the division orders that were not paid. *Brown* and *Middleton* do not excuse the lessees from payment of the lessors' royalty merely because there have been division orders executed by the lessors in favor of a purchaser of the leasehold oil and gas. We know of no authority that permits such use of a

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[140] *Id.*

[141] *Id.*

[142] *Id.*

[143] 767 S.W.2d 193 (Tex. App.-Waco 1989).

[144] *Id.* at 195.

[145] 754 S.W.2d 104 (Tex. 1984).

[146] 613 S.W.2d 240 (Tex. 1981).

[147] *Williams,* 767 S.W.2d at 195-96.

division order without express provision in the order for it.[148]

The court does not cite *Cook v. Tompkins* [149] in its opinion.

The practical effect of the holding in *Williams v. Baker Exploration Co.* is to make the lessee a guarantor for payment of royalty by the purchaser. Although the oil royalty clause gave to lessee "the option" to purchase lessor's production, it seems clear that this option had not been exercised.[150] The court suggests that to relieve the lessee from its continuing liability for payment of royalty, it must make "express provision in the [division] order for it." [151]

It is likely courts will do whatever they can to protect the lessor from a purchaser's nonpayment of royalty. Arguably, *Cook v. Tompkins* [152] provides too little protection. The marketing covenant, and the general covenant to manage and administer the lease, could easily encompass selecting a solvent purchaser, providing the necessary information to ensure proper payment, and monitoring the purchaser's performance and financial health. Arguably, *Williams v. Baker Exploration Co.*[153] goes too far. Once the lessee has discharged its marketing functions, it should not remain liable for royalty

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[148] *Id.* at 196.

[149] 713 S.W.2d 417 (Tex. App.-Eastland 1986).

[150] *Williams*, 767 S.W.2d at 194. The royalty clause obligated the lessee:

> (a) to deliver to the credit of lessor, in the pipe line to which lessee may connect its wells, the equal one-eighth 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 one-eighth part of such oil at wells . . ..

The court might have been able to resolve the dispute by interpreting the royalty clause. If the wells were not connected to a "pipe line," then the first clause of § (a) may not have been activated. The lessor could argue that by failing to connect to a pipeline the *lessee elected* "to pay lessor the average posted market price . . .." Arguably, a pipeline purchaser will have more assets to go against in the event of nonpayment. It would seem more prudent for a lessee to market oil to a major crude purchaser with a pipeline network as opposed to a mere intermediary whose major asset may be the oil they are buying.

[151] *Id.* at 196.

[152] 713 S.W.2d 417 (Tex. App.-Eastland 1986).

[153] 767 S.W.2d 193 (Tex. App.—Waco 1989).

payment unless it becomes aware of facts that would prompt a prudent operator to discontinue sales to the purchaser.

Applying the reasoning of the *Williams* case, some of the recent division order statutory initiatives may impact the lessee's liability for a purchaser's nonpayment of royalty. Consider the Oklahoma statute which provides that a division order "does not relieve the lessee of any liabilities or obligations under the oil and gas lease." [154] Statutes in Wyoming and North Dakota provide: "A division order may not alter or amend the terms of an oil or gas lease or other contractual agreement." [155] These statutes might be interpreted to impose upon the lessee continuing liability for the proper payment of royalty—whether the production being sold is gas or oil. If the lessee is going to have continuing liability, it may try to insist on structuring the sales transaction so it receives 100% of the sales proceeds. This raises the question of who the lessor needs the most protection from: an insolvent purchaser or an insolvent lessee?[156]

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[154] Okla. Stat. tit. 52, §§ 548-548.6 (Supp. 1988).

[155] *See, e.g.*, N.D. Cent. Code § 47-16-39.3 (Supp. 1988).

[156] The Oklahoma legislature has become active in this area. In 1988 Oklahoma passed the Oil and Gas Owner's Lien Act to provide a statutory lien for persons owning an interest in oil or gas once it is produced. Okla. Stat. tit. 52, §§ 548-548.6 (Supp. 1988). The lien process is similar to that employed for mechanics' liens. *See id.* § 548.4.

The Oklahoma Court of Appeals has also attempted to protect the lessor from an insolvent intermediary in the payment process. For example, in Rocket Oil & Gas Co. v. Conoco, Inc., 58 *Okla. B. J.* 2603 (Okla. App. Sept. 26, 1987), *mandate issued*, 59 *Okla. B. J.* 210 (Jan. 14, 1988) (publication withdrawn), Conoco, the crude oil purchaser, paid all the production proceeds to Rodman, the operator of the pooled unit. Apparently, no division orders had been obtained from anyone but Rodman. Rodman took bankruptcy and the interest owners sued Conoco for conversion. Conoco relied upon Okla. Stat. tit. 52, § 540 (Supp. 1988), which imposes on the "first purchaser" the obligation to ensure all interest owners are promptly paid for production they purchase, but provides:

> A. . . . The first purchaser shall be exempt from the provisions of this subsection and the owner of the right to drill and to produce under an oil and gas lease or force pooling order shall be substituted for the first purchaser therein where the owner and purchaser have entered into arrangements where the proceeds are paid by the purchaser to the owner who assumes the responsibility of paying the proceeds to persons legally entitled thereto.

[3] Effect of Division Order on Lessor's Lease Rights

Lessors often refuse to execute division orders fearing that something contained in them could diminish their rights under the oil and gas lease.[157] Their fear is usually justified. The general rule is that a division order, while in effect, can alter express lease terms, such as the royalty clause.[158] The Texas Supreme Court, in *Cabot Corp. v. Brown,*[159] has recently expanded this concept to include implied as well as express lease covenants. In *Cabot Corp.,* the mineral owner Brown entered into an oil and gas lease with Cabot. The lease required Cabot to pay royalty based upon the market value of gas. Cabot completed a well on the leased land in 1968 and Brown signed a division order obligating Cabot to pay royalties based upon prices determined by the Federal Power Commission (FPC) "if such sale be subject to the Federal Power Commission." [160]

Cabot entered into a gas exchange agreement with Transwestern, an interstate pipeline company. Cabot subsequently obtained an exemption from the FPC to permit Cabot to sell exchange gas in the intrastate market. Cabot sold much of the gas at $1.35 per Mcf, but paid royalty using lower FPC rates of $0.38 and $0.80 per Mcf. Brown sued Cabot asserting: (1) if the royalty gas was exempt from FPC jurisdiction, Cabot failed

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The court of appeals holds Conoco liable for conversion and limits the scope of § 540 as follows:

> We note that while 52 O.S. 1981 § 540 allows the first purchaser and operator, by contract, to shift the burden of *prompt payment* as between themselves, we believe, however, that this arrangement does not alter the ultimate liability of the first purchaser, Appellee Conoco herein. In the event the operator does not pay according to the agreement, the first purchaser remains statutorily liable to the royalty owners for their proportionate share of proceeds.

Rocket, 58 *Okla. B. J.* at 2605 (emphasis added).

[157] The lessor's rights could be diminished through amendment of lease terms, ratification of a document, revivor of a terminated lease, and estoppel. See note 42, *supra.*

[158] *See, e.g.,* Exxon Corp. v. Middleton, 613 S.W.2d 240 (1981).

[159] 754 S.W.2d 104 (Tex. 1987).

[160] *Id.* at 105.

to pay royalty on the market value of the gas; or (2) if the gas was subject to FPC jurisdiction, Cabot had an implied obligation to seek an abandonment of the gas to permit marketing at higher prices.[161]

Instead of evaluating FPC jurisdiction over the gas, the Texas Supreme Court holds the division order, until revoked, adopted the FPC prices for calculating royalty.[162] The court also holds that the FPC prices called for by the division order relieve Cabot, until the division order is revoked, of any implied obligation to take action to try and obtain a price different from the price specified in the division order.[163] The court's opinion seems assailable on a number of grounds.[164] However, the impact of the decision is clear: a lessor's rights under the oil and gas lease can be significantly eroded by signing a division order.[165] .

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[161] *Id.* at 106.

[162] Citing *Middleton,* the *Cabot* court states:

> [D]ivision orders executed by royalty owners, which obligated the lessees to pay royalties at lower rates than those required under the gas royalty clauses, were nevertheless binding on the royalty owners until revoked. 613 S.W.2d at 250-51. Brown was therefore limited to the interstate price allowed by federal regulation until the division orders were revoked.

Id. at 107.

[163] *Id.* at 107-08.

[164] An obvious weakness is that the court failed to enforce the plain meaning of the division order terms. Since FPC prices would apply only if the gas was subject to FPC jurisdiction, it was incumbent upon the court to determine the jurisdictional nature of the gas. The dissenting opinion of Justice Kilgarlin engages in this analysis and concludes that the gas was subject to FPC jurisdiction. However, the dissenting justices would then enforce the implied covenant to market by requiring the lessee to take whatever action a prudent operator would pursue to obtain the best current market value for the royalty gas. *Id.* at 109. For a detailed analysis of the *Cabot* case, *see* Smith, *supra* note 3, at 539-41.

[165] In addition to amending lease terms, the lessor's rights can also be affected by ratification, revivor, and estoppel. By signing a division order, an interest owner can become bound to other documents through ratification. *E.g.,* Pope v. Pennzoil Producing Co., 288 Ark. 10, 701 S.W.2d 366, 368-69 (1986) (oil and gas lease); Puckett v. First City Nat. Bank of Midland, 702 S.W.2d 232, 236 (Tex. App. 1985) (pooling agreement). If properly drafted, a division order could be used to revive a terminated leasehold or other interest. *See generally* Bradley v. Avery, 746 S.W.2d 341, 344 (Tex. App. 1988) (distinguishing ratification from revivor); *but see* De Benavides v. Warren, 674 S.W.2d 353, 361 (Tex.App. 1984) (suggests a mere reference to royalty interest in

The Kansas Supreme Court has responded to attempts to use division orders to modify the oil and gas lease by negating division order terms which conflict with a lessor's rights under the oil and gas lease.[166] This same approach has been adopted by the legislatures of North Dakota, Oklahoma, and Wyoming.[167] Each of these states has statutes that provide substantially as follows:

> A division order may not alter or amend the terms of the oil and gas lease. A division order that varies the terms of the oil and gas lease is invalid to the extent of the variance and the terms of the oil and gas lease take precedence.[168]

These statutes may have an unanticipated impact on the third party purchaser. Since lease provisions negate conflicting division order provisions, the purchaser in these states must carefully review the oil and gas lease to ensure there are no provisions which are objectionable to the third party purchaser. If the purchaser enters into a division order and sale without reviewing the lease, the purchaser may find that many of their division order terms are, by statute, unenforceable. None of the statutes distinguish between a division order tendered by a third party purchaser as opposed to a lessee purchaser.

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division order could revive a terminated defeasible term non-participating royalty interest).

[166] Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983), *cert. denied,* 474 U.S. 953 (1985); Maddox v. Gulf Oil Corp., 222 Kan. 733, 567 P.2d 1326 (1977), *cert. denied,* 434 U.S. 1065 (1978).

[167] *See* note 168 *infra* for specific provisions in statutes of these states.

[168] N.D. Cent. Code § 47-16-39.3 (Supp. 1988). In 1989 the Oklahoma legislature adopted the following language: "A division order which varies the terms of any oil and gas lease is invalid to the extent of the variance unless those changes have been previously agreed to by the affected parties." Okla. S. 107, 42d Leg., 1st Reg. Sess. (1989), to be codified as Okla. Stat. tit. 52, § 540 B. The language of the 1989 Wyoming statute is similar to the North Dakota statute, except the Wyoming statute provides that a division order may not amend the terms of an oil or gas lease "*or other contractual agreement.*" Wyo. S. 67, 50th Leg., Gen. Sess. (1989), to be codified as Wyo. Stat. § 30-5-305(a). In Oklahoma, to enjoy the statutory benefits of § 540 B, the lessor, and other payees, should revoke their division orders and enter into new ones *after* July 1, 1989. Section 540 B. provides, in part: "This subsection shall only apply to division orders executed on or after July 1, 1989."

Division orders may not contain all bad news for the lessor. In some situations, the division order may contain language that can be used offensively by the lessor against the lessee or purchaser.[169] For example, suppose the division order ties the lessor's royalty to a share of the benefits received by the lessee under a specified gas contract. This will enhance the lessor's demand for a proportionate share of all the lessee's benefits under the contract—to include take-or-pay payments.[170] This means the division order must be carefully monitored by the lessor and lessee as market conditions change so they will know, tactically, when to amend or revoke existing division orders.[171] In Kansas, Oklahoma, North Dakota, and Wyoming, such tactical use of the division order has been substantially restricted.[172]

§ 16.04 Defining a Conceptual Basis to Evaluate Division Order Problems

To advise clients, resolve disputes, and draft functional documents, attorneys must understand the concepts being employed by courts to resolve division order issues. This provides the predictability for which lawyers search and about which clients complain when it cannot be found. Perhaps the most notable aspect of division order jurisprudence is its lack

[169] *See* Sowell v. Natural Gas Pipeline Co., 789 F.2d 1151, 1154-55 (5th Cir. 1986) (expanding basis for calculating market value under oil and gas lease); TXO Production Corp. v. Prickette, 653 S.W.2d 642, 645 (Tex. App. 1983) (confirmed right to share of production from date of first sales and established venue in county where the division order was signed by royalty owner).

[170] *See generally* Smith, *supra* note 3, at 543-45.

[171] For example, a lessee may want to revoke division orders calling for royalty based upon a share of proceeds when the lease requires "market value" and the market value of gas is less than the amount being paid under a gas purchase contract.

[172] See notes 166 and 168 *supra*. However, such provisions can, in some situations, adversely affect the royalty owner. Suppose a lessee has a gas contract which calls for $3.50 per Mcf for gas. Assume the market value for gas has fluctuated between $1.90 and $1.10 per Mcf. The lease calls for royalty calculated as 1/8th of the current market value; the division order calls for payment of contract prices so long as the gas contract is in effect. Although this division order clearly benefits the lessor, the effect of the statutes would be to void the division order to the extent it varied from the oil and gas lease.

of consistent analysis.[173] For example, the division order has been regarded as a "contract." [174] However, the division order "contract" is often immune from basic contract law principles.[175] The division order has also been referred to as an "instrument," a "continuing offer," an "accord and satisfaction," and an "estoppel document." [176] The general tenor of the cases,[177] and recent legislative initiatives,[178] is that the division order will be governed by the emerging "law of division orders." Although it may be impossible to cram the emerging division order jurisprudence into a nice common law pigeonhole, it would be helpful to identify why courts, and legislatures, have shunned the common law for the creation of a separate body of division order law. Once their motivation is understood, we should be able to delineate at least some general guidelines for addressing division order disputes.

[1] Problems with the Existing Analysis

The basic problem with the existing analysis is its inconsistency. For example, in *Exxon Corp. v. Middleton*,[179] the Texas Supreme Court held that the division order was a contract. The express terms of the division order contract stated it would remain in effect so long as the lease remained in effect. However, without explanation, the court held that the division

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[173] *See generally* Smith, *supra* note 3, at 535.

[174] Chicago Corp. v. Wall, 293 S.W.2d 844, 846 (Tex. 1956).

[175] The express terms of the contract, at least in Texas, are governed not by contract principles, but rather by principles of "fairness." For example, the holding in Exxon Corp. v. Middleton, 613 S.W.2d 240, 250 (Tex. 1981), can be summarized as follows: The division order "contract" is enforceable to the extent it does not unfairly trammel the lessor's rights under the oil and gas lease.

[176] *See generally* Ethridge, "Oil and Gas Division Orders," 19 *Miss. L. J.* 127 (1948); Gregg, "Title Examination and Division Orders," 34 *Oil & Gas L. & Tax. Inst.* 313 (Sw. Legal Fdn. 1983); Knowlton & Morrow, "Division Orders: Contract, Distribution Mechanism, and Curative Tool," *Oil and Gas Agreements* 12-1, 12-11 to 12-13 (Rocky Mt. Min. L. Fdn., 1983); Rain, "A Further Look at Division Orders and Problems in Accounting and Payment of Proceeds from Oil and Gas," 8 *Rocky Mt. Min. L. Inst.* 69, 71 (1963); Note, "A Suggested Analysis for Division Orders," 17 *Tulsa L. J.* 534, 547-49 (1982).

[177] *See, e.g.*, Gavenda v. Strata Energy, Inc., 705 S.W.2d 690 (Tex. 1986).

[178] See text accompanying notes 166-168 *supra*.

[179] 613 S.W.2d 240 (Tex. 1981).

order contract remained effective only until it was revoked by either party. The court assumes either party could revoke at any time.[180] The Kansas Supreme Court, in *Holmes v. Kewanee Oil Co.*,[181] held a division order provision changing the basis for royalty calculation from "market value" to "proceeds" was unenforceable. The court held there was no consideration to support the lessor's agreement to accept a proceeds royalty instead of the market value royalty required by the oil and gas lease.[182]

As a matter of contract law, there would seem to have been consideration to support the division orders in the *Middleton* and *Holmes* cases. In each case, the oil and gas lease provided for payment of royalty based upon the "market value" of the gas. In each case, the lessee presented the lessor with a division order substituting for market value a share of the proceeds the lessee received from its gas purchaser under a long-term gas contract. At the time the division orders were signed in each case, a share of the proceeds was not a bad deal for the royalty owner. At the very least, the division order would fix the royalty value instead of making it subject to market fluctuations. It is apparent the court in each case assumed that a market value measure of royalty would always be a better deal for the lessor. In *Middleton,* the court gave the division order partial effect—it would remain the basis for royalty calculations until revoked.[183] In *Holmes,* the court held that the portion of the division order changing the basis for calculating royalty was void.[184]

It seems obvious that the court, in each case, to varying degrees, is attempting to protect the lessor from giving up rights they may have under the oil and gas lease. Courts probably start with the premise that the lessors didn't really know what they were signing, or getting, when they entered

[180] *Id.* at 250-51.

[181] 233 Kan. 544, 664 P.2d 1335 (1983), *cert. denied,* 474 U.S. 953 (1985).

[182] 664 P.2d at 1341.

[183] Exxon Corp. v. Middleton, 613 S.W.2d 240, 250–51 (Tex. 1981).

[184] *Holmes,* 664 P.2d at 1341.

into the oil and gas lease.[185] However, in keeping with traditional contract analysis, the lessor's signature on the lease is the acid test of its validity—absent fraud, misrepresentation, duress, mutual mistake, or unconscionability.[186] Instead of inquiring into the conscionability of the lease, the courts have responded with various interpretive techniques designed to return to the lessor some of what they unwittingly signed away under the express terms of the lease. The implied covenant and strict construction have been the court's tools to fashion what they perceive is a "fairer" relationship without rocking the freedom of contract boat.[187]

When lessees responded to unfavorable lease interpretations with division orders, the courts had another opportunity to address the conscionability of the situation. Instead, they have again resorted to interpretive techniques, but have been more willing to restrict freedom of contract in the process. For example, you cannot create an irrevocable "division order" in Texas.[188] Similarly, you cannot amend an oil and gas lease with a "division order" in Kansas.[189] Will the courts apply this same analysis when the "irrevocable" division order terms or the lease amendment contained in a division order benefits the *lessor*? Can lessees and purchasers avoid this division order law by calling the instrument something else?

State legislatures addressing these issues have similarly treated the division order as a special legal phenomenon. Indiana, North Dakota, Oklahoma, Wyoming, and Utah each make reference to rights or obligations surrounding the "division order." [190] It is likely many of these states will be required to distinguish the "divison order" from other types of documents as the drafting bar rises to the occasion. Two state statutes offer guidance by defining the division order as: "an

[185] *See generally* Pierce, *supra* note 6, at 453-54.

[186] *Id.* at 454-55.

[187] *Id.*

[188] Exxon Corp. v. Middleton, 613 S.W.2d 240, 250-51 (Tex. 1981).

[189] Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983), *cert. denied*, 474 U.S. 953 (1985).

[190] See notes 112, 113, 114, 154, and 168 *supra*.

instrument for the purpose of directing the distribution of proceeds from the sale of oil, gas, casinghead gas or other related hydrocarbons . . .." [191] This suggests the focus was upon the coercive technique of withholding production revenues until a division order was signed. A lessor should be able to fend for himself when a lessee seeks lease amendments but doesn't hold any of the lessor's money to facilitate "negotiations." It also protects the lessor from signing a document presented as merely a stipulation of their interest but which also affects their substantive rights.

Once lessees and purchasers realize the courts and legislatures are trying to protect the lessor from what is perceived to be unfair practices, workable alternatives can be explored. If the purpose is to invite meaningful negotiation with the lessor, this may require lessees and purchasers to make personnel available who can negotiate instead of dictate. It also means, however, that the lessor must be willing to negotiate, as opposed to dictate. The basic tenet courts and legislatures seem to be promoting is fair play while recognizing the utility of division orders. The Kansas Supreme Court has used consideration concepts to protect the lessor from lessee overreaching through the division order process.[192] The Texas Supreme Court, in *Gavenda v. Strata Energy, Inc.*,[193] explains the basis for its decision in *Exxon Corp. v. Middleton*.[194] stating:

> In [*Middleton*] . . . we held the division orders were binding until revoked, even though there had been no detrimental reliance. To provide stability in the oil and gas industry, we held for the distributors of the proceeds because they had not profited from their error in preparing

[191] Okla. S. 107, 42d Leg., 1st Reg. Sess. (1989), to be codified at Okla. Stat. tit. 52, § 540 B. Similar language is found in N.D. Cent. Code § 47-16-39.3 (Supp. 1989).

[192] Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983), *cert. denied*, 474 U.S. 953 (1985); Maddox v. Gulf Oil Corp., 222 Kan. 733, 567 P.2d 1326 (1977), *cert. denied*, 434 U.S. 1065 (1978). Courts have traditionally used consideration, and specifically the preexisting duty rule, to police the bargaining process. *See* E. Farnsworth, *Contracts* § 4.21 (Little Brown 1982).

[193] 705 S.W.2d 690 (Tex. 1986).

[194] 613 S.W.2d 240 (Tex. 1981).

> the division order—in short, because there was not unjust enrichment.[195]

In *Middleton,* the court promotes the utility of the division order but refuses to enforce the provision making the order irrevocable. The court appears to have been balancing the needs of the industry against the lessor's lease rights. Quoting from *Phillips Petroleum Company v. Williams*,[196] the court in *Middleton* recognizes the lessor's interest, stating:

> Binding as they are, however, in respect of payments made and accepted under them, these division or transfer orders did not rewrite or supplant the lease contract. They are binding only for the time and to the extent that they have been, or are being acted on and made the basis of settlements and payments and from the time that notice is given that settlements will not be made on the basis provided in them, they cease to be binding.[197]

The three major legislative initiatives in this area similarly attempt to balance the leasehold rights of the lessor against the needs of the industry.[198]

[2] The Division Order as a Sale of Goods

Although a consideration analysis may be applicable in some cases where the lessee obtains the division order, the situation is fundamentally different when the division order is obtained by a third party purchaser. There is no preexisting contract between the parties. The division order usually represents the only document between the lessor and purchaser. In this situation, a contract analysis seems appropriate. However, the court decisions and legislative enactments have not been limited to division orders between a lessee and lessor, they apply to "division orders."

The typical division order is an agreement for the sale of oil and gas to be severed by the seller and is therefore governed by

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[195] *Gavenda v. Strata Energy, Inc.,* 705 S.W.2d at 692.

[196] 158 F.2d 723 (5th Cir. 1946).

[197] *Exxon Corp. v. Middleton,* 613 S.W.2d at 250.

[198] See text accompanying notes 166-168 *supra.*

Article 2 of the Uniform Commercial Code (UCC) as a sale of goods.[199] When the division order is between the lessee and the purchaser, the division order may supplement or supplant other oral or written agreements. When the division order concerns oil, and is between the lessor and purchaser, the division order will probably be the only agreement between the parties and will constitute a sale of goods under the UCC.[200] A gas division order between the lessee and lessor, when the lessor does not have title to the gas, is arguably not a sale of goods because the lessor has nothing to sell.[201] Although the Article 2 context may be helpful for determining rights and remedies under an executed division order, it may be most useful in establishing a sales contract when the parties cannot agree on division order terms.

Returning to the hypothetical posed in section 16.02 of this article, recall that Crude Oil Purchasing Company has prepared an oil division order and presented it to Fred Farmer, the royalty owner. Fred refuses to sign, but Fred's oil continues to be produced from the lease and taken by Crude. Crude is holding money in a suspense account awaiting Fred's signature on Crude's division order. Is there any basis for Crude purchasing the oil? Is there an "agreement" between Fred and Crude?[202] There is an underlying element of inconsistency to the actions of Crude and Fred. They cannot agree on the specific terms of a sale, yet they each permit Fred's oil to move from Fred to Crude without an agreement. Article 2 seems to be well-suited to situations where the lessor refuses to sell on the purchaser's terms and the purchaser refuses to buy on the lessor's terms—yet they act as though they have some agreement regarding a sale.

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[199] UCC § 2-107(1) (1977).

[200] See text accompanying notes 203-206 *infra*.

[201] Merely entering into an agreement regarding the division of money is not a sale of goods. *See* UCC § 2-105(5) (1977) (defining "goods") and UCC § 2-106(1) (1977) (defining "sale").

[202] UCC § 1-201(3) (1977) defines "agreement" as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance . . . ."

Even though the lessor and purchaser are unable to agree upon all the terms of a sale, their conduct may provide the basic "agreement" from which the Code can fashion a contract. UCC § 2-204(1) provides: "A contract for the sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." [203] To the extent the parties have not agreed on terms, such as the sales price of oil, the Code will fill the gap through provisions such as UCC § 2-305 which provides for a "reasonable price at the time for delivery." [204]

Suppose the purchaser sends the lessor its standard form division order. The lessor rejects this offer and sends the purchaser a "Uniform Royalty Division of Interest Form" recommended by the National Association of Royalty Owners. The purchaser rejects this form. But what happens throughout this process? The lessor permits its royalty oil to be taken by the purchaser and the purchaser voluntarily takes the lessor's royalty oil. The parties may have a "contract" pursuant to UCC § 2-207(3) which provides:

> *Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale* although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any provisions of this Act.[205]

It would appear under this approach that the lessor would usually be the victor in the battle of the forms because most of the lessor's terms would "agree" with those of the purchaser while many of the purchaser's terms would not agree with the lessor's form. The UCC possibilities become even more

[203] *Id.* at § 2-204(1).

[204] *Id.* § 2-305.

[205] *Id.* § 2-207(3).

interesting if the lessor is sophisticated enough in the oil and gas business to be considered a "merchant" under the Code.[206]

If courts desire to follow a more traditional contract analysis for the sale of oil, Article 2 offers an analysis that is more in keeping with the realities of the situation. Where the lessor and purchaser cannot agree, and the lessor has not taken action to try and halt the flow of oil to the purchaser, Article 2 offers an analysis that avoids a conversion claim for the purchaser and forces a contract which may be beneficial to the lessor.[207]

§ 16.05 Eliminating Conceptual Problems

[1] Eliminate the "Division Order"

Since the basic purpose of the division order is to transfer title to oil and gas from the lessor and lessee to the purchaser, perhaps the parties should enter into a "production sales agreement" instead of a "division order." Such an agreement should be structured as a bilateral contract with each party signing and undertaking obligations to avoid consideration claims. Since there is a good chance the production sales agreement would vary terms contained in the oil and gas lease, the parties must carefully structure their documents so they are something more than a division order in disguise. If the document is deemed a division order, it may be partially ineffective in states such as Kansas, Oklahoma, North Dakota, and Wyoming;[208] in Texas, it may be revocable even though expressly made irrevocable.[209]

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[206] UCC § 2-104(1) defines "merchant" as:

> [A] person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transactions or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

Many of the Article 2 provisons only apply when the transaction is "between merchants." *See, e.g., id.* §§ 2-201(2) (statute of frauds and the written confirmation) and 2-207(2) (inconsistent terms may become part of the sales contract).

[207] See text accompanying notes 203-206 *supra.*

[208] See note 168 *supra.*

If a purchaser elects to pursue this approach, it will invariably have to face the lessor who refuses to execute anything, regardless of the terms. In this situation, unless the purchaser is satisfied with the lessee's authority to pass title to lessor's production, the purchaser should refuse to purchase until some sort of an agreement is obtained. Even if the lessor is willing to let the oil flow, the purchaser may be unwilling to buy upon terms imposed by the UCC.[210] If purchasers begin shutting off all production from a well because the lessor refuses to arrange for the sale of their oil, this may prompt development of a body of law to address the situation. Either the courts will find authority in the lessee to market the lessor's oil or begin awarding lessees damages caused by their lessors' obstruction.

One approach might be to simply provide in future leases that the lessor will sign a division order. This begs the question because we must still determine the contents of the required "division order." If this technique is used, the actual form of division order should be attached as an exhibit to the lease. If the division order is a negotiated document, and the lessor wins something in the negotiation process, the division order problem will not be solved if production is offered to a third party purchaser who objects to the division order terms.

[2] Eliminate the Lessor from the Marketing Transaction

Perhaps the best approach would be to eliminate the need for any sort of division order or production sales agreement from the lessor. This could be done by eliminating the lessor from the marketing transaction altogether. Actually this approach would answer many of the common complaints of lessor and purchaser alike. The lessor is concerned that if they sign a division order, they may be giving up rights they have under their oil and gas lease.[211] If we restructure the oil and

[209] See text accompanying notes 193-197 *supra*.

[210] See text accompanying notes 205-206 *supra*.

[211] See text accompanying notes 156-159 *supra*.

gas lease to eliminate the need for a division order from the lessor, then there will be no risk of losing lease rights. At the same time, a major headache is eliminated for the purchaser if they can deal solely with the lessee. This would also place the burden for marketing oil and gas where it always, informally, has been—on the lessee.

Instead of wasting space in the oil and gas lease specifying what sort of "division order" the lessor must sign, consider spending the time and effort creating a marketing regime that permits the lessee:

(1) To contract with a purchaser to sell all the production without the lessor's consent; and

(2) Requires the lessee to account to the lessor based upon the express and implied terms of the oil and gas lease.

The basic goal is to draft the oil and gas lease so the lessee has title to all production from the leased land and the authority to sell it to others.[212]

If the lessor insists upon having a right to take oil or gas in kind, the lease should clearly provide:

(1) The lessee has title to the production, and can sell it to a purchaser on whatever terms the lessee deems proper;[213] but

(2) Once the lessor actually has the facilities installed to take its share of production in kind, and lessor informs the lessee and purchaser of its intent to take in kind, then the lessee's marketing rights and obligations as to such production will terminate; however

(3) To the extent the lessor's marketing efforts are interrupted, or the lessor otherwise fails to dispose of all or part of its share of production, the lessee will have title to the lessor's unmarketed share of production and the lessee can make sales of such production to a purchaser.

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[212] See text accompanying notes 56-60 *supra*.

[213] However, the commitment of production by the lessee to the purchaser would be subject to the lessor's right to commence taking its share of production in kind.

Whether the interest owner is a lessor, overriding royalty owner, or some other form of nonoperating interest, the relevant lease, assignment, or conveyance should be drafted to ensure the lessee always has title to production which is not being marketed. The obvious goal is to ensure that the well can continue to produce whenever an interest owner is not actually disposing of their share of production. The interest owners should be adequately protected by the terms of their lease, assignment, or conveyance to ensure the lessee markets production in a prudent manner.[214]

For existing leases, it may be more productive to seek a lease amendment to clarify the lessee's oil marketing authority instead of seeking a division order. The lease amendment is a one-time endeavor. The division order, being revocable at will by either party, may require continuous attention as purchasers, markets, and temperaments change.

§ 16.06 Conclusion

The division order is another classic example of an agreement formed without agreement. The "negotiation" usually takes place after the fact as the parties vie for advantage—one under the terms of the agreement, the other seeking benevolent interpretation from the court, or retribution from the legislature. Division order jurisprudence is following the same path as the law governing the oil and gas lease.[215] Since the relationship created by the agreement is flawed, we rely upon the courts to piece the relationship together. Usually this will be at the expense of the dominant, or dominating, party to the relationship. This is most pronounced when the lessee is demanding a division order from the lessor.

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[214] Contracts between the lessee and purchaser should not affect the rights the lessor has against its lessee under the oil and gas lease. If the lessor is not a party to the production sales contract, and the lessee is not given any agency authority to act on the lessor's behalf, the rights of the lessor will be governed solely by the oil and gas lease. The overriding royalty owner would be in a similar position with its rights being determined by the assignment creating the interest. The nonparticipating royalty or other interest owner would focus on the conveyance document creating their interest.

[215] *See generally* Pierce, *supra* note 6, at 452-55.

The best solution to the division order mess is to simply give the lessee title to gas *and oil* produced from the leased land and eliminate the lessor from the fray.[216] This is a situation where courts can exercise their interpretive prerogatives to improve the situation for lessors, lessees, and purchasers. The common form of oil and gas royalty clause should be interpreted to give the lessee the implied contractual right to sell royalty oil and pass title to a purchaser without the lessor's consent.[217] If courts fail to broadly define the lessee's marketing authority, but instead seek to define an agreement between the lessor and purchaser, they should consider Article 2 of the Uniform Commercial Code.[218]

Division order jurisprudence will continue to be a fruitful topic for discussion at future Institutes. Many basic concepts remain to be defined by the courts, and the legislatures of many producing states are just beginning to focus on division order issues.

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[216] See text accompanying notes 211-214 *supra*.

[217] See text accompanying notes 55-60 *supra*.

[218] See text accompanying notes 199-207 *supra*.