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The Interaction of the Division Order and the Lease Royalty Clause

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THE INTERACTION OF THE DIVISION ORDER AND THE LEASE ROYALTY CLAUSE

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I. INTRODUCTION

The lease royalty clause in an oil and gas lease establishes the obligation of the lessee to pay royalties to the lessor.[1] In practice,

1. *See* 3 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 641 (1995) (discussing role of royalty clause in establishing royalty obligations); *see also* JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 269 (3d ed. 1995) (designating royalty clause

however, the royalty clause generally fails to include the details necessary to calculate the lessor's royalty,[2] primarily because marketing needs cannot fully be determined until actual production begins.[3] This shortcoming has long hindered the practical application and judicial interpretation of royalty clauses. In fact, approximately fifty years ago, one writer recognized royalty clauses as "the most ambiguous and incomplete provisions of an oil and gas lease ever to be brought before the courts."[4] Yet, despite this early recognition, the royalty clause in the typical oil and gas lease has remained virtually unchanged through the decades.[5]

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as "the main provision in an oil and gas lease for compensation for the lessor"). The obligation is established both by the express terms of the royalty clause and by covenants implied in the lease, particularly the implied covenant of marketing. *See* Amoco Prod. Co. v. First Baptist Church of Pyote, 579 S.W.2d 280, 285 (Tex. Civ. App.—El Paso 1979) (recognizing that lessee has implied covenant to act in "good faith" when selling gas of its royalty owners), *writ ref'd per curiam n.r.e.*, 611 S.W.2d 610 (1980); MAURICE H. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 84 (2d ed. 1940) (emphasizing that "[t]he concept of diligence in marketing should include the duty to realize the highest price obtainable by the exercise of reasonable efforts.").

2. For instance, a standard royalty clause reads:

> The royalties to be paid by lessee are as follows: On oil, one-eighth of that produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipe line to which the wells may be connected. Lessee shall have the option to purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase. On gas, including casinghead gas, condensate or other gaseous substances, produced from said land and sold or used off the premises or for the extraction of gasoline or other products therefrom, the market value at 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.

AAPL Form 675 Oil and Gas Lease, *in* EUGENE O. KUNTZ ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL & GAS LAW 12 (2d ed. 1993); *see* RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 7.1, at 359–60 n.6 (3d ed. 1991) (providing example of comprehensive royalty clause).

3. This inability to accurately anticipate marketing needs is an issue particularly when the lease permits the lessee to calculate royalty based on the "amount realized" from the future sale of the oil and gas. In such cases, the lessee obviously will not know the details of that future sales contract until it is actually negotiated. Those contract terms, therefore, will depend upon the quality of the oil and gas, which can only be ascertained once production begins. For example, if the gas is "sour," it is generally transported and treated before it is sold.

4. Joseph T. Sneed, Comment, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 TEX. L. REV. 641, 656–57 (1947). The student author of this article, Joseph T. Sneed, now serves as the Senior Judge for the United States Court of Appeals for the Ninth Circuit.

5. David E. Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L.J. 445, 455–56 (1987). Professor Pierce concludes that the persistence of the oil and gas lease form is due

In addition to the ambiguous wording of the lease royalty clause, the presence of other interests in the chain of title, including nonparticipating royalty or mineral interests, complicates the lessee's obligation to calculate and pay royalties.[6] As a rule, once production begins, all interest owners become entitled to their share of production or the proceeds from the sale of that production.[7]

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to the "form mentality." *Id.* at 456. Expanding on this theory, Professor Pierce explains that "[f]orms tend to be self-perpetuating; once they are used the justification for their continued use is often 'that's the form we've always used—and everyone else uses.'" *Id.* at 456–57.

6. The interpretive problems posed by deeds creating a nonparticipating royalty interest complicate the lessee's royalty payment obligations under the lease. For an example of this complication, see *Gavenda v. Strata Energy, Inc.*, 705 S.W.2d 690, 691 (Tex. 1986), in which the title examiner misinterpreted the royalty.

A nonparticipating royalty interest is an expense-free interest that entitles the owner to only a share of oil and gas production. HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 702 (1994). The owner of such an interest has no right to execute leases, to share in bonuses, or to delay rental payments. *Id.* In contrast, a nonparticipating mineral interest is a cost-bearing interest. *Id.* at 698–99. It entitles the owner to a share of bonus and delay rentals as well as royalties under existing or future leases. *Id.* at 699.

Determining whether a deed conveyed a nonparticipating mineral or royalty interest is a problem that continually plagues title examiners. *See* Bruce M. Kramer, *Conveying Mineral Interests: Mastering the Problem Areas*, 26 TULSA L.J. 175, 177–78 (1990) (recognizing difficulty in distinguishing between nonparticipating royalty and mineral interests); Richard M. Maxwell, *The Mineral-Royalty Distinction and the Expense of Production*, 33 TEX. L. REV. 463, 468 (1955) (reviewing differences between nonparticipating royalty and mineral interests); *see also* French v. Chevron U.S.A., Inc., 896 S.W.2d 795, 798 (Tex. 1995) (interpreting conveyance as creating nonparticipating mineral interest rather than nonparticipating royalty interest).

7. *See* RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 7.5, at 389–90 (3d ed. 1991) (explaining that "[w]hen production is obtained, the lessee or the purchaser of production must account to the owners of the royalty interests as provided for under the royalty clauses of the lease"). The typical oil royalty clause permits the lessor to take her share of production in kind. *Id.* § 7.1, at 360. Practically speaking, however, the lessor rarely takes her oil in kind, electing instead to have the lessee market the oil. 3 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL & GAS LAW § 659; *see also* Wolfe v. Texas Co., 83 F.2d 425, 430 (10th Cir. 1936) (recognizing that lessee acts as agent in sale to purchaser when lessor fails to take oil in kind). In contrast, the gas royalty clause typically provides that the lessor will be credited with a fractional share of the proceeds from the sale of that production. 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 289 (1996). Such a lease arrangement results in the gas purchaser contracting only with the working interest owners, whereas the oil purchaser enters into an agreement with the royalty owners as well as the working interest owners. *Id.* These differences in the royalty provisions for oil and gas are due largely to the physical differences between the two substances. JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 271–72 (3d ed. 1995). Specifically, oil can be stored easily and economically, unlike gas, which must be delivered into a pipeline. *Id.* at 272.

However, because of ambiguities in the lease royalty clause and complications in the chain of title, controversies frequently arise regarding the allocation of the production or the proceeds received from the sale of the production. Therefore, to protect themselves against liability for conversion or for failure to account properly,[8] lessees or third-party purchasers historically have implemented an additional document in the payment process: the division order.[9]

Co-tenants are entitled to their fair share of production or proceeds from sale. If the lessee has not received a lease from all of the co-tenants, then the lessee will be required to account to the nonjoined co-tenants. The basis for the accounting is net profits. *See* RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 5.1, at 202–06 (3d ed. 1991) (addressing right of nonjoined co-tenants to receive proportionate share of products produced after producing co-tenant recoups costs).

8. RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 7.5, at 390 (3d ed. 1991). Authorities have also noted that the nature of the oil and gas provisions in the lease royalty clause will dictate the appropriate cause of action. *Id.* § 7.5, at 392 n.107. To recover under a conversion theory, for example, a lessor must show she owned title to the oil or gas taken by the purchaser. *Id.* Therefore, when royalties can be paid "in kind," the lessor retains title; failure to turn over the lessor's production is grounds for conversion. *Id.* However, when royalties are to be paid "in money," as provided in the gas royalty clause, and the lessee fails to account for the money received for the lessor's production, the proper remedy is an action for unsecured debt. *Id.* For an example of a court stressing this distinction, *see* Greenshields v. Warren Petroleum Corp., 248 F.2d 61, 67 (10th Cir.), *cert. denied*, 355 U.S. 907 (1957), which noted that because the gas royalty clause divested the lessor of title, "[h]is claim can only be for a payment in money and not for the product itself." *But see infra* Part IV.A. (questioning whether "in-kind" royalty option justifies treating oil division order differently from gas division order).

9. Si M. Bondurant, *Royalty Owner Rights Under Division Orders*, 25 TULSA L.J. 571, 572 (1990); *see* Martin R. Bennett, Comment, *Division Orders: Impact of the Payment for Proceeds of Sale Statute*, 47 BAYLOR L. REV. 513, 514 (1995) (noting protective role of division order in shielding operators or purchasers from liability for conversion); *see also* JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 387 (3d ed. 1995) (stating that "[d]ivision orders protect purchasers of production and those who distribute proceeds by warranting title to production transferred and indemnifying them for payments made."). In general terms, a division order may be defined as "the instrument through which an interest owner authorizes another party to make distribution of the proceeds from the sale of production." Si M. Bondurant, *Royalty Owner Rights Under Division Orders*, 25 TULSA L.J. 571, 573–74 (1990). The origin of the division order can be traced to the early part of this century when oil was the primary product sold:

> It was sold to third-party purchasers who were neither operators nor owners of any of the oil and gas interests and who were in the business of buying crude oil as a raw material for the refining business. Crude oil at that time was marketed primarily through pipelines and later railroads and eventually trucks which purchased the oil at the well and hauled for hire the production to market. Generally, the purchasers would assume the responsibility of distributing the proceeds to the owners. The purchasers developed the division order to provide protection from liability in making distribution of proceeds from production.

In its simplest form, the division order is a relatively short document that the lessees or the purchasers of the production (payors) send to royalty owners and other interested parties (payees) in order to affirm the size of each payee's interest.[10] Generally, the division order asks the payee to warrant or to certify his or her interest, and to indemnify the payor in the event the payee is overpaid.[11] Because the basis for calculating the royalty is not defined specifically in the lease royalty clause,[12] payors also use division orders to specify the terms of the oil or gas sales contract. In turn, these terms are intended to provide the basis for calculating the payee's royalty payment.[13]

Id. at 572. The history and significance of the division order have been well explored. *E.g.*, Si M. Bondurant, *Royalty Owner Rights Under Division Orders*, 25 TULSA L.J. 571 (1990); David E. Pierce, *Resolving Division Order Disputes: A Conceptual Approach*, 35 ROCKY MTN. MIN. L. INST. 16–1 (1989); Jane Fleck Romanov, *The Division Order: Is It Still a Shield Against Liability?*, 3 TEX. OIL & GAS L.J. 25 (Jan.–Mar. 1989); Ernest E. Smith, *Royalty Issues: Take-or-Pay Claims and Division Orders*, 24 TULSA L.J. 509 (1989); Marvin G. Twenhafel, *Oil-Gas Division Orders: Their Origin, Varieties, and Usage* 27B ROCKY MTN. MIN. L. INST. 1479 (1982); Richard F. Brown, *Texas Division Orders and the Texas Division Order Statute*, THE LANDMAN, Mar./Apr. 1993, at 23; Stuart Hollimon, *Division Orders—A Primer*, 34TH OIL & GAS INST. 313 (1983).

One commentator has suggested the division order gets its name from "the fact that it sets out the division of interest in the oil run into the pipeline, among the royalty owners and lease owners." 1 EARL A. BROWN, THE LAW OF OIL & GAS LEASES § 6.01, at 6–4 to 6–5 (2d ed. 1996).

10. 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 289 (1996).

The three basic types of division orders are: (1) a third-party purchaser division order, (2) an indemnity division order, and (3) a lessee/purchaser division order. Si M. Bondurant, *Royalty Owner Rights Under Division Orders*, 25 TULSA L.J. 571, 574 (1990). The third-party purchaser division order is from "both the lessor and lessee directed to a third-party purchaser who assumes the responsibility for disbursing proceeds from production directly to the royalty owner and the working interest owner for their respective shares of proceeds." *Id.* The indemnity division order is from "the lessee to the purchaser, whereupon the purchaser pays the lessee for 100% of the production and the lessee assumes the responsibility for disbursing royalties." *Id.* The lessee/purchaser division order is "a direction from the royalty owner to the lessee to assume responsibility for disbursing proceeds to the royalty owner." *Id.* at 574–75. Therefore, it is obvious that not all division orders are signed by royalty owners; some are between the operator and purchaser. The main focus of this Article is the effect of lessees' division orders, which have been signed by royalty owners, on the lessees' royalty obligation.

11. 4 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 704.1, at 579–80 (1995). The payee who has been underpaid has a remedy against the overpaid owners. *Id.*

12. *See supra* note 2 and accompanying text.

13. *See* JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 426 (3d ed. 1995) (recognizing that payors commonly use division order "to give instructions . . . for payment of the

Although these division-order terms generally are supplied as part of a genuine effort to clarify royalty payments, they sometimes are used blatantly and unilaterally to change the payor's liability under the lease royalty clause.[14] Thus, despite the division order's seemingly innocuous nature, courts consistently have been required to resolve controversies about its effect on the lessee's royalty obligation.

Unfortunately, in resolving these disputes, Texas courts ultimately have failed to adopt a guiding theory.[15] Instead, they have vacillated between the competing policies raised in these disputes by promoting either (1) the need to protect producers with stability and finality in the payment process, or (2) the need to protect royalty owners from being unfairly denied their rights under the lease royalty clause.[16] In an attempt to provide some clarity where the

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proceeds of sale"). This use of the division order is particularly relevant when the lease provides that the royalty shall be calculated on a "proceeds" or "amount realized" basis. In such a case, it is necessary for the lessee/payor to spell out the exact terms of the contract from which the "proceeds" will be "realized" once those contracts are ultimately negotiated.

14. The classic example of using a division order to alter the payor's liability involves the substitution of an "amount realized" standard when a lease requires royalties to be calculated on the "market value" of the gas standard. *See* discussion *infra* Part II.A.1. Professor Pierce explains:

> Lessees seem to abhor the idea of consulting lessors after they have obtained their signature on the oil and gas lease. . . . Traditionally, lessees have turned to more clandestine means such as tendering division orders containing 'clarifying' language or language designed to change the royalty provisions of the oil and gas lease to try and resolve royalty calculation issues with lessors.

David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 E. MIN. L. FOUND. § 18.02[1], at 18–5 (1992).

15. Many writers have lamented the courts' failure to resolve the issue conclusively. *E.g.*, Si M. Bondurant, *Royalty Owner Rights Under Division Orders*, 25 TULSA L.J. 571, 572–74 (1990); David E. Pierce, *Resolving Division Order Disputes: A Conceptual Approach,* 35 ROCKY MTN. MIN. L. INST. § 16–01, at 16–2 (1989); Ernest E. Smith, *Royalty Issues: Take-or-Pay Claims and Division* Orders, 24 TULSA L.J. 509, 510–13 (1989); Richard F. Brown, *Texas Division Orders and the Texas Division Order Statute*, in THE LANDMAN, Mar./Apr. 1993, at 23, 23; *see also* discussion *infra* Part II.A.1. (reviewing courts' treatment of contract and estoppel as conceptual constructs for resolving division order disputes).

16. The courts' vacillation between these competing policies is most evident in the Supreme Court of Texas's two opinions in *Exxon Corp. v. Middleton*. In an original opinion, the Supreme Court of Texas held that the division orders did not amend the lease royalty clause, determining that "these documents are not contracts" that bind the payees. Exxon Corp. v. Middleton, 24 Tex. Sup. Ct. J. 6, 13–14 (Oct. 1, 1980), *withdrawn*, 613 S.W.2d 240 (Tex. 1981). More specifically, that first opinion contended that division orders were not "intended to afford a lessee the opportunity to amend the lease, relieve himself of

courts had not, the Texas legislature also addressed these competing policies and enacted provisions in 1991 governing division orders signed after that date.[17] Because those provisions are prospective only, however, case law will remain relevant for disputes stemming from division orders executed prior to 1991. In order to resolve these division-order disputes effectively in the future, courts and, likely, the legislature, must continue to strive both to clarify the law and to balance the competing policy interests of producers and royalty owners.

The purpose of this Article is to provide a practical analysis of the interaction of the lease royalty clause and the division order under Texas statutory and case law. As a paradigm for this analysis, the Article focuses on the recent court of appeals and Supreme Court of Texas opinions in *Heritage Resources, Inc. v. NationsBank*.[18] The ultimate goals of this Article are to delineate the framework for resolving royalty payment disputes involving division orders, to analyze the differences between case law and statutory provisions, and to highlight conflicts within both the cases and the statutes. Furthermore, a final section addresses division-order disputes destined to be decided in the coming decade.

II. The Evolution of Division-Order Case Law

Historically, the division-order disputes causing the most significant legal debate have arisen when a payee asserts that royalty payments are deficient for one of the following reasons: (1) the payor has incorrectly determined the gross value of the production before calculating royalties, either by using the "amount realized" standard in place of the "market value" standard,[19] or by improperly marketing the production;[20] (2) the payor has erroneously used a

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lease obligation, or secure advantages over the lessor which could not be asserted under the provisions of the lease." *Id.* at 14. In a second opinion, the supreme court reversed its stance and adopted a rule that serves the producer's goals by holding that division orders are binding until revoked. Exxon Corp. v. Middleton, 613 S.W.2d 240, 250–51 (Tex. 1981). For a further exploration of the *Middleton* court's vacillation, see discussion *infra* Part II.A.1.

17. Tex. Nat. Res. Code Ann. §§ 91.401–.406 (Vernon 1993 & Supp. 1996); *see* discussion *infra* Part III (examining Texas division-order statutes).

18. 895 S.W.2d 833 (Tex. App.—El Paso 1995), *rev'd*, 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996).

19. *See infra* Part II.A.1.

20. *See infra* Part II.A.2.

fractional interest in the order that is smaller than that actually owned by the payee;[21] or (3) the division order allows the payor to deduct too many costs from the payee's royalty.[22] In Texas, each reason has produced case law, reviewed below, governing the effect of the division order on the lease royalty clause.

A. *Incorrect Determinations of the Gross Value of Production*

1. The "Market Value Royalty" Cases

The "market value royalty" cases illustrate the essence of a typical division-order dispute: it begins with the lease royalty clause.[23] In other words, the effect of the division order on the lessee's royalty obligation becomes an issue only *after* courts have interpreted the lease language to determine that obligation. Determination of gas royalties is particularly convoluted because of the unique effects of regulation and market forces on gas prices,[24] making the gas royalty clause a perennial subject for judicial interpretation.

The gas royalty clause in the typical oil and gas lease is bifurcated.[25] It uses different terms for calculating royalty depending on whether the gas is "sold at the wells" or "sold or used off the premises."[26] Under the typical gas royalty clause, if the gas is "sold at the wells," then royalties are to be based on the "amount realized"

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21. *See infra* Part II.B.

22. *See infra* Part II.C.2–3.

23. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 241 (Tex. 1981) (stating that "[t]he problem begins with the gas royalty clause"). In particular, if the payee is a non-participating royalty or mineral owner, rather than a lessor, the problem begins with interpreting the document that created the interest. Such was the case in Gavenda v. Strata Energy Inc., 705 S.W.2d 690 (Tex. 1986). *See* discussion *infra* Part II.B.

24. John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 232–33 (1996).

25. For an example of a typical "bifurcated" gas royalty clause *see supra* note 2.

26. Texas courts have determined that gas is sold "at the well," or "on the premises," if it is sold within lease lines. *Middleton*, 613 S.W.2d at 243. In *Middleton*, the court expressly disapproved of the approach used by the El Paso Court of Appeals in *Butler v. Exxon Corp.*, 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.), which had defined "premises" to include the field. *Id.* at 243–44.

However, in *Piney Woods County Life Sch. v. Shell Oil Co.*, rather than focusing on lease lines, the court recognized that the terms "at the well" and "off the premises" were used, respectively, to distinguish between gas that did not need to be processed and gas that had to be transported for processing. *Piney Woods*, 726 F.2d 225, 240 (5th Cir.), *reh'g denied*, 750 F.2d 69 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985). Therefore, for the *Piney Woods* court, it was the quality of the gas, and not strictly the geographic lease lines, that determined whether gas was sold "on or off the premises."

from the sale.[27] If, however, the gas is sold "off the premises" then the clause provides that royalties shall be based on the "market value at the well."[28] Once a court determines that the gas has been sold "off the premises," the next obvious question becomes when and how to calculate "market value at the well."

The meaning of the phrase "market value at the well" became a crucial issue for the courts during the late 1970s and early 1980s. At that time, market conditions had created a significant divergence between the proceeds received by lessees under their long-term gas contracts and the actual market value of the gas on the day of production. The use of such long-term gas sales contracts had pervaded the oil and gas industry from the 1930s through the mid-1980s,[29] largely due to government regulation and economic considerations.[30] During the late 1970s, changing market forces and new government policies combined to cause prices prevailing on the day of production to exceed sales prices under the long-term contracts to which many lessees had dedicated their gas.[31] Conse-

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27. *Supra* note 2.

28. *Id.*

29. *See* EUGENE O. KUNTZ ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 250 (2d ed. 1993) (noting that use of long-term gas sales contracts was industry standard "from the time that interstate pipelines were constructed in the 1930s until the mid-1980s").

30. *Id.* One group of commentators succinctly described the factors influencing widespread use of long-term contracts as follows:

> In part, long contract terms reflected regulatory requirements. The Natural Gas Act of 1938 required that gas dedicated into interstate commerce be subject to a minimum fifteen year contract to assure that the 'public convenience' would be served by a certain supply. Economic considerations also demanded long contract terms. Long-term commitments were a condition of the complex financing arrangements entered into for the construction of many of the interstate pipelines. Even after the construction loans were paid, pipeline maintenance and operation generated high fixed costs, so that pipeline gas buyers made long contract terms a high priority in negotiations.

Id. at 250-51.

Professor John Lowe describes the "linear" structure of gas markets that resulted largely from government regulation:

> Producers extracted natural gas and sold it to pipelines at the well head or in the field under long-term contracts that obligated the pipeline to take or pay for minimum quantities of production. Pipelines bought gas from producers and sold it to local distribution companies, state-regulated public utilities that supply gas at the burner-tip, using minimum commodity bill tariffs to shift the risk of their take-or-pay obligations to producers. Local distribution companies retailed gas to end-users.

John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 224 (1996).

31. *See* John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 232–33 (1996) (noting that 1970s and 1980s were marked by "a combination of market forces and

quently, the definition of "market value at the well" became a focal point of litigation.[32]

Lessees argued that because they were forced to dedicate the gas to long-term contracts, those contract prices should represent the "market value" of the gas.[33] Such an interpretation was clearly in the lessees' best interest, for if "market value at the well" was equated with the prevailing price on the day of production, then many lessees would have been required to calculate royalties on a basis exceeding their actual proceeds. Lessors, however, challenged the lessees' interpretation, and asserted that the phrase "market value at the well" always contemplated the current market value of the gas.[34]

Ultimately, the lessees' argument was hindered by the presence of the bifurcated payment scheme in their leases, which called for basing royalties upon either the "market value at the well" of the gas or on the "amount realized" from its sale. Lessees asserted that each of these valuation terms permitted them to calculate royalties based upon their long-term contract prices. Their assertions inevitably led lessors and courts to question why the gas royalty clause contained two different valuation terms if those terms actually established the same basis for royalty calculations.[35]

Thus, in determining the meaning of "market value" in the ensuing royalty disputes, courts chose between two contrasting ap-

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government regulation [that] caused new gas contract prices to escalate faster than regulated long-term contract price adjustments").

32. *See* EUGENE O. KUNTZ ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 268 (2d ed. 1993) (recognizing market value royalty problem as "one of the most widely litigated and expensive issues of the oil and gas industry during the 1970s and early 1980s").

33. John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 233 (1996).

34. *E.g.*, *Middleton*, 613 S.W.2d at 240; Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968); Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981).

35. *See* John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 233–34 (1996) (addressing lessors' and lessees' contradictory interpretations of phrase "market value"). Professor Lowe contends that both of the interpretations failed to recognize the "original purpose of the royalty clause." *Id.* at 233 n.58. He then explains that lessees originally included the term "market value" in the royalty clause to ensure that if a lack of markets or the presence of better distant markets precluded sales at the well, then the lessee would have a right to "work back" to the value of the gas at the well by deducting the added costs, such as those incurred in transporting the gas for processing. *Id.*; *see* John S. Lowe, *Developments in Non-Regulatory Oil and Gas Law*, 32 INST. ON OIL & GAS L. & TAX'N 117, 144–52 (1981) (discussing original reasons for inclusion of phrase "market value" in lease royalty clause). For a succinct discussion of the "market value royalty" problem, see JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 278–79 (3d ed. 1995).

proaches. Some jurisdictions, including Louisiana,[36] Oklahoma,[37] and Arkansas,[38] viewed the lease as a "cooperative venture," which required considering the marketing realities that had confined lessees to long-term contracts. Those jurisdictions allowed lessees to calculate "market value" royalties on the basis of their lower contract price.[39] Other states, including Texas, applied the "plain meaning" rule to the lease language.[40] Therefore, in the noted case of *Texas Oil & Gas Corp. v. Vela*,[41] the Supreme Court of Texas held that "market value" means "the prevailing market price" at the time of production, regardless of the financial burden that such an interpretation places on the lessee who has entered into long-term gas sales contracts.[42]

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36. *See* Henry v. Ballard & Cordell Corp., 418 So. 2d 1334, 1338–39 (La. 1982) (finding it necessary to consider "the necessary realities of the oil and gas industry" in interpretation of lease royalty clause that called for payments to be based on "market value").

37. *See Tara Petroleum Corp.*, 630 P.2d at 1273 (recognizing long-term gas contract as "necessity of the market . . . that lessors and lessees know and consider . . . when they negotiate oil and gas leases").

38. *See* Hillard v. Stephens, 637 S.W.2d 581, 583–84 (Ark. 1982) (acknowledging market conditions that dictated common use of long-term gas sales contracts).

39. *See Hillard*, 637 S.W.2d at 583 (holding that "prevailing market price at well" was equivalent to lower contract price that lessee-producer received under its long-term sales contracts); *Henry*, 418 So. 2d at 1341 (interpreting "market value" to be equivalent to producer's long-term contract price); *Tara Petroleum Corp.*, 630 P.2d at 1274 (resolving ambiguity in favor of lessees by restricting inquiry "to whether the sale was a reasonable contract when made" and finding that producer's long-term contract was "market value").

40. *See* John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 233–36 (1996) (examining "plain meaning" and "cooperative venture" approaches for interpreting meaning of market value). A majority of states have followed a "plain meaning" approach. *Id.* at 233. In addition to Texas, states such as Kansas, Montana, North Dakota, Mississippi, and West Virginia equate market value with value on the day of production. *Id.*; *see also* Bruce M. Kramer, *Royalty Interest in the United States: Not Cut from the Same Cloth*, 29 TULSA L.J. 449, 464–68 (1994) (analyzing divergence of opinions in construing "market value royalty" clause); David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 E. MIN. L. FOUND. § 18.03[1] (1992) (evaluating use or nonuse of marketing realities in resolving market value royalty disputes).

41. 429 S.W.2d 866 (Tex. 1968).

42. *Vela*, 429 S.W.2d at 871. The *Vela* court relied heavily on *Foster v. Atlantic Ref. Corp.*, 329 F.2d 485 (5th Cir. 1964), in reaching its decision. *Id.* In *Foster*, the lease royalty clause had required the lessee to pay royalty on 1/8th of the gas produced and saved from the leased premises on the basis of the "market price prevailing for the field where produced *when run*." *Foster*, 329 F.2d at 490 (emphasis added). The *Vela* majority, however, ignored this "when run" language in construing the terms of the royalty clause. *See Vela*, 429 S.W.2d at 880 (Hamilton, J., dissenting) (contending that majority should not have relied on *Foster* because royalty clause at issue did not contain similar "market price when

Division orders played a strong supporting role in these "market value royalty" payment disputes. Saddled with royalty clauses that courts had interpreted contrary to their interests, lessees turned to the division order in an attempt to "clarify" that royalty payments would be calculated on the amounts they actually realized from their gas sales contracts. Thus, courts were faced with determining how conflicting division-order language would affect the lease royalty clause.

In analyzing the effect of such conflicting division orders, a 1978 "market value royalty" case turned to theories of contract and estoppel. In *Butler v. Exxon*,[43] the court held that division orders providing for royalty payments on the basis of the lessee's gas sales contracts were not binding on the royalty owners under either contract or estoppel theory.[44] The orders did not constitute binding contracts, according to the court, because they had been executed without consideration.[45] Furthermore, the court reasoned that estoppel theory failed to protect the lessee because it had not detrimentally relied on the division orders.[46] Accordingly, the royalty owners in *Butler* were entitled to recover for the underpayments that had resulted when the lessee had valued their royalty on the

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run" language and because *Foster* court gave no indication that it would have reached same result in absence of such language). As one author explains:

> [M]any industry representatives considered the terms of the royalty clause in *Foster* to be so unusual that they believed the when run language contained therein played a central role in the *Foster* court's decision and considered the *Foster* decision as being effectively limited to its facts. Consequently, the result in *Vela* surprised many persons in the industry despite the clear implication of the language in *Foster*.

Stuart C. Hollimon, Exxon Corporation v. Middleton: *Some Answers But Additional Confusion in the Volatile Area of Market Value Gas Royalty Litigation*, 13 ST. MARY'S L.J. 1, 9 n.24 (1981).

43. 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

44. *Butler*, 559 S.W.2d at 417.

45. *Id.*

46. *Id.* As part of its estoppel analysis, the *Butler* court distinguished Chicago Corp. v. Wall, 156 Tex. 217, 293 S.W.2d 844 (1956), an earlier case involving an oil royalty division order dispute. *Id.* In *Wall*, two interest owners executed transfer orders that erroneously stated that they had transferred all of their properties when, in fact, they had only transferred one. *Wall*, 293 S.W.2d at 846. Earlier, the interest owners had executed valid division orders. *Id.* at 845. The court held the division orders and the transfer orders were binding since the evidence showed the payor had relied on them in making payments. *Id.* at 846.

basis of the long-term contract price, rather than on the prevailing market price.[47]

Under the *Butler* decision and others,[48] division-order jurisprudence in Texas appeared to be premised on theories of estoppel and contract. Those theories require fact-specific inquiries about consideration and reliance. Such was the case for the lower courts in *Exxon v. Middleton*,[49] the seminal "market value royalty" case decided a year after *Butler*.

Engaging in the contract analysis suggested in *Butler*, the appellate court in *Middleton* found consideration for division orders that the royalty owners, the Middletons, had executed to one of the producers, Sun.[50] Undertaking a fact-specific inquiry, the court found consideration on the basis of new obligations undertaken by Sun in the division orders, including the duty to make charts and records available to the royalty owners.[51] The Middletons contended that they had implicitly revoked the division orders by filing the lawsuit.[52] The court rejected the Middletons' contention, holding that the division orders were supported by consideration and that they "constituted binding written contracts."[53] On this basis, the court concluded that the division orders were not unilaterally revocable, thereby barring the Middletons' claim against Sun for underpayment of royalties.[54]

By barring the royalty owners' claims, the appellate court in *Middleton* reinforced producers' expectations in the use of division

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47. *See Butler*, 559 S.W.2d at 417 (allowing recovery of "gas royalty payment for all gas sold . . . based on market value at the time of delivery").

48. *See, e.g.*, Pan Am. Petroleum Corp. v. Long, 340 F.2d 211, 223 (5th Cir. 1964) (viewing division order as operative instrument of transfer that is binding until revoked); Chicago Corp. v. Wall, 156 Tex. 217, 293 S.W.2d 844, 846–47 (1956) (relying on theory of estoppel to protect payor from double liability in dispute between royalty owners); Hogg v. Magnolia Petroleum Co., 267 S.W. 482, 484–85 (Tex. Comm'n App. 1924, judgm't adopted) (using estoppel to find lessee liable for conversion of lessor's lien interest in third party's share of royalty only after lessee was notified); Stanolind Oil & Gas Co. v. Terrell, 183 S.W.2d 743, 745 (Tex. Civ. App.—Galveston 1944, writ ref'd) (stating that "[a] division order is ordinarily the contract under which the production is purchased or accepted for transportation by the pipeline company.").

49. 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd in part*, 613 S.W.2d 240 (Tex. 1981).

50. *Middleton*, 571 S.W.2d at 365.

51. *Id.*

52. *Id.* at 364.

53. *Id.* at 365.

54. *Id.*

orders. In particular, the court's holding implicitly advanced the two main policy interests behind producers' use of the division order: injecting stability into the payment process and providing protection against liability. The *Middleton* opinion, however, was not entirely pro-producer. Instead, the court also evidenced a desire to protect royalty owners from the misuse of division orders by stating:

> 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 obtained from unusual or unfair provisions imposed by a party having a superior bargaining power or position.[55]

After the *Butler* and *Middleton* appellate decisions, the common law of division orders in Texas was colored by two concepts. First, Texas case law expressly embraced estoppel and contract as guiding theories. Second, cases acknowledged a need to protect royalty owners from unfair use of the division order by lessees. After the supreme court's final decision in *Middleton,* however, those concepts would fade from the focus of Texas division-order jurisprudence.

In an initial opinion later withdrawn,[56] the Supreme Court of Texas contradicted the appellate court's contract analysis.[57] In that first opinion, the supreme court declared that division orders were "not contracts," and, therefore, did not amend the lessee's royalty obligation under the lease.[58] The supreme court, however, reiterated the appellate court's view of the lessee's royalty obligation and observed that the division order "was never intended to afford a lessee the opportunity to amend the lease, relieve himself of lease obligation, or secure advantages over the lessor that could not be asserted under the provisions of the lease."[59]

Despite this apparent rejection of a contract analysis, this initial supreme court opinion did, at least, continue to further the appel-

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55. *Middleton*, 571 S.W.2d at 365.

56. Exxon v. Middleton, 24 Tex. Sup. Ct. J. 6 (Oct. 1, 1980), *withdrawn*, 613 S.W.2d 240 (Tex. 1981).

57. *Id.* at 14.

58. *Id.*

59. *Id.*

late court's concept of protecting the interests of royalty owners. In its final substituted opinion, however, the supreme court deleted all references to contract analysis and relegated the provisions favoring royalty owners to footnote status.[60] Moreover, by failing to seek evidence of reliance and detriment, the court eschewed estoppel theory.[61] Thus, instead of deducing a result from the application of a guiding theory, the court pronounced a rule devoid of a theoretical basis. Relying on an earlier Supreme Court of Texas case, *Chicago Corp. v. Wall*,[62] and several cases from the United States Court of Appeals for the Fifth Circuit,[63] the court held simply that division orders are binding "for the time and to the extent that they have been, or are being acted on and made the basis of settlements and payments," but that "they cease to be binding" once revoked by either party.[64] With the supreme court's holding

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60. Exxon v. Middleton, 613 S.W.2d 240, 251 n.8 (Tex. 1981).

61. *See* 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 291–92 (1996) (asserting that *Middleton* rule is not consistent with theories of contract, estoppel, or accord and satisfaction); *see also* Gavenda v. Strata Energy, Inc., 705 S.W.2d 690, 692 (Tex. 1986) (noting that *Middleton* court found division orders binding "even though there had been no detrimental reliance").

62. 156 Tex. 217, 293 S.W.2d 844 (1956). In *Wall*, the gas royalty owners executed "division orders" listing their respective interests in the royalty, and submitted them to the gas purchaser. *Wall*, 293 S.W.2d at 845. The plaintiffs, who had executed the division order, then sold royalty interests to a third party and executed a "transfer order" covering the interest. *Id.* Thereafter, the gas purchaser paid royalties as directed by the "transfer order." *Id.* Plaintiffs later sued the gas purchaser for underpayment, alleging that the "transfer order" incorrectly stated the proportionate interest sold by plaintiffs to the third party. *Id.* at 846. The supreme court held that the plaintiffs were bound by their orders of transfer, even though they misstated the properties transferred, until they were revoked. *Id.* at 847.

63. *E.g.*, J. M. Huber Corp. v. Denman, 367 F.2d 104 (5th Cir. 1966); Pan American Petroleum Co. v. Long, 340 F.2d 211 (5th Cir. 1964); Phillips Petroleum Co. v. Williams, 158 F.2d 723 (5th Cir. 1946). Although cited by the supreme court in *Middleton*, *Long* actually did not address the effect of a division order on the lease royalty clause. Instead, the controversy arose in the slant-hole drilling controversies in East Texas. *Long*, 340 F.2d at 213. The *Long* court focused on the division orders merely to establish that the slanted-on oil company could recover, based on conversion, from the financial institution that received the proceeds from the stolen oil from the purchasing pipelines. *Id.* at 222–24. The Fifth Circuit reviewed Texas cases and concluded that the institution's right to revoke the division order was strong proof of control, which is essential to success in a suit for conversion. *Id.* at 223.

64. *See Middleton*, 613 S.W.2d at 250 (holding that division orders are binding on royalty owners until lessee is served with copies of royalty owner's pleadings in suit to recover deficiencies in royalty payment); Ernest E. Smith, *Royalty Issues: Take-or-Pay Claims and Division Orders* (noting that division orders in *Middleton* were considered revoked when lessors filed suit and that lessee could only recover market value after such

in *Middleton*, Texas division-order jurisprudence became dominated by the binding-until-revoked rule.

A definitive rule that division orders are binding until revoked frees lessees from the factual shackles of proving consideration or reliance and blatantly promotes the producers' interests. Such a rule also injects certainty into the payment process and provides payors with protection from suits by royalty owners who have signed division orders but later argue that they have been underpaid.[65] Despite its pro-producer overtones, the *Middleton* opinion does not ignore entirely the competing concerns of royalty owners. Specifically, in footnote 8, the opinion adopts verbatim the appellate court's qualifying language, which ensures fairness to royalty owners by suggesting exceptions to the binding-until-revoked rule.[66]

2. Implied Covenants and Division Orders

As described above, in interpreting the effect of division orders on the "market value royalty" obligation in the lease, courts struggled to balance the competing interests of producers and royalty owners. Similarly, the courts repeated this struggle in cases involving royalty owners who asserted breaches of the implied covenant of marketing in challenges to the gross values producers had placed on their production. For example, in *Amoco Production Co. v.*

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time), *in* STATE BAR OF TEX., PROF'L DEV. PROGRAM, ADVANCED OIL, GAS, AND MINERAL LAW COURSE K, K-23 (1988). *But see infra* Part III.B. (discussing conflicting methods for revoking division orders under Texas statutes).

Under the rule espoused in *Middleton*, division orders have been held to be revocable by the lessee as well as by the lessor. For example, *Sun Oil Co. v. Madeley*, involved a lease that contained, in addition to a 1/8th royalty provision, a reservation to the lessors of 1/2 of the net profits from the 7/8ths working interest. 626 S.W.2d 726, 727 (Tex. 1981). For several years the lessee had paid the lessors net profits on both oil and natural gas production. *Id.* However, the lessee later revoked the division orders after determining that it had misinterpreted the net profits requirement and had overpaid royalties. *Id.* at 733. In response, the lessors asserted estoppel, ratification, and waiver based on the lessee's division orders. *Id.* The court ultimately rejected the lessor's argument that the lessee was still obligated to make payments on the net profits interest for gas after the division orders were revoked. *Id.* at 734. The lessee, however, did not seek reimbursement for past overpayments. *Id.*

65. *See* Union Producing Co. v. Driskell, 117 F.2d 229, 231 (5th Cir. 1941) (announcing: "We know of no principal upon which competent persons who have agreed upon a fixed price can, after accepting it for some years, repudiate the agreement and claim more, merely because they think the price is too low.").

66. *Middleton*, 613 S.W.2d at 251 n.8.

First Baptist Church of Pyote,[67] a decision announced before *Middleton*, the lessors premised their claim for royalty underpayments upon a breach of the implied covenant of marketing.[68] More specifically, the lessors alleged that the lessees had procured too low a price in contracting to sell the gas.[69] The lessees countered that the terms of a division order shielded them from liability.[70] The court rejected the lessees' argument, holding that a division order could not provide protection from liability for breach of the implied covenant of marketing.[71] Emphasizing the policy of protecting royalty owners, the *Pyote* court concluded:

> [T]he purposes for which the [division] order is executed and the type of economic duress which prescribes it repel the implication that it is intended to affect the obligations of the operator to the royalty owner . . . the mere execution of a division order . . . ought not to preclude the royalty owner from asserting a breach of implied obligation against the operator.[72]

For several years, *Pyote* apparently set the standard for Texas courts faced with determining the effect of division orders in cases involving alleged breaches of the implied covenant of marketing.

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67. 579 S.W.2d 280, 285 (Tex. Civ. App.—El Paso 1979), *writ ref'd per curiam n.r.e.*, 611 S.W.2d 610 (Tex. 1980).

68. *First Baptist Church of Pyote*, 579 S.W.2d at 284.

69. *Id.* Amoco held an oil and gas lease on property owned by First Baptist Church of Pyote. *Id.* at 282. Amoco then entered into a marketing contract with Lone Star Gas Co. and Delhi Pipeline Co., in which Amoco agreed to sell gas from First Baptist Church's land for prices lower than those being paid by other purchasers, in exchange for interests in other wells not owned by First Baptist. *Id.*

70. *Id.* at 288.

71. *Id.* The division orders contained the following language:

> The following covenants are parts of this instrument and shall be binding on the undersigned, their successors, legal representatives, and assigns:
>
> . . .
>
> Gas: Settlements for gas shall be based on the net proceeds at the wells, after deducting a fair and reasonable charge for compressing and making it merchantable and for transporting if the gas is sold off the property. Where gas is sold subject to regulation by the Federal Power Commission or other governmental authority, the price applicable to such sale approved by order of such authority shall be used to determine the net proceeds at the wells.

Id.

In contrast to the majority, the dissent concluded that the division orders were binding contracts that presented "a bar to the recovery." *Id.* at 290 (Preslar, C.J., dissenting).

72. *Id.* at 288 (alteration in original) (quoting MAURICE H. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 209A (2d ed. 1940 & Supp. 1964)).

Then, in *Cabot Corp. v. Brown*,[73] a case decided after *Middleton*, the court retreated from the *Pyote* position and reasserted the binding-until-revoked rule.[74] Like *Middleton*, *Cabot* was a "market value royalty" case.

In the typical "market value royalty" case, the court interprets the gas royalty clause to require the lessee to calculate royalties on a market value basis. Next, the court questions whether the division order has changed that obligation. Logically, answering that question would seem to require the court to interpret the terms of the division order.

Although courts undertook the step of interpreting the division order in several cases,[75] interpretation of the division order was not an issue in most of the "market value royalty" cases prior to *Cabot*. In those cases, the division orders clearly replaced the lease's "market value royalty" standard with an "amount realized" or proceeds basis for calculating royalties.

Arguably, the *Cabot* division order was not so clear. It provided that the lessee would pay royalties based on the price determined by the Federal Power Commission (FPC), but only "if such sale be subject to the Federal Power Commission."[76] In marketing the gas, the lessee originally executed a gas exchange agreement with an interstate pipeline company, thereby clearly subjecting the sale to FPC price regulation,[77] but later obtained an exemption that allowed sale of the gas at higher intrastate prices.[78] The lessor then claimed that her royalty had been improperly calculated on the lower FPC price and brought suit seeking recovery for the un-

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73. 754 S.W.2d 104 (Tex. 1987).

74. *Cabot*, 754 S.W.2d at 107–08.

75. Several courts have interpreted division orders and have found no conflict between the division order and the lease. *See, e.g.*, Heritage Resources, Inc. v. NationsBank, 39 Tex. Sup. Ct. J. 537, 540 (Apr. 25, 1996) (rejecting lower court's "discussion about the effect of a division order that contradicts the lease terms"); Judice v. Mewbourne Oil Co., 39 Tex. Sup. Ct. J. 533, 535 (Apr. 25, 1996) (finding that royalty provisions in leases and in one division order were not in conflict because they unambiguously required royalty owners to bear proportionate share of post-production costs); TXO Prod. Corp. v. Prickette, 653 S.W.2d 642 (Tex. App.—Waco 1983, no writ) (determining that division order did not change lessor's rights in lease); Stanolind Oil & Gas Co. v. Terrell, 183 S.W.2d 743 (Tex. Civ. App.—Galveston 1944, writ ref'd) (recognizing that division order only affected lessee in its capacity as purchaser).

76. *Cabot*, 754 S.W.2d at 105.

77. *Id.* at 105–06.

78. *Id.*

derpayment.[79] In this respect, the *Cabot* facts were analogous to those in *Middleton*. However, unlike *Middleton*, the royalty owner in *Cabot* also alleged a breach of the implied covenant to market.[80]

Instead of interpreting the division order's provisions regarding the valuation of the gas, the *Cabot* court simply invoked the binding-until-revoked rule.[81] Moreover, the court expanded the effect of the binding-until-revoked rule by holding that the division order relieved the lessee of its implied covenant reasonably to market the gas.[82] In determining the effect of division orders on implied covenants, the *Cabot* court was forced to distinguish the *Pyote* case. It did so by noting that *Pyote* involved a "proceeds" royalty clause rather than a "market value" clause.[83] Based upon this factual distinction, the *Cabot* court did not view *Pyote* as precluding the modification of implied covenant duties through division orders in *Cabot*.[84]

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79. *Id.* at 106.

80. *Id.*

81. *Cabot*, 754 S.W.2d at 107–08; *see* David E. Pierce, *Resolving Division Order Disputes: A Conceptual Approach*, 35 ROCKY MTN. MIN. L. INST. § 16.03[3], at 16–39 n.164 (1989) (suggesting that *Cabot* court should have determined jurisdictional nature of gas since division order stated FPC prices would apply only if it "was subject to FPC jurisdiction"). The dissent in *Cabot*, however, did interpret the terms of the division order, and concluded that the gas was subject to FPC jurisdiction. *Cabot*, 754 S.W.2d at 109 (Kilgarlin, J., dissenting).

82. *Cabot*, 754 S.W.2d at 107. Significantly, the court apparently concluded that the lease's implied covenant to market would have applied, but for the division order, even though the "market value" basis applied. Yet many commentators consider that the implied covenant to market does not apply to the "market value royalty" standard. Instead, they suggest that standard is determined by objective evidence of, for example, comparable sales. *See* Thomas A. Harrell, *Recent Developments in Nonregulatory Oil and Gas Law*, 31 INST. ON OIL & GAS L. & TAX'N 327, 328–46 (1980); Bruce M. Kramer & Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80's*, 46 LA. L. REV. 787, 815 n.166 (1986). But at least one commentator has concluded that implied covenants do apply to the "market value royalty" standard. *See* Jacqueline Lang Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 NAT. RESOURCES J. (forthcoming 1997) (manuscript at 9–12, 14–15, on file with the *St. Mary's Law Journal*).

83. *Cabot*, 754 S.W.2d at 107–08.

84. *Id.* The *Cabot* court neglected to address the strong language in *Pyote* condemning the use of division orders to dilute royalty owners' rights under the oil and gas lease. *See* Ernest E. Smith, *Royalty Issues: Take-or-Pay Claims and Division Orders* (criticizing *Cabot* for not making it "clear why specific *lease* language indicating how a royalty will be calculated, e.g., 'when sold by lessee, one-eighth of the amount realized by lessee,' does not negate the implied covenant to market gas at a reasonable price, whereas specific *division order* language indicating the method of calculation has that effect"), *in* STATE BAR OF

Relying on the foregoing, one might conclude that coupling *Cabot* with *Middleton* creates a division-order jurisprudence for Texas in which the producers' policies have prevailed. Yet, it should not go unnoticed that those opinions also provide inroads for royalty owners into the formidable binding-until-revoked rule. First, while *Cabot* distinguished *Pyote*, it does so on the basis of the specific language used in the division order,[85] suggesting that the wording of the division order determines whether the implied covenant to market has been negated. Unfortunately, the *Cabot* court failed to explain adequately why the *Pyote* division orders did not negate the covenant while the provisions of the *Cabot* order did relieve the lessee of implied obligations.[86] Second, the *Middleton* opinion's footnote 8 expressly named instances that could create exceptions to the binding-until-revoked rule in order to protect royalty owners. Ultimately, in the 1986 case of *Gavenda v. Strata Energy, Inc.*,[87] the Supreme Court of Texas seized upon the suggestion of that *Middleton* footnote and created an exception to the binding-until-revoked rule.

B. *"Erroneous" Division Orders Resulting in Underpayment*— Gavenda v. Strata Energy, Inc.

Unlike the previously discussed cases, *Gavenda* did not involve a conflict between the lease royalty clause and a division order. Rather, it involved a division order that misstated the interest, cre-

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TEX., PROF'L DEV. PROGRAM, ADVANCED OIL, GAS, AND MINERAL LAW COURSE K, K-27 (1988); *see also* 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 300 (1996) (criticizing *Cabot* for its ambiguity).

In his dissenting opinion in *Cabot*, Justice Kilgarlin indicated that the reasoning of Stanolind Oil & Gas Co. v. Terrell, 183 S.W.2d 743 (Tex. Civ. App.—Galveston 1944, writ ref'd) and Gavenda v. Strata Energy Inc., 705 S.W.2d 690 (Tex. 1986), should be instructive even though they did not involve claims of breach of implied covenants:

> This court has displayed a willingness to recognize as non-binding division orders in cases where the operator or lessee unjustly benefits. Implicit is the notion that division orders should not afford a lessee the opportunity to relieve himself of lease obligations or secure advantages over the lessor which he could not have asserted under the provisions of the lease.

Cabot, 754 S.W.2d at 110 (Kilgarlin, J., dissenting).

85. *Cabot*, 754 S.W.2d at 107.

86. In future cases, courts must decide whether other language used in division orders, such as references to paying based on "posted prices" for oil, calls for applying the *Cabot* or the *Pyote* holding. In other words, courts must determine whether valuation phrases are analogous to a "market value" term or a "proceeds" term.

87. 705 S.W.2d 690 (Tex. 1986).

ated by reservation in a deed in the lessor's chain of title, of non-participating royalty owners, the Gavendas.[88] Yet, despite the factual differences of *Gavenda*, the exception it created to the *Middleton* rule was applied recently by an appellate court in *Heritage Resources, Inc. v. NationsBank*[89] in resolving a conflict between a lease royalty clause and division orders. For this reason, a review of the *Gavenda* decision will aid in understanding the analysis of the *Heritage Resources* opinion, as found in Part II of this Article, and will assist in determining the viability of the *Gavenda* exception after the enactment of the 1991 statute governing division orders, as discussed in Part III.

In *Gavenda*, the attorney for the lease operator had mistakenly interpreted the Gavenda's reservation as creating a 1/16th royalty rather than the accurate 1/2 royalty.[90] Thereafter, the operator prepared division orders which reflected the erroneous fraction, resulting in underpayments to the Gavendas totaling over two million dollars at least part of which the operator retained.[91] Upon discovering the mistake, the Gavendas revoked the erroneous division orders and brought suit seeking damages incurred during the time the division orders were in effect.[92]

The operator responded to the Gavendas' suit by asserting *Middleton*'s binding-until-revoked rule. The Gavendas contended that an exception exists when unjust enrichment is involved.[93] The supreme court recognized that *Middleton* considered the absence of unjust enrichment as the basis for the binding-until-revoked rule: "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."[94] Therefore, the court held the operator liable "for whatever portion of [the Gavendas'] royalty it re-

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

89. 895 S.W.2d 833, 838–84 (Tex. App.—El Paso 1995), *rev'd*, 39 Tex. Sup. Ct. J. 537 (Apr. 15, 1996).

90. *Gavenda*, 705 S.W.2d at 691.

91. *Id.* The Gavendas were underpaid by 7/16th royalty and 7/16ths of gross production. *Id.*

92. *Id.* The Gavendas revoked the division and transfer orders two days before their fifteen-year term royalty reservation expired. *Id.* The lawsuit to recover underpayments was filed later that year. *Id.*

93. *Id.*

94. *Gavenda*, 705 S.W.2d at 692.

tained, although it is not liable to the Gavendas for any of their royalties it paid out to various overriding or other royalty owners."[95]

The *Gavenda* decision creates an unjust-enrichment exception to the *Middleton* binding-until-revoked rule which partially erodes the role of the division order as a shield for producers against liability for past payments. The exception appears to apply where: (1) an operator prepares "erroneous" division orders, (2) which error leads to underpayment to an interest owner, and (3) results in unjust enrichment of the operator who profits at the expense of the royalty owner. The lessee in this situation is liable for payments made pursuant to the division orders, but only to the extent of the royalties retained by the lessee.

A reasonable application of these criteria, however, reveals that they could fit the facts of the cases that created the binding-until-revoked rule. For example, it is difficult to discern why the *Gavenda* division order was any more "erroneous" than other division orders. If the *Gavenda* division orders were "erroneous" because they conflicted with the provisions of a royalty deed, then so too were the division orders in *Cabot* and *Middleton* "erroneous" because they conflicted with the express or implied terms of the oil and gas lease.

This elusiveness of the term "erroneous" is demonstrated further by both the majority and dissenting opinions in *Cabot*. While the *Gavenda* court appeared to consider the division order "erroneous" because its terms conflicted with the document creating the royalty interest (the deed), neither the majority nor the dissenting opinion in *Cabot* adopted that approach. Because the division order terms regarding payment in *Cabot* were not so clear as those in *Gavenda* and *Middleton*, the appropriate question for the court was not whether the orders were "erroneous," but whether the

95. *Id.* at 693. Note that on remand the appellate court ignored this proviso and held the operator liable for interests paid out to overriding royalty owners. Strata Energy, Inc. v. Gavenda, 753 S.W.2d 789 (Tex. App.—Houston [14th Dist.] 1988, no writ); *see* Jane F. Romanov, *The Division Order: Is It Still a Shield Against Liability*, 3 TEX. OIL & GAS L.J. 1, 2 (1989) (criticizing appellate court decision on remand for its inconsistency with holding of Supreme Court of Texas); *see also* Richard F. Brown, *Texas Division Orders and the Texas Division Order Statute*, THE LANDMAN, Mar./Apr. 1993, at 23 (noting that although appellate court decision appears to be inconsistent with *Gavenda*, there was no clarification by the Supreme Court of Texas because no writ was filed).

plain language of those orders permitted the lessee to calculate royalties on the basis of the FPC price. In fact, the royalty owner in *Cabot* had argued that the division orders' payment terms did not apply because the exchange between the lessee and the pipeline company was not a dedication to interstate commerce under the federal regulatory scheme.[96] Without interpreting the plain language of the division orders, however, the majority opinion summarily concluded that it was not necessary to review the question of dedication to interstate commerce.[97] Instead, the majority followed *Middleton* and held that the terms of the division order were binding until revoked.[98] The majority opinion did not even discuss the question of whether the division orders were "erroneous," so as to invoke the *Gavenda* exception.

Despite taking a different approach, the dissenter in *Cabot* also departed from the *Gavenda* court's approach to the "erroneous" criterion. In his dissent, Justice Kilgarlin determined whether the division order was "erroneous" by analyzing the specific language in the division order that provided for payments "if such sale be subject to the Federal Power Commission [FPC],"[99] noting that FPC jurisdiction would not have been invoked if the gas had not been dedicated to interstate commerce.[100] Absent FPC jurisdiction, he reasoned, the division orders would have been "erroneous" since royalties were calculated on the FPC rate.[101] Judge Kilgarlin ultimately determined that the division orders were not "erroneous," because the gas had been dedicated to interstate commerce.[102] If such an "erroneous" rate had been used, then Justice Kilgarlin would have determined that *Gavenda* provided relief

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96. Cabot Corp. v. Brown, 754 S.W.2d 104, 106 (Tex. 1987); *see also* David E. Pierce, *Resolving Division Order Disputes: A Conceptual Approach*, 35 ROCKY MTN. MIN. L. INST. § 16.03[3], at 16–39 n.164 (1989) (criticizing *Cabot* court for failing to apply plain terms of division order).

97. *Cabot*, 754 S.W.2d at 106.

98. *Id.* at 107.

99. *Id.* at 108–09 (Kilgarlin, J., dissenting).

100. *Id.* at 109 (Kilgarlin, J., dissenting).

101. *Id.* at 108 (Kilgarlin, J., dissenting).

102. *Cabot*, 754 S.W.2d at 109 (Kilgarlin, J., dissenting). Justice Kilgarlin seems to contradict himself on this issue, however. Later in the opinion he points out that because the lessee obtained exempt status "Cabot was thus freed from FPC pricing jurisdiction." *Id.* at 111. He was disturbed that, having obtained this exemption, Cabot received more for the gas, but calculated royalty on a basis which was lower than what it had actually received. *Id.* Justice Kilgarlin further stated:

to the royalty owner for past underpayments, despite the division order, because the lessee would have unjustly retained a benefit.[103] According to Justice Kilgarlin, then, a division order apparently is "erroneous" not because its terms conflict with the lease royalty clause, but because the lessee fails to follow its express terms.

The *Cabot* opinions demonstrate the amorphous contours of *Gavenda*'s "erroneous" criterion. Ironically, the *Gavenda* court's justification for an exception based on "erroneous" division orders is partly based on its "erroneous" reading of another case.[104] In *Stanolind Oil & Gas Co. v. Terrell*,[105] a royalty owner sued to recover for an alleged underpayment caused by the lessee's deduction of a gross production tax from the royalty owner's payment.[106] The royalty owner pointed to the terms of the lease, which provided that royalties would be paid "without deduction of any kind or character."[107] Attempting to avoid these lease terms, the lessee countered that the royalty owner had signed a division order expressly permitting the deduction of the tax.[108] In pertinent part, the division order in *Terrell* provided, "[s]ettlements and payments shall be made monthly for oil received . . . less any taxes required by law to be deducted and paid by you (Stanolind) as purchaser."[109]

In rejecting the lessee's division-order defense, the court did not find the division order nonbinding because it was "erroneous." Instead, the court interpreted the language of the division order, following the approach that should have been used in *Cabot*. The court's interpretation led it to conclude that the division order af-

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> I can envision no case that would depict as well the inequity of the result reached by the court today. Cabot reaped the benefits of FPC jurisdiction over the exchange with Transwestern, paying out royalties based on the lower interstate market rate. Yet Cabot sold the gas on the higher interstate market.

Id. This statement fits the *Gavenda* criterion of unjust enrichment. However, rather than urge the application of the exception to the binding-until-revoked rule on this basis, Justice Kilgarlin argued that the division order did not negate the implied covenant of marketing. *Id.* at 110–11 (Kilgarlin, J., dissenting).

103. *Id.* at 108 (Kilgarlin, J., dissenting).

104. *Gavenda*, 705 S.W.2d at 692 (citing Stanolind Oil & Gas Co. v. Terrell, 183 S.W.2d 743 (Tex. Civ. App.—Galveston 1944, writ ref'd)).

105. 183 S.W.2d 743 (Tex. Civ. App.—Galveston 1944, writ ref'd).

106. *Terrell*, 183 S.W.2d at 743–44.

107. *Id.* at 744.

108. *Id.*

109. *Id.* at 745.

fected the defendant in its position as purchaser, but not as lessee.[110] Thus, *Terrell* merely stands for the proposition that the division-order language must be carefully interpreted to determine its effect on the lease royalty clause. *Terrell* does not support a rule regarding an exception to the binding-until-revoked rule based on "erroneous" division orders.

Although *Terrell* provides weak precedent for creating an exception to the *Middleton* rule, the *Middleton* opinion itself supplies a respectable basis. As noted above, *Middleton*'s footnote 8 considers the need for exceptions to the binding-until-revoked rule to protect lessors from unfairness. By invoking unjust enrichment as its justification for carving an exception to the binding-until-revoked rule, the *Gavenda* court does, at least, comport with *Middleton*'s concern about unfairness.

Unfortunately, the unjust enrichment criterion of the *Gavenda* exception can be just as elusive as the "erroneous" criterion. Arguably, the lessees in both *Gavenda* and *Middleton* were unjustly enriched. Just as the operator in *Gavenda* benefited from the underpayment, caused by the use of the wrong fraction in calculating royalty, the lessees in *Middleton* and the other "market value royalty" cases benefited by calculating royalties on a contract basis lower than the prevailing market value.[111]

Despite this factual similarity in *Gavenda* and *Middleton*, the cases can be distinguished on the question of unjust enrichment.[112]

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110. *Id.*

111. *See* 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 301–1 (1996) (arguing that unjust enrichment can be found in both *Gavenda* and *Middleton*). Professors Smith and Weaver have written:

> The court's distinction of *Middleton* is open to question. In both *Gavenda* and *Middleton* 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 which fails to make out-of-pocket payments that are owed to a royalty owner has benefited from its mistake as fully as a lessee which 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 to him.

Id.

112. Professor Ernest Smith considered that, until recently, the *Middleton* and *Gavenda* decisions could be distinguished on an "ad hoc basis," in which courts would apply the unjust enrichment theory "if there has been an error or miscalculation in 'X' (the fraction owed the royalty owner); [and] the theory that division orders are binding until revoked would be applied if there has been a deliberate or accidental change in 'Y' (the method for determining the value of production)." Ernest E. Smith, *The New Division*

In *Gavenda*, the lessee retained money which had been received for the production, an unjust enrichment. In *Middleton*, however, the producers were not actually enriched, having never received payment for the gas based on the higher prevailing market value.[113]

This factual distinction between *Middleton* and *Gavenda*, rather than the *Terrell* opinion or the "erroneous" criterion, should define the *Gavenda* unjust-enrichment exception. In other words, the inquiry, when applying the *Gavenda* exception, should be simply whether a lessee, in making payments pursuant to an unrevoked division order, retained monies required by the lease royalty clause (or a mineral or royalty deed) to be paid to the royalty owner. For example, in *Cabot*, the *Gavenda* exception would apply if the "market value" of the gas proved to be higher than the FPC price, and if the lessee had *actually* received payment for the production on the higher price. If the lessee, Cabot, had figured royalties on a lower basis than the "market value" Cabot had received, then the *Gavenda* exception should have provided relief for the royalty owner.[114] In contrast, the *Gavenda* exception would not properly apply in *Middleton* where the lessees figured royalties based on the lower "amount realized" standard and received no greater amount for the production. Under such circumstances, the binding-until-revoked rule would remain as a complete shield from liability for payments made pursuant to unrevoked division orders.

Questions about the application of the binding-until-revoked rule and the *Gavenda* exception are likely to arise in cases contesting the deduction of post-production costs, such as *Heritage Resources, Inc. v. NationsBank*.[115] In particular, if a division order

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Order: Legal and Practical Aspects, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997). He concludes, however, that the distinction vanished after the decision in *Heritage Resources, Inc. v. NationsBank*, a case which is discussed *infra* at Part II.C.6.

113. *See* 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 301-0 to 301-1 (1996) (noting that courts have distinguished *Middleton* on basis that lessees never actually benefited from higher market prices). Similarly, in *Chicago Corp. v. Wall*, 156 Tex. 217, 293 S.W.2d 844 (1956), relied upon in *Middleton* and distinguished in *Gavenda*, the operators paid out the correct total amount of royalty owed, but, in doing so, overpaid some royalty owners and underpaid others. *Wall*, 293 S.W.2d at 846–47.

114. This apparently depicts what occurred in *Cabot*. *See Cabot*, 754 S.W.2d at 111 (Kilgarlin, J., dissenting) (protesting unfairness of lessee receiving higher intrastate market price but paying royalties on lower interstate market price); *see also supra* note 103 and accompanying text (discussing Justice Kilgarlin's dissenting opinion).

115. 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996).

permits deductions from the lessor's royalty but the lease royalty clause does not, then *Gavenda* would apply if the lessee has retained monies which the lease required to be paid to the royalty owner. It must be remembered, however, that the *Gavenda* exception limits the lessee's liability for past payments under an unrevoked division order to amounts the lessee has actually retained.[116]

In summary, while producers lamented the *Gavenda* decision for having eroded the protections of the binding-until-invoked rule, even the progenitor of that rule, the *Middleton* decision, acknowledged the need to protect royalty owners against unfair use of the division order to detract from their rights under the lease royalty clause. Because *Gavenda* has been a part of Texas law for over ten years, it is more instructive to analyze its likely application to future cases than to hope for its eventual demise. The foregoing analysis of the *Gavenda* exception suggests that courts might apply it not only to *Gavenda* settings involving a discrepancy in the size of a payee's interest, but to other situations in which a lessee has been unjustly enriched. One example is disputes in which royalty owners allege that division-order terms conflict with the lease royalty clause regarding the deduction of post-production costs. A recent Texas case, *Heritage Resources, Inc. v. NationsBank*,[117] has raised this exact issue.

C. *Division-Order Disputes Involving the Deduction of Post-Production Costs*—Heritage Resources, Inc. v. NationsBank

The court of appeals and supreme court opinions in *Heritage Resources, Inc. v. NationsBank* provide a paradigm for assessing the scope of the *Gavenda* exception, and, more generally, for analyzing the interaction of the lease royalty clause and the division order in royalty-payment disputes between lessors and their lessees.[118] These opinions are pertinent to future division-order disputes, not only because of the ultimate result, but also because of the lessons

116. *See* discussion *infra* Part II.C.2. (concluding that appellate court in *Heritage Resources* erred on this point).

117. 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996).

118. This section focuses on division orders sent to lessors by their lessees. The effect of division orders between lessors and third-party purchasers on the lessees' liability is discussed *infra* at Part III.E.

that can be learned from the analytical errors both courts committed.

1. The Framework for Resolving Division-Order Disputes

Reduced to their basics, the cases preceding *Heritage Resources* suggest a general framework for resolving royalty payment disputes between lessors and lessees that involve division orders. To begin with, courts must interpret both the lease royalty clause and the division order. This process inevitably entails application of well-known rules of interpretation that, although easy to recite, do not produce predictable results.[119] If a court determines that no conflict exists, the next question is whether the royalty requirements have been breached, rendering the lessee liable.[120] If, however, a court determines that the division order does conflict with the lease royalty provisions, then the binding-until-revoked rule shields the lessee from liability in regard to all past underpayments, unless the *Gavenda* exception applies. If *Gavenda* applies, the lessee is still liable for past underpayments, but only to the extent it retained royalty and was unjustly enriched.

Additionally, in applying this general framework, Texas courts and practitioners must determine the applicability of certain statutory provisions. The Texas legislature enacted a statute in 1983 governing a payor's liability for improper payment of royalties,[121] which was amended in 1991 to include provisions addressing division orders. But the 1991 provisions have prospective application only.[122] The statutory aspect of this framework for resolving divi-

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119. *See* Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH. L. REV. 1, 3–6 (1993) (noting that interpretive rules "'are merely statements of judicial preference for the resolution of a particular problem,'" and recognizing that "when abused, the battle of the 'canons' replaces rational thought and common sense and leads to obfuscation and uncertainty") (internal citations omitted); *see also* Laura H. Burney, *The Regrettable Rebirth of the Two-Grant Doctrine in Texas Deed Construction*, 34 S. TEX. L.J. 74, 76–80 (1993) (reviewing rules of construction for document interpretation and recognizing "amorphous nature" of these rules).

120. If payment is not made as required in the division order, then the binding-until-revoked rule would be inapplicable. 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 301 (1996).

121. Act of May 24, 1983, 68th Leg., R.S., ch. 228, 1983 Tex. Gen. Laws 966 (codified as amended at TEX. NAT. RES. CODE ANN. §§ 91.401–91.406 (Vernon 1993 & Supp. 1997)).

122. Act of June 16, 1991, 72d Leg., R.S., ch. 650, 1991 Tex. Gen. Laws 2392; *see infra* Part III (discussing Texas division order statute and 1991 amendments).

sion-order disputes is described in detail in Part III. First, however, the *Heritage Resources* opinions are discussed in light of the foregoing framework.

2. The Court of Appeals Opinion in *Heritage Resources*

In *Heritage Resources*, NationsBank, as trustee for several interest owners, brought suit in 1989 against the lessee, Heritage, claiming that Heritage had improperly deducted post-production transportation costs from royalty payments.[123] The trial court entered a judgment awarding the bank damages for the transportation deductions, plus interest and attorney fees.[124] On appeal, Heritage claimed that the trial court had misinterpreted the royalty clause as prohibiting the deduction of transportation costs.[125] Heritage also claimed that even if that interpretation were correct, the division orders expressly permitted those deductions and, under the *Middleton* rule, were binding until revoked.[126]

In resolving the dispute, the court of appeals dutifully undertook the first step in the framework outlined above: interpretation of the three different lease clauses and the division orders.[127] Each of the three clauses required the lessee to pay the lessor a fraction "of

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123. Heritage Resources, Inc. v. NationsBank, 895 S.W.2d 833, 835 (Tex. App.—El Paso 1995), *rev'd*, 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996). Bank personnel noticed the problem in January 1989 and sought recovery of the amounts deducted from royalty payments since 1985. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.* at 835–37, 838. The three lease clauses at issue read:

3. The royalties to be paid Lessor are . . .
(b) on gas, including casinghead gas or other gaseous substances produced from the land, or land consolidated therewith, and sold or used off the premises or in the manufacture of gasoline or other products therefrom, *the market value at the well of 1/5 of the gas so sold or used*, provided that on gas sold at the well the royalty shall be 1/5 of the amount realized from such sale provided, however, that *there shall be no deductions from the value of Lessor's royalty* by reason of any required processing, cost of dehydration, compression, *transportation or other matter to market such gas.*

Or:

3. In consideration of the premises, Lessee covenants and agrees . . .
(b) To pay the Lessor *1/4 of the market value at the well for all gas* . . . produced from the leased premises and sold by Lessee or used off the leased premises; provided, however, that *there shall be no deductions from the value of Lessor's royalty* by reason of any required processing, cost of dehydration, compression, *transportation, or other matter to market such gas.*

the market value at the well [for gas] . . . provided, however, that there shall be no deductions from the value of Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation or other matter to market such gas."[128]

Heritage argued that this language should be interpreted to permit the transportation cost deductions on the theory that the phrase "the value of the Lessor's royalty" was equivalent to the "market value at the well."[129] The "market value at the well" standard, according to Heritage, inherently permits the deduction of post-production costs, such as those incurred in transporting the gas.[130] Therefore, Heritage asserted, the royalty clauses should be interpreted to mean that the lessee could deduct no more than the reasonable costs permitted under the "market value at the well" standard.[131]

In considering Heritage's argument, the court invoked a familiar litany of rules of interpretation. The court, for instance, noted that its goal generally is to determine the intent of the parties as expressed in the contested instrument.[132] Here, because neither party had claimed ambiguity in the lease, the court recognized that the plain language of the lease would control without resort to extrinsic evidence.[133]

Or:

> 3. Lessee shall pay the following royalties subject to the following provisions: . . .
>
> (b) Lessee shall pay the Lessor *1/4 of the market value at the well for all gas* . . . produced . . . and sold by Lessee or used off the leased premises, . . . provided, however, that *there shall be no deductions from the value of Lessor's royalty* by reason of any required processing, cost of dehydration, compression, *transportation, or other matter to market such gas.*

Heritage, 895 S.W.2d at 835–36 (all emphasis in original).

Only the clause in the first lease has the traditional bifurcated gas clause containing the two different standards, market value and amount realized. However, under the facts of the case, the market value standard applied for that lease. *See* Heritage Resources, Inc. v. NationsBank, 39 Tex. Sup. Ct. 537, 538 (Apr. 25, 1996) (finding fact that first lease clause was bifurcated to be irrelevant for purposes of resolving case).

128. *Heritage*, 895 S.W.2d at 835–36.

129. *Id.* at 836.

130. *Id.*

131. *Id.*

132. *Heritage*, 895 S.W.2d at 836.

133. *Id.* Ambiguity is a question of law for the court. Reilly v. Rangers Mgmt., Inc., 727 S.W.2d 527, 529 (Tex. 1987). The determination of ambiguity is made "by looking at the contract as a whole in light of the circumstances existing at the time the contract was entered into." *Id.* Extrinsic evidence is not permitted to determine ambiguity but, instead, is permitted only to show how the language in the document should be interpreted. *See*

In applying this "plain language" rule, the court first considered the phrase "market value at the well."[134] Relying on a well-known oil and gas treatise,[135] the court agreed with Heritage and concluded that, as a general rule, the phrase contemplated the deduction of post-production costs from royalty,[136] but it noted that the definition was "subject to modification by the parties."[137] Ultimately, the court of appeals found such a modification in language in the lease clause providing that "there shall be no deductions [for] . . . transportation."[138]

The court of appeals in *Heritage Resources* also declared that it should make "every attempt to harmonize and give effect to all provisions of the contract so that none is rendered meaningless."[139] In rejecting Heritage's interpretation of the lease clauses, the court relied heavily on this "harmonizing" homily,[140] which was also the focus of another recent Supreme Court of Texas case, *Luckel v. White*.[141] *Luckel* involved a problem that has plagued Texas courts for decades: the interpretation of mineral deeds with conflicting fractions.[142] In *Luckel*, the court overruled a previous Texas

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Kelly v. Marlin, 714 S.W.2d 303, 304 (Tex. 1986) (permitting extrinsic evidence of surrounding circumstances to assist court in determining sense in which words were used). An instrument is ambiguous only when the application of rules of construction leaves it unclear as to which meaning is the correct one. Prairie Producing Co. v. Schlachter, 786 S.W.2d 409, 413 (Tex. App.—Texarkana 1990, writ denied).

Another recent Supreme Court of Texas case involving the deductibility issue and division orders, *Judice v. Mewbourne Oil Co.*, 39 Tex. Sup. Ct. 533 (Apr. 25, 1996), found one of the division orders at issue to be ambiguous. *See* discussion *infra* Part II.C.4. (addressing *Judice* decision).

134. *Heritage*, 895 S.W.2d at 836.

135. *Id.* (citing 3 HOWARD R. WILLIAMS & CHARLES L. MEYERS, OIL AND GAS LAW § 645.2, at 598). The appellee had not questioned this interpretation of the phrase as being correct under Texas law. *See* Appellee's Brief at 8, Heritage Resources, Inc. v. NationsBank, 895 S.W.2d 833 (Tex. App.—El Paso 1995) (No.08-94-00062-CV), *rev'd*, 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996).

136. *Heritage*, 895 S.W.2d at 836-37.

137. *Id.* at 836.

138. *See id.* at 837 (concluding "that the parties intended the gas royalty payments to be free from costs of 'any required processing, cost of dehydration, compression, transportation or other matter to market such gas'").

139. *Id.* at 836.

140. *See* Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH L. REV. 1, 72-80 (1993) (describing basic "harmonizing" canon and its development).

141. 819 S.W.2d 459 (Tex. 1991).

142. *Luckel*, 819 S.W.2d at 461. Several authors have addressed the problems associated with courts interpreting mineral deeds with conflicting fractions. *E.g.*, Laura H. Bur-

Supreme Court case, *Alford v. Krum*,[143] which had become infamous for its adoption of the "granting clause prevails" rule. The *Luckel* court rejected the use of "the granting clause prevails" rule because of its failure to give weight to all the language in the document as required by the primary tenet of deed construction, the "four-corners" rule.[144]

In *Heritage Resources*, the court of appeals' interpretation of the lease clause, unlike the lessee's theory, complied with the harmonizing canon outlined in *Luckel*. As the *Heritage Resources* court noted, the lessee's interpretation would render meaningless much of the language in the royalty clauses, but the bank's interpretation "allows all provisions to be harmonized, giving meaning to each."[145] Specifically, the bank's view provided the greater harmony "because gas royalty payments are usually subject to post-production costs; [and] if the royalty provisions at issue here did not contain the language excluding post-production costs, there would be no issue because the accepted definition of royalty interest . . . would control."[146]

Having completed the first part of the framework for resolving division-order disputes by interpreting the royalty clause, the court of appeals then turned to the division orders. The division orders in question, like those in the "market value royalty" cases, needed no interpretation regarding deductions. They clearly contradicted the lease royalty clause (at least under the interpretation adopted by the appellate court) by expressly permitting the deduction of post-production transportation costs.[147] This contradiction raised

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ney, *The Regrettable Rebirth of the Two-Grant Doctrine in Texas Deed Construction*, 34 S. TEX. L.J. 74, 97–101 (1993); Tevis Herd, *Deed Construction and the "Repugnant to the Grant" Doctrine*, 21 TEX. TECH L. REV. 635 (1990); Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH L. REV. 1, 19–43 (1993).

143. 671 S.W.2d 870 (Tex. 1984).

144. *Luckel*, 819 S.W.2d at 464. The court held that "the majority in *Alford* incorrectly failed to harmonize the provisions under the four corners rule and then erred in applying the 'repugnant to the grant rule' in disregard of the future lease clause." *Id.* Recently, the Supreme Court of Texas reaffirmed that the four corners rule, and the harmonizing canon, apply to resolve the conflicting fraction issue. Concord Oil Co. v. Pennzoil Producing Co., 40 Tex. Sup. Ct. J. 33 (Oct. 19, 1996), *mtn. for reh'g pending.*

145. *Heritage*, 895 S.W.2d at 837.

146. *Id.*

147. *Id.* at 838. The division orders at issue contained the following language:

the perennial question in division-order disputes: what is the effect of the division order on the lease royalty clause?

In answering this question, the court initially recited *Middleton* and acknowledged the binding-until-revoked rule,[148] but it then proceeded immediately to invoke the *Gavenda* exception.[149] By invoking the exception, the court of appeals faltered on several issues. First, the court misapplied the unjust enrichment criterion of the *Gavenda* exception. Second, the court failed to analyze satisfactorily the effect of two additional clauses in the division orders. One of these clauses, referred to herein as the "no amendments" clause, should have rendered application of *Gavenda* irrelevant. The other clause, referred to as the "no liability" clause, should have been analyzed in light of the "no amendments" clause rather than under the precepts of the *Gavenda* exception. Each of these errors is discussed below.

a. Application of the *Gavenda* Exception

The court of appeals gave two reasons for disagreeing with Heritage's claim that the division orders were binding until revoked.[150] One reason was based upon the *Gavenda* exception.[151] In applying that exception, the court did not evaluate the "erroneous" division-order criterion to determine whether it should be applied to errors other than those affecting the size of the parties' interest, as in *Gavenda*. Instead, it simply applied the exception because there

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> All proceeds from the sale of gas shall be paid to the undersigned or their assigns in the proportions as herein set out less taxes and any costs incurred in the handling and *transportation* to the point of sale, treating, compressing, boosting, dehydrating, or any other conditioning necessary, subject to the terms of any contract of purchase and sale which affects the above described property.

Id.

148. *Id.* Interestingly, although the court relied on *Middleton*, it referred to division orders as "contracts." *Id.* However, the *Middleton* court apparently rejected that theoretical basis. Exxon Corp. v. Middleton, 613 S.W.2d 240, 249–51 (Tex. 1981).

149. *Heritage*, 895 S.W.2d at 838–39.

150. *Id.*

151. *See id.* at 839 (concluding that "Heritage benefitted from the erroneous division orders, thus rendering them non-binding upon the royalty owners"). The other reason for the appellate court's refusal to apply the binding-until-revoked rule stemmed from conflicting evidence regarding the intended meaning of the division order language. *See id.* at 838–39 (asserting that "there is evidence within the division orders themselves that the parties intended to continue relying upon the leases, with its [sic] understanding that transportation costs would not be deducted from royalties, nor would royalty owners have their legal remedies curtailed").

was evidence that "Heritage profited from error in the division orders."[152] Specifically, the evidence showed that Heritage had contracted with the Urantia Corporation, the gas purchaser, to transport the gas from the well-head to the pipeline, and that the president and sole shareholder of Heritage was also the majority owner of Urantia.[153] Based on this evidence, the court determined that Heritage was liable for all transportation costs paid to Urantia that had been deducted from the bank's royalties.[154]

As noted above, the *Gavenda* and *Middleton* decisions likely warrant application of the exception to the binding-until-revoked rule to disputes regarding the deduction of post-production costs.[155] However, the *Heritage Resources* court's application of the exception went beyond the *Gavenda* holding. *Gavenda* shielded the lessee from liability for payments made pursuant to an unrevoked division order except for amounts actually retained by the lessee.[156] On this basis, *Heritage Resources* is distinguishable because it involved interest owners, other than Heritage, who actually benefited from the deduction of transportation charges from the royalties paid to the bank.[157] Although Heritage operated each of the wells located on the leases, it owned varying percentages of the working interest in those leases.[158] Therefore, Heritage benefited only to the extent to which it would have been liable for the transportation costs proportionate to the size of its working interests.

The court of appeals, however, did not rely on Heritage's liability as a working-interest owner. Instead, the court stressed that the

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152. *Id.* at 839.

153. *Id.*

154. *Heritage*, 895 S.W.2d at 839.

155. *See* discussion *supra* Part II.B.

156. *Gavenda*, 705 S.W.2d at 693.

157. *See Heritage*, 39 Tex. Sup. Ct. J. at 540 (recognizing that "there were other working interest owners who were not parties to the suit" and who "would benefit from an improper deduction of transportation charges from the royalties paid to NationsBank"). In its brief, Appellant explained that in some of the leases involved in the dispute, Heritage owned no interest in the producing wells. Brief of Appellant Heritage Resources, Inc. at 29, Heritage Resources, Inc. v. NationsBank, 895 S.W.2d 833 (Tex. App.—El Paso 1995) (No.08-94-00062-CV), *rev'd*, 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996). For those wells, Heritage would not have received any money for production.

158. Brief of Appellant Heritage Resources, Inc. at 7, Heritage Resources, Inc. v. NationsBank, 895 S.W.2d 833 (Tex. App.—El Paso 1995) (No. 08-94-00062-CV), *rev'd*, 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996).

president and sole shareholder of Heritage, the lessee, was also the majority owner of Urantia, the gas transporter. Although the court did not develop this "piercing the corporate veil" theory further, it apparently concluded that Heritage had been unjustly enriched by essentially receiving Urantia's payments for the transportation due to the companies' common ownership. But the real issue was not whether the gas transporter Urantia was entitled to the payments; in fact, the parties had agreed that the charges for the transportation were reasonable.[159] Rather, the question the court should have analyzed was who—the royalty owners or the lessees—should have been required to pay for the transportation costs. Because the division orders placed that burden on the royalty owners, not the lessee, in contradiction to the lease royalty clause, *Middleton* and *Gavenda* came into play. Under the *Gavenda* exception, Heritage should have been liable only to the extent to which it had been unjustly enriched *as a lessee*. Therefore, by ignoring the corporate distinctions, the court went too far in finding that the payments to the gas transporter Urantia had unjustly enriched the lessee Heritage.

In summary, under its interpretation of the lease royalty clause, and assuming that the division order did not contain the "no amendments" clause discussed below, the court of appeals erred by holding Heritage liable for all of the improperly deducted transportation costs. Under a proper application of the *Gavenda* exception, Heritage would have been liable only to the extent to which it had actually retained monies that should have been paid to the royalty owners. As described below, however, the court of appeals should not have applied *Gavenda* in this case, but, should have employed a different analysis.

b. The "No Amendments" Clause

In addition to the clause regarding the deduction of post-production costs, the *Heritage Resources* division order contained another

159. *Heritage*, 895 S.W.2d at 838–39. Nor was there any question whether the transaction between Urantia and Heritage was a sham. That question becomes relevant under the implied covenant of marketing, which was not alleged as a basis for recovery in *Heritage Resources*. Moreover, even when a lessor claims there has been a breach of the implied covenant of marketing, the fact that a subsidiary is wholly owned by a parent does not constitute a per se breach of the covenant. Parker v. TXO Prod. Corp., 716 S.W.2d 644, 646–47 (Tex. App.—Corpus Christi 1986, no writ).

clause that is commonly inserted because of the *Middleton* decision. That additional clause provided that: "[D]espite anything stated herein to the contrary, the execution of this instrument is not intended to alter or amend the Lease or any amendment thereto pertaining covering our [the royalty owners'] interest or interests shown on this instrument."[160] This type of provision logically may be referred to as a "no amendments" clause.

The question in the interpretation process is: how does this "no amendments" clause change the effect of the division order on the lease royalty clause? The familiar litany of rules applies in interpreting the lease royalty clause: The language of the "no amendments" clause must be harmonized with other language in the division order, with a goal of ascertaining the intent of the parties as expressed within the instrument. Thus, instead of relying primarily on *Gavenda* and its unjust enrichment criterion, the court should have attempted to "harmonize" the clauses.[161] The first line of the "no amendments" clause explicitly provided that, regardless of other language in the division order, none of the order's language should be interpreted as amending the lease.[162] This language of the "no amendments" clause should have negated the prior division order clause which expressly permitted the lessee to deduct costs. Under this interpretation of the "no amendments" clause, the division order never permitted the lessee to deduct transportation costs, rendering *Middleton* and *Gavenda* irrelevant.[163] Instead, the terms of the lease royalty clause governed the

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160. *Heritage*, 895 S.W.2d at 838.

161. *Id.*

162. *Id.*

163. In its reply to NationBank's motion for rehearing, Heritage argued that the "no amendments" clause should not be interpreted as permanently amending the lease royalty clause. Reply of Petitioner to Respondents' Motion for Rehearing at 11–12, Heritage Resources, Inc. v. NationsBank, 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996) (No. 95–0515). Instead, Heritage claimed that the clause should continue to shield the lessee from liability for past underpayments under *Middleton*, or, at least, limit their liability under *Gavenda*. *Id.* Absent the "no amendments" clause, Heritage would be correct in asserting that *Middleton* and *Gavenda* applied. As a matter of interpretation and as a matter of policy, however, Heritage's interpretation of the "no amendments" clause should be rejected. Contrary to the four corners rule, which requires giving effect to all language in a document, Heritage's interpretation of the clause ignores the initial admonition that the division order does not amend the lease "despite anything stated herein to the contrary." On its face, that language negates the contradictory language in the division order permitting deductions. In contrast, Heritage's interpretation views the clause as merely restating *Mid-*

lessee's royalty obligation. Thus, a correct reading of the "no amendments" clause would have rendered the lessee liable for breaching the lease.[164]

c. The "No Liability" Clause

In addition to the "no amendments" clause, the division order in *Heritage Resources* contained another clause purporting to limit Heritage's liability as operator:

> In the event the undersigned is not paid to the full amount for his division of interest of the proceeds derived from the sale of gas and condensate, the undersigned shall have *no legal action against Operator* but, instead, the undersigned shall have as its sole legal remedy against those division of interest owners who were paid in excess of the amount such an interest owner should have received from the proceeds of the sale of such gas and condensate.[165]

Heritage relied on the above clause in its attempt to avoid liability for the total amount of underpayments caused by the deduction of the transportation costs from the bank's royalties.[166] The court concluded, however, that the "no liability" clause was ineffectual,[167] unfortunately repeating a prior judicial mistake. As previously discussed, the court of appeals ignored the "no amendments" clause and misapplied the *Gavenda* exception to avoid *Middleton's* binding-until-revoked rule regarding the transportation cost deductions. Similarly, the court reasoned that *Gavenda* also rendered the "no liability" clause nonbinding and ineffective.[168] *Middleton* and *Gavenda*, however, should have been irrelevant to the court's analysis in each instance. Under the "no amendments" clause, the

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dleton, and rewrites it to read "although this division order does not permanently amend the lease, it is nevertheless binding until revoked."

Heritage's position should also be rejected as a matter of policy. The "no amendments" clause likely lulled the royalty owners into a sense of security about whether they sacrificed their rights under their leases by signing the division orders. Those expectations should be respected. *Middleton*, 613 S.W.2d at 251 n.8 (recognizing that division orders are not binding when they would "prevent relief from fraud, accident or mistake or preclude the correction of mathematical calculations").

164. *See* 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 4.6[D], at 195–0 (1996) (explaining that breach of gas lease equates to breach of contract).

165. *Heritage*, 895 S.W.2d at 839.

166. *Id.* at 838.

167. *Id.* at 839.

168. *Id.* at 838.

division order should not have been interpreted to amend the lease clause regarding deductions. Similarly, the court failed to interpret the "no liability" clause in light of the effects of the "no amendments" clause. Therefore, the only question for the court should have been whether the "no liability" clause factually amended the lease in contradiction to the "no amendments" clause.

Heritage argued in its briefs that the "no amendments" clause did not prevent enforcement of the "no liability" clause, because the latter did not factually amend the lease.[169] Such an interpretation is questionable, however, because it ignores the lessee's contractual liability to pay royalties as established in the lease. The court of appeals found on this issue that the leases required Heritage to pay royalties without deductions for post-production costs.[170] Therefore, unless the lease itself partially released Heritage from that liability,[171] it should have been liable for the total amount of deductions sought by the royalty owners under the terms of the division order and its "no amendments" clause.

A strict interpretation of the division order, similar to the approach used by the court in *Stanolind Oil & Gas Co. v. Terrell*,[172] also undermines Heritage's position on the "no liability" clause. Recall that in *Terrell* the court concluded that language in the division order regarding the deduction of taxes affected the lessee *only in its capacity as purchaser*.[173] Similarly, the "no liability" clause in *Heritage Resources* provides that the royalty owners shall have no legal action against the "operator."[174] Under *Terrell*'s strict interpretation approach, that specific language should not be inter-

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169. Reply of Petitioner to Respondents' Motion for Rehearing at 11–12, Heritage Resources, Inc. v. NationsBank, 39 Tex. S. Ct. J. 537 (Apr. 25, 1996) (No. 95–0515).

170. *Heritage*, 895 S.W.2d at 839.

171. For example, a clause absolving a lessee of liability after an assignment of its interest could have altered Heritage's liability. Although such clauses are typical in oil and gas leases, the opinion does not address the effect of other lease clauses on Heritages's liability. In *Williams v. Baker Exploration Co.*, the court found the lessee liable when an oil purchaser failed to pay the lessor. Williams v. Baker Exploration Co., 767 S.W.2d 193, 196 (Tex. App.—Waco 1989, writ denied). Although the lessor had signed the third-party purchaser's division order, the court found the lessee liable for all royalties. *Id.* However, the court noted that the lessee could have relied on a clause in the lease that absolved it of liabilities after assigning its interest. *Id.*; *see infra* Part III.E.1. (discussing *Williams* further).

172. 183 S.W.2d 743 (Tex. Civ. App.—Galveston 1944, writ ref'd).

173. *See supra* Part II.B. (discussing *Terrell*).

174. *Heritage*, 895 S.W.2d at 839.

preted to affect Heritage's liability as a "lessee." Through strict interpretation, the court also could find the remaining portion of the "no liability" clause inapplicable since it requires royalty owners to recover against overpaid "division of interest owners," while the facts in *Heritage Resources* did not involve any overpayments to such owners.

The "no liability" clause in *Heritage Resources* appears to be geared toward the lessee or operator who pays out the correct total amount of royalty required by a lease, but distributes it incorrectly among the interest owners. Requiring the underpaid owner in that situation to seek recovery only against the overpaid owners is consistent with prior law.[175] In *Heritage Resources*, however, the lessee failed to pay out the correct total amount of royalties, thereby violating its lease obligations. Accordingly, the "no liabilities" clause could not have limited Heritage's liability.

In summary, the court of appeals properly proceeded through the general framework for resolving division-order disputes. First, the court interpreted the lease royalty clauses and the division orders. Then, having determined there was a conflict between the division order and the royalty clause, it considered the effect of *Middleton*'s binding-until-revoked rule and the exception to that rule created in *Gavenda*. At this point, however, the court erred in its application of *Gavenda* by overextending the unjust enrichment criterion. In addition, in interpreting the division order, the court failed adequately to analyze the "no amendments" and the "no liability" clauses. Yet, despite these errors, the court still managed to reach the required result, at least under its interpretation of the lease royalty clause.

Unfortunately, the common law rules for interpretation of documents are notoriously malleable.[176] As a result, in most document

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175. *See* Chicago Corp. v. Wall, 293 S.W.2d 844 (Tex. 1956) (denying recovery for underpayment of royalties when operator acted in good faith by paying royalties pursuant to binding division order).

176. *See* JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 3-16, at 177 (3d ed. 1987) (recognizing that courts often use common law interpretation rules to justify desired policy results). The authors opine that:

> [T]here is no unanimity as to the content of the parol evidence rule or the process called interpretation. . . . It would, however, be a mistake to suppose that the courts follow any of these rules blindly, literally or consistently. As often as not they choose the standard or the rule that they think will give rise to a just result in the particular case. We have also seen that often under a guise of interpretation a court will actually

interpretation cases, the opposing parties claim that the language is unambiguous and recite the same litany of interpretive rules;[177] yet each party then offers contradictory conclusions about the meanings of the words.[178] *Heritage Resources* illustrates this phenomenon, not only with the parties' arguments, but also with the supreme court's opinion, which ultimately reversed the court of appeals' interpretation of the lease royalty clause.

3. The Supreme Court Opinion in *Heritage Resources*

True to the framework outlined above, the supreme court began with the lease royalty clause in resolving the *Heritage Resources* dispute.[179] In the end, its interpretation reversed the court of appeals' decision and rendered moot any discussion of the effect of division orders on the lease royalty clause.[180] Nonetheless, the justice writing for the majority opted to express his opinion, in *obiter dicta*, on the appellate court's application of *Gavenda*.[181]

Rather than being regarded as a decision having significant impact on the law of division orders, the supreme court's opinion in *Heritage Resources* likely will be known for firmly adopting a definition of the "market value at the well" royalty standard. In so doing, the supreme court's majority opinion concluded that the phrase inherently permits the deduction of post-production costs

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> enforce its notions of 'public policy' which is nothing more than an attempt to do justice.

Id. (internal citations omitted). Several authors have examined these common law rules for interpretation. *See generally* Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH L. REV. 1 (1993); Laura H. Burney, *The Regrettable Rebirth of the Two-Grant Doctrine in Texas Deed Construction*, 34 S. TEX. L.J. 74, 76–81 (1993).

177. *See* Criswell v. European Crossroads Shopping Ctr., Ltd., 792 S.W.2d 945, 950 (Tex. 1990) (Gonzalez, J., dissenting) (writing, "I find it odd that all parties to this dispute, the trial court, the court of appeals, and this court agree that the contract in question is clear as a bell and yet disagree as to its meaning."); *see also* Laura H. Burney, *The Regrettable Rebirth of the Two-Grant Doctrine in Texas Deed Construction*, 34 S. TEX. L. REV. 73, 80 (1993) (stating that "[a] preferable alternative to struggling with the amorphous nature of the rules recited in the interpretation process is to adopt fact-specific rules for construction of particular problems").

178. *See Heritage*, 39 Tex. Sup. Ct. at 548–49 (Gonzalez J., dissenting) (musing that majority and concurrence reached opposite results despite agreeing that lease in question was unambiguous).

179. *Id.* at 537–38.

180. *Id.* at 540–41.

181. *Id.* at 540.

from royalty.[182] Only a concurring opinion expressed doubt whether the phrase had achieved such clarity under Texas law,[183] and just two dissenting justices suggested that the phrase previously had not been determined unequivocally to include the deduction of post-production costs.[184]

The majority's decision that the term "market value at the well" permitted the deduction of post-production costs seems sound, although not entirely beyond question. As noted by the concurrence, many of the earlier cases placing the burden of such costs on the lessor turned largely on the specific language of the lease at issue.[185] For example, in *Martin v. Glass*,[186] relied upon by the majority, the lease provided for "net proceeds," a term that more clearly contemplated post-production deductions.[187] The majority likewise relied upon *Skaggs v. Heard*,[188] in which the court had found the phrase "at the well" ambiguous because the lease contained no express language about charging post-production expenses to the royalty owner.[189]

Despite the *Martin* and *Skaggs* decisions, many other cases support the *Heritage Resources* majority's conclusion,[190] including

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182. *Id.* at 539–40.

183. *See Heritage*, 39 Tex. Sup. Ct. J. at 541–46 (Owen, J., concurring) (evaluating inconsistencies in determining meaning of market value).

184. *See id.* at 549 (Gonzalez, J., dissenting) (stressing that "this Court has never decided previously whether market value at the well includes or excludes post-production costs . . . and lower courts have not reached agreement on the issue") (internal citations and quotations omitted).

185. *Id.* at 543–44 (Owen, J., concurring)

186. 571 F. Supp. 1406 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1994).

187. *Martin*, 571 F. Supp. at 1410.

188. 172 F. Supp. 813 (S.D. Tex. 1959).

189. *Skaggs*, 172 F. Supp. at 815–16.

190. *See Martin*, 571 F. Supp. at 1410–11 (permitting deduction of post-production compression charges based on net proceeds 'at the well'); Parker v. TXO Prod. Corp., 716 S.W.2d 644, 648 (Tex. App.—Corpus Christi 1986, no writ) (recognizing that all post-production costs can be charged to royalty owners); Texas Oil & Gas Corp. v. Hagen, 683 S.W.2d 24, 28 (Tex. App.—Texarkana 1984) (evaluating 'market value at the well' as market value of gas where sold, less reasonable and necessary transportation and processing costs), *aff'd in part, rev'd in part*, 31 Tex. Sup. Ct. J. 140 (Dec. 16, 1987), *withdrawn, set aside, dism'd as moot*, 760 S.W.2d 960 (Tex. 1988); Le Cuno Oil Co. v. Smith, 306 S.W.2d 190, 193 (Tex. Civ. App.—Texarkana 1957, writ ref'd n.r.e.) (allowing for deductibility of post-production costs from gross sales price received under division order calling for royalty 'at the well'), *cert. denied*, 356 U.S. 974 (1958).

Middleton and *Piney Woods Country Life School v. Shell Oil Co.*[191] Those cases instruct about determining market value:

> [T]he point is to determine the price a reasonable buyer would have paid for the gas at the well when produced. Comparable sales of gas at other wells may be used to do this. Another method is to use sales of processed gas and deduct processing costs. Yet another relevant measure is . . . the actual sale price of the gas less costs.[192]

In order to properly reflect value "at the well when produced," each of the above methods would require deducting transportation costs from sales away from the well-head to determine the value of the lessor's royalty. Consequently, each method appears to recognize the propriety of allowing post-production cost deductions when determining the "market value at the well."[193]

Even prior to the Supreme Court of Texas's decision in *Heritage Resources*, the high courts in other jurisdictions had labeled Texas as following the rule of charging royalty owners with their proportionate share of post-production expenses, including those for transportation. Recently, for example, in *Sternberger v. Marathon Oil Co.*,[194] the Kansas Supreme Court concluded that "the law in Texas is well established [that] . . . [p]ost-production expenses are borne proportionately by the lessor and the lessee, while the lessee alone bears the costs of production."[195] Because "the costs of transporting a marketable product to a distant market are post-production expenses," the Kansas court concluded that "transportation costs are deductible from royalties under Texas law."[196]

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191. 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985).

192. *Piney Woods*, 726 F.2d at 238–39. Along the same lines, *Middleton* lists comparable sales as "those comparable in time, quality, quantity, and availability of marketing outlets." *Middleton*, 613 S.W.2d at 246; *see also* David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 E. MIN. L. FOUND. § 18.03[4][a], at 18–24 (1992) (indicating that costs of transportation likely would be deducted from sales at different points on pipeline to render them "comparable").

193. *See generally* Owen L. Anderson, *The Gas Royalty Obligation: Is Royalty Ordinarily Payable on the "Raw" Gas at the Mouth of the Well or on "Marketable" Gas?*, 37 NAT. RESOURCES J. (forthcoming 1997) (manuscript on file with the *St. Mary's Law Journal*) (providing thorough discussion of post-production cost issue).

194. 894 P.2d 788 (Kan. 1995).

195. *Sternberger*, 894 P.2d at 805.

196. *Id.*; *see also* Garman v. Conoco, Inc., 886 P.2d 652, 657 (Colo. 1994) (recognizing Texas as having adopted rule that "nonoperating interests must bear their proportionate share of costs incurred after gas is severed at the wellhead"); Wood v. TXO Prod. Corp., 854 P.2d 880, 882 (Okla. 1992) (describing Texas as allowing deduction of compression

Although prior Texas cases were not without contradictions, one could have predicted that the Supreme Court of Texas would expressly adopt the rule other jurisdictions assumed was already in place. In fact, even the opposing parties in *Heritage Resources* accepted the court's definition of "market value at the well."[197] Thus, given the state of the law, the *Heritage Resources* opinion articulated a rule that had been "clearly foreshadowed," justifying the retroactive application of its interpretation of "market value at the well."[198]

Having interpreted the "market value at the well" standard in the *Heritage Resources* leases, the supreme court was next faced with interpreting the "no deductions" language in the lease royalty clause, which provided: "there shall be no deductions from the value of Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas."[199] In this interpretive effort, the court primarily focused on the phrase "the value of Lessor's royalty,"[200] and ultimately adopted Heritage's argument that the "value of the lessor's royalty" equaled the "market value at the well." This interpretation allowed the deduction of necessary transportation costs.[201] Because the bank conceded that transportation costs were reasonable, the court concluded there had not been a deduction from the "value of the lessor's royalty."[202]

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costs from royalty interest). For a thorough examination of the Kansas, Colorado, and Oklahoma cases, see generally Owen L. Anderson, *The Gas Royalty Obligation: Is Royalty Ordinarily Payable on the "Raw" Gas at the Mouth of the Well or on "Marketable" Gas?*, 37 NAT. RESOURCES J. (forthcoming 1997) (manuscript on file with the *St. Mary's Law Journal*).

197. *See* Respondents' Motion for Rehearing at 6, Heritage Resources, Inc. v. NationsBank, 39 Tex. Sup. Ct. J. 537 (Apr. 25, 1996) (No. 95–0515) (stating that "NationsBank does not challenge the Court's opinion" that royalty interests clearly are subject to post-production costs unless otherwise agreed).

198. *See* Carrollton-Farmers Branch Indep. Sch. Dist. v. Edgewood Indep. Sch. Dist., 826 S.W.2d 489, 518–19 (Tex. 1992) (comparing retroactive versus prospective rulings). The dissent in *Heritage Resources* argued that the majority erred in applying its holding retroactively. *Heritage*, 39 Tex. Sup. Ct. J. at 549 (Gonzales, J., dissenting).

199. *Heritage*, 39 Tex. Sup. Ct. J. at 538. The court referred to this clause as the "post-production clause." *Id.* at 539. In the present discussion, however, I have labeled this language as the "no deductions" clause.

200. *Id.*

201. *Id.* at 539–40.

202. *Id.* at 540.

The *Heritage Resources* majority's interpretation of the lease royalty clause has several flaws. First, the court contradicted the very rules of construction it recited. For example, the court noted the presumption that parties intend "every clause to have some effect,"[203] but then held that the "no deductions" phrase in the lease was "surplusage as a matter of law."[204] Such an interpretation blatantly contradicts the *Luckel* decision, discussed earlier, wherein the court disapproved of the *Alford* granting-clause-prevails rule because that rule failed to give meaning to all language in the document.[205] Unfortunately, the approach used in *Heritage Resources* represents a regression to the intent-defeating rule of interpretation rejected earlier by the court in *Luckel.*

Second, the *Heritage Resources* court failed to appreciate the implications of its own pronouncement that Texas long had followed the rule that royalty owners bear their proportionate share of post-production costs. Because that rule was well established, royalty owners assumed its application unless the lease royalty clause expressly shifted that burden. Ideally, royalty owners would prefer to shift the burden for these costs to the lessee in order to deflate the lessees' incentive to inflate post-production costs,[206] a goal the "no deduction" language in the *Heritage Resources* lease was obviously intended to accomplish.[207]

Third, both the *Heritage Resources* majority and the concurring opinions incorrectly interpreted "market value at the well" as indicating *where* to establish the value of production. That approach contradicts the *Middleton* and *Piney Woods* decisions, which had interpreted the phrase as instructing *how* the value of the lessor's

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203. *Id.* at 538.

204. *Heritage*, 39 Tex. Sup. Ct. J. at 538, 540.

205. *See supra* notes 146–49 and accompanying text.

206. *See* Garman v. Conoco, Inc., 886 P.2d 652, 661 (Colo. 1994) (en banc) (emphasizing that when "processing costs enhance the value of an already marketable product the burden should be placed upon the lessee to show such costs are reasonable, and that actual royalty revenues increase in proportion with the costs assessed against the nonworking interest"). The realization that many lessees would succumb to this temptation explains why many jurisdictions place the burden of post-production costs on the lessee under the implied marketing covenant.

207. *Heritage*, 39 Tex. Sup. Ct. J. at 548 (Gonzalez, J., dissenting). After quoting the language of the leases' "no deductions" provisions, Justice Gonzalez questioned: "What could be more clear? This provision expresses the parties' intent in plain English, and I am puzzled by the court's decision to ignore the unequivocal intent of sophisticated parties who negotiated contractual terms at arm's length." *Id.*

royalty should be calculated.[208] This contradiction is evident in the supreme court's characterization of the court of appeals' interpretation of the "no deductions" language. The majority, joined by the concurring justices, concluded that the "court of appeals erred in holding that the lease required Heritage to pay royalties based on the market value at the *point of sale*."[209] But the appellate court had not held that royalties were to be paid on the value at the *point of sale*, but instead, had simply held that if the value at the point of sale was used to calculate the royalty, then the express language in the lease prohibited the lessee from deducting any costs from that amount. Therefore, the court of appeals' opinion, unlike the supreme court's, properly viewed the "no deductions" language in the Heritage leases as instructing how, not where, to calculate the value of the lessors' royalty.

The supreme court's majority and concurring opinions have created confusion about the interpretation of existing leases and the drafting of new ones. Read narrowly, the opinions turn primarily on the phrase "the value of the lessor's royalty" in the no-deductions clause. This narrow reading suggests that royalty owners with other clauses, if worded differently, could escape the *Heritage Resources* interpretation. To avoid this confusion in future drafting, practitioners could consider heeding the words of the concurring opinion, which suggests using clauses stating that royalty would be based on the market value at the "point of delivery or sale."[210] In today's new gas market, however, marked by deregulation, unbundled prices, and evolving roles for producers, processors, and transporters, even that phrase may be difficult to interpret and easy to manipulate.

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208. *See Middleton*, 613 S.W.2d at 246–47 (describing *how* to calculate market value based on comparable sales); *Piney Woods*, 726 F.2d at 238–39 (listing three methods by which "market value at the well" may be calculated). The *Piney Woods* court clarified the meaning of "market value at the well" as follows:

> In determining market value at the well, the point is to determine the price a reasonable buyer would have paid for the gas at the well when produced. Comparable sales of gas at other wells may be used to do this. Another method is to use sales of processed gas and deduct processing costs. Yet another relevant measure is . . . the actual sale price of the gas less costs.

Id.

209. *Heritage*, 39 Tex. Sup. Ct. J. at 540.

210. *Id.* at 547 (Owen, J., concurring).

4. The Effects of *Heritage Resources* on Future Division-Order Disputes—*Judice v. Mewbourne Oil Co.*

The potential effects of the *Heritage Resources* decision on other division-order disputes regarding deductions became obvious in a decision the Supreme Court of Texas announced on the same day. *Judice v. Mewbourne Oil Co.*[211] involved the allocation of post-production compression costs under the terms of certain leases and division orders.[212] The Judices were royalty owners under three oil and gas leases,[213] and Mewbourne Oil Company was one of the working-interest owners under those leases.[214] The Judices asserted that Mewbourne had improperly deducted post-production compression costs in calculating their royalty payments.[215] Although all three leases were at issue, the lessee Mewbourne conceded that it could not deduct the charges from royalty payments under one of those leases.[216] The two remaining leases, however, provided that royalties would be calculated as a fraction "of the market value at the well of all gas produced, and saved from said leased premises."[217] Rejecting the lower court's determination that this phrase was ambiguous, the *Judice* court relied on *Heritage Resources* and held that this language entitled the lessee to charge the Judices "their proportionate share of the reasonable cost of post-production compression."[218]

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211. 39 Tex. Sup. Ct. J. 533 (Apr. 25, 1996).

212. *Judice*, 39 Tex. Sup. Ct. J. at 534.

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.* That lease royalty clause provided that:

> Lessee shall pay to Lessor as royalty on gas, including casing head gas or other gaseous substances produced from said land and sold on or off the premises, 3/16 of the net proceeds at the well received from the sale thereof, provided that on gas used off the premises or by Lessee in the manufacture of gasoline or other products therefrom, the royalty shall be the market value at the well of 3/16 of the gas so used; *as to all gas sold by Lessee under a written contract, the price received by Lessee for such gas shall be conclusively presumed to be the net proceeds at the well or that market value at the well for the gas so sold.*

Id. at 534 n.1 (emphasis added).

Royalty owners should consider a phrase similar to the one italicized to insure that the lessee bears the burden of post-production costs.

217. *Judice*, 39 Tex. Sup. Ct. J. at 535.

218. *Id.*

Next, the *Judice* court interpreted the division orders, two of which provided that "[s]ettlement for gas sold shall be based on the gross proceeds realized at the well by . . . [the Judices]."[219] The court concluded that this phrase was ambiguous.[220] Again relying on *Heritage Resources*, the court explained that "[t]here is an inherent conflict in the use of the two terms ['gross proceeds' and 'at the well'] that renders the clause ambiguous."[221] This finding of ambiguity permitted the court to consider extrinsic evidence showing the parties had intended royalties to be based on the price received for the gas *without* deductions for compression.

In interpreting a third division order, however, the court determined that it unambiguously permitted the deductions.[222] That division order provided that "[s]ettlement for gas sold shall be based on the net proceeds realized at the well."[223] Originally, another phrase expressly had permitted the deduction of costs incurred in compressing, but the royalty owners had deleted that phrase by hand.[224] Nevertheless, the court held that "net proceeds" and "at the well" expressly contemplated deductions and that the handwritten deletions did not alter the effect of those phrases.[225]

Judice, then, incorporated the *Heritage Resources* definition of "market value at the well" in interpreting the leases and division orders. Additionally, *Judice* followed the precedent of earlier cases that had interpreted the phrase "net proceeds" to permit post-production deductions.[226] Ironically, though, the *Judice* court reached its decision despite evidence that the true intent of the parties was to draft all of these documents to ensure that the lessee assumed the burden of paying all post-production costs.[227] In other words, the court's objective interpretation in *Judice* likely frustrated the

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219. *Id.* (alteration in original).

220. *Id.*

221. *Id.*

222. *Judice*, 39 Tex. Sup. Ct. J. at 536.

223. *Id.* at 535.

224. *Id.*

225. *Id.* at 536.

226. *See* Martin v. Glass, 571 F. Supp. 1406, 1415 (N.D. Tex. 1983) (recognizing "net proceeds at the well" as allowing for deduction of post-production compression charges), *aff'd*, 736 F.2d 1524 (5th Cir. 1984).

227. This outside evidence of the parties' intent had influenced the appellate court's decision. *See* Judice v. Mewbourne Oil Co., 890 S.W.2d 180, 183–84 (Tex. App—Amarillo 1994), *rev'd*, 39 Tex. Sup. Ct. J. 533 (Apr. 25, 1996).

parties' subjective intent. Nonetheless, the court's reading was technically correct, because it is objective, and not subjective, intent that governs when a court interprets the terms of a written instrument.[228]

5. The Role of *Gavenda* in the Supreme Court's *Judice* and *Heritage Resources* Decisions

The *Gavenda* exception becomes an issue only when a royalty owner seeks to avoid *Middleton's* binding-until-revoked rule in order to recover for underpayments made while a division order was in effect. In *Judice*, the court had no need to discuss *Gavenda* for two reasons. First, the parties had agreed that the division orders governed the payment of royalty until revoked by the filing of suit. Second, the Judices had decided not to hold Mewbourne liable for any benefit retained by Mewbourne when it paid royalties based on the division orders.[229] Similarly, the *Heritage Resources* court had had no need to address *Gavenda* in light of the *Heritage Resources* court's questionable interpretation of the lease royalty clause. Under that interpretation, both the division orders and the lease in *Heritage Resources* permitted the lessee to deduct post-production transportation costs. Because the division order did not change the lease royalty clause, the court did not need to consider whether the royalty owners could benefit from *Gavenda*'s exception to the binding-until-revoked rule. Nevertheless, the *Heritage Resources* court felt compelled to espouse dicta regarding the court of appeals' application of the *Gavenda* exception.

In *Heritage Resources*, the supreme court noted that, under the court of appeals' interpretation of the lease royalty clause, *Middleton* and *Gavenda* would apply.[230] The supreme court concluded, however, that "[u]nder *Gavenda*, Heritage would be liable, if at all,

228. It is the intention expressed in the language of the instrument that governs, and not the meaning that the parties actually may have intended but failed to express. Canter v. Lindsey, 575 S.W.2d 331, 334 (Tex. Civ. App.—El Paso 1978, writ ref'd n.r.e.); Davis v. Andrews, 361 S.W.2d 419, 423 (Tex. Civ. App.—Dallas 1962, writ ref'd n.r.e.). The Judices tried to amend the third division order to reflect their intent by deleting the phrase permitting the deductions. *Judice*, 39 Tex. Sup. Ct. J. at 535. In hindsight, the royalty owners should have replaced the word "net" with "gross" and should have deleted the phrase "at the well" in addition to deleting the deductions phrase.

229. *Judice*, 39 Tex. Sup. Ct. J. at 534.

230. *Heritage*, 39 Tex. Sup. Ct. J. at 540.

only for the amount of the unpaid royalty it retained."[231] Since there were other working interest owners who would have benefited from the cost deductions, the court stressed that the court of appeals erred in holding Heritage liable for the total amount of deductions.[232] That conclusion comports with the criticisms of the court of appeals' application of *Gavenda* which are outlined above in Part II. Apparently content to correct only this mistaken view of *Gavenda*, the majority opinion of the Supreme Court in *Heritage Resources* did not address the other weaknesses in the appellate court's analysis. In particular, the supreme court failed to address the appellate court's view of the corporate relationship between Heritage and Urantia in finding unjust enrichment, and its improper application of the "no amendments" and "no liability" clauses.

6. The Implications of *Heritage Resources* and *Judice* for Division-Order Jurisprudence

The supreme court and court of appeals decisions in *Heritage Resources* and *Judice* ultimately add little to division-order case law in Texas. In all likelihood, their most significant contributions will prove to be the definitions they assign to phrases commonly encountered in lease royalty clauses and division orders, particularly "market value at the well" and "net proceeds." While the definitions assigned to those phrases might frustrate the intent of the parties in particular cases, they do, at least, provide guidance in the drafting of future leases and division orders.

Aside from providing drafting guidance, however, the *Heritage Resources* and *Judice* opinions merely affirm that Texas division-order jurisprudence is sui generis. Both decisions show that, rather than being grounded in a particular theory, such as contract or estoppel, Texas division-order case law revolves around the binding-until-revoked rule. Unfortunately, neither opinion in *Heritage Resources* provides sufficient guidance about the effect which other clauses in the division order might have on that rule, including the effect of the "no amendments" clause and the "no liability" clause. Moreover, although both opinions perfunctorily proceed through the correct framework for resolving division-order disputes, they

231. *Id.*
232. *Id.*

illustrate that the malleable rules of interpretation render it impossible to confidently predict the results. Finally, in the continual battle between the competing policies of royalty owners and producers, the Texas high court's *Heritage Resources* opinion represents a victory for producers by allowing them to avoid lease language designed to ensure that they bear the burden of post-production costs.

III. STATUTORY DIVISION-ORDER LAW

The foregoing discussion of division-order case law reveals that many Texas courts overtly acknowledged the competing policies of producers and royalty owners regarding the effect of division orders on the royalty obligation. Similarly, in over a quarter of the states,[233] legislatures have recognized the need to balance these competing policies. For example, a division-order statute in North Dakota had been enacted expressly "as a means of increasing the bargaining power of landowners in their dealings with major oil companies concerning rights under oil and gas leases."[234]

In 1991, largely in response to the calls of royalty owners, Texas also adopted statutory provisions governing the use of division orders.[235] Those provisions augment the pre-existing 1983 statute

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233. *See Matrix of Division Order Statutes by State*, 21 NADOA NEWSLETTER (Nat'l Ass'n of Division Order Analysts, Dallas, Tex.), July 1995, at 14–18 (on file with the *St. Mary's Law Journal*); *see also* Ernest E. Smith, *The New Division Order: Legal and Practical Aspects* (attaching matrix of division order statutes to his article), *in* 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997).

234. Imperial Oil of North Dakota v. Consolidated Crude Oil Co., 851 F.2d 206, 210 (8th Cir. 1988); N.D. CENT. CODE § 47-16-39.3 (Michie 1995).

235. Act of June 16, 1991, 72d Leg., R.S., ch. 650, 1991 Tex. Gen. Laws 2392; *see* John R. Tilly, *Stirring the Muddy Waters: Statutory Impact on Division Orders in Texas and Elsewhere*, STATE BAR OIL, GAS & MIN. L. SECTION NEWSLETTER 1 (June 1992) (examining confusion created by division order statute). In his article, Tilly describes the setting that prompted the birth of the division order provisions:

> Prior to the opening of the 72nd Texas legislative session in 1991, Brad Shields, a lobbyist for The National Association of Royalty Owners, Inc. (NARO), approached Rep. Tom Craddick (R. Midland), a member of the House Committee on Energy, and suggested the need for legislation to protect royalty owners from onerous and unfair division orders. Aware of NARO's efforts, a lobbyist for Scurlock Permian Corp. also sought out Rep. Craddick with its own form of a bill (which the Texas Mid-Continent Oil and Gas Association and its members soon embraced) that was intended to bring some uniformity to the use of division order in Texas.
>
> Himself a royalty and working interest owner who thought the issue needed attention, Rep. Craddick agreed to sponsor such a bill. Thus began an active, sometimes

that governed the obligations of "payors," who could be either purchasers or producers, in making payments to royalty owners, or "payees," in Texas.[236] The legislative history of these 1991 amendments reveals two primary purposes for the additions: (1) merely to "enact" existing case law regarding division orders, and (2) to protect the lessor's rights in an oil and gas lease.[237]

The following sections analyze the extent to which the amended statute actually fulfills these two goals. Unfortunately, that analysis involves navigating a convoluted course of vague provisions and contradictory terms. Interpreting these terms and provisions requires applying general rules of statutory construction in addition

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> acrimonious and tense debate, inside and outside committee hearing rooms, between those who sell and those who buy petroleum products pursuant to the terms of a division order.

Id.; *see also* HOUSE COMM. ON ENERGY, BILL ANALYSIS, Tex. S.B. 1605, 72d Leg., R.S. (noting that "[c]omplaints from royalty owners emerge when the Division Orders alter the terms of the previously negotiated oil or gas lease, which is the basic legal instrument granting the rights to a lessee or operator to drill and develop a property for production.").

236. The royalty payment statute was originally passed in 1983. Act of May 24, 1983, 68th Leg., R.S., ch. 228, 1983 Tex. Gen. Laws 966 (codified as amended at TEX. NAT. RES. CODE ANN. §§ 91.401–91.406 (Vernon 1993 & Supp. 1997)). The statute was passed "to compel timely payment of proceeds to royalty interest owners by those persons or entities occupying the status of a 'payor.'" Koch Oil Co. v. Wilber, 895 S.W.2d 854, 868 (Tex. App.—Beaumont 1995, writ denied) (Walker, C.J., dissenting). The payor liability statute sets out time periods for royalty payments, permits withholding payments without interest for title problems, and allows for interest in certain other cases. TEX. NAT. RES. CODE ANN. §§ 91.402(a), 91.402(b)(1), 91.403 (Vernon 1993). The statute defines a payor as "the party who undertakes to distribute oil and gas proceeds to the payee [royalty owner]" whether as a lessee or first purchaser. *Id.* § 91.401(2). The statute originally designated the first purchaser as the payor unless the owner of the right to produce and the first purchaser agreed that the owner of the right to produce had the responsibility of paying royalties. *See* TEX. NAT. RES. CODE ANN. § 91.401 historical note (Vernon 1993) [Act of May 24, 1983, 68th Leg., R.S., ch. 228, 1983 Tex. Gen. Laws 966, 966] (providing original statutory definition of "payor"). That definition was amended in 1991 to clarify that it is sufficient for the first purchaser and producer to agree to place the responsibility on the producer. *Id.*

The original definition of "payor" was misconstrued by courts. Courts interpreted the definition as requiring, in addition to the agreement, the actual payment of the proceeds to the producer before the first purchaser could avoid payor liability. *See* Northern Natural Gas Co. v. Vandenburg, 785 S.W.2d 415, 419 (Tex. App.—Amarillo 1990, no writ) (adopting position that division order statute requires purchaser to actually pay out proceeds to producer before being relieved of liability); *see also* Ernest E. Smith, *The New Division Order: Legal and Practical Aspects*, 42 ROCKY MT. MIN. L. INST. (forthcoming 1997) (manuscript at 21-23, on file with the *St. Mary's Law Journal*) (evaluating courts' interpretation of original payor definition as imposing third requirement of actual payment).

237. HOUSE COMM. ON ENERGY, BILL ANALYSIS, Tex. S.B. 1605, 72d Leg., R.S. (1991).

to following the guidance provided by the statute's legislative history. Although commentators who undertake this interpretive process could reach different conclusions on specific issues, all would likely agree that the statute could have been more clearly written.[238]

A. *A Preliminary Issue: Whether Royalty Owners Must Sign a Division Order*

In the 1991 amendments, the Texas legislature addressed several questions regarding the effect of division orders on the obligation to pay royalties. The question initially addressed is whether payors can require royalty owners to sign a division order before royalty owners become entitled to receive their payments.[239] As a matter of industry custom, many lessees and purchasers impose such a requirement on royalty owners.[240] For example, in the Oklahoma case of *Hull v. Sun Refining & Marketing Co.*,[241] the purchaser, who had refused to make royalty payments until execution of division orders,[242] relied upon that custom when royalty owners brought suit to compel payment of royalties.[243] The Oklahoma

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238. *See* Ernest E. Smith, *The New Division Order: Legal and Practical Aspects*, 42 ROCKY MT. MIN. L. INST. (forthcoming 1997) (noting that Texas Division Order Statute is "an unfortunate example" of statute that, although seeming clear at first glance, is "fraught with ambiguity when closely examined"); Martin R. Bennett, Comment, *Division Orders: Impact of the Payment for Proceeds of Sale Statute*, 47 BAYLOR L. REV. 513, 514 (1995) (recognizing that, though purpose of division order statute may be to clarify position of purchasers and royalty owners, its poor drafting leaves many issues unresolved); Richard F. Brown, *Texas Division Orders and the Texas Division Order Statute*, THE LANDMAN, Mar./Apr. 1993, at 34-37 (outlining controversies arising out of division orders and noting how they are exacerbated by ambiguities of division order statute).

239. TEX. NAT. RES. CODE ANN. §§ 91.402(c)-(d) (Vernon 1993).

240. *See* Hull v. Sun Ref. & Mktg. Co., 789 P.2d 1272, 1278 (Okla. 1989) (stating that "a recognized custom and usage of the oil and gas industry included the requirement that royalty holders execute division orders before receiving royalty payments"); 4 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 701, at 573-74 (1995) (recognizing that payors customarily ask payees to sign division orders before paying); *see also* Donald J. Brannan, *Division Orders*, 8 E. MIN. L. FOUND. § 12.07, at 12-12 (1987) (emphasizing practical considerations that historically have mandated that royalty owners sign division orders).

241. 789 P.2d 1272 (Okla. 1989).

242. *Hull*, 789 P.2d at 1276.

243. *Id.* The purchaser, Sun, raised the lessors' failure to sign a standard division order as an affirmative defense, alleging that execution of the order was a condition precedent to the receipt of royalty payments under its (Sun's) oil purchase contract with the lessee. *Id.*

Supreme Court held that the applicable payment statute did not require execution of a division order before recovery of royalties as long as there was a showing of marketable title.[244]

While the *Hull* case provided an answer to this question in Oklahoma, no Texas court had pointedly addressed whether a lessor was required to sign a division order as a condition of payment.[245] The Texas division-order legislation, though, establishes that signing a division order *can* be made a condition for payment, but only in limited circumstances: (1) when a payee refuses to sign a "form" oil division order, the form of which is set forth in the statute;[246] or (2) when a payee refuses to sign a division order con-

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244. *Id.* at 1277; *see also* TXO Prod. Corp. v. Page Farms, Inc., 698 S.W.2d 791, 792–93 (Ark. 1985) (refusing to require lessor to sign division orders before receiving royalty payment). *But see* Blausey v. Stein, 400 N.E.2d 408, 410–11 (Ohio 1980) (requiring lessor to sign division order before receiving royalty payment).

In *Hull*, the court was not swayed by evidence that industry custom required royalty owners to sign division orders before payment. *See Hull*, 789 P.2d at 1278–79 (finding that Oklahoma payment statute prevailed over custom and usage). That custom originated with third-party oil purchasers, who had no other contractual agreements with the lessor. *See* Marvin G. Twenhafel, *Oil-Gas Division Orders: Their Origin, Varieties, and Usage*, 27B ROCKY MTN. MIN. L. INST. 1479, 1485 (1982) (stressing that division orders developed in context of third party oil purchasers). Because the oil royalty clause in the lease generally permitted the lessor to take her oil royalty in kind, the division order with the purchaser was viewed as a contract for sale. *Id.* However, as described herein, neither case law nor the division-order statute view the division order as a contract for the sale of goods. *See* discussion *infra* Part IV.A. Moreover, the view that the in-kind royalty provision leaves title to the oil in the lessee is questionable.

245. Although Texas courts had not addressed a case with facts identical to those in *Hull*, several cases had recognized the right of the royalty owner to receive interest on payments that had been withheld by a payor. *See* Phillips Petroleum Co. v. Stahl Petroleum Co., 569 S.W.2d 480, 483 (Tex. 1978) (refusing to insist on strict statutory compliance in allowance of interest when necessary to permit compensation for detention of one's money); *see also* Si M. Bondurant, *Royalty Owner Rights Under Division Orders*, 25 TULSA L.J. 571, 595–96 (1990) (stating, "[t]he Texas cases and those of other common law jurisdictions overwhelmingly support the right of the royalty owner to be paid interest on suspended funds."). In one recent case a Texas court stated, in dicta, that payors could require division orders as a condition of payment. *See* Koch Oil Co. v. Wilber, 895 S.W.2d 854, 865 (Tex. App.—Beaumont 1995, writ denied) (finding that "Tesoro [purchaser] was entitled to receive a signed division order from the payee as a condition for the payment of proceeds from the sale of oil"). However, the court in *Wilber* cited no authority for this proposition. *Id.* Texas courts have recognized the payor's right to suspend payments with interest when the division order so provides. Gulf Pipeline Co. v. Nearen, 135 Tex. 50, 138 S.W.2d 1065, 1068 (1940); Lasater v. Convest Energy Corp., 615 S.W.2d 340, 345 (Tex. Civ. App.—Eastland 1981, writ ref'd n.r.e.).

246. TEX. NAT. RES. CODE ANN. § 91.402(d) (Vernon Supp. 1997). The original 1991 version of this statutory form subsequently was amended in 1995. *See id.* historical and statutory notes (outlining 1995 amendments to division order form). The 1995 legislation

taining only the seven provisions listed in the statute.[247] Most of

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enacted the following changes and additions to the "PAYMENT" provision of section 91.402(d)'s division order form: (1) the minimum amount for disbursements increased from $25 to $100; (2) the final date for disbursement payments shifted, subject to the following proviso, from December 31 of each year to a revolving payment date of twelve months of accumulated proceeds; and (3) a sentence was added, creating the proviso that "payors may hold accumulated proceeds of less than $10 until production ceases or the payor's responsibility for making payment for production ceases, which ever occurs first." *Id.* Additionally, the legislature deleted the "20 percent" limit that had preceded "withholding tax" in the form's final sentence. *Id.*

The statutory form for oil payments allegedly fulfills the statute's criteria. Yet, the form includes terms that differ from those set forth in the statute. The form includes differing provisions regarding termination, terms of sale, and indemnity. *Compare* TEX. NAT. RES. CODE ANN. §§ 91.402(c)(1)(A)-(G) (Vernon 1993) (listing provisions that payor is entitled to include in division order that serves "[a]s a condition for the payment of proceeds from the sale of oil and gas production to payee"), *with* TEX. NAT. RES. CODE ANN. § 91.402(d) (Vernon Supp. 1997) (providing division order form that that may be used "[i]n the alternative" to satisfy the provisions of section 91.402(c)); *see also* Martin R. Bennett, Comment, *Division Orders: Impact of the Payment for Proceeds of Sale Statute*, 47 BAYLOR L. REV. 513, 519 (1995) (noting differences between form provisions and enumerated provisions necessary for conditional payment). These differences could lead royalty owners to question whether they could be required to sign this form as a condition of payment. Under rules of statutory interpretation, the answer would likely be "yes." The Texas Government Code asserts that in enacting a statute it is presumed that all language included is intended to be effective. TEX. GOV'T CODE ANN. § 311.021(2) (Vernon 1988). Similarly, case law recognizes that every word or phrase used in a statute "is presumed to have been used intentionally, with a meaning and a purpose." Valley Int'l Properties v. Los Campeones, Inc., 568 S.W.2d 680, 687 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e), *cert. denied*, 440 U.S. 902 (1978). In light of these statutory construction rules, the oil division order form should be given effect, thus requiring a payee to sign the order, when requested, before receiving royalty payments.

The National Association of Division Order Analysts has promulgated a form to be used for oil and gas. *NADOA Model Form Division Order*, 21 NADOA NEWSLETTER (Nat'l Ass'n of Division Order Analysts, Dallas, Tex.), July 1995, at 3 (on file with the *St. Mary's Law Journal*). For a discussion of the NADOA form, *see* Ernest E. Smith, *The New Division Order: Legal and Practical Aspects*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997).

247. TEX. NAT. RES. CODE ANN. §§ 91.402(c)(1)(A)-(G) (Vernon 1993). Specifically, section 91.402(c)(1) sets forth the seven permissible provisions as follows:

> (c)(1) As a condition for the payment of proceeds from the sale of oil and gas production to payee, a payor shall be entitled to receive a signed division order from payee containing only the following provisions:
>
> (A) the effective date of the division order, transfer order, or other instrument;
>
> (B) a description of the property from which the oil or gas is being produced and the type of production;
>
> (C) the fractional and/or decimal interest in production claimed by payee, the type of interest, the certification of title to the share of production claimed, and, unless otherwise agreed to by the parties, an agreement to notify payor at least one month in advance of the effective date of any change in the interest in production owned by payee and an agreement to indemnify the payor and re-

the seven listed provisions concern specific terms that serve the division order's basic purposes of affirming the size of the payee's interest and protecting the payor in the event of overpayments. Indeed, the statute explicitly provides that none of the provisions "amends" the lease.[248]

Despite the declaration that none of the seven enumerations amends the provisions, one provision arguably does permit an amendment. That provision allows inclusion of terms in division orders regarding "the valuation and timing of settlements of oil and gas production to the payee."[249] This "valuation" provision is sufficiently broad to encompass clauses such as those inserted in the *Middleton* and *Heritage Resources* division orders. The insertion of these clauses could amend the basis for calculating royalty as set forth in the lease royalty clause. As in *Middleton*, if the lease calls for valuation on a "market value royalty" basis, then a "proceeds" or "amount realized" valuation provision in the division order obviously would amend the lease royalty clause. Similarly, the language concerning deductions in the *Heritage Resources* division order also would qualify under the statute as a permissible "valuation" provision. This conclusion would follow under either the supreme court's interpretation that the lease permitted deductions,

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imburse the payor for payments made if the payee does not have merchantable title to the production sold;

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

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

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

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

Id.

248. *See* TEX. NAT. RES. CODE ANN. § 91.402(c)(2) (Vernon 1993) (providing that division order containing seven provisions listed in TEX. NAT. RES. CODE. ANN. § 91.402(c)(1) "does not amend any lease or operating agreement between the interest owner and the lessee or operator or any other contracts for the purchase of oil or gas").

249. *Id.* § 91.402(c)(1)(F). Under this "valuation" provision, if the lease royalty clause required royalty to be calculated on a "proceeds" or "amount realized" basis, then the lessee or purchaser could insert language in the division order as needed to clarify the exact terms of the underlying contract from which the "proceeds" would be "realized." The insertion of such language in a division order would not amend the lease royalty clause, and, consequently, the statute would require the lessor to sign the division order as a condition for receiving payment.

or the court of appeals' interpretation that the lease did *not* permit deductions. In the latter instances, however, the division order "valuation" terms permitting deductions would amend the lease royalty clause.

The initial question for many royalty owners in these *Middleton* and *Heritage Resources* situations is whether the statute requires them to sign division orders even though they amend the lease royalty clause. The answer appears to be "yes," because, as described above, these "amending" insertions are proper "valuation" provisions. Unfortunately, at least from the payees' perspective, the statute has no express language stating that a payee may refuse to sign a division order if any of the seven enumerated provisions in fact "amends" the lease royalty clause.[250]

Although payees may have to sign a division order containing terms that amend the lease, other provisions of the statute may protect their rights as created in oil and gas leases, even while that division order is in effect. For example, section 91.402(h) of the Texas Natural Resources Code states that a division order shall not change express lease obligations and establishes that "[a]ny provision of a division order between payee and its lessee which is in *contradiction* with any provision of an oil and gas lease is invalid to the extent of the contradiction."[251] In other words, this "no contradictions" provision negates any conflicting division-order provisions and establishes that the lease royalty clause determines the lessee's royalty obligation. By reinstating lease terms regardless of contradictory division-order terms, this provision renders *Middleton*'s binding-until-revoked rule useless for a lessee when its division order contradicts the lease royalty clause.

B. *The Role of the* Middleton *Rule*

The accuracy of the above conclusion regarding the usefulness of *Middleton*'s binding-until-revoked rule under the statute becomes

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250. The statute does contain a clause stating that division orders with those terms do not "amend" the lease. TEX. NAT. RES. CODE ANN. § 91.402(c)(2) (Vernon 1993). Yet, that section does not seem to permit the lessor to avoid the condition of payment provisions. This "no amendment" language arguably could mean that the division order does not permanently amend the lease, but that the order is nevertheless binding until revoked under section 91.402(g). Having signed the division order, the payee must rely on other provisions to find protection for his or her lease rights.

251. TEX. NAT. RES. CODE ANN. § 91.402(h) (Vernon 1993) (emphasis added).

questionable in light of other provisions of the statutory scheme. In particular, section 91.402(g) creates uncertainty about the role of *Middleton*'s binding-until-revoked rule. Section 91.402(g) adopts, nearly verbatim, the language of *Middleton* and states, "[d]ivision orders are binding for the time and to the extent that they have been acted on and made the basis of settlements and payments."[252] Based upon this language, lessees could argue that the statute preserves the *Middleton* rule and universally prevents suits for underpayment of royalties made while their division orders were in effect, regardless of whether the division order "contradicts" the lease royalty clause. For payors, such an interpretation obviously would inject more certainty into the payment process,[253] but that interpretation also would render meaningless the "no contradictions" provisions of 91.402(h), which negates division order terms that contradict the lease royalty clause.

Because of yet another provision in the division-order statute, however, the lessee's position in favor of the binding-until-revoked rule still might prevail in the "market value royalty" situation. Section 91.402(i) provides that "a division order may be used to *clarify* royalty settlement terms in the oil and gas lease."[254] That section mandates that the term "market value," as used in a lease royalty clause, "shall be defined as the amount realized at the mouth of the well."[255] Read broadly, this language purports to replace "market value royalty" standards in leases with "amount realized" standards. That switch would reverse the *Vela* rule, providing that

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252. *Id.* § 91.402(g).

253. *See* John R. Tilly, *Division Orders: Can't Live with 'Em, Can't Live Without 'Em*, 43 ANN. INST. ON OIL & GAS L. & TAX'N § 8.07[3][b], at 8–15 (1992) (explaining that under rule that division orders cannot alter lease terms, payees logically will argue they are not bound by pricing standards set out in division order if those terms contravene lease). Tilly writes:

> Such argument would, of course, expose payors to uncertain liabilities when, in good faith, payors attempted to explain and calculate the proper payment method in the division order. The better argument, it seems, is set forth in the court opinions that bind both payor and payee to the terms of the division order until revoked by one of them.

Id.

254. TEX. NAT. RES. CODE ANN. § 91.402(i) (Vernon 1993) (emphasis added).

255. *Id.*

"market value" is to be determined on the day of production rather than according to the lessee's contract price.[256]

Although interpreting section 91.402(i) to change Texas law by reversing the *Vela* rule would please producers,[257] that interpretation goes too far. According to the statute, section 91.402(i) applies to division orders, not leases, and, even then, only to division orders executed after 1991. Therefore, the statute sanctions the use of an "amount realized" standard only in a *division order* signed after that date.[258] Under section 91.402(i), then, an "amount realized" division order would "clarify" rather than contradict a "market value" lease royalty clause. And under section 91.402(g), that "amount realized" standard would be binding until revoked.

Obviously, the legislature would have created less confusion had it omitted the "clarifying" provision and simply provided that an "amount realized" standard in a division order shall not be considered a "contradiction" to the "market value" standard in a lease. Omitting the "clarifying" provision would also avoid arguments that this section permits the insertion of clauses, other than an "amount realized" standard, to "clarify" royalty terms. Rules of statutory interpretation, however, would require interpreting the word "clarify" to permit only the insertion of terms specifically set forth in the second sentence of section 91.402(i).[259]

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256. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968); *see* discussion *supra* Part II.A.1. and note 42.

257. Producers would welcome this interpretation under the marketing realities prevailing when *Vela* was decided. In today's gas market, however, "market value" prices could be lower than contract prices. *See* discussion *infra* Part IV.B.

258. 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 297–0 (1996).

259. The doctrine of *ejusdem generis* provides that "[w]here general words follow specific words in a statutory enumeration, the general words are construed to embrace only objects similar in nature to those objects enumerated by the preceding specific words." 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 47.17, at 188 (5th ed. 1992); Hightower v. State Comm'r of Educ., 778 S.W.2d 595, 598 (Tex. App.—Austin 1989, no writ). Along these same lines, "[w]here the opposite sequence is found, *i.e.*, specific words following general ones, the doctrine is equally applicable, and restricts application of the general term to things that are similar to those enumerated." 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION 47.17, at 188 (5th ed. 1992); *see* Gulf Ins. Co. v. James, 143 Tex. 424, 429–30, 185 S.W.2d 966, 969 (1945) (providing that "where words of general import are followed immediately by words of restricted import, the general language will be limited by the more restricted language").

In summary, under the Texas division-order statute, *Middleton*'s binding-until-revoked rule remains largely, but not totally, intact. In situations mirroring the *Middleton* facts, which include a signed division order supplanting the lease's "market value royalty" valuation clause with an "amount realized" standard, section 91.402(i) considers that the division order properly "clarifies" the royalty terms. The "amount realized" standard in such a case is not an impermissible "contradiction" under section 91.402(h). Moreover, under section 91.402(g) such a division order would be binding until revoked. Thus, with the *Middleton* facts, the binding-until-revoked rule is preserved.

Under the statute, however, the binding-until-revoked rule has been rendered irrelevant for the deduction issue raised in the *Heritage Resources* opinions.[260] In *Heritage Resources*, as described previously, the supreme court found no conflict between the lease royalty clause and division-order terms charging post-production transportation costs against the lessors' royalty. Because revoking the division order would not permit the lessors to avoid the burden of these costs, *Middleton*'s binding-until-revoked rule became irrelevant. However, under the court of appeals' holding that the division-order terms did conflict with the lease royalty clause, the binding-until-revoked rule governed the lessors' claim for underpayments made while the division orders were in effect.

Applying the statute to the court of appeals' view of the *Heritage Resources* case reveals that the binding-until-revoked rule would again be irrelevant. Under the division-order statute, a division order between a lessor and lessee that charges post-production costs to a royalty owner in contravention of the lease royalty clause prohibiting these deductions would be subject to the "no contradictions" fiat of section 91.402(h). Since the "no deductions" language in the division order would be invalid, the division order could not "bind" the royalty owner. Instead, the lease royalty clause would control in spite of the contradictory terms of the division order.

The approach to the deduction issue described above comports with the legislative intent behind the statute. The statute's legislative history recognizes royalty owners' concerns about division or-

260. TEX. NAT. RES. CODE ANN. § 91.402(i) (Vernon 1993).

ders requiring lessors to bear post-production costs when their leases provide that they should *not* have to bear those costs.[261] In addition, the statute's treatment of the *Middleton* rule furthers another purpose expressed in the legislative history of the bill—the goal of merely "enacting" extant case law. But, the *Gavenda* decision created an unjust-enrichment exception to the binding-until-revoked rule. Whether the statute also "enacts" that exception is discussed below.

C. *The Fate of* Gavenda

As explained earlier, a royalty owner would invoke the *Gavenda* exception in response to the lessee's reliance on *Middleton*'s binding-until-revoked rule. Therefore, to the extent that the statute renders the *Middleton* rule useless for lessees, the *Gavenda* exception becomes irrelevant as well. And recall that the exception never provided relief to royalty owners trying to recover for under payments occurring while a division order with an "amount realized" term was in effect. But what is the fate of the exception under the statute in cases with facts akin to those in *Gavenda*? In other words, what role does the *Gavenda* exception play in cases in which division orders misstate the size of the payee's interest as created in a mineral or royalty deed?

The answer to the above questions exposes a possible fallacy in the legislative claim that the division-order statute leaves existing case law undisturbed.[262] As applied to this *Gavenda* scenario, the statute appears to reverse the *Gavenda* decision. That reversal stems from omissions in the "no contradiction" provision of section 91.402(h), and from omissions in the "no amendments" provision of section 91.402(c)(2). Whereas the "no amendments" and "no contradictions" provisions of the statute protect lease royalty owners with language prohibiting amendments to "leases," they omit

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261. *See* HOUSE COMM. ON ENERGY, BILL ANALYSIS, Tex. S.B. 1605, 72d Leg., R.S. (1991) (noting that "[p]roblems arise when royalty owners are asked to bear part of the production and/or transportation costs in the Division Order agreement and feel that their portion of the proceeds from the sale of production should be free and clear of such costs, as may be outlined in the lease agreement.").

262. *See* HOUSE COMM. ON ENERGY, BILL ANALYSIS, Tex. S.B. 1605, 72d Leg., R.S. (1991) (announcing that proposed division order bill "adds language that reflects existing case law").

language negating division-order terms that contradict a "deed."[263] Under rules of statutory construction, this omission must be given effect.[264] Therefore, whether deliberately or by accident, the division-order statute apparently overrules *Gavenda*.[265]

D. *The Fate of* Cabot Corp. v. Brown

While an omission of language from section 91.402(h) has probably led to the reversal of *Gavenda*, express language in that section seems to overrule another case, *Cabot Corp. v. Brown*.[266] Section 91.402(h) provides that division orders "shall not change or relieve the lessee's . . . implied obligations under an oil and gas lease."[267] That language contradicts *Cabot*, which extended *Middleton's* binding-until-revoked rule in order to bar a royalty owner's claim for breach of the implied covenant to market. Instead of adopting the *Cabot* rule, this section appears to resurrect the holding of an earlier case, *Amoco Production Co. v. First Baptist Church of Pyote*.[268] Because this marketing covenant is implied in the lease as a matter of fact,[269] the statute's rejection of *Cabot* and resurrection

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263. TEX. NAT. RES. CODE ANN. §§ 91.402(c)(2), (h) (Vernon 1993).

264. The canon of construction known as *expressio unius est exclusio alterius* provides that when the "things to which [a statute] . . . refers are designated, there is an inference that all omissions should be understood as exclusions"). 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 47.23, at 216 (5th ed. 1992).

265. Ernest E. Smith, *The New Division Order: Legal and Practical Aspects*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (manuscript at 24, on file with the *St. Mary's Law Journal*). Professor Smith concludes that "whether intentionally or not, the division order statute may have overruled *Gavenda v. Strata Energy*." *Id. But see* Martin R. Bennett, Comment, *Division Orders: Impact of the Payment for Proceeds of Sale Statute*, 47 BAYLOR L. REV. 513, 521 (1995) (questioning whether division order statute alters holding in *Gavenda*).

266. 754 S.W.2d 104 (Tex. 1987).

267. TEX. NAT. RES. CODE ANN. § 91.402(h) (Vernon 1993).

268. 579 S.W.2d 280 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1981). In *Pyote*, the court enforced the implied covenant of marketing against a lessee despite the terms of its division orders. *Id.* at 283–84; *see also* discussion *supra* Part II.A.2.

269. *See, e.g.*, Danciger Oil & Refin. Co. of Tex. v. Powell, 137 Tex. 484, 154 S.W.2d 632 (1941) (implying covenants as matter of fact so as to carry out parties' intentions); Texas Pacific Coal & Oil Co. v. Stuard, 7 S.W.2d 878, 881 (Tex. Civ. App.—Eastland 1928, writ ref'd) (holding that implied obligation to properly develop premises "became a part of the written contract"); Petroleum Producers Co. v. Steffens, 139 Tex. 257, 162 S.W.2d 698, 699 (1942) (finding that lease terms implied obligation on lessee "to drill offset wells and development wells"); *see also* RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 8.1, at 445–48 (3d ed. 1991) (examining nature of covenants implied in oil and gas lease).

of *Pyote* comports with the goal, as expressed in the statute's legislative history, of preserving royalty owners' rights under their previously negotiated leases.[270] The rejection of *Cabot*, however, contradicts the purpose of the statute as stated in the bill analysis, which describes the statute as enacting existing law.[271] In the next section, however, this Article determines that the Texas statute effectively has adopted, and clarified, existing case law regarding another issue, the effect of a third-party purchaser's division order on the lessee's royalty obligations.

E. *The Statute's Treatment of Third-Party Purchasers*

In the preceding sections, the primary goal of this Article has been to analyze the effect of division orders on the lessee's royalty obligation, focusing on division orders sent by lessees to their lessors. Frequently, however, and particularly in the payment of oil royalties, a division order is sent to the lessor by a third-party purchaser.[272] Because the lessee is not a party to this lessor/third-party

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270. As described in the text, the statutory terms repeatedly enforce the supremacy of the lease royalty clause, and overruling *Cabot* fits with this scheme.

271. HOUSE COMM. ON ENERGY, BILL ANALYSIS, Tex. S.B. 1605, 72d Leg., R.S. 1991. *But see* Martin R. Bennett, Comment, *Division Orders: Impact of the Payment for Proceeds of Sale Statute*, 47 BAYLOR L. REV. 513 (1995) (noting statutory provisions that suggest *Cabot* has not been overruled); 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 6.5, at 299 (1996) (noting lessees could argue that instead of overruling *Cabot*, the Natural Resources Code has codified it, but recognizing that such argument makes subsection (h) "superfluous" and is inconsistent with subsection (c)).

272. Stuart C. Holliman, *A Basic Overview of Division Orders*, *in* STATE BAR OF TEX., PROF'L DEV. PROGRAM, OIL AND GAS LAW: FOR LEGAL ASSISTANTS AND ATTORNEYS C, C-4 to C-5 (1984). Mr. Holliman explains the different purposes the division order serves for an oil purchaser:

> Under the typical oil royalty clause of an oil, gas and mineral lease, the lessor or royalty owner has the right to take its share of the oil production in kind, and thereby retains title to the royalty oil until it is sold. . . . In contrast, the gas royalty clause in a typical lease provides the royalty owner with a mere right to participate in the proceeds or value derived from the sale of the gas, thereby vesting title to 8/8ths of the gas produced in the lessee at the mouth of the well. . . . The effect of these clauses upon the title to those substances is reflected in the marketing approach to them. With regard to oil, because each interest owner has the right to market its own share of the production, the purchaser must secure the commitment of each interest owner to the marketing terms it proposes in order to be assured that it will receive the entire supply of crude oil involved. A purchaser of crude oil, accordingly, will usually prepare a division order for execution by all interest owners under which it obtains a commitment from each of them to deliver their respective share of production. . . . [However,] because title to all of the gas produced is vested in the lessee, the purchaser is required to contract only with the lessee for the purchase of the gas production.

division order, questions have arisen about the effect of such a division order on the lessee's royalty obligation.

In providing satisfactory answers to these questions, it is important to consider the contrasts between the lessor/lessee relationship and the lessor/third-party purchaser relationship. Specifically, the third-party purchaser, having no contract with the lessor, justifiably relies solely on the division order in dispersing the proceeds for the oil or gas. The lessee, on the other hand, by a previously negotiated lease agreement, is obligated to pay royalties to the lessor, an obligation which the lessor does not want clandestinely diminished in a division order.

The legislature, while adopting language that is difficult to decipher, evidently respected the contrasting positions of lessees and third-party purchasers. The statute protects third-party purchasers, through its version of the binding-until-revoked rule, for payments made pursuant to an unrevoked lessor/third-party purchaser division order. In order to protect the lessor's rights in the lease, however, the statute limits the use of the binding-until-revoked rule in the case of lessor/lessee division orders. To further that purpose, the statute also specifically states that a lessor/third-party purchaser division order shall not detract from the lessee's lease royalty obligations. This section of this Article sifts through the statutory provisions which establish these rules. Determining whether these rules reflect extant case law, as proclaimed in the legislative history, necessitates reviewing cases which have considered the effect of third-party purchaser division orders on the lessee's royalty obligation.

1. Case Law

In Texas, two courts reached different results when faced with determining the effect of a lessor/third-party purchaser division order on the lessee's royalty obligation. In a 1989 case, *Williams v. Baker Exploration Co.*,[273] lessors sued three groups—the original lessees, the assignees of the lease, and the purchaser of the oil—for conversion and non-payment of royalties.[274] After the lessors had

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Id. (citations omitted). *But see* discussion *infra* Part IV.A. (questioning whether oil royalty clause properly should be interpreted as reservation of title in lessor).

273. 767 S.W.2d 193 (Tex. App.—Waco 1989, writ denied).

274. *Williams*, 767 S.W.2d at 194.

signed and returned the oil purchaser's division order, the purchaser stopped making the specified royalty payments.[275] Relying on that third-party division order, the lessees and assignees claimed they had no liability to the lessors for the purchaser's failure to pay the royalties.[276] Disagreeing, the court of appeals held that "[*Cabot*] 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."[277]

In a case with similar facts decided a few years before *Williams*, however, another Texas appellate court reached a contrary result. In *Cook v. Tompkins*,[278] a lessor had brought suit against her lessee and several other parties to recover unpaid oil royalties.[279] As in *Williams*, the lessor in *Cook* had executed division orders sent by

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275. *Id.* at 195.

276. *Id.*

277. *Id.* at 196. The court did suggest, however, that the third-party purchaser division order could excuse the lessee from liability if the order contained a provision expressly relieving the lessee of that liability. *Id.* However, that conclusion is incorrect under statutory provisions that were in effect when the *Williams* case was decided. Section 91.401 of the Texas Natural Resources Code, the royalty payment liability statute, was enacted in 1983 to provide remedies for lessors and other payees who do not receive their royalty payments. That section provides that a first purchaser is liable for failure to timely pay royalty payments unless the first purchaser and the producer have agreed that the operator [lessee] shall be responsible for making royalty payments. *See* TEX. NAT. RES. CODE ANN. § 91.401 (Vernon 1993). Under this language, the statute provides a basis for a lessor to recover from the oil or gas purchaser, regardless of a division order. It also determines liability among purchasers and operators. *See* Koch Oil Co. v. Wilbur, 895 S.W.2d 854, 864 (Tex. App.—Beaumont 1995, writ denied) (applying section 91.401 and definition of payor to determine liability of oil purchasers and operators). But the royalty payment liability statute does not purport to relieve the lessee of its lease obligations. Although this statute was enacted six years before the *Williams* case was decided, the court did not address it. In 1991, the statute was amended to add the division order provisions, discussed in Part III herein, which clarified that division orders cannot amend or detract from the lessor's rights in the oil and gas lease. In light of these statutory provisions, as they have existed since 1983, as well as in light of the amendments, it is doubtful that the *Williams* court was correct in concluding that an express provision in the lessor/third-party purchaser division order could have relieved the lessee from its lease liability. Instead, the lessee should have argued that it satisfied those lease terms, particularly its implied covenant to market, in its sale to the purchaser. Or, as the *Williams* court noted, the lessee could have relied on an express lease clause that relieved the lessee of liability after assigning all or part of its interest. *See* Williams v. Baker Exploration Co., 767 S.W.2d 193 (Tex. App.—Waco 1989, writ denied). Unfortunately, the lessee in *Williams* failed to properly plead and prove that point.

278. 713 S.W.2d 417 (Tex. App.—Eastland 1986, no writ).

279. *Cook*, 713 S.W.2d at 418.

the oil purchaser.[280] That purchaser having subsequently become bankrupt, the lessor had not been paid for her oil.[281] Although the court ultimately held that the lessee was not liable, its rationale was not that the lessor/third-party division order automatically absolved the lessee of liability.[282] Instead, the court reasoned that the lessee had satisfied the lease obligations—particularly those obligations imposed under the implied covenant to market—through its sale of the production to the oil purchaser at the current market price.[283]

The *Cook* opinion, although ultimately holding that the lessee was not liable, can be reconciled with the *Williams* court's conclusion that the third-party purchaser division orders did not supplant the royalty obligations established in the lease. The *Cook* court focused on the covenant of marketing, which is implied in the oil and gas lease, and held that the lessee had satisfied the obligations imposed on it by the marketing covenant. By focusing on this obligation, which arose under the lease, the *Cook* court implicitly recognized, as did the *Williams* court, that the third-party division orders had not replaced the lease terms. In light of this similar focus on the lease, the different results in the *Williams* and *Cook* opinions should be attributed to the *Williams* lessee's failure to argue that it had fulfilled its lease obligations, particularly its duties under the implied covenant of marketing.[284]

2. Statutory Provisions

Section 91.402(h) of the division order statute appears to adopt the *Williams/Cook* view that third-party purchaser division orders do not supplant the lease royalty clause. The first sentence of section 91.402(h) provides that "[t]he execution of a division order between a royalty owner and lessee or between a royalty owner

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280. *Id.* at 419.

281. *Id.*

282. *Id.* at 421.

283. *Id.* The *Cook* court relied on the early case *Wolfe v. Texas Co.* *Id.* at 421 n.7 (citing Wolfe v. Texas Co., 83 F.2d 425 (10th Cir.), *cert. denied*, 299 U.S. 553 (1936)). For a discussion of *Wolfe*, see *infra* note 337.

284. While the *Williams* opinion includes no discussion of the implied covenant of marketing, it does note that the lessees may have been able to avoid liability under the lease by relying on a provision in the lease stating that an assignment would relieve the lessee of liability. *Williams*, 767 S.W.2d at 196. However, the lessees failed to raise that point in their pleadings. *See supra* note 277.

and a party other than lessee shall not change or relieve the lessee's specific, expressed or implied obligation under an oil and gas lease."[285] Under this provision, a lessee remains liable under the lease, even after the lessor has signed the lessee's or a third-party's division order. In order to avoid liability, lessees must show that they have fulfilled their express and implied lease obligations.[286]

Thus, with the first sentence in section 91.402(h), the statute fulfills its declared intent to protect the lessor's rights in the oil and gas lease. The next sentence of that section furthers the same purpose by clarifying that lessor/lessee division orders, like lessor/third-party purchaser division orders, cannot detract from the lessor's rights under the lease. Specifically, that next sentence states that "[a]ny provision of a division order between payee and its lessee which is in contradiction with any provision of an oil and gas lease is invalid to the extent of the contradiction."[287] However, this "no contradictions" provision omits the "party other than lessee" phrase found in the prior sentence.

Although one might be tempted to ignore this omission as a mere legislative oversight, established rules of statutory construction would require giving it effect in interpreting the entire provision.[288] Under those rules, the omission of a reference to third-

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285. TEX. NAT. RES. CODE ANN. § 91.402(h) (Vernon 1993) (emphasis added).

286. A lessee could be successful in that effort by establishing, as did the lessee in *Cook*, that the sale of the oil or gas to a third-party purchaser fulfilled its implied covenant to market. *Cook*, 713 S.W.2d at 421. Although a court nevertheless could consider that the express obligation to pay royalties has not been satisfied, if the lessee enters into a contract with a purchaser with terms that satisfy the criteria of the marketing covenant, then the lessee should not be deemed a permanent guarantor of the purchaser's performance. In fact, section 91.401(2) provides that the first purchaser, rather than the lessee, shall be liable for failure to make timely payments unless there is an agreement that the producer or operator will make those payments. TEX. NAT. RES. CODE ANN. § 91.401(2) (Vernon 1993). Although this statutory provision was enacted in 1983, neither the *Williams* nor the *Cook* decisions discussed its effect on the lessees' liability. *See supra* note 236 for a discussion of *Vandenburg* and its misreading of the elements needed to make an operator liable under the royalty payment statute.

287. TEX. NAT. RES. CODE ANN. § 91.402(h) (Vernon 1993).

288. The Texas Government Code recognizes that in enacting a statute it is presumed that all language included is intended to be effective. TEX. GOV'T CODE ANN. § 311.021(2) (Vernon 1988). On the other hand, the canon of construction *expressio unius est exclusio alterius* is applied to omissions. This canon prescribes that "where a form of conduct, the manner of its performance and operation, and the person and things to which it refers are designated, there is an inference that all omissions should be understood as exclusions." 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 47.23, at 216 (5th ed. 1992).

party purchasers must be read as a deliberate exclusion of lessor/third-party purchaser division orders from the dictates of the "no contradictions" provision. Therefore, a purchaser's division order that contradicts the lease royalty clause would be valid until revoked, as provided in section 91.402(g).[289] In contrast, same or similar terms in a lessor/lessee's division order would be negated under the "no contradictions" proviso in the second sentence of section 91.402(h), rendering it useless for a lessee to rely on the binding-until-revoked rule. Instead, the lessee becomes liable for breaching the lease royalty clause, even for payments made pursuant to its contradictory division orders.

By negating terms that contradict the lease only in the case of lessor/lessee division orders, the statute promotes the legislative goal of protecting the lessor's royalty rights as established in its prior agreement with the lessee, the oil and gas lease. Ensuring that the lessor's express lease royalty rights survive after the lessor signs division orders, subsection (h) also expressly protects the lessor's implied rights. In doing so, it appears to resurrect the *Pyote* position regarding the effect of a lessee's division order on the lessee's implied lease obligations. Recall that the *Pyote* decision had held that a division order did not bar the lessor from holding its lessee liable for breach of the implied covenant to market,[290] but that decision was later restricted by the supreme court in *Cabot Corp. v. Brown*.[291] With the statute's apparent revival of the *Pyote* position, as well as its apparent approval of the *Williams/Cook* approach, the implied covenant to market will play a larger role in future royalty payment suits involving both lessor/lessee and lessor/third-party division orders.

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289. Professors Smith and Weaver use the example of unauthorized pooling to illustrate the different effects of the two sentences in subsection (h) on lessees and third-party purchasers. They conclude that extending protection to third-party purchasers, as described in the text, "is consistent with traditional rules of statutory interpretation and with a statutory purpose of protecting royalty owners from covert lease changes accomplished through division orders." 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL & GAS § 6.5, at 296 (1996).

290. Amoco Prod. Co. v. First Baptist Church of Pyote, 579 S.W.2d 280, 288 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1980).

291. 754 S.W.2d 104 (Tex. 1987). *See* discussion *supra* Part II.A.2.

IV. Division-Order Disputes in the Coming Decades

Because the statute maintains the viability of implied covenant complaints even after a lessor has executed division orders, courts in future cases will be required to further clarify the contours of those implied duties. Although an analysis of implied-covenant obligations is beyond the scope of this Article, other division order issues also are destined to confront Texas courts in the decades to come. Many of these disputes will focus on deciphering the division-order statutory provisions discussed earlier in Part III. Because the statute applies only to division orders executed after 1991, previously decided cases will continue to be relevant in resolving future disputes. Moreover, the principles articulated in those cases will be tested as changing market conditions spawn new controversies over the royalty obligation.

New controversies are already challenging Texas courts. One such example is oil royalty litigation in which lessors dispute payments made according to "posted price" provisions in leases and division orders. Another example is cases involving the *Vela* scenario in reverse. This section briefly addresses the implications of these two types of disputes for Texas division-order jurisprudence.

A. *The "Posted Price" Litigation*

Historically, lessors have not disputed royalty payments for oil as frequently as they have contested royalty payments for gas. Until recently, the markets for oil, unlike for gas, had not given lessors reason to challenge their oil royalty payments.[292] Many of those payments were based on the "posted price" for oil,[293] a familiar standard set forth either in the oil royalty clause or in division or-

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292. The oil markets, of course, have historically experienced extreme fluctuations. However, those fluctuations did not cause lessors to challenge the bases used by their lessees in calculating royalty. For a general historical discussion of fluctuations in the oil market, *see* Daniel Yergin, The Prize: The Epic Quest for Oil, Money and Power *passim* (1991)

293. The following clause is an example of a posted price royalty provision:

> paying the market price prevailing in the field where produced on the date same is run or sold; or, if there is no posted price in the field, the posted average price in the field, the posted price average price for Gulf Coast fields of Louisiana for oil of like grade and gravity.

3 Howard R. Williams & Charles J. Meyers on Oil and Gas Law § 642.2, at 502.3 (1995) (citing typical Louisiana lease form).

ders. The term "posted price" developed in the early days of the oil industry, when companies actually posted their prices on fence posts in the oil fields.[294] For decades, royalty owners remained content with royalty payments based on that well-established standard.

Beginning in 1983, circumstances began to change when a commodities market for oil was established on the New York Mercantile Exchange (NYMEX), and lessors began noticing that the NYMEX price frequently exceeded posted prices.[295] Lessors began to claim that their lessees were calculating royalties on the "posted price" and then re-selling the oil through affiliates for the higher NYMEX prices. In response, many lessors—including the states of Texas, California, Alaska, New Mexico, and Colorado, as well as private land owners—brought suit against the major oil companies challenging their age-old practice of calculating royalties on the basis of "posted prices."[296]

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294. Jim Henderson, *Oil Bust*, TEX. BUS., Jan.–Feb. 1996, at 28, 29.

295. Craig R. Carver, *Natural Gas Price Indices: Do They Provide a Sound Basis for Sales and Royalty Payments?*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997). One author has described the market changes that led to the posted price litigation as follows:

> Until the mid-1980s, crude was worth whatever the oil companies said it was worth. The game changed when oil futures began trading on the New York Mercantile Exchange, where the market value was established in the trading pit and made public immediately. It was then that posted prices diverged from market value.

Jim Henderson, *Oil Bust*, TEX. BUS., Jan.–Feb. 1996, at 28, 29–31. However, oil producers continued to pay royalties on the lower posted price set by themselves rather than the higher NYMEX price. *Id.* at 31; Josh Kurtz, *Oil Roulette*, SANTA FE REP., June 14–20, 1995, at 11, 11. In refuting the allegations that they have underpaid royalties, the oil company defendants have argued, among other points, that the NYMEX price does not represent the value they have agreed to base royalties upon in their leases. "In other words, the [NYMEX] price is not a price for oil which is produced at a well, but is a commodity trading price affected by different factors than individual wellhead sales." Robert H. Thomas, *Issues in Oil Royalty Litigation*, *in* STATE BAR OF TEX., PROF'L DEV. PROGRAM, ADVANCED OIL, GAS, AND MINERAL LAW COURSE R, R–11 (1996).

296. Craig R. Carver, *Natural Gas Price Indices: Do They Provide a Sound Basis for Sales and Royalty Payments?*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997). In California, officials for the state and the city of Long Beach accused seven of the state's largest oil companies of undervaluing oil produced from federal lands for the past 32 years. Josh Kurtz, *Oil Roulette*, SANTA FE REP., June 14–20, 1995, at 11, 11. The parties settled out of court in 1993 for $345 million. *Study Renews Royalty Issue on California Crude*, OIL & GAS J., May 27, 1996, at 26. The oil companies still failed to admit any wrongdoing. Matthews L. Wald, *Did Oil Firms Shortchange U.S.?*, ORANGE COUNTY (CAL.) REG., Mar. 31, 1996, at A3. The settlement prompted the United States Department of Interior to form an interagency team in 1994 to investigate underpayment of royalties on federal land. *Study Renews Royalty Issue on California Crude*, OIL & GAS J., May 27, 1996, at 26. Cali-

1. The "Retained Ownership" View of the Oil Royalty Clause and Its Effect on Division-Order Analysis

The current "posted price" litigation raises myriad issues, procedural and substantive.[297] For example, courts will be asked to de-

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fornia assisted the agency in its study by obtaining company documents sealed after the settlement. *Id.* The interagency study suggests that major oil companies in California "received premiums above posted prices, but used posted prices as a benchmark for paying royalties during the period 1978 to 1993." Nancy Moore, *Spot Prices for Oil Royalties Suggested*, PLATT'S OILGRAM NEWS, Dec. 18, 1995, at *2–3, *available in* 1995 WL 14219602. It is estimated that as many as "10 oil companies may have underpaid royalties on federal oil produced in California by as much as $856 million during the past 20 years." *Study Renews Royalty Issue on California Crude*, OIL & GAS J., May 27, 1996, at 26. In late August, the U.S. Minerals Management Service initiated a nationwide audit to investigate potential underpayments of royalties for crude oil. *See U.S. and Canadian Industry News: U.S. MMS Hunts Down Royalty Underpayments*, ENERGY ALERT, Aug. 26, 1996, at *1, *available in* 1996 WL 8298373 (noting MMS's intention "to clamp down on producers who paid royalties based on posted prices for their crude while selling it at a premium to posted prices").

Alaska has taken in $3.7 billion in back taxes and royalties from three oil companies since 1978. Josh Kurtz, *Oil Roulette*, SANTA FE REP., June 14–20, 1995, at 11, 11. In Texas, the Texas General Land office is suing ten of the nation's largest oil producers for underpayment of royalties. *See* Texas Gen. Land Office v. Amoco Prod. Co., No. 95–08680 (345th Dist. Ct., Travis County, Tex., Nov. 22, 1995). In another suit, "[a] Texas resident and an Oklahoma foundation . . . filed a class action against 26 major oil companies and marketers alleging a conspiracy to fix prices." Hillary Durgin, *Suit Accuses 26 Oil Firms of Price Fixing*, HOUS. CHRON., Apr. 12, 1996, at *1, *available in* 1996 WL 5592342. This second suit "seeks to represent any royalty owner who received payment for oil from anywhere in the continental United States, except for Alaska, New York, Ohio, Pennsylvania, West Virginia and the Wilmington Field at Long Beach, California." *Id.*

According to a recent study commissioned by the Land Offices of Texas, New Mexico, and Colorado, oil companies have been underpaying royalty owners by 3% to 6%. Jim Henderson, *Oil Bust*, TEX. BUS., Jan.-Feb. 1996, at 28, 28. This 1994 study, conducted by the Dallas-based Summit Resource Management, Inc., concluded that the posted price "is arbitrary and only loosely related to the actual market value of oil." *Id.* at 29. The Summit Report explains that "[t]he posted price usually has absolutely no bearing on the actual value of the crude oil and is used only for accounting purposes and to reduce royalty and tax payments." SUMMIT RESOURCES MANAGEMENT, INC., CRUDE OIL ROYALTY PAYMENT ANALYSIS: REPORT TO THE STATE LANDS OFFICES OF COLORADO, NEW MEXICO, AND TEXAS (Feb. 21, 1995).

297. The substantive issues asserted in the suit filed in Texas by the General Land Office include whether the defendants violated: (1) their express obligations assumed under leases and division orders; (2) their implied duty to market with due diligence and obtain the best price reasonably possible; (3) their statutory duties as lessees under sections 52.131, 32.155 and 34.057 of the Texas Natural Resources Code and sections 66.74 and 109.75 of the Texas Education Code; (4) their duty as merchants under the UCC to act reasonably and in good faith and fair dealings; and (5) their duty to properly account and pay production taxes on royalties. Plaintiffs' First Amended Original Petition at 8–10, Texas Gen. Land Office v. Amoco Prod. Co., No. 95–08630 (345th Dist. Ct., Travis County,

cide whether the implied covenant of marketing applies to the companies' actions, and if it does, to decide whether the companies' pricing and marketing practices have violated that covenant.[298] In answering those and other questions, the courts first

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Tex., Nov. 22, 1995). The procedural questions raised by the petition include whether the controversy can be appropriately certified as a class action and the effect of the statute limitations on the plaintiffs' claims. It is important to note that in deciding these issues, the courts should consider the extensive statutory schemes in place regarding leases on state lands and the calculation and payment of royalties to the state. There are many different types of state lands: public school lands, relinquishment act lands, free royalty lands, University of Texas system lands, state park lands, eleemosynary and state memorial park lands, and lands owned by departments, boards or agencies of the State of Texas. *See* H. Philip Whitworth, *Leasing and Operating State-Owned Lands for Oil and Gas Development,* 16 TEX. TECH L. REV. 673, 675–86 (1985) (distinguishing various state lands which may be leased and developed for oil and gas). The authority to regulate operations on state lands has been conferred by statute to the General Land Office, the School Land Board, and various boards for lease. *See* TEX. NAT. RES. CODE ANN. §§ 31, 32, and 34 (Vernon 1993 & Supp. 1997) (establishing various administrative authorities to regulate operations on state lands). These authorities have individual statutory schemes that address both the leasing and the calculation and payment of royalties to the state. *See generally* 31 TEX. ADMIN. CODE § 9.5 (West 1996) (listing procedures in which state properties are leased for exploration and development of oil and gas and applicable regulatory scheme). For example, the General Land Office relies on market value for computing and paying royalties to the state. *Id.* § 9.7(b)(1)(E)(i). Furthermore, because the Division Order statute expressly does not apply to a majority of state owned lands, these statutory schemes assist in determining the role and function of division orders on royalty payments owed to the state. *See* TEX. NAT. RES. CODE ANN. § 91.405 (Vernon 1993) (exempting lands controlled by board of regents of The University of Texas System and by General Land Office from provisions of division order statute).

298. The primary contention regarding the scope of the implied covenant of marketing is whether or not the lessee has a duty to place the lessor's interests above its own in marketing the oil or gas. For example, in *Amoco Production Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280, 288 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1980), the court concluded the lessee had breached the covenant because the marketing arrangement, which was advantageous to Amoco and some of its lessors, did not satisfy the standard as applied to the plaintiff lessor.

The recent posted price litigation raises issues frequently raised in suits alleging breach of the implied covenant to market. Courts have questioned marketing practices that appear to benefit only the lessee, and not the lessor, in making sales to affiliates. For example, in *Texas Oil & Gas Corp. v. Hagen*, the court imposed a strict burden when the lessee sold gas to an affiliate. 683 S.W.2d 24 (Tex. App.—Texarkana 1984), *aff'd in part, rev'd in part*, 31 Tex. Sup. Ct. J. 140 (Dec. 16, 1987), *withdrawn, set aside, dism'd as moot*, 760 S.W.2d 960 (1988). But courts have noted that sales to affiliates do not constitute an automatic violation of the marketing covenant. *See, e.g.*, Shelton v. Exxon Corp., 719 F. Supp. 537, *aff'd in part, rev'd in part*, 921 F.2d 595 (5th Cir. 1991); Parker v. TXO Prod. Corp., 716 S.W.2d 644, 646 (Tex. App.—Corpus Christi 1986, no writ). *See* Jacqueline Lang Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 VAND. L. REV. 1473, 1510 (1981) (discussing implied covenant to market); Roger D. Williams, *Lessee Duties and Lessor Rights in Gas Contracting Under the Implied Marketing Covenant*

must address a concept that has been at the periphery of division-order jurisprudence, a concept this Article refers to as the "retained ownership" view of the oil royalty clause. This "retained ownership" view of the oil royalty clause could justify a conceptual approach to oil division orders different from the approach developed in the courts for gas division orders.

The basis for the "retained ownership" theory for oil begins with the language of the oil royalty clause itself. In addition to permitting lessees to pay oil royalties on the basis of posted prices, the typical clause provides the lessee with another option, the right to pay the royalty "in kind" by delivering a fractional share of the produced oil to the lessor.[299] Such an in-kind provision is common in the oil royalty clause because oil, unlike gas, can be easily and economically stored and transported.[300]

Because of the in-kind oil royalty provision, many commentators and courts have advanced the theory that, after executing the lease, the lessor retains title to the fractional share of the oil as stated in the lease, which historically has been 1/8th.[301] Having retained title to that oil, this theory proceeds, the lessor uses the division order as a contract to sell the lessor's oil to the purchaser.[302] Based upon

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of Oil, Gas, and Mineral Leases, 26 TULSA L.J. 547 *passim* (1991) (examining lessee duties and lessor rights under implied marketing covenants of oil and gas leases).

299. A typical clause providing the right to pay oil royalty in-kind reads:

> The royalties to be paid by Lessee are as follows: On oil, one-eighth of that produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipe line to which the wells may be connected. Lessee shall have the option to purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase.

AAPL Form 675 Oil and Gas Lease, *in* EUGENE O. KUNTZ ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 12 (2d ed. 1993).

300. *See supra* note 7.

301. *See, e.g.*, Stuart C. Holliman, *A Basic Overview of Division Orders*, *in* STATE BAR OF TEX., PROF'L DEV. PROGRAM, OIL AND GAS LAW: FOR LEGAL ASSISTANTS C, C–25 (1984); David E. Pierce, *Resolving Division Order Disputes: A Conceptual Approach*, 35 ROCKY MTN. MIN. L. INST. § 16.02[1], at 16–5 to 16–6 (1989); Susan McCready Edwards, Comment, *A Suggested Analysis for Gas Division Orders*, 17 TULSA L.J. 534, 535 (1982); Richard F. Brown, *Texas Division Orders and the Texas Division Order Statute*, THE LANDMAN, Mar./Apr. 1993, at 25. Early Supreme Court of Texas cases that decided whether royalties should be treated as realty or personalty for tax purposes perpetuated this view. *See* Hager v. Stakes, 116 Tex. 453, 294 S.W. 835, 840 (1927).

302. For example, Williams and Meyers define a division order as "[a] contract of sale to the purchaser of oil or gas. The order directs the purchaser to make payment for the value of the products taken in proportions set out in the division order." HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 299 (9th ed. 1994).

this reasoning, lessees could argue that the division order "contract," rather than the oil and gas lease, creates the payment obligation for the retained oil.

This "retained ownership" view of the oil royalty clause could affect the posted price litigation in several respects. For example, if the lessor/lessee oil division order is classified as a contractual sale of goods, then the *Uniform Commercial Code's* covenant of good faith and fair dealing, rather than the lease's implied covenant of marketing, would apply.[303] Similarly, if the lessors have "sold" their oil pursuant to third-party purchaser division orders, then the defendant lessees could argue that they have no contractual liability to the lessors. Moreover, because the "retained ownership" theory requires a different conceptual framework for oil, both parties could argue that case law developed from gas division order cases is inapposite for oil division orders. Under that argument, courts would be faced with the task of creating a separate set of rules regarding oil division orders and the effect of oil division orders on the lessee's royalty obligation.

In deciding whether to view the oil division order differently from the gas division order, courts should scrutinize the cases primarily responsible for perpetuating the "retained ownership" theory. These cases were decided in the 1920s and 1930s, an era of oil and gas jurisprudence marked by doctrinal confusion,[304] when the

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303. U.C.C. § 2-107(1); *see* David E. Pierce, *Resolving Division Order Disputes: A Conceptual Approach*, 35 ROCKY MTN. MIN. L. INST. § 16.04[2], at 16-46 to 16-47 (1989) (concluding that oil division orders logically could be considered sales of goods subject to UCC). Whether the duties imposed by the UCC would differ substantially from those imposed by the covenants implied in the oil and gas lease would be an issue for the courts to decide.

304. A. W. Walker, Jr., *Fee Simple Ownership of Oil and Gas in Texas*, 6 TEX. L. REV. 125, 125-26 (1928). In examining this era of oil and gas jurisprudence, Professor Walker explained the confusion created by early cases:

> [T]here is in the process of evolution today a distinct body of rules of law which may properly be designated the law of oil and gas. . . . As a result of this changing viewpoint many of the early decisions on the subject in this state, which have never been expressly overruled, are, by reason of the effect of recent decisions, no longer authoritative, and serve but to mislead those unfamiliar with the progress of this branch of the law. And indeed, in some instance, these early cases have seemingly confused our present courts, or else there has been a failure to properly appreciate the far-reaching effect of the principles enunciated in recent Supreme Court decisions, with the result that our reports today contain a heterogeneous mass of cases many of which are obviously conflicting and extremely confusing to the searcher after the law.

Id.

courts were asked to determine whether, for taxation purposes, the interests created in oil and gas leases should be treated as realty or personalty. For example, in *Hager v. Stakes*,[305] the Supreme Court of Texas concluded that the in-kind oil royalty provision effectively excepted title from the lessee to the stated fractional share of the oil in the lessor.[306] The lessor's retention of title to this portion of the oil caused the court to conclude that this retained portion was taxable against the lessor as real property.[307]

In reaching this conclusion based on the "retained ownership" view, the *Hager* court had to distinguish an earlier case, *Stephens County v. Mid-Kansas Oil & Gas Co.*[308] *Stephens County* is known for establishing the principle that the oil and gas lease vests the lessee with a fee simple determinable interest in 8/8ths of the oil and gas in place, leaving in the lessor a possibility of reverter and the right to receive its profit from the exploitation of the land by the lessee.[309] In *Hager* the court recognized that the *Stephens County* view of the royalty, as the right to receive a profit, might require labeling the lessor's royalty as personalty rather than realty.[310] Therefore, the *Hager* court distinguished the earlier case of *Stephens County* and stressed that the lease language in *Stephens County* provided the *lessee* with the option to pay in-kind or in cash.[311] Because, in contrast, the in-kind provision in the *Hager* leases was at the option of the *lessor*, the court concluded that the lessor had retained title to the oil, which created a real property interest in the lessor.[312]

In his early influential writings about the nature of estates created by the oil and gas lease, Professor A. W. Walker questioned

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305. 116 Tex. 453, 294 S.W. 835 (1927).

306. *Hager*, 294 S.W. at 840.

307. *Id.* at 842.

308. 113 Tex. 160, 254 S.W. 290 (1923).

309. *Stephens County*, 254 S.W. at 292. *See, e.g.*, RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 1.3, at 30–31 (2d ed. 1991); 1 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 203.3, at 44 (1995); 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 2.2, at 27–30 (1996). Not all jurisdictions view the oil and gas lease as creating a fee simple determinable in the lessee. In fact, Texas is only one of about three jurisdictions adopting that view. RICHARD W. HEMINGWAY, THE LAW OF OIL & GAS § 6.1, at 259 n.32 (3d ed. 1991).

310. *Hager*, 294 S.W. at 839–40.

311. *Id.* at 840.

312. *Id.* at 841.

the distinction made in the *Hager* case.[313] He illustrated that the *Hager* approach would require a case-by-case reading of oil royalty clauses: leases that provided lessees with an option between an in-kind or cash royalty payment would pass all title to the lessee, while those with an in-kind option resting with the lessor would pass title to only 7/8ths of the oil to the lessee.[314] Under this logic, only in the latter situation would the lessor's royalty be considered realty.[315]

In order to avoid the inconsistencies rendered inevitable with this case-by-case approach, Professor Walker suggested that policy required viewing all oil and gas royalties as realty, regardless of variations in the oil royalty clause.[316] Otherwise, as he demonstrated, the oil and gas industry would be hindered in the application of other real property principles, including the dictates of the recording statutes and the Rule Against Perpetuities.[317] To accomplish this policy goal and to avoid conflicting case-by-case decisions, he suggested viewing the lessor's oil royalty, regardless of whether the lessee had the option to pay that royalty in kind, as unaccrued rents.[318] Under this approach, the lessor's royalty would be classified as real property because common law principles consider unaccrued rents as real property.[319]

In a case decided after Professor Walker had published his views, the Supreme Court of Texas disapproved of language in the *Hager* decision. In *Sheffield v. Hogg*,[320] the supreme court expressly

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313. A. W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 1, 34 (1928).

314. *Id.* This example assumes that the lease called for the usual 1/8th royalty.

315. *Id.*

316. *See id.* at 37 (demonstrating why it is "highly desirable" to consider all royalty interests as land interests).

317. *Id.* at 13, 38. In Kansas, for example, nonparticipating royalty interests are void under the Rule Against Perpetuities (RAP) because that state has not viewed those interests as vested real property interests. *See* Cosgrove v. Young, 642 P.2d 75, 83–84 (Kan. 1982). In *Cosgrove*, the court held that an instrument executed in 1918 created an interest in royalties from future leases and, as such, was subject to RAP. *Id.* The court concluded that because the interest might not vest within the RAP period, the interest was void. *Id.* *See generally* Laura H. Burney, *A Pragmatic Approach to Decision Making in the Next Era of Oil and Gas Jurisprudence*, 16 J. ENERGY, NAT. RESOURCES & ENVTL. L. 1, 47–48 (1996) (criticizing court's approach in *Cosgrove*).

318. A. W. Walker, Jr., *The Nature of Property Interests Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 1, 40 (1928).

319. *Id.*

320. 124 Tex. 290, 77 S.W.2d 1021 (1934).

pointed to the need to ensure stability in the oil and gas industry, quoting Professor Walker's conclusion that "problems and complications and the resulting confusion of land titles can be avoided by a holding that all royalties . . . regardless of the method of payment, are interests in land."[321] After *Sheffield*, some commentators have concluded that it should be considered well-settled in Texas that the oil and gas lease vests 8/8ths of the oil and gas in the lessee, not 7/8ths, with the lessor retaining a possibility of reverter in 8/8ths.[322] In fact, recent Supreme Court of Texas cases have embraced this view of the estates created by an oil and gas lease.[323]

In addition to questioning the analysis of the tax cases as a matter of policy, Professor Walker questioned their approach to document interpretation.[324] Under the language used in most leases, the in-kind provision in the oil royalty clause arguably should not

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321. *Hogg*, 80 S.W.2d at 1026. The *Sheffield* court's approach represents a pragmatic, yet effective, approach to the taxation issue, an approach I have advocated elsewhere. *See* Laura H. Burney, *A Pragmatic Approach to Decision Making in the Next Era of Oil and Gas Jurisprudence*, 16 J. ENERGY, NAT. RESOURCES & ENVTL. L. 1 *passim* (1996).

322. RICHARD W. HEMINGWAY, THE LAW OF OIL & GAS § 2.5, at 59 n.94 (3d ed. 1991). The prevailing view is that the royalty payment is real property, although payable in money, and the oil and gas lease is viewed as placing the entire mineral estate in the lessee. *See* State v. Quintana Petroleum, 134 Tex. 179, 186–87, 133 S.W.2d 112, 115 (1939) (concluding that interests reserved in mineral leases or conveyed from leasehold estates are realty). In an earlier article, I criticized the tax cases for creating an "estate misconception" about the estates created by an oil and gas lease. Laura H. Burney, *The Regrettable Rebirth of the Two-Grant Doctrine in Texas Deed Construction*, 34 S. TEX. L. REV. 73, 88–89 (1993). Under the "estate misconception," a lessor/grantor considers that she has retained title to 1/8th of the oil *and* the gas because of the royalty clause. *Id.* That misconception leads to problems in conveyancing. Because lessors consider that they own 1/8th of the oil and gas after leasing their lands, they insert the wrong fraction in mineral deeds. *Id.* For example, a lessor intending to convey 1/2 of her interest would use the fraction 1/16, assuming she should multiply 1/2 times her 1/8th royalty. *Id.* at 89. The result has been numerous deeds with conflicting fractions. *Id.* At least one jurisdiction has expressly incorporated the effects of the estate misconception into its interpretative approach. *See* Heyen v. Hartnett, 679 P.2d 1152, 1158 (Kan. 1984). However, the Kansas Supreme Court considered the estate misconception only after ruling that the deed was ambiguous. Recently, the Supreme Court of Texas held that a deed with the conflicting fractions 1/12 and 1/96 unambiguously conveyed a 1/12 mineral interest. In reaching that conclusion, the court considered the estate misconception "instructive" but not "dispositive." Concord Oil Co. v. Pennzoil Prod. Co., 40 Tex. Sup. Ct. J. 33, 40 (Oct. 18, 1996).

323. "When the lessor owns all the mineral estate (8/8) and executes an oil and gas lease, the lessor has conveyed all the mineral estate (8/8) but has retained a possibility of reverter in the entire mineral estate." *Concord Oil Co.*, 40 Tex. Sup. Ct. J. at 39; *see* Luckel v. White, 819 S.W.2d 459, 461 (Tex. 1991) (viewing lease as conveying 8/8ths to lessee).

324. A. W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 1, 40 (1928). Specifically, Professor Walker questioned:

be considered a reservation at all.[325] Indeed, the granting clause of an oil and gas lease purports to convey all of the oil and gas to the lessee.[326] Moreover, traditional rules governing the interpretation of documents require that reservations must be unequivocally stated,[327] which precludes finding reservations by implication.[328] In light of these interpretative rules, courts should not view the in-kind royalty option as a reservation of title to the oil, but instead, as establishing a payment method for the consideration referred to in the granting clause, the royalty.[329] Unlike the "retained ownership" view, such an interpretation is more compatible with rules of

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> And, assuming the correctness of the proposition announced in that decision that the reservation of royalties payable in kind, as expressed in an ordinary type of oil and gas lease, denotes an intention to except title to the royalty oil from the grant, about which the writer confesses considerable doubt, does it necessarily follow, because title to the entire eight-eights of all minerals upon which the royalties are payable in money are regarded as passing to the lessee, that the unaccrued royalties that are payable in money are personalty?

Id.

325. *Id.* at 40–41. *But see* 3 EUGENE O. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS LAW § 39.2(b), at 285 (1989) (writing, "[t]he effect of providing for delivery of royalty oil in kind is to retain title to such oil in the lessor.").

326. A. W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 1, 8–9 (1928); *see also Stephens County*, 113 Tex. at 168, 254 S.W. at 292 (recognizing lease as conveying all oil and gas in place).

327. There is a presumption that a conveyance passes to the grantee all of the estate owned by the grantor, unless there are clear words to the contrary. *See, e.g.*, Waters v. Ellis, 158 Tex. 342, 347, 312 S.W.2d 231, 234 (1958); Cockrell v. Texas Gulf Sulphur Co., 157 Tex. 10, 15, 299 S.W.2d 672, 675 (1956); Brown v. Davila, 807 S.W.2d 12, 14 (Tex. App.—Corpus Christi 1991, no writ). Because a conveyance is construed against the grantor to pass the greatest estate possible, any reservation of interest must be clearly and plainly stated. *See* Graham v. Kuzmich, 876 S.W.2d 446, 448 (Tex. App.—Corpus Christi 1994, no writ); *see also* Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH L. REV. 1, 117–24 (1993) (reviewing application of "greatest estate canon").

328. Courts will not allow a grantor to assert a reservation by implication when the mineral estate is not expressly reserved. Chambers v. Huggins, 709 S.W.2d 219, 222 (Tex. App.—Houston [14th Dist.] 1985, no writ) (stating that "a reservation of minerals must be made by clear language and courts do not favor reservation by implication"). *See generally* RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 3.2, at 123–28 (3d ed. 1991); Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH L. REV. 1, 117–23 (1993).

329. The lessor's royalty is generally referred to as part of the consideration for the lease. RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 8.1, at 446 (3d ed. 1991) (explaining that "[t]he primary interest and consideration of the lessor is in the royalty payments to be returned from production.").

document interpretation and it avoids the unpredictability inherent in a case-by-case approach.[330]

Just as the rules for document interpretation fail to support the "retained ownership" view of the oil royalty clause, precedent provides little reason to adopt that view. While cases explicitly have applied the "retained ownership" view of the oil royalty clause in resolving taxation issues, Texas cases have not expressly embraced that view as a basis for determining the effect of oil division orders on the lessee's royalty obligation.[331] For example, in the *Williams* and *Cook* cases discussed earlier in Part III, the lessees argued that lessor/third-party purchaser division orders were contracts for the

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A typical granting clause reads as follows:

1. Lessor, in consideration of the sum of _____ Dollars ($_____), in hand paid, receipt of which is hereby acknowledged, and the royalties herein provided, does hereby grant. . . .

AAPL Form 675 Oil and Gas Lease, *in* EUGENE O. KUNTZ ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 12 (2d ed. 1993). A recent Texas case apparently has adopted this view of the oil royalty. *See Concord Oil Co.*, 40 Tex. Sup. Ct. J. at 39 (stating, "[w]hen the lessor owns all the mineral estate (8/8) and executes an oil and gas lease, the lessor has conveyed all the mineral estate (8/8) but has retained a possibility of reverter in the entire mineral estate.").

330. Early Texas cases rejected a case-by-case approach to interpreting the granting clause. According to Professor Walker, from 1915 to 1923, "courts . . . determine[d] the nature of the lessee's property interest by an examination of the wording of the granting clause in each particular lease." A. W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 1, 6 (1928). In a subsequent period, which began with *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923), this case-by-case approach to the granting clause was rejected. *Id.* at 7. According to Professor Walker, the Supreme Court of Texas in *Stephens* held "that the ordinary variations in the wording of granting clauses in oil and gas leases are purely superficial and that the parties actually contemplate the creation of the same property interest despite these differences in phraseology." *Id.* at 7–8.

331. *See* Richard F. Brown, *Texas Division Orders and the Texas Division Order Statute*, THE LANDMAN, Mar./Apr. 1993, at 26 (recognizing retained ownership theory has not been adopted by division order cases). For example, in an early oil case, the court stressed estoppel in articulating a pre-*Middleton* binding-until-revoked rule. Hogg v. Magnolia Petroleum, 267 S.W. 482, 484 (Tex. Comm'n App. 1924, judgm't adopted). A later gas division order case relied on *Hogg* without noting conceptual differences between gas and oil division orders. Chicago Corp. v. Wall, 150 Tex. 217, 222–23, 293 S.W.2d 844, 847 (1956). Admittedly, several commentators and treatises have repeated the retained ownership mantra. *See* 3 EUGENE O. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 39.2(b), at 285–86 (1989) (noting royalty clause that provides for delivery of royalty oil in kind retains title in lessor and permits lessor to recover on breach of contract theory); Stuart C. Holliman, *A Basic Overview of Division Orders*, *in* STATE BAR OF TEX., PROF'L DEV. PROGRAM, OIL AND GAS LAW: FOR LEGAL ASSISTANTS AND ATTORNEYS C, C–21 (1984); EUGENE O. KUNTZ ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 249 (2d ed. 1993).

sale of the lessors' oil.[332] As explained above, that argument stems from the notion that oil division orders should be treated as different from gas division orders because of the in-kind provision in the oil royalty clauses. In both cases, however, the courts implicitly rejected that notion by recognizing that the division order did not supplant the express or implied lease obligations.[333] Significantly, the Texas division order statute has codified the *Williams/Cook* view of the oil division order, rather than a contract approach based on the "retained ownership" theory.[334]

In the ongoing "posted price" litigation, courts should heed the words of Professor Walker before designating oil division orders as contracts for the sale of goods based on the "retained ownership" view of the oil royalty clause. As he demonstrated, the cases supply a questionable basis for adopting the "retained ownership" view. Unfortunately, these cases represent a phenomenon common in oil and gas jurisprudence. Rather than striving to adopt overriding principles for oil and gas law to ensure doctrinal consistency and predictability, the early courts created rules in a random

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332. *Cook*, 713 S.W.2d at 420; *Williams*, 767 S.W.2d at 195. In *Williams* the lessees, as appellees, argued that "pursuant to the terms of each division order appellants' royalty oil was sold only to [the purchaser] and not to any appellee, and under the division order each appellant looked solely to [the purchaser] for payment for the oil sold." *Williams*, 767 S.W.2d at 195.

333. In fact, the *Williams* court expressly applied gas division order case law, namely the *Middleton* and *Cabot* cases. However, the court determined that those cases did not require exempting the lessee from liability when the third-party purchaser failed to pay royalties. *Williams*, 767 S.W.2d at 195–96.

334. *See* discussion *supra* Part III.E.2; *see also* Ernest E. Smith, *The New Division Order: Legal and Practical Aspects*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (noting that division order is not contract but affirmation of interest). The statute treats oil and gas division orders the same. Specifically, the definition of a division order in the statute provides that the term means "an agreement signed by the payee directing the distribution of proceeds from the sale of oil, gas, casinghead gas, or other related hydrocarbons." TEX. NAT. RES. CODE ANN. § 91.401(3) (Vernon 1993). The definition of a "payor" in the statute includes division orders signed both between lessors and lessees, and lessors and third-party purchasers. *Id.* § 91.401(2). "Payor" means the party "who undertakes to distribute oil and gas proceeds to the payee, whether as the purchaser of the production of oil or gas . . . or as operator . . . or as lessee." *Id.* The only distinction made in the statute between oil and gas is that the statute provides an optional form for oil only. *Id.* § 91.402(d). However, the National Association of Division Order analysts have promulgated a model form for oil and gas. *NADOA Model Form Division Order*, 21 NADOA NEWSLETTER (Nat'l Ass'n of Division Order Analysts, Dallas, Tex.), July 1995, at 3 (on file with the *St. Mary's Law Journal*). For an excellent discussion of the NADOA form, see Ernest E. Smith, *The New Division Order: Legal and Practical Aspects*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997).

fashion, as they responded to narrow issues for which the common law provided few direct answers.[335] In light of this ad hoc approach, the taxation cases provide weak precedent for adopting the "retained ownership" view of the oil royalty clause as guiding doctrine for resolving division-order disputes. Moreover, recent cases of the Supreme Court of Texas have implicitly rejected the "retained ownership" view of the estates created by an oil and gas lease.[336]

In scrutinizing the taxation cases, courts should also recognize that those cases invoked the "retained ownership" view of the oil royalty clause, in a limited context, in order to accomplish worthy policy goals. Courts also should consider the competing policies of the lessors and lessees in the context of "posted price" disputes. Regardless of the in-kind option for oil, lessors generally rely on the lessees to market both the oil and gas as provided in the lease.[337] As evidenced even in the *Middleton* decision, courts have recognized the need to prevent lessees from using the division order to detract from the lessor's express and implied rights as estab-

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335. Laura H. Burney, *A Pragmatic Approach to Decision Making in the Next Era of Oil and Gas Jurisprudence*, 16 J. ENERGY, NAT. RESOURCES & ENVTL. L. 1, 9–12, 19 (1996); *see* RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 1.3, at 26—34 (3d ed. 1991).

336. *See, e.g.*, *Concord Oil Co.*, 40 Tex. Sup. Ct. J. at 39; *Luckel*, 819 S.W.2d at 461.

337. *See* EUGENE O. KUNTZ ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 248 n.33 (2d ed. 1993) (noting that "[l]essors rarely take royalty oil in kind"); *see also* Wolfe v. Texas Co., 83 F.2d 425, 432 (10th Cir. 1936) (recognizing that lessee can act as agent for lessor in marketing oil but implied covenant is still applicable). The logic of the *Wolfe* case is questionable. The oil royalty clause provided that the lessee would "deliver to the credit of lessor, free of costs, in the pipe line to which he may connect his wells, the equal one-eighth part of oil produced." *Id.* at 427. However, the lessor made no arrangements to store or market the oil. *Id.* In order to justify the lessee's action in marketing the oil to a purchaser, the court viewed the lessee as the lessor's agent. *Id.* at 432–33. If that relationship applies, then the law of agency, rather than the standards imposed by covenants implied in the lease, would govern the analysis of the lessee's actions. The distinction is significant because, while agency rules can create a fiduciary relationship between agent and principal, courts have resisted that heightened duty as between lessors and lessees. *See* David E. Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L.J. 445, 479 (1987) (noting implications of finding agency relationship between lessor and lessee). Yet the *Wolfe* court concluded that the lessee had fulfilled its implied covenant of marketing. *Wolfe*, 83 F.2d at 434. This conclusion is significant because it suggests the court also determined that the implied covenant of marketing applies to oil, despite the in-kind provision of the oil royalty clause, quoted above. *See id.* at 432 (quoting scholars regarding implied covenant to market). Therefore, the *Wolfe* case could represent a rejection of the "retained ownership" view of the oil royalty clause.

lished in the lease royalty clause. To the extent that the cases spawned by gas royalty controversies have respected that policy, those cases should be equally applicable to cases determining the effect of oil division orders on the lessee's oil royalty obligation.[338]

Ultimately, if courts reject the "retained ownership" view of the oil royalty clause, they would simplify division-order jurisprudence in two respects. First, rejecting the "retained ownership" view obviates the need to create case law for oil division orders separate

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338. There will obviously be countless questions for the courts to resolve as they begin to apply these cases to the facts raised in the "posted price" litigation. For example, if the plaintiffs need to avoid the binding-until-revoked rule with the *Gavenda* exception, the unjust-enrichment criterion must be satisfied. In that regard, the plaintiffs may have to show that the lessees benefited because the affiliate transactions used in marketing the oil were shams designed to benefit the lessees by allowing them to calculate royalty on a basis lower than the amount they actually received for the oil. That same evidence will be relevant in supporting that plaintiffs' implied covenant claims. *See* Parker v. TXO Prod. Corp., 716 S.W.2d 644, 647 (Tex. App.—Corpus Christi 1986, no writ). But first, courts must decide whether the implied covenant applies to a "posted price" provision. If that term is treated as synonymous with market value, some commentators consider the implied covenant to be irrelevant. *See* Thomas A. Harrell, *Recent Developments in Nonregulatory Oil and Gas Law*, 31 INST. ON OIL & GAS L. & TAX'N 327, 328–29 (1980); Bruce M. Kramer & Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80's*, 46 LA. L. REV. 787, 815 n.166 (1986). *But see* Jacqueline Lang Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 NAT. RESOURCES J. (forthcoming 1997) (manuscript at 14, on file with the *St. Mary's Law Journal*) (noting that neither *Vela* nor *Middleton* held that market value royalty clause barred implied covenant to market). If the covenant does not apply, then comparable sales should be used to determine the appropriate valuation basis. Yet even that standard involves scrutinizing sales to affiliates. *See* 3 EUGENE O. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 40.4, at 332 (1989) (recognizing that "[i]f . . . the lessee is a corporate affiliate of the purchaser and the sale is not at an arm's length, the sale will not be accepted as representing the market price or market value."). The lower court in *Middleton* recognized that if such sales were not legitimate arm's length transactions, they could not be counted as comparable sales. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 358 (Tex. App.—Houston [14th] 1978), *rev'd in part*, 613 S.W.2d 240 (Tex. 1981). In disagreeing with Exxon's argument that the trial court erred in refusing to consider sales to affiliates, the court stated:

> It would be manifestly unjust for a lessee to sell gas to a subsidiary or to an affiliated firm, person or corporation for a low price and allow that company to extract a larger price in the resale of such product. To allow a lessee to pay royalty out of a shallow pocket while receiving proceeds in a deep pocket would be intolerable.

Id.

As discussed earlier, when the state serves as lessor there are extensive statutory schemes in place that govern. The statute specifically provides that if a transaction is not an arm's length transaction, it will not be a comparable sale needed to determine market value. *See* 31 TEX. ADMIN. CODE § 9.7(b)(1)(E)(ii) (Vernon 1996) (stating, "[i]f a contract is not negotiated at arm's length, or was between affiliated parties, the presumption that market value is equal to gross proceeds shall not apply.").

from case law already developed for gas division orders. Second, avoiding separate treatment of oil and gas division orders would create consistency with the Texas division-order statutory provisions which treat post-1991 oil and gas division orders the same. That consistency is significant because eventually those statutory provisions, rather than case law, will govern disputes regarding the effect of oil and gas division orders on the royalty obligation.

B. *The* Vela *Scenario in Reverse*

Just as market changes for oil have fueled the "posted price" litigation, the restructuring of traditional gas markets has led to a variety of new disputes concerning the gas royalty obligation.[339] For instance, lessees who have been paying royalties pursuant to division orders that contain an "amount realized" standard now would prefer to pay royalties on the "market value royalty" standard, as set forth in the lease.[340] The "market value royalty" standard, in today's deregulated gas market, is potentially lower than the amount the lessees are realizing from their gas sales contracts with third-party purchasers. Therefore, in order to take advantage of the more favorable lease language, lessees have seized upon *Middleton*'s binding-until-revoked rule.[341] Ironically, lessees also are now championing the *Vela* opinion's "plain meaning" interpre-

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339. *See* John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 223-26 (1996) (describing recent changes in natural gas market structure and their effect on natural gas business). One of the new disputes concerning the gas royalty obligation involves determining which marketing charges are deductible. *See id.* at 228 (recognizing new royalty obligation disputes over issues including "incentive payments to the lessee, (*e.g.*, gas inventory charges, reservation fees, supply bonuses) upon production payments to the lessee or upon profits from investment devices such as hedges, trades, or swaps"). *See generally* Owen L. Anderson, *The Gas Royalty Obligation: Is Royalty Ordinarily Payable on the "Raw" Gas at the Mouth of the Well or on "Marketable" Gas?*, 37 NAT. RESOURCES J. (forthcoming 1997) (manuscript on file with the *St. Mary's Law Journal*).

340. Michael P. Irvin, *The Implied Covenant to Market in the Deregulated Natural Gas Industry*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (recognizing that in today's market, where lessees are selling gas at price greater than market value, lessees would rather base royalty payments on lower market value price). See Coastal Oil & Gas Corp. v. De Los Santos, No. 94–12219 (193d Dist. Ct., Dallas County, Tex., Nov. 23, 1994), for an example of a *Vela* case in reverse.

341. *See* Michael P. Irvin, *The Implied Covenant to Market in the Deregulated Natural Gas Industry*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (manuscript on file with the *St. Mary's Law Journal*); Carroll Martin & Jane Webre, *Gas Royalty Issues: Who, What, How and When? Valuation and Payment in Today's Market*, 46 INST. ON OIL & GAS L. & TAX'N § 2.05[1], at 2–10 (1995).

tation of the "market value royalty" standard, an interpretation they loathed when gas prices peaked in the 1970s.

Now that market conditions may have reversed the positions of lessees and lessors, regarding both the interpretation of the "market value royalty" standard and the effect of division orders on the royalty obligation, appellate courts may be asked to reevaluate the *Middleton* and *Vela* decisions. This "reverse *Vela*" scenario raises the following questions. First, can *lessees* revoke division orders under *Middleton*, although that case formulated the binding-until-revoked rule in response to a *lessor's* attempt to avoid the payment provisions in division orders? Second, can a lessee calculate royalties on the "market value royalty" standard even if that standard is lower than the amount actually realized by lessees from gas sales contracts? As explained below, courts are likely to answer both questions in the affirmative.

1. Application of the Binding-Until-Revoked Rule

For lessees, an initial step toward taking advantage of prevailing market-value prices, which could be lower than their contract prices, is to revoke division orders containing "amount realized" standards for calculating royalties.[342] Although *Middleton* clearly held that a lessor could revoke a disadvantageous division order, it took a later case to clarify that the binding-until-revoked rule applies for lessees as well. In *Sun Oil Co. v. Madeley*,[343] Sun Oil's division orders provided for royalty payments that exceeded the

342. For division orders signed after August 26, 1991, the statutory provisions regarding revocation will apply. *See* TEX. NAT. RES. CODE ANN. § 91.402(g) (Vernon 1993). However, for division orders signed before August 26, 1991, *Middleton*'s methods for revoking will apply. *See supra* note 64 (describing how to revoke division order according to *Middleton*); *see also* Stuart C. Holliman, *A Basic Overview of Division Orders* (discussing methods for revoking division orders), *in* STATE BAR OF TEX., PROF'L DEV. PROGRAM, OIL AND GAS LAW: FOR LEGAL ASSISTANTS AND ATTORNEYS C, C-7 (1984). Moreover, it should be noted that both the statutory provision and the *Middleton* opinion provide that division orders are binding only "to the extent that they have been acted on and made the basis of settlements and payments." TEX. NAT. RES. CODE ANN. § 91.402(g) (Vernon 1993); *Middleton*, 613 S.W.2d at 250 (quoting Phillips Petroleum Co. v. Williams, 158 F.2d 723, 727 (5th Cir. 1946)). Therefore, a lessee who begins making payments according to the lease clause, without having formally revoked the division order, could argue that the "amount realized" standard in the division order is not "binding" because it has not been "acted on." *See* Coastal Oil & Gas Corp. v. De Los Santos, No. 94-12219 (193d Dist. Ct., Dallas County, Tex., Nov. 23, 1994).

343. 626 S.W.2d 726 (Tex. 1981).

requirements of the lease.[344] That error stemmed from Sun's mistaken interpretation of a net-profits clause in the lease.[345] Soon after realizing its error, Sun revoked the division orders.[346] In an effort to force Sun to continue calculating its royalties as set forth in the division orders, the lessors asserted estoppel, ratification and waiver.[347] Relying on *Middleton*, the court rejected the lessors' argument and held that Sun could make royalty payments based upon the lease clause, once the division orders were revoked.[348] *Madeley*, therefore, provides initial support for the lessees' case in the "reverse *Vela*" scenario.

2. Application of the "Market Value Royalty" Standard

Just as *Madeley* affirms the lessee's right to revoke a division order, the *Middleton* and *Vela* opinions support the lessee's right then to pay royalties according to the "market value royalty" standard in the lease, even if that amount is less than the amount the lessee actually receives from its oil or gas sales contracts. The *Vela* and *Middleton* courts applied a "plain meaning" approach to the term "market value" in the gas royalty clause.[349] Both courts treated the lease royalty clause and the lessee's gas sales contract as totally independent of each other and held that market value was to be determined on the day of production.[350] The effect of those judicial holdings was to require the lessee to assume all of the financial risks in contracting to sell the gas.[351]

Having assumed these financial risks when gas prices rose, it is logical for the lessees now to enjoy the benefits bestowed by de-

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344. *Madeley*, 626 S.W.2d at 727.

345. *Id.* The lease contained, in addition to a 1/8th royalty provision, a reservation to the lessors of 1/2 of the net profits from the 7/8ths working interest. *Id.* For several years, the lessee had paid the lessors net profits on both oil and natural gas production. *Id.* Later, the lessee determined that the net profits interest applied only to oil. *Id.*

346. *Id.*

347. *Id.* at 734.

348. *Id.* Sun Oil, however, did not seek reimbursement for past overpayments.

349. *See* John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 223-24 (1996) (recognizing that *Vela* and *Middleton* represent majority view by plainly interpreting "market value" as "the price a willing buyer and seller would agree upon at the time of production").

350. Exxon v. Middleton, 613 S.W.2d 240, 244–45 (Tex. 1981); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968).

351. *See* David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 E. MIN. L. FOUND. § 18.03[b], at 18–28 (1992).

creased market values.[352] Thus, absent lease language expressly prohibiting a lessee from calculating royalties based on amounts that are lower than the amounts the lessee actually received, lessees should be successful in capitalizing on decreased market values in a reverse *Vela* scenario.[353]

3. Application of the Texas Division-Order Statute

In determining the relative rights of lessees and lessors in a "reverse *Vela*" scenario, the statute applies to division orders executed after 1991. And the statutory provisions likely will lead to the same conclusions reached under the foregoing case law analysis. Regarding application of the binding-until-revoked rule, the first question raised above, section 91.402(g)[354] reflects the *Madeley* position that division orders are revokable by both lessees and les-

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352. *See id.*(reasoning that "in a gas market of de-escalating prices, the lessee should be able to reap the full benefit of its contract risk assumption").

353. *Accord* Michael P. Irvin, *The Implied Covenant to Market in the Deregulated Natural Gas Industry*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (manuscript at 64, on file with the *St. Mary's Law Journal*) (contending that, in absence of express stipulation stating otherwise, market value royalty clause should be interpreted literally). Federal regulations have already addressed the problem for lessors in the reverse *Vela* scenario. *See* 30 C.F.R §§ 206.152(h), 206.153(h) (1995). That legislation provides that in no event may a lessee calculate royalties on a basis lower than what the lessee receives. *Id.; see also* Michael P. Irvin, *The Implied Covenant to Market in the Deregulated Natural Gas Industry*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (manuscript at 64 n.207, on file with the *St. Mary's Law Journal*).

In jurisdictions that have adopted the cooperative venture approach, rather than the plain meaning approach, lessors might be successful in arguing that the implied covenant of marketing requires the lessee to calculate royalties on the higher price, whether it be the market value or the lessee's sales contract. Michael P. Irvin, *The Implied Covenant to Market in the Deregulated Natural Gas Industry*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (manuscript at 64–65, on file with the *St. Mary's Law Journal*). *But see* Craig R. Carver, *Natural Gas Price Indices: Do They Provide a Sound Basis for Sales and Royalty Payments?*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (manuscript at 51–52, on file with the *St. Mary's Law Journal*) (considering that *Tara* jurisdictions might allow market value payments that are lower than amounts realized). In a plain terms jurisdiction like Texas, however, some commentators would conclude that the implied covenant of marketing should not provide a means to the lessee's end on this issue. They reason that the covenant is irrelevant when the "market value royalty" lease standard applies because that standard is a fact question requiring objective opinion evidence. Bruce M. Kramer & Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80's*, 46 LA. L. REV. 787, 815 n.166 (1986); *see supra* note 344. Professor Jacqueline Weaver, however, argues that *Middleton* and *Vela* did not foreclose application of the implied covenant of marketing to a "market value royalty" standard. *See supra* note 338.

354. TEX. NAT. RES. CODE ANN. § 91.402(g) (Vernon 1993). The statutory provision reads as follows:

sors. In answering the second question, the lessors will long for an express statutory provision prohibiting lessees from calculating their royalty based on amounts that are lower than the proceeds the lessee receives from its sales contract. The statute, however, contains no such provision. In making such an argument, a lessor might point to section 91.402(i), which states that "the terms 'market value' . . . or other such language . . . shall be defined as the amount realized."[355] But as explained earlier in Part III, under rules of statutory interpretation, that section 91.402(i) only should permit using a division order to replace the lease's "market value royalty" standard with an "amount realized" standard; it should not be interpreted to create a rule that universally equates the definitions of those two standards in oil and gas leases.[356] Although lessors obviously would prefer such a rule for the "reverse *Vela*" scenario, that rule should not apply without lease revisions or future statutory changes.

V. CONCLUSION

In developing division order doctrine, both the courts and the legislature have struggled with the competing policies of producers and royalty owners. In the courts, producers seeking protection from liability and efficiency in the payment process championed the binding-until-revoked rule, as established in *Middleton* and expanded in *Cabot*, for defining their royalty obligation. Royalty owners, on the other hand, loathed the use of the division order to detract from their rights as established in the lease royalty clause. Those owners praised cases such as *Gavenda*, *Pyote*, and *Williams* for providing the protection they deemed warranted by their inferior bargaining position. Ultimately, under case law and the division-order statute, both royalty owners and producers endured deletions from their doctrinal "wish lists."

> Division orders are binding for the time and to the extent that they have been 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. Division orders are terminable by *either party* on 30 days written notice.

Id. (emphasis added).

355. TEX. NAT. RES. CODE ANN. § 91.402(i) (Vernon 1993); *see supra* Part III.B. for a discussion of § 91.402(i).

356. *See* discussion *supra* Part III.B.

Although the Texas division-order statute includes several provisions that require careful study, its terms can be harmonized to articulate a workable set of rules that fairly give and take from the wish lists of interest owners, producers, and purchasers. For example, the statute answers the perennial question of whether royalty owners must sign a division order before receiving payments. By endorsing that condition in a limited context, the statute simultaneously permits purchasers to proceed efficiently with the payment process, and assures lessors that their rights under their leases will not be diminished.

Whether that assurance to lessors is genuine, however, depends upon the particular issue involved. For example, the statute in effect permits the lessee to amend a lease calling for a "market value royalty" standard by allowing the lessee to "clarify" that the actual definition of "market value" is the "amount realized."[357] On the other hand, the division order does not provide a certain shield for the lessee against liability for breach of implied covenants. Nor does the statute permit the lessee to allocate post-production costs to the lessor if the lease clearly prohibits deducting those costs.[358] Yet, a nonparticipating royalty owner in a *Gavenda* situation may find that the binding-until-revoked rule prohibits recovery for past underpayment of royalty, without exception.

Division-order disputes are destined to confront Texas courts in the decades to come. The awkward wording and internal inconsistencies of the current division-order statute will spawn litigation over its meaning and effect. Also, for division orders executed before 1991, because existing case law applies, questions about the interpretations of those cases will persist as a source of dispute. Moreover, market changes have led to new controversies over the royalty obligation. These new disputes, particularly the "posted prices"[359] and "reverse

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357. In the restructured gas market of the 90s and beyond, lessees likely won't have the motivation to "clarify" leases in this manner. As noted previously in Part IV.B., today the market value or spot market prices may be lower than the contract price.

358. The trick, as evidenced in *Heritage Resources*, is drafting language that a court will interpret as expressing that intent.

359. Texas Gen. Land Office v. Amoco Prod. Co., No. 95–08680 (345th Dist. Ct., Travis County, Tex., Nov. 22, 1995). For an article discussing the factors that led Land Commissioner Garry Mauro to sue several major oil companies for underpayment of royalties, see Jim Henderson, *Oil Bust*, TEX. BUS., Jan.–Feb. 1996, at 28.

Vela"[360] disputes, have already resulted in widespread litigation. Additionally, in the prevailing market in which the lessee's marketing function has become more diverse and expensive, the issue of allocating post-production costs will continue to arise. Resolving all of these controversies will require courts, and most likely the legislature, to revisit division-order case law and statutory provisions and to reconsider the competing policies of royalty owners and oil and gas producers.

360. David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 16 E. MIN. L. FOUND. § 18.03, at 18–19 (1992); Michael P. Irvin, *The Implied Covenant to Market in the Deregulated Natural Gas Industry*, 42 ROCKY MTN. MIN. L. INST. (forthcoming 1997) (manuscript at 60–61, on file with the *St. Mary's Law Journal*); *see* discussion *supra* Part IV.C.