

## TO SUSPEND OR NOT TO SUSPEND? THAT IS THE QUESTION!

BY: M. RYAN KIRBY & VY "TINA" HUYNH OF KIRBY, MATHEWS & WALRATH, PLLC

An essential factor in oil and gas exploration and production is the title examination. In examining title, an oil and gas attorney should review every relevant instrument filed of record in the locality where the land is situated. Then, the attorney will prepare a title opinion, based on his/her title examination, expressing the present ownership rights in the subject property. The title opinion should also describe the actions required to cure defects or uncertainties in title. In some cases, where title is not clear or marketable, it may be necessary to suspend payments to a royalty owner until title has been cured.

In order to avoid unnecessary litigation, it is extremely important to be cognizant of the laws involving the payment of proceeds to royalty owners, especially when the suspense of royalty payments is allowed and the quantum that may be suspended.

Working interest owners have the responsibility to pay or cause to be paid any royalties due under the lease agreement from which the working interest owner derived its interest, even if it is not the operator of the well or property.<sup>1</sup> Oftentimes, a working interest owner and royalty owner will disagree on the amount to be paid.

For example, in *Neel v. Killam Oil Co.*,<sup>2</sup> successors-in-interest in a nonparticipating royalty (NPRI) filed a declaratory judgment suit to establish their claimed ownership of one-half (1/2) of the royalty interest in the oil and gas produced under a lease.<sup>3</sup>

The suit involved two subsequent deeds conveying NPRIs. In the first deed, Anita Ugarte de Ortiz conveyed to Joe A. Ortiz an NPRI in September, 1945. In December of the same year, Joe A. Ortiz conveyed his entire interest in the NPRI to George E. Neel, also by deed (the Ortiz-Neel deed).<sup>4</sup> The appellants, Neel and Mayo, are George E. Neel's successors-in-interest.

The Ortiz-Neel deed conveyed to Neel an undivided one-half (1/2) interest in and to all the oil and gas royalty that may be produced from the subject lands. However, the Ortiz-Neel deed noted that if said land was currently under an oil, gas and mining lease or leases, it was agreed that the sale would be made subject to the terms of that subject lease. The deed also had a future lease clause that addressed the royalty amount in the event that any of the current subject leases terminated lapsed or forfeited. Specifically, the future lease clause stated that if there be any such lease or leases, terminate, lapse or is forfeited, then Grantee shall own and be entitled to receive as a free royalty an undivided one-sixteenth (1/16<sup>th</sup>) of all the oil produced and saved from the premises.

When the two 1945 deeds were executed, the land was subject to an oil and gas lease, signed in 1940, which reserved a one-eighth (1/8<sup>th</sup>) royalty interest in production. This 1940 lease eventually expired, and a new lease was executed in 1980, which granted a one-fourth (1/4<sup>th</sup>) royalty in production. While the 1940 lease was in effect, Neel and Mayo received a one-sixteenth royalty (1/16<sup>th</sup>), which was derived by multiplying the one-half (1/2) interest granted in the Ortiz-Neel deed by the one-eighth (1/8<sup>th</sup>) royalty that was reserved in the 1940 lease. After the 1980 lease was executed, Killam Oil Company, Ltd. and Hurd Enterprises, Ltd. (Killam and Hurd) relied on the royalty interpretation approach offered in *Alford v. Krum*<sup>5</sup> and continued to pay Neel and Mayo royalties based on the one-half (1/2) interest granted in the deed, which gave them a one-eighth (1/8<sup>th</sup>) royalty, derived by multiplying the one-half (1/2) interest granted in the deed by the one-fourth (1/4<sup>th</sup>) royalty that was reserved in the 1980 lease.

(Continued on next page)

<sup>1</sup> Tex. Nat. Res. Code § 91.403(2).

<sup>2</sup> *Neel v. Killam Oil Co.*, No. 04-01-00148-CV, 2002 Tex. App. LEXIS 3603 (Tex. App. San Antonio May 22, 2002), op. withdrawn, reh'g denied, 88 S.W.3d 334, 2002 Tex. App. LEXIS 5571 (Tex. App. San Antonio 2002, no pet.)

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at 4.

<sup>5</sup> *Alford v. Krum*, 671 S.W.2d 870 (Tex. 1984).

However, in 1991, the Texas Supreme Court issued an opinion rejecting the Alford approach<sup>6</sup>. Killam and Hurd construed this opinion as altering the interpretation of the Ortiz-Neel deed, and decided that Neel and Mayo were only entitled to a fixed one-sixteenth (1/16<sup>th</sup>) royalty interest in production instead of the one-eighth (1/8<sup>th</sup>) royalty that they were currently receiving. Because the parties could not agree on how to construe the deed, Killam and Hurd completely ceased paying all royalties.

Should they have suspended Neel and Mayo's NPRI? This is where Killam and Hurd, the working interest owners, made a mistake. Regardless of how the deed should have been construed, the parties both agreed that Neel and Mayo were entitled to at least a one-sixteenth (1/16<sup>th</sup>) royalty interest. Thus, the Court held that because Killam and Hurd wrongfully withheld the undisputed one-sixteenth (1/16<sup>th</sup>) royalty interest, Neel and Mayo were entitled to interest on that amount.

The Texas Natural Resources Code provides that payments of proceeds derived from the sale of oil or gas may be withheld without interest beyond the time limits set out in section 91.402(a) when there is a dispute concerning title that would affect distribution of payments.<sup>7</sup> However, if a payment is withheld in violation of section 91.402, the payor must pay interest to a payee.<sup>8</sup> The Court states that the purpose of the statute is to protect royalty owners from intentional payment delays while permitting delays that result from legitimate title disputes.

Although the statutory provisions do not define exactly what qualifies as a title dispute for the purpose of suspending royalty payments without incurring a penalty, the Court states that it would be inequitable to allow Killam and Hurd to withhold payment on those portions of the royalties that they agree are due. Since none of the oil company defendants disputed that Neel and Mayo are entitled to at least a one-sixteenth (1/16<sup>th</sup>) royalty interest, Killam and Hurd owed interest on those royalties that were not in dispute.

What can we learn from *Neel v. Killam*, and how can you and your company avoid the costs of unnecessary litigation or having to pay interest on withheld royalty amounts that were not in dispute? While it may be easier to just hit the "suspend" button and suspend a royalty owner's interest entirely, the most cost-effective way to go about a dispute with royalty interest owners is to allocate the royalty interest on production into two separate accounts: 1) undisputed amount; and 2) amount in dispute, also known as a "suspense account." Operators should use suspense accounts for problems concerning mineral interests (royalties, overriding royalties, production payments, bonuses, delay rentals, shut-in royalties, minimum royalties, net revenue interests, and working interests). Situations that require a suspense account include but are not limited to: a cloud on title, a bad address, and pending litigation over an interest.

As an operator, the smart move would be to establish and enforce standard procedures based on the statutory requirements to be followed by employees who are interacting with royalty interest owners. You will be pleased to see that the inconvenience is definitely outweighed by the benefits.

#### About the Authors:



M. Ryan Kirby is a founding Partner with Kirby, Mathews & Walrath, PLLC. In addition to his legal practice, M. Ryan Kirby is also a frequent speaker at seminars for various Landmen's organizations; he also serves as an Adjunct Professor at South Texas College of Law, where he teaches the Texas Oil, Gas and Land Titles course.

Vy "Tina" Huynh is an Attorney with Kirby, Mathews & Walrath, PLLC. Vy "Tina" Huynh is an attorney licensed and practicing in Texas and a member of the Oil, Gas and Mineral Law Section of the Houston Bar Association and State Bar of Texas.

<sup>6</sup> *Luckel v. White*, 819 S.W.2d 459 (Tex. 1991).

<sup>7</sup> TEX. NAT. RES. CODE ANN. § 91.402(b)(1) (Vernon 2001).

<sup>8</sup> TEX. NAT. RES. CODE ANN. § 91.403(a). (Vernon 2001).