

# To Suspend or Not to Suspend? That is the Question!

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# Title Opinions

- What is a title opinion?
  - An Original Title Opinion is the most common type of title opinion, and provides the client with an attorney's professional opinion regarding the advisability of commencing drilling operations on a particular tract of land.
  - It is a statement of a opinion by an attorney, in the form of a letter, as to the state of the title to land, mineral, royalty or working interests. The opinion will often require that curative instruments be obtained or curative actions be taken, before the property interest is purchased, drilled on, or otherwise dealt with.

# Title Opinions

- What is it for? Why is it needed?
  - Title opinions serve to assure companies and individuals that the exploration or drilling projects they wish to engage in are legally supportable.
  - Title attorneys disclose all discoverable defects and describe the actions required to cure defects or uncertainties in title.

# Title Opinions

- How are working interest owners affected?
  - 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.
  - When the working interest owner suspends payment, the quantum that is suspended can have various potential impacts affecting the working interest owner's time and pocketbook.
  - Thus, in order to avoid unnecessary expense of time and money on litigation, it is extremely important to be cognizant of the laws involving the payment of proceeds to royalty owners.

# Royalty Payments

The following slides will answer the following questions:

- When is it necessary to suspend royalty payments?
- What is the quantum that may be suspended?
- Who is responsible for the royalty payment?
- What happens when there's a dispute on the amount of royalty to be paid?

## Tex. Natural Resources Code §91.402 (a) Time For Payment of Proceeds

- (a) The proceeds derived from the sale of oil or gas production from an oil or gas well located in this state must be paid to each payee by payor on or before 120 days after the end of the month of first sale of production from the well. After that time, payments must be made to each payee on a timely basis according to the frequency of payment specified in a lease or other written agreement between payee and payor. If the lease or other agreement does not specify the time for payment, subsequent proceeds must be paid no later than:
- (1) 60 days after the end of the calendar month in which subsequent oil production is sold; or
  - (2) 90 days after the end of the calendar month in which subsequent gas production is sold.



## Tex. Natural Resources Code §91.402 (b) Time For Payment of Proceeds

- (b) Payments may be withheld without interest beyond the time limits set out in Subsection (a) of this section when there is:
- (1) a **dispute** concerning title that would affect distribution of payments;
  - (2) a **reasonable doubt** that the payee:
    - (A) has sold or authorized the sale of its share of the oil or gas to the purchaser of such production; or
    - (B) **has clear title to the interest** in the proceeds of production;
  - (3) **a requirement in a title opinion that places in issue the title,** identity, or whereabouts of the payee and that has not been satisfied by the payee after a reasonable request for curative information has been made by the payor.

## §91.402 (b) Time For Payment of Proceeds – In Practice

In practice, because they present a lower bar to get over, the most frequent grounds for suspending payments without incurring interest penalties are in the following circumstances:

- (1) a **dispute** concerning title that would affect distribution of payments;
- (2) a **reasonable doubt** that the payee **has clear title to the interest**;
- (3) **a requirement in a title opinion that places in issue the title,**



# Neel v. Killam Oil Co.

- This case presents a dispute of royalty interest in the oil and gas produced under a lease.
- Underlying Facts:
  - The suit involved 2 subsequent deeds conveying NPRI's.
  - Sept. Deed (09/1945): Anita Ugarte de Ortiz conveyed to Joe A. Ortiz an NPRI.
  - Dec. Deed (12/1945): Joe A. Ortiz conveyed his entire NPRI interest to George E. Neel.
    - Granting Language:
      - “an undivided one-half (1/2) interest” in and to all oil and gas royalty that “may be produced” from the subject lands, made subject to any terms if the land was currently under an OGML.
    - Future Lease Clause: “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...”

## Neel v. Killam Oil Co. (*cont.*)

- So, what's the problem?
  - At the time of conveyance, land was subject to a 1940 lease, which reserved a one-eighth ( $1/8$ ) royalty interest in production.
    - Successors-in-interest of the Grantee (Successors) were receiving a one-sixteenth ( $1/16$ ) royalty interest.
      - Derived by multiplying the one-half ( $1/2$ ) granted interest from the Sept. Deed by one-eighth ( $1/8$ ) reserved by in the 1940 Lease.
  - In 1980, a new lease was executed because the 1940 lease expired.
    - New lease granted a one-fourth ( $1/4$ ) royalty in production.
      - A one-eighth ( $1/8$ ) royalty interest was now being paid out to the Successors.
        - Derived by multiplying the one-half ( $1/2$ ) granted interest from the Sept. Deed by one-fourth ( $1/4$ ) reserved by in the 1980 Lease.
        - *Alford v. Krum* royalty interpretation approach was being followed for royalty payments.



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## Neel v. Killam Oil Co. (*cont.*)

- What is the *Alford v. Krum* royalty interpretation approach?
  - The court in *Krum* found that the purpose of the future lease clause is to explain or restate the operative effect of the grant in the granting clause in the event that any present lease terminated and that future leases were executed.
  - Consequently, Texas courts generally have treated the fractional interests in the last phrase of the future lease clause as **nothing more than a restatement or confirmation of the interest deeded in the previous portions of the instrument.**
  - Therefore, Killam did not restrict Successors' royalty interest to the one-sixteenth that was recited in the future lease clause.

## Neel v. Killam Oil Co. (*cont.*)

- Okay, so what's the real problem?
  - In 1991, the Texas Supreme Court issued an opinion rejecting the Alford approach that Killam had been following on their royalty payments to Successors.
  - Based on this opinion, Killam decided that Successors were only entitled to a fixed one-sixteenth (1/16) royalty interest in production instead of the one-eighth (1/8) currently being paid.
  - Because the parties couldn't agree, *Killam completely ceased paying all royalties.*

## Neel v. Killam Oil Co. (*cont.*)

- So what did the court say? Should they have suspended Successors' NPRI?
  - Statutory provisions do not define what qualifies as a title **dispute** for the purpose of suspending royalty payments without incurring a penalty.
  - In *Neel v. Killam Oil Co.*, the Court stated that “it would be inequitable to allow Killam and Hurd to withhold payment on those portions of royalties that they agree are due.”
  - Thus, we can infer that the portion of the payment “in dispute” is that part of the interest that the working interest owner and the royalty owner do not agree on, and that is the portion of the payment that may be suspended.

## Neel v. Killam Oil Co. (*cont.*)

- So what did the court say? Should they have suspended Successors' NPRI?
  - Killam Oil Co. did not dispute that Successors were entitled to at least one-sixteenth (1/16) royalty interest.
  - The “dispute” involved whether Successors were entitled to an additional one-sixteenth (1/16) royalty interest, totaling a one-eighth (1/8) royalty.
  - There was no title dispute that would affect distribution of at least the one-sixteenth (1/16) royalty interest.
  - **So, it would have been inequitable to allow Killam and Hurd to withhold payment on those portions (1/16) of the royalties that they agreed were due.**



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# Consequences for Improper Suspension

- So if there's a dispute, can Working Interest Owners just cease making royalty payments?
  - As previously stated, the *Texas Natural Resources Code* § 91.402(b) 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;**
    - a **reasonable doubt** that the payee **has clear title to the interest** in the proceeds of production;
    - a **requirement in a title opinion that places in issue the title**
  - However, if a payment is withheld in violation of section 91.402, meaning if the conditions enumerated in § 91.402(b) are not met, the operator who suspends the interest *must pay interest to the payee.*

## Tex. Natural Resources Code §91.403. Payment of Interest on Late Payments

- (a) If payment has not been made for any reason in the time limits specified in Section 91.402 of this code, **the payor must pay interest** to a payee beginning at the expiration of those time limits at two percentage points above the percentage rate charged on loans to depository institutions by the New York Federal Reserve Bank, unless a different rate of interest is specified in a written agreement between payor and payee.
- (b) Subsection (a) of this section does not apply where payments are withheld or suspended by a payor beyond the time limits specified in Section 91.402 of this code because of the conditions enumerated in Section 91.402 of this code.
- (c) The payor's obligation to pay interest and the payee's right to receive interest under Subsection (a) of this section terminate on delivery of the proceeds and accumulated interest to the comptroller as provided by Title 6, Property Code



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## Purpose of Tex. Natural Resources Code §91.403. Payment of Interest on Late Payments

- The purpose of §91.403 is to protect royalty owners from intentional payment delays while permitting delays that result from legitimate title disputes.

# What should Killam Oil Co. have done differently?

- Killam shouldn't have been too quick to hit the suspend button and suspend Successors' royalty interest entirely.
- Because a portion of the royalty interest was not disputed, **Killam should have continued payment on the portion of undisputed royalty interest.**
  - This can be done by severing the amount undisputed from the entire amount claimed.

## Lesson Learned

- With all that said and done, what can we learn from *Neel v. Killam*? If you or your company were in Killam Oil Co.'s shoes, what should you do differently?
  1. Don't suspend the royalty owner's interest entirely, unless the entire interest is "in dispute".
  2. Allocate the royalty interest on production into two separate accounts.
    - i. Undisputed amount.
    - ii. Amount in dispute. (a/k/a "suspense account")
- As an operator, the smart move would be to establish and enforce standard procedures on the statutory requirements to be followed by employees who are interacting with royalty interest owners.





Q&A



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