The Do's and Don'ts of Division Orders

The purpose of this paper is to provide practical advice using substantive law to assist mineral owners or their trusted advisors regarding their purpose, promulgation, and use within the industry. The main focus of this paper is division orders under Oklahoma law, and specifically the interplay between division orders and 52 O.S. § 570.1 *et. seq*., better known as the Production Revenue Standards Act ("PRSA"). However, to provide context, this paper will also examine how other states handle various issues related to division orders.

What are Division Orders?

The original purpose of division orders were to serve as agreements between the owner of oil and the purchaser of the oil. As Professor Eugene Kuntz noted in his treatise on Oil and Gas, "[t]he division order is drafted in terms of an order from the owner of oil to the pipeline purchaser, by which the owners warrant title to the oil and authorize payment for such oil in accordance with the terms and conditions set forth in such division order." 3 Kuntz, Law of Oil and Gas § 39.5. He goes on to note that "[t]he division order contains many provisions relating to the terms of the sale of oil, transfers of interest, and ratification of leases; and such order becomes effective as to each party who signs the order, regardless of whether or not all parties eventually sign." *Id*. Terms of division orders vary, but traditionally they constitute a "continuing offer on the part of the owner of oil to sell such oil to the pipeline purchaser under the terms prescribed" and "simply provides that if the owner of oil delivers oil for sale, the purchaser may accept delivery of the oil and thereby consummate a sale under the terms prescribed in the division order."

At the time Kuntz wrote his treatise, he was a describing a market in which lessors commonly sold oil to pipeline companies, and the pipeline companies would in turn pay the royalty owners their share of royalties. Modernly, this process may still occur for small leases, however most lessees now either purchase the oil themselves or ask royalty owners to execute a form

division order to be maintained by the lessee. This modern practice is contemplated by the PRSA which defines a division order as:

> [A]n instrument for the purpose of directing the distribution of proceeds from the sale of oil, gas, casinghead gas or other related hydrocarbons which warrants in writing the division of interest and the name, address and tax identification number of each interest owner with a provision requiring notice of change of ownership. A division order is executed to enable the first purchaser of the production or holder of proceeds to make remittance of proceeds directly to the owners legally entitled thereto and does not relieve the lessee of any liabilities or obligations under the oil and gas lease. Terms of a division order which conflict with the terms of any oil and gas lease are invalid, unless previously agreed to by the affected parties. This subsection shall only apply to division orders executed on or after July 1, 1989.

52 O.S. § 570.11.

As is evidenced by the language of § 570.11, the PRSA is primarily concerned with division orders in which the royalty owner and the lessee come to an agreement regarding the "division of interest" that the lessee or other holder of proceeds is supposed to use in calculating the amount of money owed to the royalty owner. The evolution of the division order from a document intended to warrant title to oil to a document intended to confirm the size of the interest owned by the royalty owner is due to the changing landscape of oil and gas production. At the time of Kuntz's writing about division orders, virtually all wells were drilled vertically and were generally produced from regulatory spacing units of 160 acres or less. However, as technology increased, these regulatory spacing units increased and modernly generally encompass 640 acres or more. The increasing size of these units means that more royalty owners are sharing the oil being sold from each well. At the same time, many of the interests owned by royalty owners are being passed down from one generation to another in increasingly smaller fractions. The combination of an increased geographic area drained by each well and the fractionalization of mineral ownership within that geographic area have created increasingly small fractional interests. The process for determining the size of these interests is also growing in complexity as the chains

of title – which must be examined in order to generate a complete division of ownership within a regulatory spacing unit – get longer and more complex as time goes on.

Thus, the modern division order is primarily concerned with ensuring that the division of interest that a lessee, or other holder of proceeds, uses to pay each royalty owner is correct. However, the PRSA also gives lessee's a reason to want to confirm the contact information and tax ID number of the royalty owner. 52 O.S. § 570.10 provides that the lessee or other holder of proceeds must pay proceeds to the royalty owners within set time periods or else they must incur 12% compound interest on all amounts not timely paid. However, Oklahoma law places no obligation on royalty owners to ensure that their contact information is in the public record or that the lessees have their current contact information. Because of this structure, lessees often wind up owing interest on payments owed to royalty owners whom they are unable to pay on time because they cannot locate the royalty owners to pay them. Thus, lessees or other holders of proceeds are anxious to ensure that they always have up-to-date contact information for anyone entitled to receive royalty from them.

Is Executing a Division Order Necessary?

In Oklahoma there is no requirement that a royalty owner execute a division order. In *Hull v. Sun Refining and Mktg. Co*., 1989 OK 168, 789 P.2d 1272, the Oklahoma Supreme Court stated that:

> The custom and usage that Sun relies upon – execution of a division order as a condition precedent for payment for royalty proceeds – did not survive the enactment of [the PRSA]. Although agents may contract and bind their principals to trade custom and usages, that power does not extend to customs and usages, which are either illegal or contrary to public policy. The requirement that lessors execute division orders before receiving royalty payments conflicts with the sprit and letter of [the PRSA] and is violative of the public policy intended to be promoted through its enactment – prompt payment to royalty owners of proceeds from the sale of oil or gas.

However, this is not true in all jurisdictions. There are three (3) basic approaches nationally. In Texas, New Mexico, Utah, and Ohio, division orders are required before a royalty owner may receive payment. Texas, New Mexico and Utah all provide statutory schemes related to the execution of division orders, with Texas even having a form division order in the statute itself. Ohio does not have a statutory scheme, but case law suggests that a lessee or other holder of proceeds would be entitled to withhold payment of royalties for lack of a signed division order.

In Louisiana and Colorado, a statutory scheme does not excuse lessees or other holders of proceeds from paying royalties if they do not have a signed division order, but these states do place obligations on the royalty owners to provide lessees with their contact information. In Colorado a lessee may withhold payment if a royalty owner refuses to confirm their division of interest in writing. Thus, while these jurisdictions do not expressly require a division order to be executed before payment of royalties, they effectively require all the same information that would normally be contained within a division order to be exchanged between the royalty owner and lessee, otherwise payments may be consequentially withheld by the lessee.

Finally, a number of states follow a similar practice to Oklahoma and do not expressly require division orders to be executed before payment must be made. These states include North Dakota, Pennsylvania, Wyoming, West Virginia, Arkansas, and Kansas. However, similar to Oklahoma, most of these states allow a lessee or holder of proceeds to suspend payment to the royalty owners for various other reasons, such as a defect in title. Some states, such as Kansas, Oklahoma, Wyoming, and Arkansas, allow for the lessee or holder of proceeds to interplead the funds into Court or deposit them into a specific fund for safe keeping. Other states, such as Pennsylvania, North Dakota, and West Virginia, allow the lessee or holder of proceeds to suspend payments without interest if the royalty owners are unlocatable.

What Is the Downside to Executing a Division Order in Oklahoma?

Division orders are conceptually not a bad idea. They provide certainty between the parties regarding a royalty owners division of interest and ensure that the lessee or holder of proceeds has the current contact information for the royalty owner. However, most royalty owners do not have the information sufficient to calculate their division of interest in a particular well or unit. In order to calculate the division of interest, the royalty owner will need to know several things. First, the royalty owner will need to know the size of their interest. Do they own an interest in a five (5) acre tract, or a forty (40) acre tract? They will then need to determine if they own all of the minerals in that tract, or merely a fraction of the minerals in the tract. Since most minerals in Oklahoma are owned fractionally, this is a common problem with the only way of solving it being have the title records examined by a competent landman or title attorney who can interpret the records from patent to present.

However, assuming that a mineral owner knows the exact size of their interest relative to their tract, in order to understand their division of interest as expressed in a division order they will need to know the size of the drilling and spacing unit that embraces their tract so that they may determine what percentage of the entire drilling and spacing unit belongs to them. In addition they will need to know the royalty rate agreed to in the oil and gas lease, pooling order, or other title document from which their interest is derived. Finally, if the well is a horizontal well that drains more than a single mile section, they will need to know the allocation percentage between the section in which they own an interest and any other sections that the well also drains.

Luckily, the PRSA provides that "[p]roceeds from the sale of oil or gas production from an oil or gas well shall be paid to persons legally entitled thereto. . ." 52 O.S. § 570.10(B)(1). This means that the burden is on the lessee or other holder of proceeds to come up with an excuse not

to pay the person those proceeds. In *Hull*, the Oklahoma Supreme Court held that execution of a division order was not a prerequisite to a royalty owner receiving payment of their share of royalty proceeds. *Hull v. Sun Ref. & Mktg. Co.*, 1989 OK 168, ¶ 18, 789 P.2d 1271, 1279. In reaching its decision, the Oklahoma Supreme Court rejected arguments from Sun Refining and Marketing Company that the industry custom of requiring royalty owners to execute division orders prior to paying them should be considered in interpreting the terms of the PRSA. The Oklahoma Supreme Court rejected this view, their reasoning being that by enacting the PRSA, the Oklahoma legislature had determined that the only reason to withhold payment from royalty owners was a lack of marketable title, which they included in the PRSA:

> The Legislature's use of the term "shall" in § 540(A) in relation both to the time when payments must commence and to payments to interest owners with marketable title indicates a legislative mandate equivalent to the term "must," requiring interpretation as a command. . . Because the only condition for which § 540 justifies suspension of royalty payments is the existence of unmarketable title, requiring execution of a division order as a condition precedent to recovery would create a condition for payment neither expressly nor impliedly imposed by the Legislature in a statute written in clear and unambiguous terms.

Hull v. Sun Ref. & Mktg. Co., 1989 OK 168, ¶ 10, 789 P.2d 1271, 1276.

Thus, if there's no obligation to agree to a division of interest in a division order, then royalty owners should avoid signing them gratuitously. It is also the obligation of the lessee or other holder of proceeds to pay the owner correctly; thus, if the division of interest used by the lessee or holder of proceeds is too small, the royalty owner will then have a claim against them for the underpayment. However, if the division of interest used by the lessee or holder of proceeds is too large, resulting in an overpayment to the royalty owner, then the royalty owner may be liable to the lessee or holder of proceeds for the overpayment. *Hull v. Sun Ref. & Mktg. Co.*, 1989 OK 168, ¶ 12, 789 P.2d 1271, 1277. In *Shanbour v. Phillips 66 Natural Gas Co.*, the Oklahoma

Supreme Court recognized that a lessee who overpaid a royalty owner not only had an equitable claim for recoupment but was also entitled to interest on the overpayment from the time the royalty owners should have become aware of the overpayments. *Shanbour v. Phillips 66 Natural Gas Co.*, 1993 OK 128, ¶ 10, 864 P.2d 815, 817.

In short, since the common law and the PRSA give both lessees and other holders of proceeds the rights to recoup from one another in the event that the lessee or holder of proceeds makes a mistake in calculating a parties division of interest, there is no need for the parties to contractually agree as to a decimal interest. A division order is also not necessary to verify the contact information of the royalty owners. This may be done with a simple letter, or if the lessee is a larger and more sophisticated company, a change of address form or even an online portal.

If Division Orders Aren't Necessary, Why Do Lessees Use Them?

Modernly, division orders include many provisions that give them rights well beyond their equitable right of recoupment. Often times division orders will seek to include language which create indemnity obligations that go well beyond the equitable right to recoup overpayments. An example of this language might look something like the following:

> If Owner is overpaid any amount by Payor, Owner shall promptly return such overpayment to Payor. If Owner does not return any such overpayment within ten (10) days after mailing of written notice to Owner's last known address by Payor and Payor thereafter commence a legal proceeding to recover any such overpayment, as part of any judgment in Payor's favor, Payor shall also be awarded all costs and expenses incurred by Payor, including reasonable attorneys fees, in attempting to recoup any such overpayment as may be permitted under applicable law. Payor shall have the right at its sole discretion, to set off from amount owed to any owner from the sale of Oil or from the sale of crude oil, condensate or other liquid hydrocarbons produced from other properties against any amounts which may be owed to Payor by the respective Owner under the provision hereof or any other transactions with Payor.

This provision has broadened the rights of the lessee or holder of proceeds, by creating a very short time limit by which the overpaid royalty owner must pay back any overpaid royalties. It also

provides that the lessee or other holder of proceeds may be entitled to money damages and attorney's fees related to any costs that they have in recovering the money that they accidentally overpaid. This provision also gives them the right to set off the overpaid amounts against any other transaction that they have with the overpaid royalty owner. They have provided the royalty owner with nothing in return for these additional benefits to lessee or other holder of proceeds.

Another common term seen in division orders is a modification to the PRSA's obligation that the lessee or other holder of proceeds pay royalties to the royalty owner timely. While the PRSA allows lessees and other holders of proceeds to aggregate certain amounts of proceeds below one-hundred dollars ($100.00) annually before paying them to the royalty owner, many division orders attempt to modify this statutory scheme for their own benefit. An example of this might be something like the following:

> [I]f the monthly payment due an Owner is less than the great of fifty dollars ($50.00) or the amount under the applicable state law which a purchaser is not required to immediately disburse, Payor may defer such payment, without interest, until the amount payable to said Owner equals or exceeds said amount.

Here again, we see the division order providing rights to the lessee or other holder or proceeds without any compensation. The lessee or other holder of proceeds has now set up a system in which they do not owe any interest on royalties that they can withhold until they reach an amount that the lessee or other holder of proceeds has determined is worth the trouble of paying.

Some division orders even go so far as to include statements that if a royalty owner's title is unmarketable or has other issues, the lessee or other holder of proceeds may withhold proceeds without interest until the defect is cured. An example of this might look something like this:

> Until satisfactory evidence of title is furnished or in the event of any adverse claim to the Oil, lien or dispute at any time concerning title or ownership to the oil, the proceeds, thereof, and/or the Lands, Payor shall have the right at any time and from time to time to withhold payment for oil accruing to the interest or interests affected thereby until such adverse claim, lien or dispute shall have been fully settled,

> without liability for damage or interest to the Owners in any such case, if permitted by applicable state law.

This language cuts the royalty owner out of the opportunity to receive interest for time periods in which their title is unmarketable. Interest that in Oklahoma would otherwise be guaranteed by the PRSA. While this provision does include language which states "if permitted by applicable state law", in *In Re Tulsa Energy, Inc.*, 111 F.3d 88 (10th Cir. 1997), the 10th Circuit Court of Appeals held that such a provision could be applied to a royalty interest in Oklahoma.

What Can I Do Instead of Signing a Division Order?

To the extent that the division order is intended to serve as a way for the royalty owner to provide the lessee or holder of proceeds with information like their current contact information and tax ID number, there is no reason this information cannot be transferred to them without signing an onerous division order. A simple letter stating the current contact information for the royalty owner, the royalty owner's tax ID number, and even any specifics regarding where payment should be directed will place all of this information into the hands of the lessee or other holder of proceeds.

Providing this information to a lessee or other holder of proceeds is generally a good idea, as it serves the practical function of making it easier for them to locate you and pay you the way in which you would like to be paid. Providing a tax ID number also avoids the need for them to withhold taxes from your check, which will avoid a tax penalty for you in the future. Another great way to provide this information is by enclosing an IRS Form W-9 with the letter that gives the lessee or other holder of proceeds all the information that they need to pay you correctly.

Here is an example of a simple letter which might be appropriate:

To Whom It May Concern:

I received a division order from you for my mineral interests in the _________ well in __________ County, Oklahoma. My owner number is _________________. Under Oklahoma law, I decline to sign the division order. *See Hull v. Sun Refining and Mktg. Co*., 1989 OK 68, 789 P.2d 1272.

I have attached a completed Form W-9, which contains my current address and my Taxpayer Identification Number (TIN). Please place me in pay status and please pay me monthly for proceeds greater than twenty-five ($25.00). *See* 52 O.S. § 570.10(B)(3)(c).

In summary, division orders are not required under Oklahoma law and their purpose can easily be accomplished through other means. Modern division orders are almost always used to modify the rights of royalty owners without providing them with any benefits or compensation.