

Q12 – July 2016 – Selected Answer 1

(1) The Texas Railroad Commission (RRC) cannot properly require Allison or Clean Oil to plug the abandoned well. Because Ben owned a working interest at the time the well was abandoned, he can be compelled to plug the well. At issue is who is responsible for plugging an abandoned oil well.

In Texas, the owners of an operating working interest of the well at the time it was abandoned are required to plug a well. In event that they do not, the next group responsible are anyone else who held a non-operating working interest in the property at the time the well was abandoned or ceased to produce. Finally, if neither of these two parties are available to plug the well, the state of Texas will plug the well using funds from the clean oil recovery fund.

Dirty Oil operated the well at the time it was abandoned. Thus, Dirty Oil is primarily responsible for the costs associated with plugging the well. However, because Dirty Oil cannot be found, the responsibility to plug falls on other parties who held working interests in the well at the time the well was abandoned or ceased to be used. Allison owned a nonparticipating royalty interest (NPRI) at the time, because she retained a royalty interest for herself when she conveyed Blueacre to Ben. The owner of an NPRI is not entitled to lease the property, and is considered to have a non-working interest. Accordingly, Allison cannot be held responsible for plugging the well. Ben, on the other hand, owned the executive interest to Blueacre. He was entitled to lease the property to Dirty Oil, which he did so, and thus when the well was abandoned by Dirty Oil, he held a working interest in the tract. In other words, at the time the well was abandoned, Dirty Oil had ceased production and all working interest in the tract had reverted back to Ben under the fee simple determinable term of the oil and gas lease. Thus, because Ben owned a working interest in the tract at the time it was abandoned, he is required to plug the well. Other working interest holders that would qualify include nonparticipating tenants in common.

In the event that a non-operating working interest holder from the time of abandonment cannot be found, the state of Texas will plug abandoned wells using funds from the clean oil recovery fund. The money to plug these wells comes from drilling licenses fees and other income that the RRC receives. Thus, if Ben is unable or refuses to plug the well, the well will be plugged by Dirty Oil.

Clean Oil is not responsible for plugging the well. A subsequent lessee who was not present on the tract when the well was abandoned will never be responsible for plugging the well. They did not hold a working interest in the land when the well was abandoned, and accordingly will not be held responsible for plugging it now.

(2) Clean Oil cannot properly condition payment of the royalty payments to Ben agreeing to sign a division order that includes the requirement that Ben pay to cap the former Dirty Oil well. At issue is (i) what is permitted to be included in a division order, and (ii) whether a lessee can withhold payment for failure to sign a division order that includes an improper statement.

A division order is an order that directs how and to whom royalty payments should be paid. A division order that contradicts a lease is void. Common terms included in a division order are: names and addresses of the royalty interest holders; partition agreements; clauses governing how payment will be handled in the event of a dispute concerning the land; any pooling agreements; and so on. A lessee may withhold royalty payments from a royalty interest holder who refuses to sign a division order that contains these common, permitted terms authorized by statute, and in the event that the royalty interest holder sues for back payments, the royalty interest holder is not entitled to withheld payments. However, a lessee may not condition payment and refuse to pay if a royalty interest holder refuses to sign a division order that contains improper restrictions not permitted by law. In the event that a lessee does condition payment on refusal to sign a division order with improper terms, the royalty interest holder is entitled to withheld payments.

The clause in division order requiring Ben capping the well is not a proper term for a division order under the division order statute. Accordingly, Clean Oil was not permitted to condition payment based on Ben's refusal to sign the division order. Since they have wrongfully withheld royalty payments, Ben and Allison are entitled to receive those payments.

(3) The lease will not terminate if Clean Oil fails to make royalty payments to Allison and Ben. At issue is the effect on an oil and gas lease in the event that a lessee refuses to make royalty payments.

In Texas oil and gas leases, failing to pay royalty interests results in a breach of contract action, not a termination of the lease. Thus, even if Clean Oil refuses to make the royalty payments, the lease will persist. This is because Texas oil and gas leases, and the lease in question between Ben and Clean Oil, is a fee simple determinable. In other words, the lease will continue "so long as oil, gas, or other minerals are produced in paying quantities." Once Clean Oil timely drilled a well that began producing oil in paying quantities, the lease will continue until the well stops producing oil in paying quantities. Paying or failing to pay royalties will not alter the lease, and is instead treated as a breach of contract action.

1. The Texas Railroad Commission cannot properly require Allison, Ben or Clean Oil to plug Dirty Oil's abandoned well. The primary party responsible for plugging an abandoned well is the operator that had control over the well at the time of its abandonment. If the operator cannot be found, then persons with a working interest in the well at the time of its abandonment may be held responsible for plugging the well. Landowners and royalty holders are not responsible for plugging abandoned wells. If neither the responsible operator or persons with working interests in the abandoned well can be located, the Railroad Commission will use funds accrued for the purpose of paying for the clean-up of abandoned wells to pay for plugging the well.

Here, Dirty Oil is the operator who had control over the well at the time of its abandonment. Therefore, Dirty Oil is the party responsible for plugging the well. Given that Dirty Oil has dissolved and none of its shareholders, who would be persons with a working interest in the well, can be found, the Railroad Commission will have to use the Commission fund for plugging abandoned wells to plug the well on the property.

2. Clean Oil cannot properly condition payment of the royalty payments on Ben agreeing to sign a division order that includes the requirement that Ben pay to cap the former Dirty Oil Well. A division order is a written instrument that sets out the fractional interests of persons entitled to a share of production under an oil lease. An oil lessee may withhold royalty payments, without paying interest on those payments, if a lessor refuses to sign a division order that contains statutorily-authorized provisions. By law, division orders may contain provisions that set out the fractional shares of all persons with an interest in the minerals under lease, a description of the relevant property, and other procedural elements. However, lessees are not statutorily authorized to include in division orders a provision requiring royalty holders to plug abandoned wells on the property. Not only are royalty holders not obligated to plug such wells, as discussed above, but such a provision is simply not authorized by statute. An oil lessee that improperly withholds royalty payments in such a situation will be required to pay interest on the royalties withheld.

Here, Clean Oil has sent Ben a division order with the statutorily-unauthorized provision requiring Ben to cap the Dirty Oil in order for Ben and Allison to receive their royalty payments. Because such a provision is not authorized by law, Clean Oil has no right to condition payment of the royalty payments to Ben and Allison on Ben agreeing to sign the division order.

3. The lease will not terminate if Clean Oil fails to make royalty payments to Allison and Ben. The typical oil lease provides for a primary term, in which the lessee may maintain the lease without producing oil in paying quantities. Thereafter, a secondary term begins in which the lessee may maintain the lease so long as it is producing oil in paying quantities. If a lessee fails to produce in paying quantities, a lease may provide that the lessor may nonetheless hold the lease by paying delay rentals. If the lessee does not pay delay rentals, the lease will terminate. However, there is no similar rule with respect to the payment of royalties. If a lessee fails to make royalty payments that are required under a lease, the effect is not to terminate the lease. Rather, the lessee has breached the lease. The lessor, in turn, may sue the lessee for damages.

Here, Ben had a typical oil and gas lease with Clean Oil. The lease had a primary term of three years, and it then allowed Clean Oil to maintain the lease "as long thereafter as oil, gas or other minerals are producing in paying quantities." Clean Oil has timely drilled a well on Blueacre that is capable of producing in paying quantities. Thus, there is no indication that the lease may be terminated for failure to produce in paying quantities. Because Clean Oil is producing in paying quantities, and there is no other provision in the lease allowing Ben to terminate due to improperly withheld royalties or failure to pay royalties, the lease will not terminate if Clean Oil fails to make the royalty payments to Allison and Ben.

1. The Texas Railroad Commission Cannot Properly Require Allison, Ben, or Clean Oil to Plug the Well.

The issue is that Dirty Oil, the previous lessee, failed to plug its abandoned well.

A lessee and any groups tasked with operating the well is required to plug an abandoned oil well in Texas. This duty does not go to lessors or royalty owners. Royalty owners are those that only have a right to percentage of royalties produced from minerals in the property. Furthermore, a new lessee, cannot be forced to plug the well either. The Texas Railroad Commission will plug the well when there are no responsible parties left to plug.

In the instant case, Allison is a royalty owner of the property. This is because she validly conveyed the property to another individual and only maintained a interest in the mineral royalties. As such, she will never be responsible for plugging a well. Since Ben simply leased the land and was not involved in creating the well, he too is not responsible. Clean Oil, as a subsequent lessee, cannot be required to plug either, especially since it was unaware of the well when it purchased. Only Dirty Oil can truly be required to plug this well. Since Dirty Oil no longer exists, the Railroad Commission will be forced to plug the well itself.

Since there are no responsible parties left for creating the oil well, the Railroad Commission will plug the well. The Railroad Commission cannot force any of the other parties to perform this.

2. Clean Oil Cannot Condition Payment of Royalties on Ben Agreeing to Pay for Plugging the Well

The issue is that Clean Oil is attempting to change the terms of the lease through a division order.

The Division Order Statute relating to division orders prevents division orders from being used to change the terms of the lease. They are however, allowed to "clarify" the terms of the lease. However, changes in pay or the responsibilities of the parties may not be changed through a division order as these go far beyond a clarification.

Clean Oil is requesting the Ben pay for the plugging of the well. However, Ben never had any responsibility to plug that well. Furthermore, division orders cannot be used to change the terms of the lease. Putting the burden of plugging the well on Ben would be a tremendous change to their lease's terms and responsibilities. As such, he cannot be allowed to alter the lease through this mechanism.

Since division orders cannot be used to change the terms of the lease, Clean Oil may not condition payments through a division order.

3. The Lease Will Not Terminate if Clean Oil Fails to Make Royalty Payments

The issue is that Clean Oil is breaching the lease by not paying royalties.

Failing to paying royalties of a lease is certainly a breach if unjustified. However, courts generally do not terminate the lease when royalties are not paid. Usually, the provision of damages will be perfectly adequate enough to compensate the lessor.

Clean Oil's only violation is its the unwillingness to pay the royalties. This does not typically lead to termination of the lease. Allison and Ben can certainly seek damages in court for their losses. However, absent extreme circumstances this lease will not end.

The lease will most likely not be terminate, absent some additional issues.