ENERGY LAW

Payment of Proceeds from Production Under the PRSA

The Obligation to Determine Current 'Marketable Title'[1 2]

By Kraettli Q. Epperson

THERE IS A STATUTORY SYSTEM IN PLACE IN OKLAHOMA that controls how the proceeds from production arising from the extraction of mineral interests are paid by the first purchaser of production (purchaser) to the proper persons (the owners legally entitled thereto). How does it work, and does it work?[3]

The Production Revenue Standards Act (PRSA) requires, *"All proceeds from the sale of production shall be regarded as separate and distinct* from all other funds of any person receiving or holding the same *until such time as such proceeds are paid to the owners legally entitled thereto. Any person* holding revenue or proceeds from the sale of production *shall hold such revenue or proceeds for the benefit of the owners legally entitled thereto.* Nothing in this subsection shall create an *express trust*."[4] However, there is an "implied trust" created.[5]

What "production" is the statute referring to? According to Section 570.2(2) of the PRSA: "'Produce,' 'Producing' and 'Production' mean the physical act of severance of *oil and gas* from a well by an owner and includes but is not limited to the sale or other disposition thereof ..." So, the "owner" of a mineral interest, such as the minerals, royalties, working interests, overriding royalty interests, etc. (mineral interests), would be entitled to the proceeds from the "sale or other disposition."

In *Hull*, the Oklahoma Supreme Court explains what must be established to identify who are the "owners legally entitled thereto [to the proceeds of production]": "The lessors have demonstrated the only condition precedent to a recovery under [52 O.S] §540 – *marketable title*."[6] And, by statute, such "marketability of title shall be determined in accordance with the then current title examination standards of the Oklahoma Bar Association."[7]

According to such "current title examination standards of the Oklahoma Bar Association," *"A marketable title is* one free from apparent defects, grave doubts and litigious uncertainty, and consists of both legal and equitable title fairly *deducible of record*."[8]

Practically speaking, the title to any real property interest, including mineral interests, is determined from a review of the local county land records where the subject oil and gas interest is located.[9] The analysis and conclusions derived from this search of the local county land records – relating to mineral interests – are typically set forth in a division order title opinion (DOTO) prepared by a licensed attorney.[10]

In fact, according to the Oklahoma attorney general:

> While the rationale of the previous opinion is incorrect, we adhere to the conclusion expressed in that opinion that the examination of the abstract pursuant to 36 O.S. 5001© *(1981) must be done by a licensed attorney. We reach this conclusion because the examination required by statute would only be useful if the examiner expressed an opinion on the marketability of the title. This constitutes the practice of law by the examiner.*[11]

Hence, the DOTO must be prepared by a "licensed attorney." This DOTO needs to be dated effective after the date of first production to ensure the proper party receives its proceeds. Such

conclusions in a DOTO state: who is the current holder or holders of marketable title to the mineral interests and their specific interest (type and quantity), and who are, therefore, the "owners legally entitled thereto" (*i.e.*, to the proceeds of production).

In advance of drilling and completing a well, the producing party will acquire a drilling title opinion (DTO) by a licensed attorney (to ensure there is a lease or other agreement with everyone holding the right to drill). Thereafter, before distributing proceeds, a DOTO is typically secured to bring the title search current. Then the purchaser can use this information from the DOTO to prepare their "pay decks," which specify the owner and their type and quantum of interest. This information is transferred to a form known as a division order (DO) to be signed by the owner of such production.

As of 1989, the content of such DO was defined (for the first time) by statute:

A division order is an instrument for the purpose of directing the distribution of proceeds from the sale of oil, gas, casinghead gas or other related hydrocarbons which *[1] warrants in writing the division of interest* and the [2] name, [3] address and [4] tax identification number of each interest owner with [5] 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.[12]

This Oklahoma statutory set of terms for the DO tracks closely with the current standard industry form for a DO.[13]

The majority opinion in the *Hull* case was based on the then-current statute that did not mention a DO and stated, "We find that: 1) because the only condition for which 52 O.S. Supp. 1985 §540 justifies suspension of royalty payments is the existence of unmarketable title, failure to execute a division order is not a defense to an action for the payment of proceeds from oil production".[14]

However, the majority opinion in *Hull* also explains, "We note that 52 O.S. Supp. 1985 §540 was amended effective July 1, 1989 [to define the form and purpose of a DO]. We express no opinion as to how the amendment may affect future causes presenting the issue of execution of division orders."[15]

And the minority opinion in *Hull* notes:

To reach this broad-brush "public policy" result, the majority has apparently interpreted §540 in total isolation, for in its own opinion the majority has acknowledged that: …

> 5) The new 1989 amendment to §540, 52 O.S. Supp. 1989 §540 (B), explicitly provides for the execution of division orders as a prerequisite for payment to royalty owners, from and after the effective date of July 1, 1989.

… Certainly the first purchaser may withhold proceeds when title is not marketable, but *demonstration of marketable title alone is not sufficient* in and of itself to cause an owner to be "legally entitled" to receive payment. Clearly then, under §540, 'causes' other than unmarketable title may exist which make an owner not legally 'entitled' to receive payment for proceeds of production. Failure to execute a division order to purchaser to provide that purchaser with directions for payment and setting forth the terms and conditions for the purchase of royalty oil is one such "cause" under §540 which must be met before a royalty owner would be "legally entitled" to be paid from proceeds.[16]

Both the majority and the minority opinions in *Hull* make it clear that – on a go-forward basis – by amending the PRSA in 1989 to add the definition of the DO, the Legislature has added the requirement for the mineral interest owner to sign a DO *before proceeds are paid.* Who has the obligation to properly make the payment of the proceeds from the sale of production of oil and gas to the owners legally entitled to those proceeds? It is important to note that the payments to the owners of royalty and payments to the working interest owners are not necessarily treated the same. Under the PRSA, to whom is the purchaser required to make payments? The following portion of the PRSA explains that obligation. Section 52 O.S. § 570.10. C. 1. provides:

> 1) A *first purchaser* that pays or causes to be paid proceeds from production to the *producing owner* of such production *or*, at the *direction of the producing owner*, pays or causes to be paid *royalty proceeds* from production *to:*
>
> a. the royalty interest owners legally entitled thereto, or
>
> b. the operator of the well, shall not thereafter be liable for such proceeds so paid and shall have thereby discharged its duty to pay those proceeds on such production.

The PRSA also contains several definitions critical to the proper application of the PRSA. The definitions are contained in 52 O.S. §570.2 and provide as follows:

> As used in the PRSA:
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> 1) "Owner" means a person or governmental entity with a legal interest in the mineral acreage under a well which entitles that person or entity to oil or gas production or the proceeds or revenues therefrom;
>
> 2) "Produce," "Producing" and "Production" mean the physical act of severance of oil and gas from a well by an owner and includes but is not limited to the sale or other disposition thereof;
>
> 3) "Producing owner" means an owner entitled to produce who during a given month produces oil or gas for its own account or the account of subsequently created interests as they burden its interest; …
>
> 12) "Working interest" means the interest in a well entitling the owner thereof to drill for and produce oil and gas, including but not limited to the interest of a participating mineral owner to the extent set forth in Section 87.1 of Title 52 of the Oklahoma Statutes.

Look at this above process and these above definitions to see how the PRSA is to be applied. The purchaser has three ways to pay proceeds from production. First, pay the producing owner all the proceeds attributable to the interest owned by the producing owner. What is meant by this language? Presumably, it means all the interest covered by the oil and gas leases owned by the producing owner. So, if the producing owner has leases on one-fourth of the mineral interest in the well, this would allow payment of one-fourth (25%) of all proceeds to that producing owner. After that payment, the purchaser has no further liability for those proceeds. The producing owner would be then responsible for payment of any royalty interest directly to the party legally entitled thereto. The second way to pay royalty is for the purchaser to make payment of the royalty directly to each of the owners legally entitled thereto. The

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third way to pay royalty is for the purchaser to pay the royalty proceeds to the operator. The operator is then responsible for payment of royalty to the owners legally entitled thereto. Under any of the three payment methods above, the purchaser is obligated to pay the producing owner for the producing owner's share of production. If the purchaser pays the royalty proceeds to the producing owner or the operator, the purchaser "shall not thereafter be liable for such proceeds so paid and shall have thereby discharged its duty to pay those proceeds on such production."

The next question to be considered is: After the parties obtain a DOTO and secure DOs based on the ownership that would be represented by the title examiner to include all parties legally entitled to production from the well, what happens if there is a change in ownership of some or all of the mineral interests? In other words, when the purchaser learns of a recorded assignment or deed, how does the purchaser decide whether to change the pay decks to reflect the purported new owner? What information is necessary to change an interest set forth in the original ownership provided in the DOTO? What evidence of title can be relied upon by the party making distribution of proceeds when notice of a change of ownership is received by the party making such distribution?

When changing the payees from such initial set of owners, can the purchaser prepare the pay decks and a transfer order (*i.e.*, a revised DO signed by both the grantee/assignee and the grantor/assignor) based on something less than a proper check of the title in the land records through a supplemental title opinion? This lesser title check might be to rely upon a recorded assignment of a portion of or all "the assignor's/grantor's right, title and interest." If such assignment is by the then-current record holder (or holders) of such specified mineral interest, fine. But if it is from assignors or grantors holding less than such interest "of record," it is clearly inadequate standing alone to identify who holds "marketable record title" to such interest and to change the name of the recipient of the proceeds. Only the original DOTO will show who initially owns 100% of the ownership of record, and only subsequent recorded assignments or deeds from all the then-current record owners, as identified in a supplemental title opinion (by a "licensed attorney"), would support any change in payee.

A DO by its terms typically (see NARO form) requires the owner of production to give notice to the purchaser whenever such title is transferred,[17] and the usual lease terms also call for such notification of a transfer of title.[18] These two requirements might arguably suggest the acquisition of a transfer order[19] signed by both the assignors/grantees (*i.e.*, the initial owners) and the assignees/grantees under a recorded assignment or deed, as such initial owners are shown on the DOTO, purporting to convey a specific interest (or even 100% or all "of the grantor's right, title and interest") would permit the purchaser to change the payee.

But such conclusion would be presuming the recorded assignment or deed was from the true owners. We all know what often happens when we make assumptions without adequate investigation – a "snafu." There could have been a prior recorded assignment or deed from the true owner to a third party other than the grantee on the recorded assignment or deed being offered, so the later recorded assignment or deed conveyed nothing. This is because a person cannot convey an interest they do not own.[20] There is no incentive for the assignor or grantor of a mineral interest to notify the purchaser it has conveyed its interest away to a third party and to thereby prompt the purchaser to halt future payments to the assignor or grantor.

Consequently, 1) if the purchaser makes payments to a new purported owner based solely on the new recorded assignment or deed and a resulting new transfer order (without

a supplemental title opinion) and 2) if a third party was the true assignee under a previously recorded but undisclosed assignment or deed, the purchaser would remain liable to the true owner for missed payments. The purchaser can try to rely on the warranty in the transfer order signed by a non-owner to recover such misapplied monies from such recipient of the funds (assuming there is a "deep pocket" and no lapsed statute of limitation). However, that still leaves the purchaser, as a trustee under an "implied trust," liable to make a duplicate payment to the rightful recipient.

Whenever changing the payee of proceeds from the initial payee under the DOTO and the initial DO based on a new recorded assignment or deed, or whenever a new purchaser takes over purchasing production under a new purchase contract, a prudent step would be to have a supplemental title opinion prepared by a licensed attorney to discover what the public land records reflect about the status of title.

It is certainly true that the purchaser cannot be expected to undertake the enormous burden to *re-check* record title each and every month before making the next monthly payment of proceeds to an owner to ensure title has not been transferred of record. However, the purchaser is still obligated to make the initial due diligence review of the title by securing a DOTO (after the date of first sale of production) and then securing a DO from the then-record owners. Thereafter, if the purchaser is considering changing the recipient of such payments for some reason, such as the receipt of a recorded assignment or deed purportedly from all or some of the initially determined owners, there might be negative consequences upon failure to perform due diligence. Such due diligence may require a supplemental title opinion.

In addition, how can the process be improved? Currently, there is no requirement for the purchaser to place any notice of record in the county records to put owners on constructive notice of the rights of the purchase, and, therefore, this is no way for an owner to determine the purchaser from the county records. The information could be determined by researching records outside of the county records, but such records may not be easy to find, and owners may not know where to look for the information.

A similar problem of records not being recorded and, therefore, not providing constructive notice existed under the pooling statute (52 O.S. §87.1). Owners were being affected by actions of the Oklahoma Corporation Commission in a pooling order, but no notice of the order was required to be recorded in the land records of the county clerk and indexed against the lands involved. In 1993, the pooling statute was amended to require the recording of an affidavit of pooling elections with the pooling order attached.[21] It would be an aid and provide constructive notice to the owners if a similar statute was enacted to require notice by the purchaser be recorded in the land records and indexed against the lands where the production is being produced.

ABOUT THE AUTHOR

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ENDNOTES

1. The author expresses his appreciation for the assistance of Richard K. Goodwin, an attorney from Edmond, for his assistance in drafting this article.

2. Note there is pending before the 2022 session of the Oklahoma Legislature SB1524 that will require (among other changes), for the first time, the signing of a division order before the owner of the proceeds of production will be entitled to receive such proceeds. However, the terms of such bill will not address the topic covered in this article: After having a DOTO and a DO based on such DOTO, when one is changing the payee and the DO due to notice of an assignment of such interest, whether there is a need for a supplemental title opinion.

3. *See* the relevant statute, the Production Revenue Standards Act (PRSA), 52 O.S. Sections 570.1 *et seq.*, and the existing precedential Oklahoma case law, *Hull v. Sun Refining*, 1989 OK 168 (*Hull*).

4. 52 O.S. §570.10.

5. However, as declared by the Oklahoma attorney general: "It is, therefore, the official Opinion of the Attorney General that: The Legislature intended an *implied trust (whether resulting or constructive)* under the provisions of Section 570.10(A) of Title 52. *See Cacy v. Cacy*, 619 P.2d 200, 202 (Okla. 1980); *Littlefield v. Roberts*, 448 P.2d 851, 856 (Okla. 1968); *Bryant v. Mahan*, 264 P. 811, 812 (Okla. 1927). Furthermore, the holder of the revenue or proceeds of oil and gas production is an *implied trustee* who has no rights in or to such revenue or proceeds and who is under a statutory duty to pay the revenue proceeds of oil and gas production to the implied beneficiaries; *i.e., the owners legally entitled thereto*. The holder of the revenue or proceeds of oil and gas production acquires no right, title or interest in such revenue or proceeds." 2008 OK AG 31, ¶22.

6. *Hull v. Sun Refining & Marketing Co.*, 1989 OK 168, ¶18, 789 P.2d 1272, 1280 (note: 52 O.S. §540 became §570.10).

7. 52 O.S. §570.11(D)(2)(a).

8. Oklahoma Title Examination Standard 1.1: Marketable Title Defined.

9. *See* 25 O.S. Sections 10-13, regarding notice, and 16 O.S. Sections 15 and 16, regarding creation of constructive notice. *Also see: Constructive Notice: Oklahoma's Hybrid System Affecting Surface and Mineral Titles* by Kraettli Q. Epperson (89 *OBJ* 40: January 2018).

10. For references to a DOTO, see Model Form Operating Agreement (1989) A.A.P.L. Form 610-1982, Article IV, Titles, A. Title Examination; and *Hull*, para. 3, and 789 P.2d page 1274; and *McClain v. Ricks Exploration Co.*, 1994 OK CIV APP 76, FN 12, 894 P.2d 472, FN 12; and *Fleet v. Sanguine, Ltd.*, 1993 OK 76, FN 20(7), 854 P.2d 892, FN 20(7).

11. 1983 OK AG 281, para. 6-7.

12. 52 O.S. §570.11 Division Order Defined.

13. For instance, see the NADOA Model Form Division Order (Adopted 9/95 – Amended 1/17).

14. *Hull*, ¶10; the PRSA was subsequently amended in 1989 to define the division order.

15. *Hull*, FN7.

16. *Hull*, minority, ¶¶2 and 5; Note: the court places the duty on the mineral owner to establish that it holds "marketable title" and does not require the holder of production proceeds to prove "unmarketable title."

17. *See* the statutory form at 52 O.S. Section 570.11.

18. *See*, for example, any of the Producers 88 Oil and Gas Leases.

19. Note that a DO and a transfer order are not recorded.

20. *Atkinson v. Barr*, 1967 OK 103, ¶22, 428 P.2d 316, 320 – in the absence of a warranty and after-acquired title, a conveyance can only convey what the grantor owns.

21. 52 O.S. Section 87.4.