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A SUGGESTED ANALYSIS FOR GAS DIVISION ORDERS

I. INTRODUCTION

Although natural gas was once flared off as an unprofitable by-product of oil production,¹ increases in natural gas prices and the promise of deregulation² have recently made that industry and its legal instruments the focus of attention in a number of lawsuits.³ Natural gas royalty owners whose payments are based on the price of natural gas have begun to re-examine the lease provisions for those payments, recognizing that a legal uncertainty may carry the potential for a large court recovery.⁴

The division order, a writing directing the royalty payor as to whom and how much to pay, has been used in the petroleum industry since the early part of this century,⁵ yet its legal identity remains less than clear.⁶ Nowhere is this legal anonymity more painfully obvious than when the division order provisions are found to conflict with the lease provisions.⁷ As natural gas prices, and lawsuits, increase, it is imperative that a satisfactory legal analysis be established for the gas divi-

1. Exxon Corp. v. Middleton, 571 S.W.2d 349, 352 (Tex. Civ. App. 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981); *see also* J. CLARK, THE OIL CENTURY 149-53 (1958).

2. *See* 15 U.S.C. § 3331(a) (Supp. III 1979).

3. *See, e.g.*, Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980) (royalty owners challenging meaning of "market value" in the lease); Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981) (royalty owners challenging, *inter alia*, enforceability of gas division orders); Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App. 1977), *writ ref'd n.r.e.* (royalty owners challenging meaning of "sold at the wells" in lease provisions). The Butler opinion neatly sums up the source of most of the current natural gas based litigation: "The basic dispute results from the fact that the price of natural gas in the intrastate market in Texas rapidly escalated from the time the gas discovered under these leases was sold for less than 20¢ per Mcf in 1970 to over \$2.00 per Mcf by early 1975." 559 S.W.2d at 412.

4. *See, e.g.*, Exxon v. Middleton, 571 S.W.2d 349, 355 (Tex. Civ. App. 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981), where at the trial court level the Middletons were awarded \$1,027,299 in damages and \$132,333 in prejudgment interest from just one of the defendants.

5. *See, e.g.*, Elliot, Jones & Co. v. Waurika Oil Ass'n, 253 S.W. 601, 602 (Tex. Civ. App. 1923) (involving a division order executed in 1919).

6. A division order has been called variously a "device," a "supplementary contract," an "instrument" in the nature of a "continuing offer (which may be revoked at any time) to sell" oil to the purchaser under certain specified conditions, and many variations of these terms. It is perhaps all of these.

Gregg, *Title Examination and Division Orders*, 19 INST. ON OIL & GAS L. & TAX'N 29, 29 (1968).

7. In a recent case, such a conflict prompted a royalty owners' class action suit seeking \$988,000 in damages from the defendant petroleum company. Maddox v. Gulf Oil Corp., 222 Kan. 733, 567 P.2d 1326 (1977), *cert. denied*, 434 U.S. 1065 (1978).

sion order so that it may be enforced in its appropriate uses and be protected from abuse by overreaching lessees or plaintiff royalty holders. An analysis of the purposes of the division order and the legal framework underlying the enforcement of oil division orders suggests a related legal framework for gas division orders.

An oil and gas production arrangement, simplified for purposes of analysis, usually involves three parties: the landowner who leases the property for its mineral development; the operator or producer who leases the property from the landowner and conducts all drilling operations on the property; the oil and gas purchaser who contracts with the lessee to purchase the oil and gas produced from drilling on the property.

In part, the lessor's compensation⁸ for leasing property is the royalty interest retained through the lease—a share of the oil and gas production or its value free of the costs of production.⁹ In the typical oil and gas lease, the oil royalty interest is based on an interest in the oil itself or in the proceeds from the sale of the oil.¹⁰ When oil is produced and brought to the surface, it is considered personal property,¹¹ a certain portion of which belongs to the lessor as a royalty interest.

In contrast to the lessor's possible reservation of an interest in the oil itself as a royalty, the lessor of gas reserves only a share of the proceeds from the sale of that commodity¹² due to the difficulty of gas storage and the impracticability of the lessor's choosing to take the gas royalty "in kind."¹³ Title to all gas which may be produced under the lease vests in the lessee at the time the lease is executed and the lessor reserves only a share of the potential proceeds.¹⁴ A gas royalty is an

8. Before drilling begins, the lessor's compensation usually consists of the lease bonus and drilling delay rentals. See generally 1 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS §§ 15.5, 15.6 (1962); 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW 65, 175-76 (1981).

9. 1 E. BROWN, THE LAW OF OIL AND GAS LEASES § 6.00 (2d ed. 1973); 1 E. KUNTZ, *supra* note 8, § 15.4; 8 H. WILLIAMS & C. MEYERS, *supra* note 8, at 656-58.

10. See generally 3 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 659 (1981).

11. See *Shreveport-El Dorado Pipe Line Co. v. Bennett*, 172 Ark. 804, —, 290 S.W. 929, 931 (1927); *Bounds, Division Orders*, 5 INST. ON OIL & GAS L. & TAX'N 91, 91 (1954); *Gregg, supra* note 6, at 30.

12. 3 H. WILLIAMS & C. MEYERS, *supra* note 10, § 643.1. "Although . . . payment in kind provisions are common in oil royalty clauses, such provisions are only infrequently found in gas royalty clauses."

13. "Concerning gas royalties the case is entirely different. Gas cannot be delivered in kind, nor can one-eighth of it be set apart as royalty." S. GLASSMIRE, OIL AND GAS LEASES AND ROYALTIES § 62 (2d ed. 1938).

14. See *Craig v. Champlin Petroleum Co.*, 300 F. Supp. 119, 125 (W.D. Okla. 1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970) ("The defendant, as lessee under the oil and gas leases, was the owner of the entire 8/8 of the gas when produced . . ."); *Tidewater Assoc. Oil Co. v. Clemens*,

obligation on the part of the lessee to pay a certain amount of money to the lessor based on the amount of gas production. The royalty obligation thus creates a debtor-creditor relationship between the lessee and lessor.¹⁵

II. DIVISION ORDERS

The division order is a writing, usually drafted by the purchaser or the lessee, executed by the lessor and all parties holding an interest in the production to be sold.¹⁶ The division order provides the royalty payor with a precise and definite statement of whom and how much to pay.¹⁷ All parties holding interests in the production are asked to sign

123 S.W.2d 780, 783 (Tex. Civ. App. 1938) ("[B]y the grant in the lease ownership and title to all the gas produced from the land passed to [the lessee]."); *see also* AAPL Form 670, Oil and Gas Lease, reprinted in 3 E. KUNTZ, *supra* note 8, § 136.12 (gas royalty clauses provide only for money payment, not for in kind payment, so entire interest in gas, if produced, is in the lessee); R. HEMINGWAY, *THE LAW OF OIL AND GAS* § 7.5, at 325 (1971) ("Title to the gas passes to the lessee upon execution of the lease."); Bounds, *supra* note 11, at 110 ("[T]he title to the gas passes to the lessee in the lease.").

15. Tidewater Assoc. Oil Co. v. Clemens, 123 S.W.2d 780, 784 (Tex. Civ. App. 1938); R. HEMINGWAY, *supra* note 14, § 7.5, at 325 ("The relationship between the lessee and the lessor is not one of principal and agent [as it is in the sale of oil production], but of debtor and creditor."); Bounds, *supra* note 11, at 110 ("When gas is used or disposed of by the lessee the relationship of debtor and creditor arises.").

16. *See generally* 2 E. BROWN, *supra* note 9, § 16.02(4)(D)(2); R. HEMINGWAY, *supra* note 14, § 7.5; 4 H. WILLIAMS & C. MEYERS, *supra* note 10, § 701; Bounds, *supra* note 11, at 91-123; Ethridge, *Oil and Gas Division Orders*, 19 MISS. L.J. 127 (1948).

17. The function of the division order in the oil business is to be implied from the very name itself. It is an order to the person or company purchasing the production from the land directing that person or company to make payment for the value of the products taken in the proportions set out in the division order.

Bounds, *supra* note 11, at 91.

Payment of royalties is usually made on the basis of division orders. A division order is an instrument, required by the purchaser of oil or gas, where there is more than one person interested in the proceeds thereof, fixing the fractional interest of each person entitled to participate in such proceeds.

Brown, *Royalty Clauses in Oil and Gas Leases: Their Nature, Construction and Remedies for Breach Thereof*, 16 INST. ON OIL & GAS L. & TAX'N 139, 184 (1965).

A division order is an instrument required by the purchaser of oil or gas in order that it may have a record showing to whom and in what proportions the purchase price is to be paid. Its execution is procured primarily to protect the purchaser in the matter of payment for the oil or gas.

Wagner v. Sunray Mid-Continent Oil Co., 182 Kan. 81, —, 318 P.2d 1039, 1047 (1957).

The division order is directed to the party paying royalties. The following excerpt is from an oil division order which was the subject of litigation in *Amerada Petroleum Corp. v. Melton*, 139 Okla. 119, 281 P. 591 (1929): "The undersigned, certify and guarantee that they are the legal owners of all wells . . . including the royalty interest and until further notice you will give credit for oil received from said wells as per directions below . . ." *Id.* at 121, 281 P. at 592. For additional examples of division order forms, see 2 E. BROWN, *supra* note 9, §§ 18.06-.07; 6 W. SUMMERS, *THE LAW OF OIL AND GAS*, §§ 1383-1395 (1967); 4 H. WILLIAMS & C. MEYERS, *supra* note 10, §§ 701.1-3.

division orders before the sale of the production will occur,¹⁸ since the division order is intended to provide the purchaser with indemnity for the payments made.¹⁹ The division order usually contains language that it is revocable or that it is to be in effect until further notice.²⁰ It is drafted after a title search by the lessee or royalty payor to establish all interest holders in the production²¹ and contains language to effect the signors' warranty of title.²² Finally, the division order contains specific language as to how the royalty interest owner shall be paid, including where and when payment shall be received, and how the amount of payment, based on the royalty interest, shall be calculated.²³

The division order serves two general purposes, although it may be drafted to accomplish other ends as well. The first purpose is to stipulate the owners of interests in the production and to warrant title in those interests.²⁴ The division order provides the royalty payor with

18. Although a royalty interest holder has a right to receive payment, that right may not be enforceable unless the royalty interest holder has signed a division order. *See, e.g.,* Blausey v. Stein, 61 Ohio St. 2d 264, —, 400 N.E.2d 408, 410-11 (1980) ("We hold that the requirement that appellant execute a division order prior to receiving her royalty payments does not contravene any specific provision of the lease, and is not such a burden that it can be considered an attempted modification of the agreement."). *But see* 2 E. BROWN, *supra* note 9, § 16.02(4)(D)(2) (suggesting that the lessee who withholds royalty payment until the royalty owner has signed a division order may be liable for breach of his express lease obligation to pay royalties as well as breach of the lessee's implied covenant to market the production).

19. *See* Gregg, *supra* note 6, at 30:

The necessity for a division order for the protection of the purchaser is obvious. The oil and gas when produced become the personal property of those owning it; and, in order to avoid liability for conversion, the purchaser has the duty and obligation to determine the ownership of the personal property which he is receiving for his own use, and to secure the agreement of the owners to his taking and the terms thereof.

See also Wagner v. Sunray Mid-Continent Oil Co., 182 Kan. 81, —, 318 P.2d 1039, 1047 (1957) ("[A division order's] execution is procured primarily to protect the purchaser in the matter of payment for the oil and gas . . ."); Blausey v. Stein, 61 Ohio St. 2d 264, —, 400 N.E.2d 408, 410 (1980) ("A division order is a direction and authorization to the purchaser of oil to distribute the purchase price in a specified manner."); 4 H. WILLIAMS & C. MEYERS, *supra* note 10, § 701 ("There is, then, an obvious need for protection for the distributor of such fund against liability for improper payment. To meet this need, instruments known as division orders . . . are employed."); Brown, *supra* note 17, at 185 ("[T]he main purpose of the typical division order is to protect the purchaser of products produced on a lease in a division of the proceeds, paid by him . . .") (emphasis in original).

20. 2 E. BROWN, *supra* note 9, § 16.02(4)(D)(2) (terminability at any time is a distinguishing feature of the division order).

21. For a description of this process, *see* Gregg, *supra* note 4, at 34-46, 85-88.

22. "The undersigned hereby certify and guarantee that they are the legal owners in the proportion set out below of all the oil produced from . . ." 4 H. WILLIAMS & C. MEYERS, *supra* note 10, § 701.1.

23. "Provisions concerning the price of casinghead gas and natural gas tend to be rather complex by reason of the difficulty of allocating costs and profits to various aspects of a continuous process of gathering, treatment, transportation, and sale." 4 H. WILLIAMS & C. MEYERS, *supra* note 10, § 704.6, at 672.

24. When production commences and the lessee attempts to market production, the pur-

indemnity for the *parties* who are paid. The second purpose of the division order is to provide a specific basis for the calculation of royalties, including a designation of which costs and taxes shall be deducted from the royalty amount.²⁵ The division order also provides the royalty payor with indemnity for the *amount* paid.

A division order most often becomes the basis of a lawsuit where its provisions conflict with the provisions of the lease as to the payment of royalties.²⁶ The lessor or royalty owner may not notice any conflict between the lease and the division order initially and may accept royalty payments according to the division order for some time before such difference reaches his attention.²⁷ Once the difference becomes apparent to him, the royalty owner may revoke the division order, precluding any future payments until the conflict is resolved. The legal controversy arises when the royalty owner challenges those payments

chaser requires warranty of title to the production before completing the purchase. The division order constitutes a specific, concise statement of the interest owners at the time of production. While the lease and any subsequent recorded transactions already contain the title information set forth in the division order, the division order compiles all the information current at the time of production and combines this information with the owners' warranty of title. *See* cases cited *supra* note 19; Bounds, *supra* note 11, at 92. The lessee in all likelihood could not find a purchaser, and thus could not meet its implied covenant to market the production, unless division orders warranting the interest holders' title to the production or the proceeds from the sale of the production were executed.

25. Although the lessee's express duty to pay royalty is created at the time the lease is executed, the parties generally do not know what type of production, if any, will be developed. Lease provisions for royalty are necessarily general to cover the actual production and marketing circumstances which may result. The provisions in a division order, executed after production is discovered, can be more specific, incorporating current information. *See* Simpson v. United Gas Pipe Line Co., 196 Miss. 293, —, 17 So. 2d 200, 202 (1944) ("Aside from any other question, this division order establishes and fixes the gas prices to be paid by [buyer] to [royalty holder]."); H. WILLIAMS & C. MEYERS, *supra* note 10, § 705 ("Thus the lease may provide in very general terms for the payment of royalty on production and the division order . . . may contain much more specific provisions on the same matters . . .").

26. *See, e.g.,* J.M. Huber Corp. v. Denman, 367 F.2d 104, 110 (5th Cir. 1966) (whether "market price" royalty basis in lease is synonymous with proceeds-of-sale royalty basis in division order); *see also* Phillips Petroleum Co. v. Williams, 158 F.2d 723, 727 (5th Cir. 1947); Gonsoulin v. Shell Oil Co., 321 F. Supp. 900, 901 (W.D. La. 1971); Craig v. Champlin Petroleum Co., 300 F. Supp. 119, 125 (W.D. Okla. 1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970); Maddox v. Gulf Oil Corp., 222 Kan. 733, —, 567 P.2d 1326, 1328 (1977), *cert. denied*, 434 U.S. 1065 (1978); Exxon Corp. v. Middleton, 613 S.W.2d 240, 242, 249-52 (Tex. 1981); Chicago Corp. v. Wall, 156 Tex. 217, —, 293 S.W.2d 844, 846 (1956); Butler v. Exxon Corp., 559 S.W.2d 410, 416 (Tex. Civ. App. 1977), *writ ref'd n.r.e.*; Stanolind Oil & Gas Co. v. Terrell, 183 S.W.2d 743, 745 (Tex. Civ. App. 1944), *writ ref'd n.r.e.*

27. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981) (royalties were paid for approximately thirty years before the royalty owners found a conflict between the lease and the division orders). The "difference" between the lease and the division order may be an error, an intentional manipulation by the drafter, or a technical legal distinction not apparent to the parties to the division order. Unfortunately for the defense of the division order drafter, the typical "difference" has been the result of an intentional manipulation. *See* Brown, *supra* note 17, at 185.

already received under the signed division order. Must the royalty owner accept the amount and terms stipulated in the division order or may the royalty payor be held to the amount and terms of the lease as a court may find them?

When a conflict between a division order and the lease is presented, judicial treatment of the division order may be unpredictable.²⁸ Presently, there is no judicial agreement as to what a division order is or how it shall be enforced,²⁹ although such instrument has been in use since the turn of the century and has remained virtually unchanged.³⁰ Despite the routine use of division orders and general recognition of the purposes they were designed by the industry to serve, the fate of a particular division order subjected to judicial scrutiny is uncertain, as the legal theory behind the existence and enforcement of division orders has generally lagged behind the needs and intentions of the oil and gas industry. While there has developed a sufficient legal theory to accommodate oil division orders, discussed below, the same is not true of gas division orders, where legal analysis has been sparse and contradictory. Increasing attention on the gas industry illustrates the importance of developing a clear legal analysis for the evaluation of gas division orders which can be relied upon by the parties involved in shaping their transactions to best achieve their legitimate objectives.

The essential difficulty underlying legal analysis of the division order centers around the consideration issue; specifically, what consideration, if any, does the royalty owner receive for the execution of the division order? If the royalty owner does not receive consideration, is the division order enforceable on another legal basis such as promissory estoppel? And, if a division order is revocable upon notice, can it be a contract? In addition to resolving the consideration issue, an appropriate legal analysis should accommodate the intentions of the parties in signing the division order without permitting such order to overcome the supremacy of the lease.

28. Compare *Butler v. Exxon*, 559 S.W.2d 410 (Tex. Civ. App. 1977), *writ ref'd n.r.e.* (court found division orders unenforceable because executed without consideration) with *Chicago Corp. v. Wall*, 156 Tex. 217, 293 S.W.2d 844 (1956) (court found division orders were binding contracts). Interestingly, these contradictory results are the product of the same jurisdiction. The *Butler* court distinguished *Chicago* by stating that there was no detrimental reliance in the *Butler* case as there had been in *Chicago*, but this statement is not explained in light of the facts of either case.

29. See *supra* note 6.

30. *Bounds*, *supra* note 11, at 92.

A. *Oil Division Orders*

A satisfactory legal analysis was developed to accommodate the intentions of parties to oil division orders through the "sale doctrine."³¹ Development of the sale doctrine was possible because of the nature of oil production and because of the legal interests of the lessor and lessee in the product. The oil royalty owner may take as royalty a share of the proceeds from the sale of production or a share of the production itself.³² The sale doctrine is based on the possibility of the royalty owner taking payment in kind. Since the royalty owner can be regarded as owning part of the oil production in the tank or pipeline, when the purchaser contracts to buy all the production, he seeks to purchase the royalty share as well.³³

Based on an interpretation that the royalty holder is an actual owner of a portion of the oil, courts have analogized the signing of the division order to a standing offer to sell the royalty owner's share of the oil produced.³⁴ The division order is an offer for a unilateral contract which the purchaser may accept by sending the royalty payment. The standing offer to sell is accepted each time the purchaser sends payment according to the division order, completing the contract for sale.³⁵ Once accepted by performance, the offer cannot be revoked.³⁶ The royalty owner is bound by payments made and accepted, as such payments are viewed as completed contracts of sale. Yet the royalty owner can challenge the division order as a basis for future payments by revoking it, since the division order is simply an offer to sell which is

31. See generally *Amerada Petroleum Corp. v. Melton*, 139 Okla. 119, 281 P. 591 (1929); *Hogg v. Magnolia Petroleum Co.*, 267 S.W. 482 (Tex. Civ. App. 1924); *Ethridge*, *supra* note 16; *Rain, A Further Look at Division Orders and Problems in Accounting and Payment of Proceeds from Oil and Gas*, 8 ROCKY MTN. MIN. L. INST. 69, 70 (1963).

32. R. HEMINGWAY, *supra* note 14, § 7.5; *Bounds*, *supra* note 11, at 110; *Lange, The Production of Oil and Gas and Some of the Problems Reached By It*, 22 INST. ON OIL & GAS L. & TAX'N 113, 140 (1971); *Rain*, *supra* note 31, at 69; *Stucky, Current Developments and Views Concerning Rights and Status of Landowners-Lessors*, 21 INST. ON OIL & GAS L. & TAX'N 83, 137 (1970).

33. "In the case of oil production, the purchaser therefor buys oil both from the lessor and from the lessee. It will prepare a division order to be signed by all owners of an interest in production . . ." R. HEMINGWAY, *supra* note 14, § 7.5.

34. See *Amerada Petroleum Corp. v. Melton*, 139 Okla. 119, 122, 281 P. 591, 593 (1929); *Stanolind Oil & Gas Co. v. Terrell*, 183 S.W.2d 743, 745 (Tex. Civ. App. 1944), *writ ref'd n.r.e.*

35. See, e.g., *Amerada Petroleum Corp. v. Melton*, 139 Okla. 119, 122, 281 P. 591, 593 (1929); *Hogg v. Magnolia Petroleum Co.*, 267 S.W. 482, 484 (Tex. Civ. App. 1924). See generally *Ethridge*, *supra* note 16; *Comment, Royalty Division Orders*, 23 LA. L. REV. 571, 572-73 (1963).

36. See, e.g., *Amerada Petroleum Corp. v. Melton*, 139 Okla. 119, 122, 281 P. 591, 593 (1929): Having executed said contract or division order, and defendant having delivered said oil as directed and instructed in said division order so executed by plaintiff, and all parties having acted on said division order and contract, the plaintiff cannot recover for oil that was delivered by his assignee as per his directions.

subject to revocation at any time prior to acceptance.³⁷ Thus, in the case of a conflict between the lease and the division order, the royalty owner cannot dispute any amount of royalty already paid, if such amount accords with the division order, but may revoke the division order as to future payments and require the order to be rewritten in congruence with the lease.³⁸

The sale doctrine places the burden on the lessor to compare the division order with the lease previously executed to ascertain whether the royalty provisions correspond. If the lessor fails to compare the two writings and there is a conflict, the purchaser is not liable for any deficiency in past payments³⁹ as long as royalties were paid according to the division orders. Although the sale doctrine places the burden of examination upon the lessor, the doctrine also recognizes the division order's revocability, so the lessor retains a great degree of control over the terms of royalty payments.⁴⁰

The sale doctrine fulfills the oil industry's purpose in requiring division orders: the protection of the oil purchaser against liability for any past erroneous royalty payments. The "sale" fiction, based on the royalty owner's potential interest in the actual production, and the analogy of the division order to a standing offer to sell satisfactorily avoid the issue of consideration while providing the lessor and the oil purchaser with the degree of flexibility and protection they respectively require.

B. *Gas Division Orders*

The sale doctrine, however, cannot provide a justification for gas division orders because of the differences in the physical properties of oil and gas. Whereas oil can be economically and safely stored, gas cannot.⁴¹ The possibility that the oil royalty owner may take the roy-

37. "When *accepted* by the Choate Oil Corporation, [the division order] was a contract of sale complete within itself for the sale of plaintiff's [royalty]." *Id.* (emphasis added).

38. The division order is the royalty owner's direction and authorization to the royalty payor (4 H. WILLIAMS & C. MEYERS, *supra* note 10, § 701), or his "standing offer" in terms of the sale doctrine, thus he controls the content of the directions, or of the "offer."

39. See, e.g., Hogg v. Magnolia Petroleum Co., 267 S.W. 482, 485 (Tex. Civ. App. 1924) ("We cannot agree . . . that 'by signing that division order Hogg put it beyond his power to recall the permission he thereby gave for the sale and purchase of the incumbered property.'").

40. At least one court has maintained that the "until further notice" clause in the typical division order did not render the division order revocable. Kaufman v. Arnaudville Co., 186 So. 2d 337, 341 (La. Ct. App. 1966). The general view, however, seems to be that a distinguishing feature of the division order is its revocability. See Exxon Corp. v. Middleton, 613 S.W.2d 240, 250 (Tex. 1981); Brown, *supra* note 17, at 185.

41. See *supra* note 13.

alty in kind rests on the fact that the royalty owner's share may be safely separated and stored. It is the possibility that the royalty owner may own an interest in the actual production that the sale doctrine is based upon.⁴² In contrast, the gas royalty owner's interest is only in the proceeds of the sale from the gas.⁴³ There is less possibility that the gas royalty owner could take the royalty in kind since the physical qualities of gas prevent the type of safe storage possible with oil. Without the likelihood of ownership of part of the actual production, there is no basis for either the sale doctrine or the analogy of the division order to a standing offer to sell. The typical gas lease grants complete title in the gas to the lessee.⁴⁴ Since the lessee owns a one hundred percent interest in the gas produced, the royalty interest in a gas lease is strictly a duty on the part of the lessee to pay the lessor a certain amount for the gas produced.⁴⁵ Whereas with the oil lease there is a possibility that the lessee and the royalty holder are co-owners of production (if the royalty holder were to take the royalty in kind), the relationship between the lessee and the royalty owner involved in gas production is one of debtor-creditor.⁴⁶

Clearly, the basis for the fiction of the sale doctrine has vanished since the gas royalty holder neither owns any part of the production to be sold nor any possibility of such ownership. Complete title to the gas production is in the lessee. The division order can no longer be considered a continuing offer to sell which may be accepted by the purchaser's payment of royalty because the royalty owner has nothing to sell the purchaser. The royalty owner holds only a right to payment from the lessee.

Since the gas lease grants complete title in the gas production to the lessee, it may appear that there is no need for the execution of division orders because the lessee has the authority to sell all the gas produced. However, the gas division order serves a slightly different purpose than that of the oil division order. While the primary function of the oil division order is to warrant the interest owners' title to the production, the main purpose of the gas division order is to provide a specific basis for royalty computations.⁴⁷ Because gas royalty computa-

42. See *supra* notes 31-34 and accompanying text.

43. See *supra* notes 12-15 and accompanying text.

44. See *supra* note 14.

45. See *supra* note 15 and accompanying text.

46. R. HEMINGWAY, *supra* note 14, § 7.5, at 325.

47. Bounds, *supra* note 11, at 110-11. "Thus the chief problem involved in both the natural gas and the casinghead gas division order is the question of price or the basis of settlement."

tions are usually complicated and dependent upon the circumstances of production,⁴⁸ the gas division order is essential as the industry device that specifically provides for the method of computation once the circumstances of production are known.⁴⁹ The gas division order also serves the purpose common to oil division orders of specifying to whom royalties shall be paid.⁵⁰

Judicial recognition and enforcement of gas division orders have been no more predictable than with oil division orders. In examining situations where the lease and the gas division order conflict or where the division order contains provisions not expressly within the lease, courts have developed two distinct rationales for the effect and enforceability of the division order.

III. ANALYSIS OF GAS DIVISION ORDERS

A. *Division Orders: Unenforceable Writings?*

One judicial view of the enforceability of a division order which conflicts with the lease defines the order as merely a stipulation of interests executed without consideration. As such, the order is not a contract and therefore is not enforceable.⁵¹ The gas division order, which is typically required by the purchaser of the gas, is generally drafted and submitted to the royalty owners by the lessee.⁵² The division order is primarily executed for the benefit and protection of the purchaser or the distributor of funds from the sales.⁵³ Yet the royalty owner appar-

48. *Id.*; see *supra* note 23.

49. Gregg, *supra* note 6, at 31-32; 4 H. WILLIAMS & C. MEYERS, *supra* note 10, § 705, at 685: "Thus the lease may provide in very general terms for the payment of royalty on production and the division order . . . may contain much more specific provisions on the same matters"

50. Whereas in oil division orders the most important purpose of the division order is the statement of the interest holders and their warranty of title, in the gas division order, warranty of title by the royalty owners is not so crucial, since the lessee owns complete title to production. The gas division order signors warrant their interests, but not their title to the gas because they have none. The purchaser seeks a specific basis for royalty calculations in the gas division order. See *generally* Bounds, *supra* note 11, at 117-18.

51. See *Maddox v. Gulf Oil Corp.*, 222 Kan. 733, —, 567 P.2d 1326, 1328 (1977), *cert. denied*, 434 U.S. 1065 (1978) ("Here the unilateral attempt by [lessee] in the division orders to amend the oil and gas leases . . . was without consideration. Therefore, the provisions in the division order regarding waiver of interest are null and void as determined by the trial court."); *Butler v. Exxon Corp.*, 559 S.W.2d 410, 417 (Tex. Civ. App. 1977), *writ ref'd n.r.e.* ("Basically, a division order sets forth the interest of each owner for purposes of payment by the purchaser of the product being sold. It is executed without any consideration."); cf. *Stanolind Oil & Gas Co. v. Terrell*, 183 S.W.2d 743, 745-46 (Tex. Civ. App. 1944) (division order not enforceable where it contradicts the lease; applied to oil division order rather than gas division order).

52. 2 E. BROWN, *supra* note 9, § 16.02(4)(D)(2).

53. See *Wagner v. Sunray Mid-Continent Oil Co.*, 182 Kan. 81, —, 318 P.2d 1039, 1047 (1957), quoted at note 17, *supra*.

ently does not receive consideration for execution of the gas division order.⁵⁴ Without consideration, the division order may be unenforceable and the lessee unprotected from suit by the royalty owners even with respect to royalties paid and accepted.⁵⁵ This reasoning may render division orders which are found to conflict with the lease ineffectual when challenged in court.

If the division orders are found unenforceable for lack of consideration, the lessee may attempt to defend its position on the basis of a detrimental reliance or promissory estoppel theory.⁵⁶ Courts have been inconsistent in the application of the estoppel doctrine to enforce division orders.⁵⁷ The underlying rationale of those decisions refusing to recognize estoppel based on division orders may be that the lessee's reliance on a division order drafted by the lessee which states different

54. Under the terms of the lease or assignment, the royalty owners hold the right to be paid. The division order is not the instrument which creates the royalty interest or the right to receive royalty. The only apparent benefit of the division order seems to be its provision of a definite basis for payment for the lessee. As a practical matter, the signing of the division order entitles the royalty owner to the commencement of royalty payments. However, since the royalty owner already has the legal right to the royalty under the lease, the royalty payment cannot operate as consideration since it is, in effect, a pre-existing debt. 1A A. CORBIN, CONTRACTS § 171 (1963).

55. See, e.g., *Craig v. Champlin Petroleum Co.*, 300 F. Supp. 119, 125 (W.D. Okla. 1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970) (execution of division orders did not estop lessors from claiming royalties based on market price as provided in lease); *Maddox v. Gulf*, 222 Kan. 733, —, 567 P.2d 1326, 1328 (1977), *cert. denied*, 434 U.S. 1065 (1978) (in the absence of consideration, provisions of division order are null and void); *Butler v. Exxon Corp.*, 559 S.W.2d 410, 417 (Tex. Civ. App. 1977), *writ ref'd n.r.e.* (execution of division order done without consideration and therefore not binding).

56. "(1) A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise." RESTATEMENT (SECOND) OF CONTRACTS § 90 (1973). The following cases involve the defendant's invocation of detrimental reliance as a defense: *Craig v. Champlin Petroleum Co.*, 300 F. Supp. 119, 125 (W.D. Okla. 1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970) (defense failed); *Bi-County Properties v. Wampler*, 378 N.E.2d 311, 316 (Ill. App. Ct. 1978) (recognized estoppel); *Wagner v. Sunray Mid-Continent Oil Co.*, 182 Kan. 81, —, 318 P.2d 1039, 1048 (1957) (recognized estoppel); *Amerada Petroleum Corp. v. Melton*, 139 Okla. 119, 122, 281 P. 591, 593 (1929) (defense succeeded); *Butler v. Exxon Corp.* 559 S.W.2d 410, 417 (Tex. Civ. App. 1977), *writ ref'd n.r.e.* (defense failed).

57. See *Butler v. Exxon Corp.*, 559 S.W.2d 410, 417 (Tex. Civ. App. 1977), *writ ref'd n.r.e.* (lessee's receiving royalty payment for three years according to division order did not estop royalty owner from suing for recovery of amount due under lease provisions); *accord* *Craig v. Champlin Petroleum Co.*, 300 F. Supp. 119, 125 (W.D. Okla. 1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970) (royalty owners were not estopped by division orders based on lessee's gas sale contract to claim a larger amount based on the lease royalty provision). *But see* *Gonsoulin v. Shell Oil Co.*, 321 F. Supp. 900, 901 (W.D. La. 1971) (Louisiana jurisprudence recognizes estoppel doctrine as particularly applicable to suits based on division order apportionments because lessee relies on the division order); *Chicago Corp. v. Wall*, 156 Tex. 217, —, 293 S.W.2d 844, 846-47 (1956) (evidence showed that lessee relied on royalty owners' direction in division orders and that royalty owners could not now claim that lessees should not have so relied); *cf.* *Texas Co. v. Pettit*, 107 Okla. 243, 247, 220 P. 956, 959 (1923) (oil division orders created an estoppel to claim greater royalties).

royalty terms than those in the lease is inherently unreasonable.⁵⁸ In any case, the invocation of promissory estoppel will not necessarily protect the lessee when the royalty owner challenges payments received and cannot provide the requisite legal framework to uphold division orders.

To conclude that division orders are legally ineffective if they contradict the lease essentially promotes the royalty owners' interests and the contractual supremacy of the lease. The royalty owners' interests are significantly protected because the burden is on the lessee to ensure that the lease and division order correspond and will be interpreted accordingly in court.⁵⁹ The royalty owners' interests are further protected by judicial refusal to recognize that the division order "induces any action or forbearance"⁶⁰ resulting in a detrimental reliance.⁶¹ In the absence of detrimental reliance, the royalty owner is not estopped from bringing suit to challenge royalties paid and accepted under the terms of the division order. Finally, judicial determination that division orders are not binding preserves traditional contract theory, namely, refusal to enforce a mere writing in the absence of a finding of consideration.⁶²

While contract theory may justify those decisions holding the royalty division orders unenforceable if they conflict with the lease, the practicalities of the gas purchasing business do not. As discussed earlier, the realities of gas production require that the lessee attempt to provide a concrete basis upon which to carry out the lease obligation to pay royalties.⁶³ Since this concrete basis cannot be established in the

58. This view seems untenable since it is precisely to provide a reliable basis for royalty payments that the lessee seeks the execution of the division order. It is also important to remember that a conflict between the lease and the division order may not always be readily apparent or intentional and, in fact, may only be determined by judicial analysis.

59. The difficulty the industry member may have in predicting judicial interpretation of division order language is discussed generally in Note, *The Market Value Controversy: Exxon Corp. v. Middleton*, 16 TULSA L.J. 550 (1981).

60. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1973).

61. See *Butler v. Exxon Corp.*, 559 S.W.2d 410, 417 (Tex. Civ. App. 1977), writ *ref'd n.r.e.* (refusing to recognize a detrimental reliance on the division orders).

62. See *supra* note 52 and accompanying text. Some courts have acknowledged that a division order could be formed and written as a contract and thus bind the parties, but if not so written, the division order cannot be made binding by the courts. See *Kaufman v. Arnaudville Co.*, 186 So. 2d 337, 342 (La. Ct. App. 1966):

It is entirely possible that a division order might be executed under such circumstances as to constitute a contractual modification of the relations previously prevailing between operator and royalty owner. But this should appear clearly. No court ought to infer an intent to enter into such a contractual modification without cogent evidence thereof.

63. See *supra* notes 48-51 and accompanying text.

lease due to numerous unknown factors existing at the time of the lease execution, it must necessarily be established in a subsequent writing, namely, the division order, at the time production is commenced. Because of the need to make more specific the general provisions of the lease, the division order should not be disregarded as a mere writing without effect,⁶⁴ even though it appears to contradict a lease provision. The division order meets a practical industry need and, in the absence of fraud and bad faith, should be given effect through an appropriate legal analysis which does not offend traditional contract theory.⁶⁵

B. *Division Orders: Revocable Contracts?*

A majority of the courts confronted with the issue of the enforceability of division orders relies almost exclusively on a Texas case, *Chicago Corp. v. Wall*.⁶⁶ In *Chicago*, the Texas Supreme Court found that the signing of division orders by royalty owners "created a contractual relationship" between the royalty owners and the lessees.⁶⁷ Addressing the consideration issue, the court found that the lessee's good faith and reliance on the division orders were consideration for the formation of a contract.⁶⁸ At the time of the execution of the division order, there was no consideration given to the royalty owners. Instead the court focused on the lessee's subsequent reliance. Having found the division orders enforceable as contracts, the *Chicago* court further held the orders to be binding until revoked.⁶⁹ Under traditional principles, a contract cannot be unilaterally revoked without rendering the revoking party liable for breach of contract.⁷⁰ The *Chicago* opinion, however, circumvents basic contract theory by defining division orders as en-

64. When courts refuse to enforce a division order as to royalties which have been paid and accepted, they thwart the lessee's primary purpose in the execution of the division order by leaving the lessee liable to suit for royalties already paid.

65. See generally Brown, *supra* note 17, at 185; Gregg, *supra* note 6, at 30-33; Stucky, *supra* note 32, at 138-39.

66. 156 Tex. 217, 293 S.W.2d 844 (1956).

67. *Id.* at —, 293 S.W.2d at 846.

68. Obviously, the [lessee] acted in good faith in following the instruction in the . . . orders. . . . There is no evidence of probative force to sustain the finding of the jury that the [lessee] did not rely on [such] orders. Since the [royalty owners] directed the [lessee] as to how to credit and pay their royalty interest by the written . . . orders, they cannot now claim that the [lessee] was not entitled to rely on such directions.

[Lessee] paid out the fund to others upon their faith in the solemn declarations of the [royalty owners], and, until the division order and transfer orders are revoked, the [lessee] has no alternative except to pay the fund to the persons named in the transfer orders.

Id. at —, 293 S.W.2d at 846-47.

69. *Id.* at —, 293 S.W.2d at 847.

70. 1 A. CORBIN, *supra* note 54, § 38.

forceable contracts which may be revoked at will.⁷¹

The *Chicago* court reached its conclusion after discussing *Hogg v. Magnolia Petroleum Co.*,⁷² a case involving oil division orders. As discussed above, the oil division order is viewed as the royalty owner's standing offer to sell the royalty share of the oil produced.⁷³ In keeping with traditional contract principles, the oil division order may be unilaterally revoked before its acceptance.⁷⁴ The unilateral revocation of gas division orders, on the other hand, is not supported by traditional contract theory because the gas division order cannot be regarded as an offer to sell.⁷⁵ Nevertheless, the *Chicago* court applied the revocability aspect of oil division orders to gas division orders to allow the royalty owners to revoke the orders.

The *Chicago* case is the foundation for most subsequent opinions interpreting gas division orders as binding until revoked.⁷⁶ Although the *Chicago* opinion provides both protection to the lessee for royalty payments made and accepted according to the division order and a certain degree of flexibility to the royalty owner, who may revoke the division order at any time, there is no adequate legal theory to support that court's conclusion. Without theoretical support, the opinion does not provide a consistent judicial effect,⁷⁷ thus gas producers relying on division orders to make royalty payments remain on uncertain legal ground.⁷⁸

C. *Executory Accord*

Oil and gas division orders provide an important link in the oil

71. 156 Tex. at —, 293 S.W.2d at 846-47. The court offers no specific explanation for its conclusion but does refer to both the lessee's "reliance" and the contractual nature of oil division orders.

72. 267 S.W. 482 (Tex. Civ. App. 1924).

73. See *supra* notes 32-38 and accompanying text.

74. 1 A. CORBIN, *supra* note 54, § 38.

75. See *supra* notes 42-47 and accompanying text.

76. See, e.g., *Bankers Life Ins. Co. of Nebraska v. Scurlock Oil Co.*, 447 F.2d 997, 1002 (5th Cir. 1971); *J.M. Huber Corp. v. Denman*, 367 F.2d 104, 110 (5th Cir. 1966); *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 250 (Tex. 1981); *Smith v. Liddell*, 367 S.W.2d 662, 666-67 (Tex. 1963); *Koenning v. Manco Corp.*, 521 S.W.2d 691, 697 (Tex. Civ. App. 1975).

77. See, e.g., *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 249-52 (Tex. 1981). The trial court found the division orders to be supported by consideration, and thus enforceable, but that such orders could also be unilaterally revoked. The Court of Civil Appeals also found the division orders enforceable, based, *inter alia*, on the statutory presumption that written contracts are supported by consideration, but held that they could not be unilaterally revoked. The Texas Supreme Court, although first finding the division orders unenforceable, finally held them to be enforceable and unilaterally revocable upon rehearing.

78. See *supra* note 28.

and gas marketing process,⁷⁹ as their relative permanence in form and use amid legal and mineral production developments attests.⁸⁰ The sale doctrine provides legal justification for the enforcement of oil division orders,⁸¹ yet no equivalent legal doctrine controls the enforcement of gas division orders. In the absence of consistent legal treatment, gas division orders are susceptible to abuse, either by overreaching lessees or by royalty owners anticipating large court recoveries.

The division order serves the necessary function of providing specific instructions for royalty payments which could not practicably be done at the time of the lease execution. Insofar as the division order is used to effectuate this purpose it should be recognized and enforced by courts when challenged. Yet division orders have been used to accomplish other purposes which they were not originally intended to accomplish.⁸² For example, if a division order is written to unilaterally modify express provisions of the lease, it is an abuse of the division order's purpose which should not be judicially upheld. A legal framework is necessary for the consistent analysis of division orders, so that those division orders serving a legitimate function in the lessee-lessor relationship may be upheld while those being abusively manipulated by one party are not enforced. The discussion following suggests the executory accord as an appropriate legal framework for the analysis of division orders.

The problem with gas division orders is contractual due to the debtor-creditor relationship established by the lease royalty provision between the royalty owners and the lessee.⁸³ While the lease creates a debt, in the event of production, it does not specify the amount of the debt or even to whom it will be paid. Where a debt exists whose amount or terms are unknown or in dispute, the parties may agree to create an executory accord between themselves.⁸⁴ An executory accord is "an agreement for the future discharge of an existing claim by a substituted performance."⁸⁵ In the case of an executory accord, the consideration for each party entering into this second contract is the benefit of

79. "As the lease is the contractual prerequisite of production, so the division order is the basis of marketing and distribution." Ethridge, *supra* note 16, at 127.

80. *See supra* note 5.

81. *See supra* notes 31-40 and accompanying text.

82. *See Brown, supra* note 17, at 185; Stucky, *supra* note 32, at 138.

83. *See supra* notes 44-47 and accompanying text.

84. *See generally* 6 A. CORBIN, *supra* note 54, § 1268 (1963).

85. *Id.*

settling the acknowledged but uncertain debt.⁸⁶ As applied to the gas division order, consideration for the contract would be each party's interest in the actual payment of a specific amount of royalty, as opposed to the duty or right to payment of an uncertain amount of royalty as created in the lease.

The executory accord, as Corbin notes,⁸⁷ does not discharge the previous debt. Instead it provides that the performance of the executory accord, rather than its formation, will discharge the previous debt. In the event of the debtor's failure to perform, the creditor may sue the debtor on the claim of the original debt or on the terms of the executory accord. In the case of a gas lease, the lessee's failure to pay royalties entitles the royalty owner to sue the lessee either on the terms of the lease or those of the division order. Treated as an executory accord, the division order does not replace or modify the lease, but rather exists as a supplement to the lease upon which the lessee may base its performance of royalty payments.

In order for the gas division order to function as an executory accord, it must contain necessary contract language such as a recital of consideration (establishing a certain amount for an unspecific debt) for the contract's formation. The division order should be attended by appropriate contract formalities, including the signature of all parties to be bound by the order, so it is not mistaken for an attempted unilateral modification of the lease.

Molding the division order into an executory accord through judicial treatment and industry practice resolves the consideration issue and transforms the order into an enforceable contract with regard to payments made and accepted under its provisions. If written and judicially recognized as a contract, the gas division order would not be revocable by one party and would be a more permanent commitment on the part of both the lessee and the royalty owners. Such permanence seems justified both by the importance of the division order royalty stipulations and by the long-term arrangements in gas sales.⁸⁸

As an executory accord, the division order would be enforceable only insofar as it is designed to accomplish certain legitimate objectives. The consideration for the division order as an executory accord

86. *Id.*

87. *Id.* "[I]t is the promised performance that is to discharge the existing claim, and not the promise to render such performance."

88. *See* *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269, 1273 & n.12 (Okla. 1981) (recognizing the necessity of long-term gas sales contracts).

is the specification of a definite amount for the "unsettled debt" created by the general royalty provision of the lease. As long as the division order is used for that limited purpose, it may be enforced. To the extent that division orders are drafted to do something more than specify the uncertain lease debt, they may be unenforceable unless additional consideration is given.

Although some courts would summarily refuse enforcement of an apparent amendment to the lease in the form of a division order,⁸⁹ the supremacy of the lease should not be maintained without reason. In the case of gas leases, as has been discussed, the royalty provision cannot be made specific. Only at the time of production and marketing can royalty calculations and payments be made specific. The rationale behind maintaining the supremacy of the lease, which is necessarily vague and incomplete as to gas royalties, over the division order, which is clear and specific as to royalty amounts, is difficult to sustain.

IV. CONCLUSION

As the market value of gas continues to rise, formerly acquiescent royalty owners will continue to challenge the basis of their royalty payments. A legal analysis to accommodate the mutual interests underlying the function of gas division orders must be developed. A single rule cannot be established to determine the enforceability of gas division orders, since each division order varies from the rest. A legal framework, however, such as that of the executory accord, should be consistently invoked for the coherent analysis and, when justified, enforcement of gas division orders.

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89. *See, e.g.*, *Maddox v. Gulf Oil Corp.*, 567 P.2d 1326, 1328 (Kan. 1977) (division order terms perceived as a unilateral attempt to amend the lease regarded as null and void).