

Non-Executive Interests and Horizontal Pooling

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Types of Non-Executive Interests

- Non-Executive Mineral Interest (NEMI)
 - An interest in the mineral estate but without the power to execute leases
 - Typically shares in bonus, rentals and royalties
 - Created by reservation or by grant
- Non-Participating Royalty Interest (NPRI)
 - An expense-free interest in oil or gas, if and when produced
 - Created by reservation or by grant

Basic Elements of NPRIs

- Non-possessory
- No right to enter on the land
- Vested incorporeal interest in land
- No right to demand partition
- Mineral fee owners cannot compel partition

Relationship between the Executive and NPRI Owner

- The executive has the right to negotiate and sign an oil and gas lease covering the NPRI.
- The executive may not grant to the lessee the right to pool the NPRI unless the right to pool the NPRI was reserved in the instrument creating the NPRI or the NPRI owners consent to pooling. *Montgomery v. Rittersbacher*, 424 S.W.2d 210, 213 (Tex. 1968).
- The NPRI owner is bound by the lease negotiated and executed by the executive, but the executive cannot agree to pool (and therefore diminish) the NPRI. An NPRI owner must consent to pooling.

Duties of the Executive to Non-Executives

- The duty of executives to non-executives is described as a “fiduciary duty” and the executive should obtain every benefit for the non-executives that he exacts for himself.
- The executive must not engage in self-dealing. *Manges v. Guerra*, 673 S.W.2d 180 (Tex. 1984).
- *Lesley v. Veterans Land Board of the State of Texas*, 352 S.W.3d 479 (Tex. 2011):
 - The executive (a developer that planned to build and sell “ranchettes”) acquired 25% of the minerals, all executive rights and all of the surface estate.
 - Developer sold lots with deed restrictions that prohibited oil and gas drilling.
 - The Texas Supreme Court concluded that the developer breached its fiduciary duty by placing the deed restrictions on the lots.

Duties of the Executive to Non-Executives

- Distinction between the duty owed to NEMI and NPRI:
 - The duty owed by the executive to the NPRI owner arises from the *contractual* position of the parties .
 - The duty owed by the executive to the NEMI owner is based on the *relationship* between the parties (*Lesley*).
- *Friddle v. Fisher*, 378 S.W.3d 475 (Tex. App. – Texarkana 2012):
 - The executive executed a lease but did not inform the NPRI owner.
 - The NPRI owner was not charged with constructive notice of the lease because it was executed and recorded after he acquired his NPRI.
 - The executive was required to hold royalties due to the NPRI owner as constructive trustee.
- The lessor cannot circumvent the royalty owed to NPRI owners by reserving an additional overriding royalty.

NPRIs and Vertical Wells

- The NPRI owner is entitled to a share of production based on ownership of production in lands where the well is located or on contract (pooling) giving a share of production.
- The NPRI interest may not be diluted without the consent of the NPRI owner.

NPRIs and Vertically Pooled Units

- Pooling allows lessees to join tracts from one or more leases to form a single unit where a single tract is often insufficient in size to meet the Texas density or spacing requirements.
- Operations anywhere within the unit are treated as though they occurred on all land within the unit, and production from a well within the pooled unit is treated as though it is producing on all tracts pooled into the unit. *Key Operating & Equipment v. Hegar*, No. 13-0156, 2014 Tex. LEXIS 504 (Tex. June 20, 2014).
- Royalty is distributed according to the proportion each pooled interest's acreage bears to the entire unit.

Vertical Pooling of NPRIs

- The NPRI owner must decide whether to pool their interest.
- Drillsite Tract:
 - Typically it is in the best interest of the NPRI owner not to pool the interest. The NPRI would participate on an undiluted basis.
- Non-Drillsite Tract:
 - Typically it is in the best interest of the NPRI owner to pool the interest. The NPRI would participate on a diluted basis.

Methods of Ratification

- Ratify the Oil and Gas Lease
 - Has the same effect as if the NPRI executed the oil and gas lease covering his interest.
 - The NPRI owner will share in production on a diluted basis for all wells drilled in the unit.
 - The NPRI interest will also be diluted for drillsite tract wells.
 - When must the ratification occur? In what form?
- Joint Execution of the Oil and Gas Lease
 - May result in a community lease.
 - Prevents the NPRI owner from deciding whether to pool his interest or participate on an undiluted basis.
- Pooling Agreement
 - Pooling agreement grants the lessee pooling authority on a limited basis.
 - Allows the NPRI owner to wait and see and selectively grant pooling on a unit-by-unit basis to prevent dilution of the NPRI.

The Problem of Excess Royalty

- Absent ratification, the NPRI owner must be paid on an undiluted basis, which may result in excess royalty.
- Which party is responsible for bearing any excess royalty?
 - The lease may provide that all royalty interest covered by this lease (whether or not owned by the lessor) shall be paid out of the royalty herein provided.
 - There is conflicting authority.

Community Leases

- A community lease includes separate tracts in which the ownership is not uniform (*e.g.*, differing NPRI owners in the separate tracts).
- A community lease pools the minerals and royalty in the separate tracts, but does not automatically pool the NPRI interests.
- Essentially, a community lease is an offer to NPRI owners to pool that may be accepted by ratifications from the NPRI owners.

Community Leases

- An anti-communitization clause does not preclude ratification by NPRI owners.
- Example of an anti-communitization clause:

If this lease now or hereafter covers separate tracts, no pooling or unitization of royalty interest as between any such separate tracts is intended or shall be implied or **result merely from the inclusion of such separate tracts within this lease** but Lessee shall nevertheless have the right to pool as provided above with consequent allocation of production as provided above. As used in this paragraph 4, the words “separate tract” mean any tract with royalty ownership differing, now or hereafter, either as to parties or amounts, from that as to any other part of the leased premises.

Application to Horizontal Wells

- Generally, the rules relating to NPRIs for vertical wells apply to horizontal wells. *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 646 (Tex. App. – Austin 2000, pet. denied).
- Each tract penetrated by the horizontal drainhole is a drillsite tract.
- Ratifications from each NPRI owner in each pooled unit or community lease tract to avoid the possibility of excess royalty.

Allocation of Production to NPRIs

- In the absence of pooling or a ratification, each NPRI owner is entitled to their share of production attributable to their tract with reasonable certainty. *Browning Oil Co., Inc. v. Luecke*, 38 S.W.3d 625, 647 (Tex. Civ. App. – Austin 2000, pet. denied).
- How is it possible to determine how much production is attributable to a particular tract with reasonable certainty?
 - Proof will require expert testimony from geologists and/or petroleum engineers.
 - Even with the testimony, the amount of production may still be uncertain.
- Alternatives:
 - Pay on surface acreage
 - Pay on fractional share of volume of production
 - Production Sharing Agreement

New Issues

- NPRI interests are prevalent in areas with prior production (*e.g.*, Permian and Eagle Ford).
- Sophisticated mineral owner leases do not include *Triolo* clause or expressly exclude payment of excess NPRI from the lessor's royalty.
- It is increasingly difficult to obtain blanket lease ratifications from NPRI owners.

Other Considerations

- Consider whether to risk creating a community lease by leasing multiple tracts:
 - Without knowing whether the tracts are burdened by NPRI.
 - Large tract aggregated by the acquisition of smaller tracts may create a community lease.
- Does the lease include covenants to identify NPRI owners and/or obtain ratifications or indemnity against reduced royalty if the NPRI owners do not ratify?
- Does the lease contain a clause that provides that all royalty is paid out of the lessor's reserved royalty?

Other Considerations

- Lessee should not participate with the executive rights owner in creating lease provisions detrimental to the NPRI owner or the lessee could be liable for participation in a breach of duty. *Kimsey v. Fore*, 593 S.W.2d 107 (Tex. Civ. App. – Beaumont 1980, writ ref'd n.r.e.).
- Lessee should consider potential claims for a share of production by NPRI owners who do not know that a well is drilled on or pooled with a tract burdened by an NPRI. *Benevides v. Warren*, 674 S.W.2d 353 (Tex. Civ. App. – San Antonio 1984, writ ref'd n.r.e.).
- Petition for a Receiver for Royalty Interest by Nonresident or Absentee. Tex. Civ. Prac. & Rem. Code § 64.093.
- A NPRI owner may seek to force pool its interest in an existing proration unit under Tex. Nat. Res. Code §§ 102.011-102.012.

Questions?

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