OIL AND GAS LAW 101 FOR ESTATE PLANNERS

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Presented by

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MINERAL INTERESTS IN ESTATE PLANNING AND PROBATE

I. A Brief Overview of Mineral Interests Under Texas Law.

Real property includes land, and whatever is permanently annexed thereto. Mineral interests are considered real property in Texas. Once oil and gas is produced, it becomes personal property. The term "land" includes oil and minerals in place; however, an owner may also sever the mineral estate from the surface estate. A severance of the surface estate from the mineral estate occurs by a conveyance of the mineral interests or by conveying the surface and retaining the minerals.

A mineral lease upon its execution and delivery is not a mere option or executory contract, but operates as a present conveyance of the oil and gas in and under the described lands, and vests in the lessee a determinable fee in the oil and gas in place. Incidents of mineral ownership include (i) the developmental right, the right to lease, and the right to economic benefits under the lease (bonus, delay rentals, and royalty). Sometimes there will be a need to determine whether an interest in land is an interest in minerals. The current rules as to the meaning of "minerals" or "other minerals" are set forth in Moser v. U.S. Steel Corp. Courts look to the intent of the parties from the four corners of the instrument, so that the intent of the parties is given effect. If the intent of the parties is unclear, the date of the mineral severance will determine the type of test used to define "minerals."

If the severance occurred before June 8, 1983, the court applies the Surface Destruction Test ("SDT") to cases. Under the SDT, minerals did not include substances which cause substantial destruction to the surface estate when removed. Surface owners in Texas ended up owning more valuable substances, which in other states would have been considered minerals.

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2 Renwar Oil Corp. v. Lancaster, 276 S.W.2d 774, 776 (1955); Toledo Society for Crippled Children v. Hickok, 152 Tex. 578 (1953).
3 Humble Oil & Ref Co. v. West, 508 S.W.2d 812 (Tex. 1974).
5 Fred A. Lange & Aloysius A. Leopold, LAND TITLES AND TITLE EXAMINATION (Texas Practice), 2nd ed., § 331.
7 Moser v. U.S. Steel Corp., 676 S.W.2d 99 (Tex. 1984). For a more in depth discussion, the author refers you to Joseph Shade, PRIMER ON THE TEXAS LAW OF OIL AND GAS, 3rd ed., § IV.
8 See generally Joseph Shade, PRIMER ON THE TEXAS LAW OF OIL AND GAS, 3rd ed., § IV.
If the severance occurred after June 8, 1983, the court applies the Ordinary and Natural Meaning Test ("O&NM") to cases. While Moser does not explicitly define O&NM, the court seems to define a substance as a mineral if it is generally regarded as a mineral in the community at the time and place where the severance took place. Moser seems to apply a scientific definition to a substance, although there is no general acceptance of the definition of "minerals."

A. Some Basic Terms. While these definitions are commonly understood by most attorneys, the author includes these terms simply for reference.

1. **Fee Simple.** It is absolute ownership of real property.

2. **Mineral Interest.** The mineral interest in oil and gas consists of the fee simple ownership of oil and gas in place under a parcel of land and the exclusive right to search for, develop and produce oil and gas from the property.

3. **Surface Interest.** The surface estate interest is what remains in the bundle of rights of land ownership after the mineral interest has been severed. Controversy often arises over whether substances belong to the mineral estate or the surface estate.

4. **The Dominant and Servient Estate Theory.** One of the incidents of mineral fee ownership is "the implied easement to use the surface and subsurface in any way reasonably necessary for exploring, drilling, production, transporting, and marketing."
   
   In Texas, it is well-established law that the mineral fee is the dominant estate and "that the mineral estate can enjoin actions by the surface owner or lessee that interfere with the reasonable use, operation and development of the mineral estate."

   Disputes often occur with the surface owner as to what is reasonable use of the surface estate for development of the mineral estate. There are restrictions on a mineral owner's right to develop the mineral estate, such as contractual, deed, and judicial restrictions.

5. **Rule of Capture.** It is the common law principle that there is no liability for drainage of oil and gas from another's land as long as there has been no trespass or violation of relevant statutes and regulations.

6. **Drainage.** It is the "[m]igration of oil or gas in a reservoir due to pressure reduction casted by production from wells bottomed in the reservoir."

7. **The Executive Right and Nonexecutive Interests.** The right to lease is the executive right. The executive right may be severed from the other incidents of mineral ownership. A nonexecutive interest, also sometimes referred to as participating royalty and nonparticipating mineral interest,

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10 *Id.*

11 Joseph Shade, *PRIMER ON THE TEXAS LAW OF OIL AND GAS*, 3rd ed., Appendix A.
"lacks the right to join in the execution of oil and gas leases and (probably the right to develop).\textsuperscript{12}

8. **Mineral Lease.** It is the most common method of creating a mineral estate. A lease may last for "three years and for so long thereafter as oil, gas and other minerals are produced." "Three years" is just an example. Lease term duration varies on the period of time the lease was executed, the type of minerals being developed, and the geographic location of the mineral interest.

9. **Royalty Interest.** A royalty interest is a real property interest with two distinguishing characteristics: It is nonpossesory and free of production and operating expenses.\textsuperscript{13} Types of Royalties:

   a. **Landowner’s Royalty.** The most common transaction in which a royalty is created is probably the execution of a mineral lease.\textsuperscript{14} The landowner who executes the mineral lease retains a right to a specified amount of gross production.\textsuperscript{15} A landowner’s royalty varies considerably based on the period of time the lease was executed, the type of minerals being developed, and the geographic location of the mineral interest.

   b. **Non-Participating Royalty Interest.** The non-participating royalty owner is entitled to a free share of production without regard to the terms of the lease.\textsuperscript{16} This type of royalty is frequently created in deeds of real estate, by either grant or reservation.\textsuperscript{17}

   c. **Overriding Royalty Interest.** It is carved out of the lessee’s interest under a mineral lease. Assignments of overriding royalties are commonly used to obtain financing and as a method of compensating landmen, geologists, and other individuals or entities for services provided to the oil and gas company.\textsuperscript{18}

10. **Shut-in Royalty.** It is a payment by the lessee to the lessor to maintain an oil and gas lease while there is no production because a well is shut-in and incapable of production.

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\textsuperscript{12} Id.
\textsuperscript{13} Ernest E. Smith and Jacqueline Lang Weaver, *Texas Law of Oil and Gas*, 2\textsuperscript{nd} ed., Chapter 2, Subsection 2.1[B](1).
\textsuperscript{14} Id.
\textsuperscript{15} Id.
\textsuperscript{16} Id.
\textsuperscript{17} Joseph Shade, *Primer on the Texas Law of Oil and Gas*, 3\textsuperscript{rd} ed., Appendix A.
\textsuperscript{18} Id.
11. **Net Revenue Interest.** Net revenue interest or revenue interest of the working interest partners is the revenue attributable to working interest owners for their share of the well less the royalty.

12. **Bonus.** A payment made to a lessor to induce him or her to execute a mineral lease.

13. **Delay Rental.** A payment from the lessee to lessor to maintain an oil and gas lease during the primary term to maintain the lease during the primary term without drilling.

14. **Working Interest.** The working interest, also referred to as a leasehold interest or operating interest, is the portion attributable to the working interest partners that are responsible for all costs involved in exploration, production, and completion of a well. It is essentially the rights to the mineral interest acquired by an oil and gas lease.

15. **Depletion.** There is "physical depletion," which is the exhaustion of a mine or a petroleum reservoir by extracting the minerals. "Economic depletion" is the reduction in the value of a wasting asset by removing the minerals.

**II. Probating and Administering Mineral Interests.**

When probating or administering mineral interests, it becomes necessary to identify mineral interests for purposes of preparing a probate inventory, preparing a federal estate tax return (Form 706), if applicable, and to transfer legal ownership to the distributees of the estate. An Inventory, Appraisement and List of Claims identifying the estate property, must be filed within ninety (90) days following the appointment of the Executor or Administrator, and must provide the fair market value of the various probate assets on the date of death.

**A. Where is the Property?** The first step is to obtain from the client sufficient information to identify the location and type of mineral interests. In many instances, the client may not have that information readily available. A few ways to determine the type and location of mineral interests is to request the following from the client:

- Mineral Deeds and Leases;
- Stubs from Royalty Checks and/or Division Orders for Producing Royalty Interests;
- Property Tax Records;
- Previous Income Tax Returns; and
- Inventory, Appraisement & List of Claims from a predecessor estate showing previously inherited mineral interests.

**B. Producing vs. Non-Producing Mineral Interests.** If a client can only provide where the minerals are located, such as the county, some basic research will need to be conducted. This starts with distinguishing whether the mineral interests are producing or non-producing.

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1. **Producing Mineral Interests.** Producing mineral interests can be researched in the property tax records by searching the owner’s name to locate the operator, or oil and gas company. For example, records may be found at the following websites: Fort Worth (www.tad.org/); Dallas (www.dallascad.org/); Callahan, Erath, Floyd, Hartley, Harrison, Henderson, Hood, Hopkins, Knox, Lipscomb, Midland, Mills, Montague, Morris, Navarro, Palo Pinto, Parker, Reeves, Runnels, Stephens, Somervell, Van Zandt and Wise (http://southwestdata.com/corp/); and small counties (http://appraisaldistrict.net/). The operator, along with the name of the well and unit, is usually listed on the tax statement. With this information, you can contact the operator to obtain copies of mineral deeds, assignments, conveyances, or unit designations. You may also research the Railroad Commission of Texas records online at http://www.rrc.state.tx.us/ to obtain additional information. It is advisable to contact the operator before contacting the Railroad Commission because the information the operator provides you will be more detailed.

2. **Non-Producing Mineral Interests.** Non-producing mineral interests can be researched in real property records by the grantor/grantee name. Many local county websites allow you to search records for free, such as Dallas County (http://roamdallaspropertyrecords.com/ailis/search.do); Collin County (http://countyclerkrecords.co.collin.tx.us/webinquiry); and Tarrant County (https://ccrecordse.tarrantcountytx.gov/RealEstate/SearchEntry.aspx?e=newSession). You may also research records for a fee at www.texaslandrecords.com. However, most small county real property records are not accessible via the Internet. Even many large county real property records only go back to the late 1980s on the Internet. In those situations, you can contact the county clerk and request a record search of the grantor/grantee indices for a particular name and time period for a nominal fee. In some cases, it may be necessary to hire a landman to locate mineral interests; however, this method can be costly (especially if mineral interests are located in numerous counties).

C. **Leasehold and Working Interests.** An estate may include working interests or leasehold interests. Care should be taken to distinguish between a working interest and a leasehold interest. The leasehold refers to a specific lease or specific part of a lease, whereas the working interest is a share of gross production subject to the risk and expense of exploration and production. An overriding royalty interest is an interest in the oil and gas produced at the surface that is carved out of the working interest.

D. **Valuation of Mineral Interests.** Mineral interests must be described and valued at fair market value on an estate inventory and its estate tax return. Fair market value is the price that a willing buyer and a willing seller would pay for the property. Time of valuation for

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20 See generally Roger E. Beecham, Assigning Oil and Gas Leases, 27th Annual Advanced Oil, Gas and Energy Resources Law Course, Houston, Texas, October 8-9, 2009.

21 For an in-depth discussion regarding valuation of mineral interests, the author refers you to Alan B. Harp, Estate Planning with Mineral Interests: Valuation Issues, Fort Worth Club, Fort Worth, Texas, September 23, 2010.
the inventory and estate tax return is date of death.\textsuperscript{22} A rule of thumb with respect to royalty interest is that the fair market value of minerals is three times the cash flow from the twelve months preceding the date of a decedent's death.\textsuperscript{23} Again, this is just a rule of thumb and is not binding upon the IRS. If production is declining, there has been trouble with the well(s), or there are other adverse factors, the rate can be reduced.\textsuperscript{24} An appraisal by a petroleum engineer is probably the best evidence of value, especially when dealing with overriding royalty interests, working interests, and non-producing mineral interests.\textsuperscript{25}

E. Leasing Minerals. The situation often arises where a personal representative or an executor is approached to execute a lease on behalf of an estate.

1. Dependent Administration. Section 367(b) of the Texas Probate Code provides:

   Personal representatives of the estate of decedents, appointed and qualified under the laws of this State, and acting solely under orders of court, may be authorized by the court in which the probate proceedings on such estates are pending to make, execute, and deliver leases, with or without unitization clauses or pooling provisions, providing for the exploration for, and development and production of, oil, other liquid hydrocarbons, gas (including all liquid hydrocarbons in the gaseous phase), metals, and other solid minerals, and other minerals, or any of such minerals in place, belonging to such estates.

   The personal representative must file an application with the court that: (a) describes the property fully enough by reference to the amount of acreage, the survey name or number, or abstract number, or other description adequately identifying the property and its location in the county in which situated; (b) specify the interest thought to be owned by the estate, if less than the whole, but ask for authority to include all interest owned by the estate, if that be the intention; and (c) set out the reasons why such particular property of the estate should be leased.\textsuperscript{26} Neither the name of any proposed lessee, nor the terms, provisions, or form of any desired lease, need be set out or suggested in any such application for authority to lease for mineral development.\textsuperscript{27}

\textsuperscript{22} For federal estate tax purposes, there is an alternate valuation option. All assets may be valued on the date of death that is six months after the date of any distribution, sale, exchange, or disposition, whichever is earlier. See IRC, Section 2032

\textsuperscript{23} James E. Brill, Editor and Project Director, \textit{Texas Probate System}, State Bar of Texas, 3\textsuperscript{rd} ed, Worksheet 7.

\textsuperscript{24} \textit{Id.}

\textsuperscript{25} \textit{Id.}

\textsuperscript{26} Tex. Prob. Code § 367(c)(1).

\textsuperscript{27} \textit{Id.}
At the hearing on the application to lease, the Judge will require proof as to the necessity or advisability of leasing for mineral development the property described in the application and in the notice.\textsuperscript{28} The order authorizing leasing must include:

\begin{itemize}
  \item[a.] the name of the lessee;
  \item[b.] the actual cash consideration, if any, to be paid by the lessee;
  \item[c.] a finding that the personal representative is exempted by law from giving bond, if that be the fact and not a fact, then a finding as to whether or not the representative's general bond on file is sufficient to protect the personal property on hand, inclusive of any cash bonus to be paid, if any; and
  \item[d.] a complete exhibit copy, either written or printed, of each lease thus authorized to be made, shall either be set out in the order or attached thereto and incorporated by reference in said order and made a part thereof.\textsuperscript{29}
\end{itemize}

The authorized primary term shall not exceed five (5) years, subject to the terms and provisions of the lease extending it beyond the primary term by paying production, by bona fide drilling or reworking operations, whether in or on the same or additional well or wells, with no cessation of operations more than sixty (60) consecutive days before production has been restored or obtained or by the provisions of the lease relating to a shut-in gas well.\textsuperscript{30} Section 367 of the Texas Probate Code may only be used for dependent administration and not independent administration.

2. **Independent Administration.** A will often contains language authorizing an independent executor to execute oil and gas leases. If the will does not include language authorizing the independent executor to execute an oil and gas lease, it is believed that unless restrained by language in the will, an independent executor has the power to execute oil and gas leases that will bind the decedent's devisees after the estate has been closed.\textsuperscript{31} The authority to execute an oil and gas lease "seems unassailable when exercised in connection with paying the estate's or descendant's debts, setting aside exempt property or dividing property among the distributees."\textsuperscript{32} It has been "argued that because section 367 grants the probate court power to enter an order allowing a personal representative to execute oil and gas leases, that section is a source of similar power for

\textsuperscript{28} Tex. Prob. Code § 367(c)(5).
\textsuperscript{29} Id.
\textsuperscript{30} Tex. Prob. Code § 367(c)(7).
\textsuperscript{31} Ernest E. Smith and Jacqueline Lang Weaver, *Texas Law of Oil and Gas*, 2\textsuperscript{nd} ed., Chapter 2, Subsection 2.3 [D](2)(b).
\textsuperscript{32} Id.
independent executors.\textsuperscript{33} Even if section 367 is a source of similar power for independent executors, it "still leaves open the possibility that an oil and gas lease can be validly executed only when necessary for the 'settlement' of the estate, and that a lease entered into for the estate's 'preservation' would be beyond the power of the independent executor."\textsuperscript{34} The practical reason for arguing that an oil and gas lease can be validly executed when necessary for the "preservation" of the estate is to "protect the estate's land against drainage."\textsuperscript{35}

In \textit{Lowrance v. Whitfield}, the court held:

\ldots [U]nder the particular circumstances present here, the independent executor does have authority to execute an oil and gas or mineral lease during an independent administration of an estate for the purpose of preserving and protecting the assets of the estate. To hold otherwise could subject an independent executor to potential liability for nonfeasance in preserving the assets of the estate.\textsuperscript{36}

Note that \textit{Lowrance v. Whitfield} is a fact specific case and does not remove all doubt as to an independent executor's authority to execute an oil and gas lease in the absence of express language in the will authorizing the independent executor to execute an oil and gas lease.\textsuperscript{37}

It is important to carefully consider all the circumstances involved in a given fact situation before an independent executor executes an oil and gas lease on behalf of the estate. In certain circumstances, an independent executor's actions on behalf of the estate executing an oil and gas lease may be challenged.\textsuperscript{38}

\textbf{F. Transferring Title.}

There are several methods available for transferring title to minerals depending on the circumstances.

\begin{enumerate}
\item \textbf{No Administration.} If there is no administration of the estate, such as muniment of title or small estate affidavit, certified copies of the will and order in a muniment of title case or the affidavit in the case of a small
\end{enumerate}


\textsuperscript{34} \textit{Id.}

\textsuperscript{35} \textit{Id.}

\textsuperscript{36} 752 S.W.2d 129 (Tex. App.-Houston [1st Dist.] 1988, writ denied).

\textsuperscript{37} Ernest E. Smith and Jacqueline Lang Weaver, \textit{Texas Law of Oil and Gas}, 2\textsuperscript{nd} ed., Chapter 2, Subsection 2.3 [D](2)(b).

\textsuperscript{38} For a more in-depth discussion, the author refers you to Ernest E. Smith and Jacqueline Lang Weaver, \textit{Texas Law of Oil and Gas}, 2\textsuperscript{nd} ed., Chapter 2, Subsection 2.3 [D](2)(b).
estate affidavit should be recorded with the county clerk in all the counties where the mineral interests are located.

2. **Appointed Personal Representative.** For estates where an administrator or executor has been appointed, the personal representative can execute a mineral deed or assignment\(^{39}\) conveying the mineral interests to beneficiaries. If you do not have sufficient information to describe the location and type of mineral interests, the administrator or executor can execute a general blanket deed to transfer ownership. An example of a general blanket deed is attached as Exhibit A, hereto. Even though you may have very little information to describe the mineral interests, you will want to include as much property identification information as possible in the deed. Deeds executed by an administrator or executor should be recorded with the county clerk in all the counties where mineral interests are located. With a general blanket deed, you will want to record the deed in all counties where you have identified that decedent may have owned mineral interests.\(^{40}\)

3. **Power of Sale.** If a will does not include a power of sale provision, the recent legislative change to Section 145A of the Texas Probate Code permits distributees to agree to give the independent executor or administrator the power of sale. The consent needs to be authorized in the order to show the power of sale exists. The change to Section 145A applies to individuals that died on or after September 1, 2011.

4. **Affidavit of Heirship.** If a person dies without will (intestate), an Affidavit of Heirship may be used to establish heirship of persons that have title to property. An Affidavit of Heirship is a statement of facts concerning the family history, genealogy, marital status, or the identity of the heirs of a decedent. Affidavits of Heirship are also used in a proceeding to declare heirship or in a suit involving title to real or personal property.\(^{41}\) Probate Code Sec. 52A provides a form for an Affidavit of Heirship, although this form is only a guideline. A copy of this form is attached as Exhibit B, hereto. The next step after preparation of the Affidavit of Heirship, is a deed that usually conveys title into a single heir who may then keep the property or sell it. A special warranty deed or deed without warranties, but not a quitclaim deed, is usually used to convey title. Title companies generally do not insure property conveyed by quitclaim deeds. All heirs named in the Affidavit of Heirship must sign the conveyance to a single heir. Both Affidavit of Heirship and deed are filed in the real property

\(^{39}\) Different rules apply to assignments of oil and gas leases and overriding royalty interests. For further analysis of the rules and issues associated with assignments, the author refers you to Roger E. Beecham, Assigning Oil and Gas Leases, 27th Annual Advanced Oil, Gas and Energy Resources Law Course, Houston, Texas, October 8-9, 2009.

\(^{40}\) Careful drafting is required for a blanket conveyance. In *J. Hiram Moore, Ltd. v. Greer*, 172 S.W.3d 609 (Tex. 2005), the Court concluded that the combination of the ambiguous specific grant when read with the general grant in the legal description rendered the deed itself ambiguous. For in-depth discussion on the importance of language used in legal descriptions, the author refers you to George Snell, III, and Ana Maria Marsland - Griffith, Legal Descriptions - A Little Background and A Few New Issues, State Bar of Texas Oil, Gas and Energy Resources Law Section Report, March 2011.

\(^{41}\) Tex. Prob. Code § 52.
records in the county in which the property is located - the affidavit first, and then the deed. Most title companies and oil landmen have traditionally relied on Affidavits of Heirship to clear gaps in title (unless there is some reason to suspect an Affidavit of Heirship’s authenticity).\(^{42}\)

G. Getting the Money. In the case of an estate involving producing mineral interests, you will need to contact the operator, or oil and gas company.\(^{43}\) to request a new division order be prepared. The division order is the document that is signed by the owner (the beneficiary) that reflects new ownership as to how royalty payments are to be distributed. Depending on the type of administration, the operator usually requires evidence as to probate or the administration of the estate. You will want to verify with the operator what type of documentation it requires to issue a new division order. A new division order does not transfer title.


\(^{43}\) A list of oil and gas companies, along with contact information, may be found at the National Association of Division Order Analysts website (http://www.nadoa.org/publications.html, click on the “Royalty Owner Relations” link under the Merger and Acquisitions Directory).
OKLAHOMA MINERAL OWNERSHIP BY NON-RESIDENTS

Minerals in place and oil and gas leasehold interests are real property under Oklahoma law. Rich v. Doneghey, 71 Okla. 204, 177 P. 86 (1918). Transfers of minerals and leaseholds during lifetime or at death and rights of intestate heirs will be governed by the laws of the State of Oklahoma.

Common Law State with Elements of Community Property

Although Oklahoma is a common law state, the provisions for a surviving spouse upon death of the first spouse give the spouse enforceable rights which are similar to community property rights. If a husband and wife have acquired property by joint industry of husband and wife during coverture, the surviving spouse is entitled to one-half of the property. The deceased spouse cannot defeat the surviving spouse’s share by a valid last will and testament. The surviving spouse is given what is called a forced share. 84 O.S. § 44. If the surviving spouse has filed for divorce which is pending at the time of death of the deceased spouse, the surviving spouse is still entitled to a forced share. Estate of Miller v. Miller, 768 P.2d 373 (Okla. App. 1988).

Homestead

Oklahoma has a homestead law to protect the spouse, and transfers of surface real estate may not occur unless both spouses join in and sign the deed. The signature of a spouse for the transfer of a mineral interest which is a separate property and not acquired during coverture is not needed but may be advisable.

Intestacy

To determine intestate shares under Oklahoma law, one must first determine if the death occurred before or after July 1, 1985. 84 O.S. § 44. If after July 1, 1985, then unless limited by an antenuptial marriage contract, the estate will go entirely to the surviving spouse if there are no surviving issue, parent, brother or sister. If there are surviving issue who are all issue of the surviving spouse, then one-half to the spouse and one-half to surviving issue. If there are surviving issue, one of whom is not issue of the surviving spouse, then the spouse receives one-half of the property acquired by joint industry during coverture, and an undivided equal part of property not acquired by joint industry (spouse shares equally with all children).

The methods of transferring title to minerals in Oklahoma upon the death of a decedent:

1. Affidavit. The affidavit procedure may be used for testate as well as intestate decedents. However, title is not marketable until the affidavit has been recorded for ten years in the county clerk’s office. The statute permitting use of an affidavit has been in effect since November 1, 1999, for any intestate decedent. The amendment to allow this procedure for a testate decedent became effective May 10, 2010.

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Requirements to Establish Marketable Title via Affidavit.

(a) An affidavit stating decedent's death and testamentary status (intestate, testate, testate but unprobated, probated but with mineral interests omitted from final decree). For testate decedents, the will should be attached to the affidavit.

(b) Affidavit must list names of decedent's heirs and relationship to the decedent.

(c) Affidavit must state that the maker is related to the decedent or otherwise has personal knowledge of the facts within the affidavit.

(d) The affidavit or title transaction must have been recorded for 10 years in the county clerk's office.

(e) During the 10-year period, no instrument inconsistent with the heirship provided in the affidavit was filed with the county clerk.

2. Recording Domiciliary Probate Proceeding. No procedure for recording domiciliary probate proceedings is recognized in Oklahoma which will provide marketable title.

3. Short Form Ancillary Probate. In order to use this short form procedure, the domiciliary probate must have an order distributing the estate. This will not normally be available in a state which authorizes independent administration.

Requirements for Short Form Ancillary Probate.

(a) Petition must have attached a certified copy of the last will and testament, order admitting the will to probate and an order distributing the estate from the domiciliary probate proceeding. If intestate, a certified copy of the order appointing personal representative and order distributing the estate is required.

(b) Jurisdictional facts must be stated and must include identity of the heirs, legatees and devisees as well as an affidavit from the domiciliary personal representative that notice to Oklahoma creditors has been given or that there are no Oklahoma creditors known or reasonably ascertainable. Otherwise, notice to creditors must be given as required in a normal Oklahoma probate procedure.

(c) Notice of the hearing must be given at least 20 days in advance to the heirs, devisees, and legatees, and if all addresses are not known, then notice must be published 20 days before the hearing.

4. Formal Ancillary Procedures. If the short form ancillary procedure cannot be used or if there is a need to move forward prior to the domiciliary court order of distribution being entered, the estate must be probated under procedure applicable to domiciliary decedents. Must provide authenticated copy of will and domiciliary order admitting will to probate.
5. **Waiver Probate.** If a formal ancillary proceeding is to be filed, counsel should request that the petition be drafted to request that the court authorize a waiver probate. If written consent can be obtained from all heirs, legatees and devisees, the court may:

   (a) Authorize the personal representative to make any transactions on behalf of the decedent’s estate without further authorization by the court. (58 O.S. § 239).

   (b) Waive the necessity for preparation of an inventory, appraisement or filing of an accounting. (58 O.S. §§ 239, 281).

   (c) The consent of heirs who are neither devisees nor legatees is not required if the will has been admitted for more than three months, and there are no challenges presented to the will which must contain a residuary disposition. (58 O.S. § 239).

This waiver procedure can be very helpful for either a testate or intestate non-resident of Oklahoma. The court can give personal representative power to lease even if not in the will or if intestate.

6. **Statutory Power to Lease If No Power in Will.** If there is no power in the will to lease, then the following options are available:

   (a) Use the waiver probate procedure with consents from heirs, devisees and legatees. (58 O.S. § 239).

   (b) If lease bonus is $500 or less, the personal representative may secure approval of the court endorsed on the lease with the court finding that the bonus value does not exceed $500. (58 O.S. § 928.1).

   (c) If lease bonus is above $500, the personal representative may file a Petition to Sell Oil and Gas Lease with the court and set the matter for hearing.

      (i) Notice must be published in the county in which the proceedings are located and also in the county where the land is located if different.

      (ii) After obtaining approval from the court, personal representative may execute the oil and gas lease but it must be subject to confirmation by the court which is obtained by filing a return of sale of oil and gas lease.

      (iii) The order confirming sale of oil and gas lease should be delivered to the purchaser of the oil and gas lease along with the original lease. A certified copy of the order confirming the sale should be recorded in the county where the land is located.

7. **Termination of Joint Tenancy With Right of Survivorship.** If title to the minerals are held in joint tenancy with right of survivorship, then the survivor may file a petition requesting the judicial determination of death of the joint tenant and termination of the joint tenancy with all rights of ownership vesting in the survivor. 58 O.S. § 911. Notice must be given by mailing to all heirs of decedent if intestate and all heirs, devisees and legatees if testate and other potential claimants (interested in the property). Notice is also to be published once in the county at least ten days prior to the hearing.
8. **Simpler Termination of Joint Tenancy.** The surviving joint tenant may file an affidavit describing the real property and providing recording documentation including book and page of the document which created the tenancy and the date of death of the deceased tenant. A certified copy of the certificate of death should also be attached. If death occurred before January 1, 2010, and if surviving tenant is not the surviving spouse of a decedent, a release from the Oklahoma Tax Commission of the estate tax lien must also be attached.

Both procedures may also be used to determine the death of a life tenant with the property vesting in the remainderman.

9. **Special Rules Concerning Indian Land.** Before statehood, Oklahoma was Indian Territory, and Congress passed legislation for the protection of the Native Americans and their lands. The owner's right to transfer or lease is restricted, and approval from the Department of the Interior must be obtained. This area is beyond the scope of this outline, and reference should be made to the federal statutes and appropriate regulations.
NEW MEXICO MINERAL OWNERSHIP BY NON-RESIDENTS

Minerals in place and oil and gas leasehold interests are real property under New Mexico law [Duvall vs. Stone, 54 NM 27 (1949) and Terry vs. Humphreys, 27 NM 564 (1922)]; therefore, the transfer of minerals or oil and gas leasehold interests by a non-resident of New Mexico is governed by the laws of the State of New Mexico.

Community/Separate Property Elements:

New Mexico is a community property state. All property in New Mexico is presumed to be community property if the property is acquired during marriage [NMSA 1978, Section 40-3-12 (1973)]. The decedent would have the ability to transfer the decedent’s community one-half interest in minerals or other real property located in New Mexico. All separate property (property generally owned prior to marriage or acquired by gift, devise, inheritance, or bequest during marriage [NMSA 1978, Section 40-3-8 (1990)]) is generally transferred in accordance with the direction of the decedent. Classification of minerals as community or separate determines how minerals are distributed upon an intestate death and how the minerals can be distributed according to a will, trust, or other testamentary devise.

Conveyances or transfers of community real property (including leases with an initial term of five years or if the lease is for an indefinite term) must be joined in (signed) by both spouses or the conveyance/transfer is void [NMSA 1978, Section 40-3-13 (1993)]. If funding a trust, family limited partnership, family limited liability company or other entity, it is important to have both spouses sign the transfer/conveyance of any minerals/leasehold interests in New Mexico, even separate property to avoid the question of whether property is community or separate.

Intestate Succession:

Upon the death of a spouse, all community property under the intestate laws of New Mexico, goes to the surviving spouse. Upon the death of a decedent, one-quarter of any separate property goes to the surviving spouse and three-quarters of the separate property would be divided among the surviving children.

The methods of transferring title to minerals in New Mexico upon the death of a decedent:

1. Affidavit. No procedure for recognizing affidavits of heirship, for intestate decedents, is allowed under New Mexico law.

2. Recording Domiciliary Probate Proceedings. No procedure for recording domiciliary probate proceedings is recognized in New Mexico.

Reprinted with permission from The American College of Trust and Estate Counsel and James Maddox and Scotty Holloman, Maddox, Holloman & Kirksey, PC, Hobbs, New Mexico. Scotty Holloman is an Adjunct Professor at Texas Tech Law School teaching oil and gas law.
3. **Intestacy.** In the event the decedent died intestate, a formal determination of intestacy should be conducted before the court in New Mexico where the properties are located. The determination of heirship can be done with or without the appointment of a personal representative. The determination of heirship would require notice and hearing which are similar to the notice and hearing requirements of the formal probate of will set forth under paragraph 1 above.

4. (a). **Statement of Domiciliary Foreign Personal Representative.** If no local administration or application is pending in New Mexico, a foreign domiciliary personal representative may file a statement with the court where the New Mexico property is located setting forth the name and address of the domiciliary personal representative along with an authenticated copy of the will, order admitting the will to probate, and letters testamentary from the domiciliary probate and any bond given. This filing grants to the domiciliary foreign personal representative the right to exercise as to assets in New Mexico all powers of local personal representatives. This includes the ability to execute and deliver deeds or assignments of distribution.

(b). **Statement of Domiciliary Foreign Personal Representative along with probate of the will.** The method set forth in paragraph 4(a) above can be followed along with the entry of an order admitting the will to informal probate in New Mexico. The domiciliary foreign personal representative would have the same powers to deal with New Mexico property. Admission of the will to probate gives title examiners some comfort especially in the event there is a testamentary trust established under the terms of the will which receives the New Mexico minerals.

5. **Formal Ancillary Probate.** The domiciliary personal representative petitions the New Mexico court for the formal (with prior notice) probate of the will and formal appointment of the domiciliary personal representative as an ancillary personal representative in New Mexico. This procedure requires notice and hearing, and requires an authenticated (three way certificate) copy of the will, order admitting the will to probate, and letters testamentary to be filed with the New Mexico court with the petition. Notice has to be given of the hearing, which would include notice by publication. Notice is given 14 days prior to the hearing date to the heirs and devisees. Notice by publication requires publication once a week for three weeks, with the last publication being at least 10 days prior to hearing. After the will is admitted to probate and letters testamentary issued, the probate is handled in the same manner as a domiciliary proceeding. This would include publishing notice to creditors, accountings (which can be waived), and petitioning the court for approval of distributions along with deeds of distribution.
Oil and Gas Law 101 for Estate Planners
61st Tulane Tax Institute

October 31 – November 2, 2012

Permission granted for use at the 61st Tulane Tax Institute
We Are Using the Term “Minerals” Literally……

- This presentation focuses on the valuation of oil and gas interests from the mineral owners’ perspective
- Fee minerals… royalty interests
- As distinguished from leasehold/working interests and overriding royalty interests carved out of the working interest
Types of Mineral Interests and Ownership Vehicles

- Fee minerals (non-producing)
- Royalty & ORRI interests
- Working interests (leasehold)

<table>
<thead>
<tr>
<th>Asset Level</th>
<th>Entity Level</th>
<th>Family Holding Entity (FLP/LLC)</th>
<th>Privately Held Oil &amp; Gas Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty Interests</td>
<td>Typical</td>
<td>Typical</td>
<td>Occasional</td>
</tr>
<tr>
<td>Working Interests</td>
<td>Typical</td>
<td>Typical</td>
<td>Typical</td>
</tr>
<tr>
<td>Non-Producing Fee Minerals</td>
<td>Typical</td>
<td>Rare</td>
<td></td>
</tr>
</tbody>
</table>

3
Mineral/Royalty Interests vs. Working Interests

- Key differences between royalty and working interests:
  - Mineral interests have the opportunity to receive a lease bonus.
  - Mineral interests will not expire if leasehold/working interests turns uneconomic and are no longer held by production (HBP).
  - Mineral/royalty interests are not cost bearing – drilling and completion expenditures (“D&C” costs), lease operating expenses (“LOE”), and workover, etc. Thus, the mineral interest holder doesn’t bear direct operational/mechanical risk.
  - Mineral/royalty interests will never get a cash call.
  - Mineral interests are passive interests and investors do not need technical expertise to own them. On the other hand, the operated working interest controls the decision to drill/explore a subject location and a mineral interest cannot influence the exploitation of subject minerals.
Royalties Are Worth More Than Working Interests

- All else being equal, the projected net cash flow stream from royalty interests are more valuable than the net cash flow stream from working interests. See following page.

- Reserve engineers don’t always make a distinction between the different types of interests in their valuation work.

- Admittedly there could be buyer group/segmentation dynamics involved:
  - Retail investors (without oil and gas technical expertise) are chasing yield in today’s low interest rate environment, artificially driving royalty metrics higher than market fundamentals would dictate.
### Royalty and Working Interest Valuation Metrics

Data from June 2011 to June 2012.


(b) Average monthly cash flow during six months prior to sale.

<table>
<thead>
<tr>
<th>Region</th>
<th>Royalty and Overriding Royalty Interests</th>
<th>Working Interests (Operated and Non-Op)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Price/boepd (a)</td>
<td>Price/monthly cash flow (b)</td>
</tr>
<tr>
<td>Appalachian</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Ark-La-Tex</td>
<td>$237,543</td>
<td>88.3 x</td>
</tr>
<tr>
<td>Gulf Coast</td>
<td>$210,378</td>
<td>79.9 x</td>
</tr>
<tr>
<td>Michigan Basin</td>
<td>$216,572</td>
<td>75.3 x</td>
</tr>
<tr>
<td>Mid-Continent</td>
<td>$263,714</td>
<td>100.7 x</td>
</tr>
<tr>
<td>Permian</td>
<td>$258,148</td>
<td>115.4 x</td>
</tr>
<tr>
<td>Rockies</td>
<td>$238,401</td>
<td>99.2 x</td>
</tr>
<tr>
<td>South Texas</td>
<td>$204,976</td>
<td>73.9 x</td>
</tr>
</tbody>
</table>
Royalty Interests Worth 3x Annual Cash Flow?

- What’s the disconnect with (monthly) data on prior slide?
  - New technology (horizontal drilling/slick water fracs) is breathing new life into legacy fields or opening new production horizons/zones.
  - Advent of online auction (EnergyNet) increases market efficiency of royalty properties.
  - Non-producing properties have value.
  - 3x might apply to highly fractionalized interests ($100 cash flow per month), but not the 3,000 acre ranch.

- Mineral aggregator shops (the unsolicited offers mineral owners receive periodically in their mailbox) offering to purchase very small mineral interests.
- Non-sophisticated seller, in need of cash or to avoid administrative or tax hassle, might sell.
Key Drivers of Mineral Interest Value

- As in any valuation exercise, valuation is driven by:
  - The expected cash flow to be generated by the subject minerals.
  - The risk of that cash flow stream.

- Drivers of the expected cash flow stream:
  - Historical decline of producing mineral base (any regeneration or reserve replacement experienced from new wells/zones, in-fill drilling program?)
  - Any “upside” expected? (in or near hot play?)
    - Lease bonus’ in area greater than $200 per acre?
  - Percentage leased vs. unleased
  - Lease bonus potential
  - Oil vs. natural gas reserve and production mix
Key Drivers of Mineral Interest Value (cont’d)

- **Drivers of risk:**
  - Diversification/size of subject mineral portfolio
    - Number of properties, counties and/or states
    - Number of operators
    - Number or exposure to different plays or basins?
  - Commodity price risk
Valuation Mechanics/Procedures

- For producing minerals:
  - We utilize reserve reports on producing (PDP) properties

- For non-producing minerals:
  - Transaction metrics ($/net mineral acre). See following slide
  - Drill out scenario where we estimate timing of drilling, amount of wells possible on mineral footprint, and type curves from area.
    - Multiple of lease bonus

- Compare resulting value to mineral and royalty transaction metrics (multiple of cash flow)
Non-Producing Fee Mineral Valuation Metrics

This document contains confidential information and is intended only for the recipient named. In addition, this document contains information and data regarding the prior sales of properties sold in the EnergyNet auction marketplace. All information and data reflect EnergyNet’s experience regarding the sale of properties in the past and do not establish a value for specific properties that may be sold in the future. You are advised that investments in oil and gas properties involve substantial risk, including the possible loss of principal. These risks include commodity price fluctuations and unforeseen events that may affect oil and gas property values.
Historical and Forward Strip Oil and Gas Prices

Historical Spot Pricing (June 2007-June 2012) and NYMEX Strip Pricing (August 2012-July 2017) as of June 29, 2012

- Henry Hub Natural Gas
- West Texas Intermediate Oil
Select Professionals

Alan B. Harp, Jr., CFA, ASA

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CASE STUDY A

Resident of Louisiana dies owning producing mineral interests in Oklahoma. Decedent was married at time of death but to a second spouse who is not the father of her three children. She told her children that all of her minerals were inherited from her grandparents. Her will has been probated in Louisiana, and all Louisiana property distributed to the testamentary trust. All three children are co-trustees of the testamentary trust.

Once you notify the oil company of the death, the revenue flow will be thrown in suspense until you satisfy their title requirements. Explain "suspense." You may want to spread out the transfer requests over a period of time so that not all revenues are suspended at once.

Assume that the revenues are fairly small but the children want to keep the revenue flowing. What makes practical sense and won't cost too much in legal fees.

ISSUE: What options are available to keep the money coming in?

(Oklahoma answers)

Try the Oklahoma affidavit procedure first. Affidavit is new and not accepted by all companies. Does not provide marketable title if a sale is anticipated in near future.

If company will not accept affidavit, look at the cost of a short form ancillary procedure which requires only one hearing in one of the Oklahoma counties. Can record the one court order in all of the Oklahoma counties. (Funds accruing in suspense may eventually cover cost of probate.)

If you have only a mineral interest that is not producing, consider using the affidavit procedure alone so that you have marketable title after ten (10) years or, if and when, the property becomes producing.

If the death occurred prior to January 1, 2010, and you filed Oklahoma estate tax return and obtained tax release, then record tax release against the property with contact information. This allows a lease broker checking for a lease to know who to contact. You can then possibly negotiate a lease with an extra payment to assist with the legal fees of perfecting title. If the oil company pays a higher bonus, they will have to provide this information in a force pooling but they can pay certain legal fees without it affecting the bonus price. (This option may save a little money over the affidavit, but is not effective for title cleanup.)
RESIDENT OF NORTH ATLANTIC STATE OWNS A NUMBER OF PRODUCING AND NONPRODUCING MINERAL INTERESTS IN MULTIPLE STATES (NM, OK & TX) AND IN MULTIPLE COUNTIES IN EACH STATE. PROPERTIES WERE INHERITED FROM GRANDPARENTS. CLIENT DID NOT RECEIVE ANY TITLE INFORMATION FROM HIS GRANDPARENTS’ ATTORNEY AT THE TIME OF THEIR DEATHS AND HAS NOT KEPT GOOD RECORDS ON SUBSEQUENT LEASING ACTIVITIES AND THE FAMILY ATTORNEY IN TEXAS WHO PROBATED HIS GRANDPARENTS’ ESTATES IS LONG GONE AND HIS FILES ARE UNAVAILABLE. IN THE LAST FEW YEARS, THE INCOME FROM THESE INTERESTS HAS GONE FROM A FEW THOUSAND DOLLARS A YEAR TO TENS OF THOUSANDS OF DOLLARS A MONTH! CLIENT (WHO HAS STRONG ENVIRONMENTAL CONCERNS) IS STARTING TO THINK THAT HORIZONTAL DRILLING AND FRACKING MAY NOT BE ALL BAD AFTER ALL. CLIENT HAS BEEN ADVISED TO PLACE THESE INTERESTS IN AN LLC/FLP FOR LONG-TERM MANAGEMENT PURPOSES AND TO FUND HIS REVOCABLE TRUST WITH HIS OWNERSHIP INTEREST IN THE LLC/FLP. LLC/FLP CAN ALSO BE USED TO SIMPLIFY THE GIFTING OF PARTIAL INTERESTS IN THESE MINERALS.

ISSUES:

- Short of a very expensive title search in all these jurisdictions, how do you make sure you convey all the minerals interests owned to the LLC/FLP (there may even be unknown mineral interests in other counties)?

- Provide local counsel with copies of all division orders and royalty check stubs on producing minerals and all lease proposals (whether or not accepted - most do not keep rejected lease proposals but should for future reference).

- Get copies of inventory of minerals in grandparents' estates filed of record in their probate proceeding, if available – issue: some of the interests will probably have changed after the grandparents’ deaths due to sales, farm-outs, leases, etc.

- Use catch-all clause in conveying documents - has its drawbacks but does provide some basis for title support.

SHOULD SPOUSE SIGN THE CONVEYING DOCUMENTS? IF SO, IN WHAT CAPACITY?

- Following the conveyance of the mineral interests of record, what is the process of having the royalty payments flow to the LLC/FLP? Discuss division orders.