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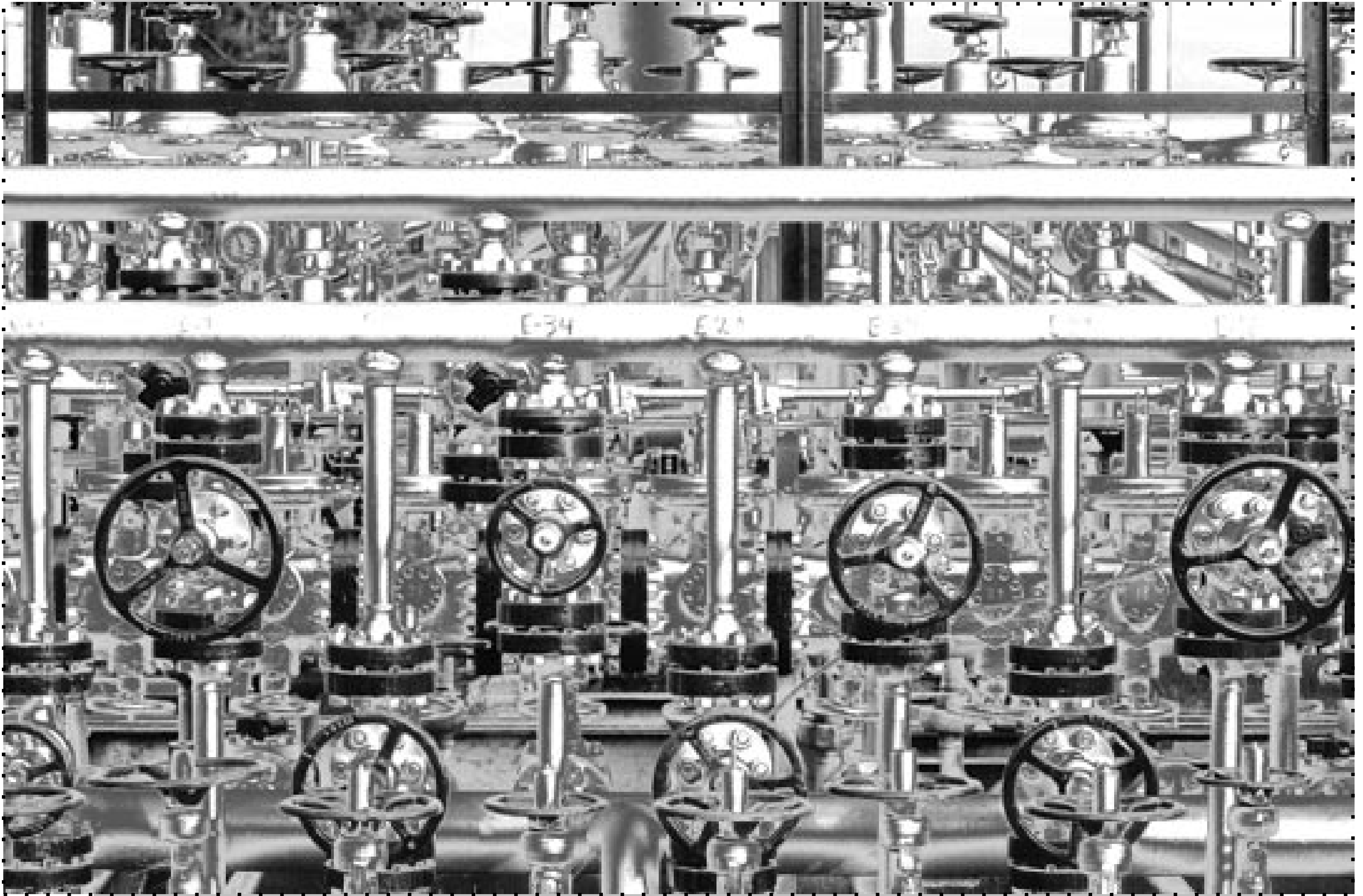

Rights and Responsibilities of Mineral Cotenants

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Special Report 843

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Revised May 2005
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Creation of a cotenancy in mineral property poses issues to both co-owners and mineral lessees (oil companies). Many questions can be resolved by recognizing that the rules of possession and accounting that govern ownership and use of the surface apply to the minerals.

The rule of possession permits the mineral lessee to drill anywhere on the property from a legal location with a lease from one mineral cotenant. A mineral lease from all cotenants is not required.

The duty of accounting dictates the manner of distributing the proceeds from the well among the consenting and nonconsenting cotenants before and after payout. The rules vary depending on whether the tract serves as a drill site or as a corridor tract of a horizontal borehole.

In Texas, a mineral lessee may partition the mineral estate among the consenting and nonconsenting cotenants and avoid the duty of accounting.

The following scenario serves as the example throughout this report:

> George and his sister Harriet inherited 500 acres from their parents. The inheritance included both the surface and minerals. Recently, several oil companies approached the two seeking to lease their mineral interest.
>
> George, who farms the surface, does not want to lease because of the possible interference with his farming operations. Harriet, who lives in the city, does not care about the surface and wants the revenue from leasing and possible production. George informs his sister that he would negate her efforts by refusing to sign any oil and gas lease.

In Texas, real property is generally divided into three estates, the surface, the minerals and more recently the groundwater. Each may be owned by the same person or entity or separately by different persons or entities. Division of the surface and minerals generally occurs when the person or entity owning both estates sells the surface and retains the minerals.

Texas courts have ruled that any type of estate that can be created in the surface can be created in the minerals. Texas courts also recognize that the same types of cotenancies or co-ownerships can be created in either.

Disagreement among mineral cotenants is a common problem. What happens if one or more cotenants refuse to sign a mineral lease? What affect does this have on the cotenants who sign?

Two rules of law set precedent regarding the rights of cotenants in either surface or minerals. One relates to the right of possession, the other to the duty of accounting.

Right of Possession

It is well established in Texas that each cotenant has a right to occupy any part of the jointly owned property. One cotenant's right of possession is not exclusive. The possession must be shared.

The rule of possession, when applied to adverse possession, has interesting implications. Can one cotenant adversely possess another? The answer is no, unless one cotenant informs the other that he or she intends to exercise exclusive possession to all or a part of the property. (This is sometimes referred to as repudiating the other cotenant's title to the land.)

Regarding the second rule, each cotenant must account to the other for all the income and expenses arising from projects conducted on the property by one cotenant without the other's consent. In the opening example, if George is farming the surface, he must account to Harriet each year for farming expenses and divide any resulting profits. However, George has the right to recoup Harriet's share of the farming expenses, if not paid in advance, before dividing the profits.

A review of the mineral estate is helpful in understanding the rules of possession and accounting. Five separate and distinct interests comprise the mineral estate. These include: (1) the right to lease the minerals, sometimes called the *executive right;* (2) the right to develop and produce the minerals; (3) the right to receive bonus; (4) the right to receive delay rentals; and (5) the right to receive royalties.

Generally, when a cotenancy is created in the minerals, each of the five interests is divided equally among the cotenants. The magnitude of the division depends on the number of cotenants.

In the opening example, George and Harriet own an undivided one-half interest in each of the five rights. If there had been ten surviving children, each child could have received an undivided 10 percent interest in each of the mineral rights. At the same time, the parents may have left one child an undivided one-half interest with the remaining nine children sharing the other half.

The five interests do not necessarily have to be divided equally among the cotenants. The mineral interests, sometimes referred to as a bundle of sticks, are capable of being divided or separated in infinite combinations just as five sticks could be physically divided or separated.

For example, what if George and Harriet were just two of five children who inherited the land? Legally, but not practically, the parents could have structured the devise so that each child received one mineral right (or stick) and nothing else. George could have received all the executive rights and Harriet the right to receive all the delay rentals. Each of the other three children could have received one of the remaining three interests.

Going back to the opening example, though, suppose an oil company offers Harriet a three-year lease, $100-an-acre bonus, a one-sixth royalty and $5-per-acre annual delay rentals. What impact would it have on George's mineral interest if Harriet signs the lease? The answer is very little, if any.

Harriet owns an undivided right to 50 percent of all the mineral interests. She does not need George's consent to exercise these rights. Thus, the oil company gets a valid lease by paying Harriet a $25,000 bonus (1/2 x 500 acres x $100). The oil company would owe her a one-twelfth royalty from production (1/2 x 1/6) and $1,250 annual delay rentals for each year there are no operations conducted during the primary term (1/2 x 500 acres x $5).

Note. Most oil companies now use "paid-up" leases. This means oil companies tender all delay rentals at the beginning of the lease with the bonus. This avoids subsequent annual payments for delay rentals.

If Harriet signs the lease, on which part of the 500 acres can the oil company drill? The oil company may drill any where seismic tests indicate is a prime location as long as the drill site conforms to the spacing requirements of the Railroad Commission of Texas. Generally, this requires a minimum of 467 feet from a property or lease line. Harriet's right of possession to any portion of the land as a cotenant is transferred to the mineral lessee via the mineral lease.

The same rule applies regardless of the number of co-owners. Only one co-owner needs to enter a mineral lease in order for the oil company to drill anywhere on the property as long as the spacing requirements of the Railroad Commission of Texas are met. Consequently, George cannot block drilling activity on the land by refusing to sign the lease.

Accounting Among Cotenants

The rule that allows an oil company to drill on the leased premises with one cotenant's consent is tempered by the rule of accounting. Here is how it works.

Suppose Harriet possessed sufficient resources to drill an oil or gas well. She opts to drill her own well rather than enter an oil and gas lease. Can she drill without George's consent?

The answer is yes. By owning half of the minerals, she possesses one half of the right to explore and produce. Her right of possession as a cotenant gives her the right to locate the well wherever she chooses as long as it is a legal location.

Suppose Harriet's test well costs $500,000. Is George liable for one half of the costs? Again, the answer is yes. George's ownership of one-half the minerals imposes one-half of the reasonable and necessary exploration and drilling costs. However, Texas law does not require any out-of-pocket costs from a nonconsenting mineral cotenant. Instead, the drilling cotenant (Harriet) must recoup George's share of the well costs from his share of future revenue from the well.

In other words, the drilling cotenant must bear all costs in connection with the test well. The drilling cotenant is entitled to reimbursement but only from the nonconsenting cotenant's pro rata share of subsequent revenue. If the drilling venture does not result in production, or does not yield sufficient revenue to cover the nonconsenting cotenant's well costs, the nonconsenting cotenant has no legal or personal obligation to pay the balance. This is sometimes referred to as a *carried interest*.

If Harriet drills a $500,000 test well, she has the right to recoup $250,000 from George's share of future production. Because George owns an undivided one-half of the minerals, the $250,000 comes from one-half of the first $500,000 of the well's revenue, taking into account necessary and reasonable marketing costs. If the total revenue never reaches $500,000, George has no personal liability for the balance.

Revenue After Payout When One Cotenant Drills

But what happens when Harriet gets reimbursed from George's share of production? What happens to George's interest after payout? In this case, George participates in the well according to his undivided interest. Because George owns an undivided one-half of the minerals, he has the right to receive one-half of the production after payout; again, taking into account reasonable posts of production and marketing.

Revenue After Payout When Cotenant Leases Drill Site Tract or Tract Serving as Corridor for a Horizontal Borehole

But what happens if Harriet does not drill, but instead leases her half interest to an oil company? According to Texas law, the same rules of accounting apply, except the leasing oil company shoulders the initial drilling costs and assumes the duty of accounting.

Assume Harriet reserves a one-sixth royalty in the lease. George refuses to sign. As before, he becomes liable for one-half the reasonable and necessary exploration and production costs payable from his share of future production. The oil company enters and drills a well for $500,000. When the company recoups the well costs, George would receive one-half of the well's revenue less reasonable marketing costs until the well ceases to produce, just as before.

Harriet, on the other hand, bears no direct or indirect exploration and production costs and no duty to account. She would receive 1/12th of the production as a royalty (1/2 x 1/6) commencing with the well's first production until it ends.

George may choose to alter his position as a nonconsenting cotenant by ratifying the lease. Ratification occurs when George accepts benefits under the lease or by executing a division order. Ratification allows George to participate in the revenue in the same manner as his sister. There would be no change after payout.

Revenue After Payout When Cotenant Leases Non-Drill Site Tract or One Not Serving as a Corridor for a Horizontal Borehole

Texas case law recognizes an exception to the rule of accounting when the lease tract does not serve as a drill site nor a corridor tract for a horizontal borehold. The Texas Supreme Court announced the rule in *Superior v. Roberts,* 398 S.W. 2nd 276.

In this case, one cotenant, who owned half the minerals, leased to Superior Oil Company. The other cotenant did not lease to anyone. Superior drilled a vertical well, but not on the tract. The tract was included in the pooled unit, though.

When the well reached payout, the nonconsenting cotenant (Roberts) asked Superior for an accounting. Superior refused, and Roberts sued. The Texas Supreme Court ruled that Superior had no duty to account to Roberts in this situation.

Basically, the leasing oil company has no duty to account to a nonconsenting cotenant when:

- One or more of the cotenants lease their undivided interest to an oil company and the lease permits the oil company to pool or unitize the tract.
- The premises are not used as a drill site, but the tract is placed in a pooled unit.
- No contractual relationship exists between the leasing oil company and the nonconsenting cotenant.
- The nonconsenting cotenant has made no attempt to ratify the lease.
- The leasing oil company has not prevented the nonconsenting cotenant from developing the property.

Note. The Texas Supreme Court rendered the *Superior* decision in 1966 before the advent of horizontal drilling. The majority of wells at the time were vertical wells. Today, most wells are horizontal wells. The Railroad Commission of Texas views a tract serving as a corridor tract in the same manner as a drill site tract. Hence, legal precedent exists to apply the *Superior* decision to corridor tracts as well as drill site tracts.

Leasing to Different Oil Companies

Suppose George decides to lease his undivided interest to a different oil company. In other words, Harriet leases to the ABC oil company, and George leases to the XYZ oil company. If ABC enters and drills a producing well, does the XYZ company owe George a royalty from production even though XYZ did not participate in the well?

In Texas, the answer is yes. XYZ must pay royalties to George just as if George had signed with the same oil company as Harriet. Had George signed a lease for a 1/5 royalty, XYZ is liable to George for 1/10 (1/2 x 1/5) of the production or its monetary equivalent.

Partitioning

However, assume George will not sign a lease with any oil company. If the nonconsenting cotenant's interest is particularly large, as is the case with George, the oil company may lose all desire to take a lease from any other cotenant. The reason is the drastic cut in the oil company's revenue interest (50 percent) once payout is achieved (see table on page 5).

In Texas, the mineral lessee has an alternative. Section 23.001 of the Texas Property Code permits an oil company to partition the rights of the leased mineral cotenants. Partitioning is done according to the number of undivided mineral acres the oil company has leased, assuming the minerals are equally distributed under the tract.

Assume the oil company gets Harriet to sign an oil and gas lease. George absolutely refuses. Furthermore, it is economically infeasible for the oil company to have a 5/12 revenue interest after payout. (See table.) In this case, the oil company may wish to proceed under Section 23.001 of the Texas Property Code and partition 250 mineral acres for Harriet. This gives Harriet 100 percent of the minerals under 250 acres, and George owns 100 percent of the minerals under the remaining 250 acres. The oil company may then drill on Harriet's 250 partitioned mineral acres. It would have a 5/6 revenue interest before and after payout. George would have no interest in a well drilled on Harriet's partitioned acreage and vice versa.

The partitioning may not be according to the cotenant's undivided interest in the tract. Texas courts seek to ensure the partitioned tracts have equal value, not equal area. Texas case law presumes that any minerals under a tract are distributed equally in the absence of proof to the contrary.

Fiduciary Duty of the Executive Owner

In the scenario discussed so far, each cotenant owned a part of all five interests comprising the mineral estate. A cotenancy may exist without this arrangement. It is quite common for the five interests to be separated as well as divided among several individuals.

For example, when one cotenant owns all of the surface and a part of the minerals, the surface owner attempts to acquire all the executive rights to fully protect the surface in the event of drilling. the other four interests may be equally divided among the rest of the cotenants.

In the opening example, assume the parents left all the executive rights to George who farms the surface and gives Harriet one-half of the bonus and one-half of the royalties. (This means Harriet receives one-half of whatever royalty George negotiates in the lease.)

Because Harriet acquired no executive rights, she is at George's mercy concerning:

- When a lease is entered,
- The magnitude of the bonus payments,
- The size of the royalty reserved,
- The length of the primary term and
- Other lease terms and provisions.

Texas law recognizes a unique relationship when the executive rights are stripped from one or more of the mineral cotenants who then own only the right to receive royalty. The law imposes a duty of utmost fair dealing (or a fiduciary duty) on the holder of the executive rights when leasing the mineral property. The executive owners must negotiate the best terms possible on behalf of the nonexecutive owners. The executive owner cannot structure a transaction to benefit himself or herself at the nonexecutive owner's expense.

The following represent a few of the examples where the Texas courts have held that the executive owners breached their fiduciary duty by:

- Failing to lease when the land is being drained
- Failing to enter a lease when it was possible to do so, thus depriving the nonexecutive owners of potential revenue
- Developing the property personally when it was possible to do so under a leasing arrangement at greater revenue to the nonexecutive owners
- Failing to share all possible royalties with the nonexecutive owners by negotiating an overriding royalty

Cotenancy does not in itself create the fiduciary duty. It results only when one or more of the mineral cotenants who own a royalty interest are stripped of executive rights.

Unknown Cotenants

Finally, examination of the rights of cotenants in the mineral estate would not be complete without considering the possibility of an unknown, unascertainable or missing cotenant. Suppose George and Harriet's parents owned an undivided 90 percent of the minerals. The other 10 percent was reserved in 1890. No one can determine who or where the heirs reside today.

The Texas Legislature enacted special rules for missing mineral owners. Section 64.091 of the Texas Civil Practice and Remedies Code provides for the appointment of a receiver to act vicariously on behalf of the missing mineral cotenant(s). The lease proceeds are paid to and retained by the clerk of the district court where the receiver is appointed. The funds are used for the benefit of the unknown owner or owners. However, any unclaimed royalties escheat to the state of Texas after three years.

Conclusion

The rights of mineral co-owners in Texas are well defined. Because Texas mineral production has occurred more than 100 years, Texas courts have addressed many of the issues that arise. Basically, Texas courts apply the same rules that govern surface cotenancies to those created in the minerals. In each instance, the courts strive to protect the individual co- owner's rights, yet allow society to benefit from mineral production.

This report is a revision of reprint 463, which first appeared in Tierra Grande. *The overview of the rights of cotenants is for information only and is not intended to substitute for legal counsel. Those concerned about specific aspects of the law involving cotenancy and mineral estates should contact an attorney.*

The Real Estate Center offers additional publications related to mineral leasing:

Hints on Negotiating an Oil and Gas Lease, http://recenter.tamu.edu/pdf/229.pdf

Termination of an Oil and Gas Lease, http://recenter.tamu.edu/pdf/601

"Subdivision Drill Sites," http://recenter.tamu.edu/pdf/690

Minerals, Surface Rights and Royalty Payments, http://recenter.tamu.edu/pdf/840

"Recent Rulings Affecting Oil and Gas Interests," http://recenter.tamu.edu/pdf/1140

"Scrutinizing Royalty Payments," http://recenter.tamu.edu/pdf/1559

Table 1. Four Leasing and Nonleasing Cotenants

Situation One: Four Cotenants – A, B, C and D						
Col. 1	**Col. 2**	**Col. 3**	**Col. 4**	**Col. 5**	**Col. 6**	**Col. 7**
			(Col. 2 x Col. 3)	(Col. 2–Col. 4)	(Same as Col. 4 when lease entered)	(Same as Col. 5 when lease entered)
Cotenants and Oil Company	Cotenant's Undivided Interest	Royalty Reserved in Lease	Royalty Received Before Payout	Oil Company's Revenue Before Payout	Royalty Received After Payout	Oil Company's Revenue After Payout
A	1/4	1/6	1/24	5/24	1/24	5/24
B	1/4	1/5	1/20	1/5	1/20	1/5
C	1/4	1/4	1/16	3/16	1/16	3/16
D	1/4	unleased	0*	1/4**	1/4*	0
Oil company	na	na	na	203/240	na	143/240

Source: Real Estate Center at Texas A&M University

Table 2. Six Leasing and Nonleasing Cotenants

Situation Two: Six Cotenants – A, B, C, D E and F						
Col. 1	**Col. 2**	**Col. 3**	**Col. 4**	**Col. 5**	**Col. 6**	**Col. 7**
			(Col. 2 x Col. 3)	(Col. 2–Col. 4)	(Same as Col. 4 when lease entered)	(Same as Col. 5 when lease entered)
Cotenants and Oil Company	Cotenant's Undivided Interest	Royalty Reserved in Lease	Royalty Received Before Payout	Oil Company's Revenue Before Payout	Royalty Received After Payout	Oil Company's Revenue After Payout
A	1/6	1/6	1/36	5/36	1/36	5/36
B	1/6	1/8	1/48	7/48	1/48	7/48
C	1/6	3/16	1/32	13/96	1/32	13/96
D	1/6	unleased	0*	1/6**	1/6*	0
E	1/6	unleased	0*	1/6**	1/6*	0
F	1/6	unleased	0*	1/6**	1/6*	0
Oil company	na	na	na	265/288	na	121/288

*Illustrates a nonconsenting cotenant's participation in the revenue of the well before and after payout.
**Illustrates the recouopment of the nonconsenting cotenant's share of costs before payout.
Source: Real Estate Center at Texas A&M University

1096-100-843