Blood & Oil: Strategies for Mineral Cotenancy Disputes in Texas

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Boring Legal Disclaimer

- All views shared are personal perceptions and preferences, not necessarily shared by my employer or anyone else.
- Nothing herein is intended to constitute the furnishing of legal advice.
Black Acre
Black Acre

Abel  Bob  Cain  David
Basics of Cotenancy

- Each cotenant has the absolute right to develop and use the land, and one cotenant may use Black Acre without fear of owing any rumination.

- As a general rule, one cotenant is not a trustee for the other, and no fiduciary duty is owed by one to the other.

- A cotenant in possession of the common estate who fails to adequately protect the property will be deemed to have committed waste, and will be liable to his cotenants for losses resulting therefrom.

- Where a cotenant has obtained rents or profits from the common estate, he must account to the other cotenants for their share of the proceeds\textit{ minus the reasonable and necessary expenses}.\footnote{Here, the footnote is not specified.}
Basics of Cotenancy Accounting

- Where a cotenant has obtained rents or profits from the common estate, he must account to the other cotenants for their share of the proceeds *minus the reasonable and necessary expenses*.

- Where a cotenant has expended funds to preserve the common estate, he may seek reimbursement from his cotenants.

- But a cotenant who incurs speculative expenses is not entitled to reimbursement from his fellow cotenants.
  - Instead, he is entitled to recoup his reasonable and necessary expenses upon accounting to his cotenants for their proportionate share.
Cotenancy of the Mineral Estate

- Each cotenant (regardless of the amount of interest he/she owns) may explore, drill and develop oil and gas without the participation of the other cotenants.
- When an oil and gas lease has been executed, the lessee has acquired a fee simple determinable in the mineral estate.
- In the event a lease is acquired on an undivided interest, the lessee steps into the shoes of the lessor for cotenancy purposes.
Black Acre – Oil and Gas Leases

BigOilCo

Abel

Bob

Cain

ThirdPartyCo

David
Black Acre No. 1 Well – Production Decline Curve


Formula for decline curve hyperbolic function: $Q_t = Q_i / [(1 + b \cdot D_i \cdot t)^{1/b}]$, where $Q_t$ = Production in month $t$, $Q_i$ = Production rate at time 0, $b$ = Hyperbolic parameter, $D_i$ = Initial decline rate, $t$ = Month in production. This has been reproduced via Excel spreadsheet with the following formula: $Q_t = Q_i \cdot (1 + b \cdot D_i \cdot t)^{-1/b}$. Production was calculated on a monthly basis with an assumed production life of 221 months.
Black Acre No. 1 Well – Revenue

Yearly Gross Revenue (Discounted)*

1 2 3 4 5 6 7 8 9 10

$1,000s

$0 $1,000 $2,000 $3,000 $4,000 $5,000 $6,000 $7,000 $8,000

Year

$6,893 $2,948 $1,472 $814 $483 $303 $198 $133 $92 $65

*$Discounted monthly at annual interest rate of 10%

~$13.5MM

$45/Barrel Oil

10
Black Acre No. 1 Well – Revenue

100% Leased at a 25% Royalty

- Royalty, 25%
- BigOilCo, 75% Net Revenue Interest (NRI)

~$13.5MM

~$10.2MM
- $6.5MM (Cost)

~3.7MM Profit

Net Present Value (NPV)
Effects of a Carried Interest on NRI

Before Payout

- BigOilCo, 81.25%
- Royalty, 18.75%
- Abel: $\frac{1}{4} \times \frac{1}{4} = \frac{1}{16}$
- Bob: $\frac{1}{4} \times \frac{1}{4} = \frac{1}{16}$
- Cain: $\frac{1}{4} \times \frac{1}{4} = \frac{1}{16}$
- David: X

After Payout

- BigOilCo, 56.25%
- ThirdPartyCo, 25.00%
- Royalty, 18.75%
Effects of a Carried Interest on Net Revenue

Back Acre No. 1 Well - Oil Revenue and Payout Status

Net Revenue ($1,000s)

Cumulative gross cash flow ($1,000s)

Month

Payout

100% Working Interest NRI
75% (Carried) Working Interest NRI
Pay Out Status
Effects of a Carried Interest on NPV

<table>
<thead>
<tr>
<th>Working Interest Minus Carried Balance</th>
<th>Net Present Value (NPV)</th>
<th>Profit/Investment Ratio (PIR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>100%</td>
<td>$3,680</td>
<td>1.000</td>
</tr>
<tr>
<td>98%</td>
<td>$3,700</td>
<td>0.980</td>
</tr>
<tr>
<td>95%</td>
<td>$3,500</td>
<td>0.950</td>
</tr>
<tr>
<td>90%</td>
<td>$3,100</td>
<td>0.900</td>
</tr>
<tr>
<td>80%</td>
<td>$2,700</td>
<td>0.800</td>
</tr>
<tr>
<td>75%</td>
<td>$2,766</td>
<td>0.750</td>
</tr>
</tbody>
</table>

The graph illustrates the change in Net Present Value (NPV) and Profit/Investment Ratio (PIR) as the working interest minus carried balance decreases from 100% to 75%.
Top-Leasing Strategy

- As a general proposition, a third party will be unable to rely on Big Oil’s drilling activity to perpetuate its lease.
  - See Hughes v. Cantwell, 540 S.W.2d 742, 743-44 (Tex. Civ. App. – El Paso 1976, writ ref’d n.r.e.)

- A typical habendum clause in a “standard lease” will state that “this Lease shall be for a term of ___ years from this date (called ‘primary term’) and as long thereafter as oil and gas or other hydrocarbons are being produced from said land or land with which said land is pooled hereunder.”

- Courts have held that where this kind of language is used that “The obligations which must be performed [in order to keep the lease alive] are specifically assigned to the Lessee.”
  - “acts of third parties or strangers to the contract [will] not suffice to meet his requirements of performance.”
Top-Leasing Strategy

- Upon expiration, possession of the mineral estate, as to that undivided interest, reverts back to the mineral owner. Said mineral owner—now a cotenant in the mineral estate—would begin sharing in the proceeds of production.
  - Unless, of course, Big Oil has previously obtained a top lease from that mineral owner.

- A top lease is “[a] lease granted by a landowner during the existence of a recorded mineral lease which is to become effective if and when the existing lease expires or is terminated.”

- The basic function of the top lease is to put the top lessee “next-in-line” in the event the existing lease terminates, or is ultimately held to have terminated. The goal is to tie-up the mineral interest owner’s development rights before other competitors, including the existing lessee, have a chance to get a lease.

Top-Leasing Strategy

NRI Over the Life of the Well: 75% Working Interest, Cotenant Carried, Top Lease Vests at 3 Years

NRI

Payout

Top Lease Vests

Month

1 11 21 31 41 51 61 71 81 91
Top-Leasing Strategy

Effects of a Carried Working Interest on NPV and PIR
(Top Lease Scenario)

- Net Present Value (NPV) ($1,000s)
- Profit/Investment Ration (PIR)

Bar chart showing the comparison between NPV and PIR as the Working Interest Minus Carried Balance varies from 100% to 75%.

- NPV ($3,680, $3,190, $2,766)
- PIR (0.40, 0.47, 0.51, 0.58)

100% 98% 95% 90% 80% 75%
Reasonable and Necessary Expenses

- “[A] cotenant has the right to extract minerals from the common property without first obtaining the consent of his cotenants; however, he must account to them on the basis of the value of any minerals taken, less the necessary and reasonable costs…”
  - Wagner & Brown, Ltd. V. Sheppard, 282 S.W.3d at 426

- “[W]hat is allowed the working cotenant, when called to account by another cotenant, is all expenses necessarily incurred by him in good faith in producing and rendering the product available.”
  - Burnham v. Hardy Oil Co., 147 S.W. 330

- Categorical Exceptions:
  - Dry Holes
  - Interest
Other Considerations

- **Workovers, frac jobs and other operations**
  - Cost of workovers which fail to reestablish production from non-producing wells are excluded. *Neely v. Intercity Management Corp.*, 752 S.W.2d 644
  - Cost of workovers which do not increase production or unsuccessful attempts to obtain production from a particular formation are likely to be excluded. *Bomar Oil & Gas Inc. v. Loyd*

- **Well-by-Well Accounting or Tract-by-Tract?**
  - Producing cotenant begins to account to his cotenants as the cost of each individual well are recouped or as the costs of all drilling on the common estate is recouped?

- **Who Owes the Cotenant’s Royalty?**
Recent Caselaw

- **Devon Energy v. Apache Corporation**
  - *Devon Energy Prod. Co. v. Apache Corp.*, 550 S.W.3d 259
  - Court of Appeals, 11th District, Eastland
  - April 30, 2018

- **Cimarex Energy v. Anadarko Petroleum**
  - *Cimarex Energy Co. v. Anadarko Petroleum Corp.*, No. 08-16-00353-CV
  - Court of Appeals, 8th District, El Paso
  - March 13, 2019
Devon Energy v. Apache Corporation

- Texas Court of Appeals case focusing on whether Apache had statutory liability for paying royalties to the Lessor Plaintiffs pursuant to their leases with Devon.
  - *Devon Energy Prod. Co. v. Apache Corp.*, 550 S.W.3d 259
  - Tex. Supreme Court denied Petition for Review in October of 2018

Apache’s liability for paying royalties to the Lessor Plaintiffs under their leases to Devon is by no means established. See Caleb A. Fielder, *Blood and Oil: Exploring Possible Remedies to Mineral Cotenancy Disputes in Texas*, 50 Tex. Tech. L. Rev. 171, 199–202 (2017) (noting that this is a question that has not been expressly answered by case law and opining that the royalty, if any, owed to the third-party lessor (i.e., the Lessor Plaintiffs in this case) would be owed by the nonparticipant lessee (i.e., Devon)). As noted by Fielder:

Moreover, as between the driller and the nonparticipant, one would be hard-pressed to argue that the drilling party is responsible for the royalty payments of his cotenant’s lessor. First, the drilling party in this scenario has no lease with the nonparticipant’s lessor. He is a stranger to the nonparticipant’s contract and has made no covenants, implied or otherwise. Moreover, because it is undisputed that the operator owes his non-drilling cotenant nothing until he has recouped his reasonable and necessary expenses, it would strain credulity to argue that the operator now owes him royalty merely by virtue of the fact that the cotenant has leased to a third party. Each owner in a cotenancy acts for himself and no one is the agent for the other nor has any authority to bind the other merely because of the relationship. Lastly, obligating the drilling party to pay his nonparticipating cotenant’s royalty burden would create an opportunity for abuse. In an aggressive cotenancy scenario, the nonparticipating cotenant and his lessor could simply amend their lease to create an inordinately large royalty.

*Id. at 202* (internal quotations and footnote omitted).
Cimarex Energy v. Anadarko Petroleum

- Texas Court of Appeals case focusing on whether Cimarex’s Lease was held by cotenant Anadarko’s production.
  - Cimarex Energy Co. v. Anadarko Petroleum Corp., No. 08-16-00353-CV
  - No Petition for Review currently filed.
Questions?

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