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LAW LETTER

Mineral Rights vs. Royalties

Recent Rulings Affecting Oil and Gas Interests

Oil and gas exploration and drilling declined in Texas during the past decade. Much of the activity shifted outside the United States. Recently, however, domestic activity has increased because higher oil and gas revenue, combined with new technologies such as 3-D seismic, has improved the odds of finding reserves at lower costs.

During the interim, the Texas Supreme Court rendered several significant decisions affecting oil and gas interests. Because controversies usually arise during the height of drilling activity, owners of oil and gas interests, as well as producers and others, need to know the decisions and their consequences.

The most important, yet confusing, decisions dealt with deed interpretations. Setting the precedent was *Luckel v. White,* 819 S.W. 2d 459 (Tex. 1991). Prior to this decision, Texas courts ruled that the granting clause controlled when the deed contained conflicting language. This ended in 1991. Now the courts must ascertain the intent of the parties from the language in the entire document. This is referred to as the "four corners" rule because everything within the four corners of the deed must be examined. This has proven to be a challenging task as evidenced by the *French v. Chevron,* 896 S.W. 2d 795 (Tex. 1995). Perhaps some background information on the mineral-royalty distinction may clarify this decision.

A mineral interest (or the mineral estate) is composed of five separate, distinct rights. These are sometimes referred to as a bundle of sticks because they can be divided and/or separated into the same infinite combinations. These rights, according to *Altman v. Blake,* 712 S.W. 2d 117, (Tex. 1986), include the right to:

- sign or execute a lease—i.e., the executive right,
- develop the premises,
- receive bonuses,
- receive delay rentals and
- receive royalties.

The ownership of all the minerals (or mineral estate) entails the ownership of all five rights. The ownership of half the minerals entails the ownership of half of each right.

As a general rule, the owner of all or a part of the minerals is entitled to receive a portion of the royalty reserved in the oil and gas lease. For example, the owner of all the minerals receives one-fifth of the production if the lease royalty is one-fifth. Under the same circumstances, the owner of half the minerals receives one-tenth of the production (1/2 x 1/5).

The ownership of a royalty is more complex. As noted, royalty is but one of the five rights composing the mineral estate. Four forms or packages of ownership are possible:

- participating,
- nonparticipating,
- fractional or
- fraction of.

The term *participating royalty* is a misnomer. Actually, it should be called a royalty with associated mineral rights because it includes the royalty, the executive right and the right to receive bonuses and delay rentals. A *nonparticipating royalty* (or bare royalty), on the other hand, is simply the royalty interest standing alone.

A royalty may be either a *fractional* or a *fraction of*. The two appear quite similar grammatically but differ significantly in how each shares in production.

Grammatically, a *fractional royalty* has no prepositions between the numerical fraction being conveyed or reserved and the word *royalty:* "The Grantor hereby reserves (conveys) an undivided *one-half (1/2) royalty* in the oil and gas produced." This entitles the owner to half of all the production from a well (or tract) regardless of the size of the royalty reserved in the lease.

A *fraction of royalty* has one or more prepositions between the numerical fraction being conveyed or reserved and the word *royalty:* "The Grantor hereby reserves (conveys) an undivided *one-half (1/2)* ***of*** *the royalty* in the oil and gas produced." This entitles the owner to half of the royalty reserved in the lease. This is drastically less than a fractional royalty.

In *French v. Chevron,* the Texas Supreme Court decided whether the deed language conveyed a mineral or royalty interest and how the grantee shared

in production. The decision has a significant impact on future interpretation of mineral-deed controversies.

The granting clause in *French* clearly conveyed a mineral interest. A subsequent clause indicated that a royalty—not a mineral—interest was conveyed. Prior to the *Luckel* decision, the granting clause would have settled the controversy.

The importance of the case centers on how the court interpreted the language referencing the royalty interest. The clause read, in part, "It is understood and agreed that this conveyance is a royalty interest only." The deed described the *royalty interest only* as being devoid of all executive and development rights and all the rights to receive bonuses and delay rentals.

In a unique way, the court concluded that the language conveyed a mineral, not a royalty, interest. Basically, it was a *mineral interest* stripped of everything except the royalty.

By analogy, assume someone owns a building with five floors. The owner wants to convey the top floor and retain ownership of the lower four. In the deed, the owner conveys the entire building, then reserves (retains) ownership of the first, second, third and fourth floors. Did the owner actually convey the top floor or the entire building? According to *French*, the entire building was conveyed with reservations.

In such instances, how does the grantee (the one who receives the mineral interest, stripped of all rights except the royalty) share in production? The court concluded that this is a conveyance of a *fraction of royalty*, not a *fractional royalty*.

The court reached the correct decision concerning the grantee's share of production. The analysis, however, creates some problems. The following are likely to be encountered by practitioners of oil and gas law because of the court's reasoning.

1. For an interest to be deemed a royalty, not a stripped-down mineral interest, the language must provide that the royalty is from "actual production." The mere use of the word *royalty* in itself is insufficient.
2. By the same token, an interest will never be deemed a royalty by describing it as the remaining interest after stripping (or reserving) the other four from a mineral interest.
3. The recipient of a *fractional mineral* interest, stripped of everything but the royalty, shares in production the same as the owner of a *fraction of royalty*, not a *fractional royalty*. However, attorneys may request a stipulation of interest from the owners to avoid future disputes

The last case decided by the Texas Supreme Court also dealt with a royalty interest. A royalty interest sometimes is referred to as being "cost free." This means that in the event of production, the royalty interest is free and clear of exploration and production costs (*Twentieth Century-Fox Film v. Texas*, 286 F2d 373). However, the royalty interest is subject to post-production costs such as transportation, compressing, dehydration and separating. These costs and expenses are deducted proportionately, based on the size of the lease royalty.

To avoid the deductions, royalty owners (those who have executive rights) negotiate an appropriate lease clause. The oil companies agree to bear all post-production costs on the royalty owners' behalf.

The validity of this provision was questioned in *Heritage Resources, Inc. v. NationsBank* (95-0515), 4/25/96. The court ruled that the clause eliminating the post-production costs from the royalty was surplusage, as a matter of law, whenever the royalty is fixed "at the well" or "wellhead."

Two dissenting judges felt that the court clearly ignored the contractual provision to the contrary negotiated by sophisticated parties.

On the same day and in a similar case, the high court ruled that royalty owners must bear their proportionate share of compression and other post-production costs (*Judice v. Mewbourne Oil Co.* [95-0115], 4/25/96).

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