



NADOA Annual Institute

Non-Participating Royalty Interests and Executive Rights



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Overview



Non-Participating
Royalty Interests



Recent
Developments
Regarding the
Interpretation of
Non-Participating
Royalty Interests



Duties Owed by
Executives to
NPRI/NEMI Owners

Types of Non-Executive Interests

- Non-Executive Mineral Interest (NEMI)
 - An interest in the mineral estate but without the power to execute leases
 - Typically shares in bonus, rentals, and royalties
 - Created by reservation or by grant
- Non-Participating Royalty Interest (NPRI)
 - An interest free of drilling and exploration costs
 - Created by reservation or by grant



Basic Elements of NPRIs

- Non-possessory
 - No right to enter on the land
 - Vested incorporeal interest in land
 - No right to demand partition
 - Mineral fee owners cannot compel partition
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- *ConocoPhillips Co. v. Koopmann*, 547 S.W.3d 858 (Tex. 2018) (concluding that a term NPRI interest did not violate the rule against perpetuities).



Types of NPRIs

- Two Types of NPRIs
 - Fixed
 - Floating
- Not all jurisdictions have recognized the distinction between fixed and floating NPRIs



Types of NPRIs

- Fixed Royalty (Fractional Royalty)
 - The stand-alone right to a particular share of the proceeds from production
 - The NPRI is not proportionately reduced based on the lease royalty rate
 - Example: A 1/16 fixed royalty is entitled to the same 1/16 of the royalties from production irrespective of the lease royalty rate



Examples of Language Creating a Fixed Royalty

1. A one-fourth royalty in oil, gas and other minerals in and under and hereafter produced
2. A fee royalty of $1/32$ of the oil and gas
3. An undivided one-sixteenth royalty interest of any oil, gas, or minerals that may hereafter be produced
4. One-half of the one-eighth royalty interest
5. An undivided $1/24$ of all the oil, gas, and other minerals produced, saved and made available for market
6. 1% royalty of all the oil and gas produced and saved
 - 2 Williams & Meyers § 327.1



Floating Royalty

- Floating Royalty (Fraction of Royalty)
 - The interest shares in a portion of the royalty and varies (or floats) with the lease royalty rate
 - The mineral owner's royalty is proportionately reduced according to the lease royalty rate
 - Example: A $1/2$ NPRI (or NEMI) that is subject to a lease with a $1/4$ royalty rate will be entitled to $1/2 \times 1/4 = 1/8$ of the royalties from production
 - Generally, addition of the word “of” before royalty creates a floating royalty





Examples of Language Creating a Floating Royalty

1. 1/16 of all oil royalty
2. The undivided 2/3 of all royalties
3. One-half interest in all royalties received from any leases
4. An undivided one-half interest in and to all royalty
5. One-half of one-eighth of all oil, gas and other mineral royalty that may be produced
6. One-half of the usual one-eighth royalty
 - 2 Williams & Meyers § 327.1

Fixed vs. Floating: Interpretation of NPRIs

- Historically, the granting clause was considered superior to any conflicting language in other parts of the instrument
- Recent case law has shifted the focus away from the granting clause to an attempt to discern the intent of the parties





Traditional Interpretation

- The traditional approach treated “the usual 1/8” according to its plain meaning and multiplied the double fraction to find a fixed royalty.
- *Alford v. Krum*, 671 S.W.2d 870, 872 (Tex. 1984)
- Example: A reservation of “one-half (1/2) of the usual one-eighth (1/8)” reserved a fixed 1/16 royalty. *Wynne/Jackson Dev. L.P. v. PAC Capital Holdings, Ltd.*, 2013 Tex. App. LEXIS 6865, at *11-15 (Tex. App.—Corpus Christi 2013, pet. denied).
- There are a significant number of Texas decisions that have followed this approach.

Interpretation of NPRIs

- The “Four Corners” Rule
 - *Luckel v. White*, 819 S.W.2d 459, 461 (Tex. 1991) (“The primary duty of a court when construing such a deed is to ascertain the intent of the parties from all of the language in the deed by a fundamental rule of construction known as the ‘four corners’ rule”).
- Estate Misconception Theory
 - *Graham v. Prochaska*, 429 S.W.3d 650, 657 (Tex. App.–San Antonio 2013, pet. denied) (explaining that the estate misconception theory is the theory “that the parties from that period mistakenly assumed and conceptualized the landowner's royalty as set at one-eighth of production”).



The Estate Misconception Theory Takes Hold

- *Sundance Minerals, L.P. v. Moore*, 354 S.W.3d 507, 512 (Tex. App.–Fort Worth 2011, pet. denied)
 - The court determined that 1/2 floating royalty was reserved when the grantor reserved “one half of the usual one-eighth royalty.”
 - The court explained the reference to the usual 1/8 royalty was “merely an example showing the type of interest they intended to reserve, not a further limitation.”
- Other courts follow *Sundance Minerals* and conclude that a floating royalty is reserved when there is a reference to the “usual 1/8 royalty”





Courts Stretch the Estate Misconception Theory Further

- *Graham v. Prochaska*, 429 S.w.3d 650, 658-59 (Tex. App.—San Antonio 2013, pet. denied)
 - Reservation provided: “One half (1/2) of the one-eighth (1/8) royalty to be provided in any and all leases for oil, gas and other minerals now upon or hereafter given.”
 - The court examined all the language in the deed and reviewed the instruments referenced in the deed and concluded that the parties intended that the royalty interest be a floating interest and be 1/2 of royalty provided by any current or future lease and that the parties incorrectly assumed that the royalty provided in an oil and gas lease would always be 1/8.
- *Medina Interest, Ltd. v. Trial*, 2015 Tex App. LEXIS 6382, at *15 (Tex. App.—San Antonio 2015, no pet. h.) (interpreting a reservation of “our undivided interest in and to the 1/8 royalties paid the land owner” to reserve a floating royalty interest).




The Texas Supreme Court Weighs In

- *Hysaw v. Dawkins*, 483 S.W.3d 1 (Tex. 2016)
 - The testatrix devised to each child an NPRI of “an undivided one-third ($1/3$) of an undivided ($1/8$) of oil, gas or other minerals, the same being a non-participating royalty interest”
 - The will also provided that each child “shall receive one-third of one-eighth royalty”
 - The Court concluded that they “cannot embrace a mechanical approach requiring rote multiplication of double fractions whenever they exist. Rather, considering the testatrix’s will in its entirety, we hold that she intended her children to share future royalties equally, bequeathing to each child a $1/3$ floating royalty, not a $1/24$ fixed royalty.”



Wenske v. Ealy, 521 S.W.3d 148 (Tex. 2018)

- The Texas Supreme Court, citing to both *Luckel* and *Hysaw*, addressed the proportion in which a deed reserving a 3/8 mineral interest (and conveying a 5/8 interest) bore a NPRI interest.
- The Texas Supreme Court concluded that based on the language of the deed, the parties intended to split the benefits and burdens of the minerals in the same proportion as their ownership of them. This deed (1) granted the minerals to the Ealys, (2) reserved 3/8ths of the minerals to the Wenskes, and (3) put the Ealys on notice that the entirety of the minerals are subject to the outstanding 1/4th NPRI to avoid a warranty claim. However, the court expressly stated that this is not a default rule.




U.S. Shale Energy II, LLC v. Laborde Props., L.P., 551 S.W.3d 148 (Tex. 2018)

- The Texas Supreme Court addressed a reservation that provided “an undivided 1/2 interest . . . The same being equal to 1/16 of production.” A subsequent oil and gas lease provided for a 20% royalty.
- The dispute focused on whether the NPRI reservation reserved a 1/2 floating NPRI or a fixed 1/16 NPRI.
- The Texas Supreme Court concluded that it was a 1/2 floating NPRI



WTX Fund, LLC v. Brown, No. 08-17-00104-CV, 2020 Tex. App. LEXIS 94 (Tex. App. – El Paso Jan. 8, 2020)

- The 1951 Deed provided:
 - “Have bargained . . . and quitclaim . . . all of grantors’ right, title, interest and estate in and to the leasing rights, bonuses and delay rentals in and to all the oil, gas and other minerals.”
 - “[I]t being intended hereby to convey to grantee, his heirs and assigns, all of grantors' right, title, interest and estate in and to the 7/8 leasing rights or working interest in the oil, gas and minerals in and under said land together with all bonuses, delay rentals, oil payments and all other rights and benefits . . . together with the right of ingress and egress at all times for the purpose of enforcing his rights thereunder”



Hoffman v. Thomson, 630 S.W.3d 427 (Tex. App. – San Antonio 2021, pet. filed)

- The reservation provided: “an undivided three thirty-seconds ($3/32$'s) interest (same being three-fourths ($3/4$'s) of the usual one-eighth ($1/8$) royalty) in and to all of the oil, gas and other minerals, in to and under or that may be produced from the land herein conveyed.”
- The court explained that the reservation could not be interpreted as a fixed $3/32$ nonparticipating royalty interest because all of the language could not be harmonized.
- The court explained that the only reasonable interpretation was a floating $3/4$ nonparticipating royalty interest.



Van Dyke v. Navigator Group, 2020 Tex. App. LEXIS 10448 (Tex. App. – Eastland 2020, pet. filed)

- The 1924 deed from Mulkey to White included the following reservation: “It is understood and agreed that one-half of one-eighth of all minerals and mineral rights in said land are reserved in grantors, Geo. H. Mulkey and Frances E. Mulkey, and are not conveyed herein.”
- The court concluded that the estate misconception theory was not applicable because there were no conflicting fractions to harmonize, but a single description composed of two fractions and held that the deed reserved a fixed 1/16 mineral interest.

Relationship between the Executive and NPRI Owner

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



Duties of the Executive to Non-Executives

- Although not a fiduciary duty, the duty of executives to non-executives is described as a type of a “fiduciary duty” and the executive should obtain every benefit for the non-executives that he exacts for himself.
- The executive must not engage in self-dealing. *Manges v. Guerra*, 673 S.W.2d 180 (Tex. 1984).
- *Friddle v. Fisher*, 378 S.W.3d 475 (Tex. App. – Texarkana 2012):
 - The executive executed a lease but did not inform the NPRI owner.
 - The NPRI owner was not charged with constructive notice of the lease because it was executed and recorded after he acquired his NPRI.
 - The executive was required to hold royalties due to the NPRI owner as constructive trustee.
- The lessor cannot circumvent the royalty owed to NPRI owners by reserving an additional overriding royalty.



Duties of the Executive to Non-Executives

- *KCM Financial LLC v. Bradshaw*, 457 S.W.3d 70 (Tex. 2015)
 - Dispute arose relating to the obligation of the executive to maximize the royalty terms in an oil and gas lease
 - Executive owes a duty of utmost good faith and fair dealing and to acquire for the non-executive every benefit that he exacts for himself
 - However, the executive is not required to subordinate its interest in favor of the non-executive (unlike a fiduciary duty)





Duties of the Executive Extend Beyond Monetary Payments

- The duty owed by the executive is not limited to obtaining bonus or monetary consideration, but can be breached by a refusal to execute an oil and gas lease covering the NPRI interest.
- *Lesley v. Veterans Land Board of the State of Texas*, 352 S.W.3d 479 (Tex. 2011):
 - The executive (a developer that planned to build and sell “ranchettes”) acquired 25% of the minerals, all executive rights, and all of the surface estate.
 - Developer sold lots with deed restrictions that prohibited oil and gas drilling.
 - The Texas Supreme Court concluded that the developer breached its fiduciary duty by placing the deed restrictions on the lots.

Refusal of the Executive to Execute an Oil and Gas Lease

- *Texas Outfitters Ltd., LLC v. Nicholson*, 534 S.W.3d 65 (Tex. App.–San Antonio 2017, pet. granted)
 - Texas Outfitters purchased 1,082 acres in Frio County, Texas which included all of the surface and 50% of the executive rights. Texas Outfitters planned to use the lands for ranching and wild game hunts.
 - Texas Outfitters rejected multiple offers to lease the ranch.
 - The court explained that Texas Outfitters gained for itself the unfettered use of the surface for its hunting operation and the ability to sell its land at a large profit free of any oil and gas lease.
 - As a result, Texas Outfitters breached its duty of utmost good faith and fair dealing by refusing to execute the oil and gas lease offered by El Paso and damaged the non-executives in the amount that they would have received had the lease been signed by Texas Outfitters.
 - The court stated that “[a]lthough protecting an existing use of the surface estate is a legitimate interest, an executive breaches its duty if it protects the surface estate by refusing to permit any mineral lease.”



Texas Pooling and NPRI

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



Texas Pooling and NPRIs

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



Texas Pooling and NPRI

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





Methods of Ratification

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



Q&A

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