OIL AND GAS PROPERTIES IN AN ESTATE:
“A TALE OF SUSPENSE”

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Living where we live makes at least a bit of knowledge of the “awl bidness” mandatory. Many of our clients work in the industry. Many own oil and gas interests as assets in their estates. When such clients die, the oil and gas assets pass pursuant to the will, trust or through the laws of intestacy.

Let us use the usual scenario: A client dies. His will is filed for probate. The hearing is held. An independent executor is appointed and takes the oath. As the estate attorney, what do you tell the executor to do? With bank accounts, you send the executor over to the bank after the probate hearing, armed with letters testamentary and the Tax ID number assigned to the estate, to get authority over the accounts. The same is true for brokerage accounts. The process usually works quite efficiently on such assets. However, when you go down the property list and reach oil and gas interests, the knowing probate attorney should put up a stop sign, or at least a slow sign. The oil and gas transfer process is not slick (pardon the pun), it is not fast, and it can cost your estate client money if you don’t approach it with some planning and stealth.

The reason we are not enthusiastic about notifying the oil companies is that they may legally take the opportunity to quit paying the estate temporarily. More about that later.

In the meantime, it is necessary to understand some basics about oil and gas terminology.

**TERMS**

**MINERAL INTERESTS:** The owner of a mineral interest owns the hydrocarbons under the ground. The mineral owner can lease the mineral interest, has a right to receive bonus and delay rentals, but most importantly for our purposes, has the right to receive royalties when there is production developed on the property and his minerals are extracted. Royalties translate to money. On a check from a Purchaser, the mineral owner is designated as “RI” or Royalty Interest. A royalty or mineral owner bears no part of the cost of drilling the well or getting the oil and gas sold and marketed.

**WORKING INTERESTS:** The owner of a working interest on a producing property is part of the oil company side of the production equation, i.e., the company or individuals who locate, lease, drill, complete and operate the well. The working interest owner bears all expenses associated with production, including paying the royalty owners. On a check from a Purchaser, the working interest owner is designated as “WI” or Working Interest.
**OVERRIDING ROYALTY INTERESTS**: Although it is confusing, an overriding royalty owner is really closer to the working interest owners than royalty owners. An overriding royalty interest is created by a working interest owner and deducted from that interest – a piece of the well given perhaps to a geologist or landman working on the project in lieu of a fee. An overriding royalty interest owner pays no lease expenses and is treated for income tax purposes in the same manner as a royalty owner. On a check from a Purchaser, the overriding royalty owner is designated as “ORI” or “OR” or Overriding Royalty Interest.

**SURFACE INTERESTS**: Although the surface is not usually considered in the transfer of oil and gas interests, it can be involved. In Texas, particularly in West Texas, the State has designated certain properties as Mineral Classified Lands. The surface has been sold to private individuals, but the state retains the minerals in these tracts. However, the State has designated the surface owners as its agent on these properties and allows them to negotiate the terms of any mineral lease of these properties. In exchange for serving as agent, the surface owners are allowed to receive half of the bonus and delay rentals under the lease and half of the royalty from any production developed under the lease. On the check from the Purchaser, it would still be shown as “RI” for royalty, but it is not quite the same. For example, a will that designated the decedent’s minerals went to one party and surface interests to another will be transferring all of the agent rights, including the right to receive part of the royalty, to the surface beneficiary.

**OTHER MINERALS**: Many oil and gas leases are limited to those substances only. Other minerals are covered by separate leases. Surface owners might be due royalties on production of other minerals, including coal and uranium, depending on the extraction method.

**REAL PROPERTY**: Oil and gas and other minerals are considered real property interests. A bequest in a will concerning real estate should be interpreted as conveying the mineral rights in that property regardless of whether the minerals are mentioned. They are deemed to be conveyed unless specifically reserved or otherwise designated.

**THE TRANSFER PLAYERS**

In dealing with companies to transfer oil and gas properties, the executor must have a rudimentary knowledge of what is being transferred. If it is a mineral interest, the executor will need to talk to the Purchaser of the oil and gas. If it is a working interest, the executor will need to talk to the Purchaser and the Operator of the lease.

**THE PURCHASER**: The Purchaser is the company that sends the checks to the owners, including your decedent. Prior to sending the check, the Purchaser has bought the oil and gas gathered at the well site and delivered it by truck or pipeline to another purchaser up the chain – a utility company, a refinery, etc. The Purchaser then allocates the money it has been paid among the owners of the production, including the royalty owners and the working interest owners. Prior to sending the check, the owner is furnished a Division Order asking that the owner verify the interest credited to them. Division Order Title Opinions are very important in the division process. The title examiners preparing such opinions must make certain that the interests of all parties add up to 100%, not
always an easy task. After receiving a signed division order, the Purchaser deducts and pays production taxes due to the state of Texas (4.6% for oil, 7.5% for gas) and sends the checks to the proper parties. The checks will continue as long as production continues. On small leases, a Purchaser is allowed to accumulate up to $100 before disbursing funds, but it must distribute annually, regardless of how small the amount. Thus, the December checks are sometimes less than the postage necessary to send them.

**THE OPERATOR:** A working interest owner deals with the Purchaser for income and with the Operator for expenses. The Operator may or may not have drilled the well, but he is in charge of daily operations after production is developed. The Operator and the working interest owners work under a Joint Operating Agreement that governs allocation of expenses, repairs, workovers, additional drilling and other operations. The Operator sends out monthly invoices to the working interest owners for lease operating expenses (LOE). He will continue to send invoices even after you are dead.

The executor of the estate owning oil and gas properties has a fiduciary obligation to gather assets belonging to the estate and to pay all debts. Nevertheless, haste can make waste in this particular process. It is possible to continue to collect the income and continue to pay lease operating expenses without an official notification of death. Deposit the income checks. Pay the lease operating expenses. There will be a time for proper notification but not necessarily right after the funeral.

**“DADDY’S DEAD – DON’T TELL THE OIL COMPANIES!”**

While that command sounds harsh, it is based on long experience. Enthusiastic executors have called every 800 number on every check received by the decedent, only to be told that certain documents will be necessary for transfer, and until such documents are furnished and reviewed, all payments will be withheld. An income stream stops, often a significant one, and the well-intentioned executor is distressed and angry with the attorney for not telling him this would happen.

Okay. On the point of telling or not telling, we hereby give you these facts:

1. Purchasers have a statutory right to temporarily stop payments to an owner of production when there is a title dispute. See Exhibit “A” to this paper.

2. Being dead is a title dispute.

3. The cessation of payments is “to be put into suspense,” or, more commonly, your interest “is suspended.”

4. In the oil business, “suspense” is a verb, regardless of what your English teacher said.

5. No interest is required to be paid on “suspended” interests, unless there is negligent behavior by the Purchaser. This has to be proven in court and seldom applies to estates. All interest on suspended funds goes to the Purchaser, not the owner.
6. Being suspended can last a long time. The Purchaser determines the documentation necessary to release funds, and since it has custody of the funds, there is no urgency on its part.

7. Being suspended by the Purchaser on working interests can result in having no money to pay the Operator for lease operating expenses. Those bills are never suspended, only income.

8. Avoid suspense. Don’t tell the Purchaser until you are ready to make the transfer and can plan the transition on your schedule.

9. Keep depositing the checks – don’t send them back or the Suspense Watch Dogs will get suspicious.

10. Begin the process of recording certified copies of the will and the order admitting it to probate in every Texas county where production exists. The Purchasers will ask for evidence this has been done.

11. **Suspense:** Not good English. Not good situation.

**WHAT TO TELL THE PURCHASER WHEN YOU DECIDE TO TELL THE PURCHASER**

When the time comes to move the oil and gas properties, the executor needs to decide where to move them. With a major estate with an estate tax return to be prepared, it should be a two-step process. The first place to transfer the assets is to the estate under the estate tax identification number. When administration has been completed, there will be a transfer out of the estate to the parties designated in the will. With a modest, non-taxable estate, I have had some success in a one-step process from the decedent to the parties designated in the will, avoiding the intermediate step of holding the properties in the estate name.

The transfer process should begin with a packet of materials sent to the Purchaser. Here is what most Purchasers want to see:

1. Will (copy okay).

2. Order admitting the will to probate (copy okay).

3. Letters testamentary (copy okay).

4. Death certificate or Verification of Death (copy okay).

5. Furnish evidence that the will and order admitting it to probate has been recorded in the Texas counties where the production is located.

6. Give the names and addresses of the new owners. **NOTE:** This is especially true in the multi-trust estate planning will with no clues given
as to where the mineral properties are going. Tell them which trust got
them, or whether there was an asset exchange and the surviving
spouse got all, or whatever. The division order analyst is not privy
to your allocation discussions with the executor and CPA.

7. Consider a distribution deed. (See discussion below.)

Your packet should include a letter of instruction asking that Transfer Orders be
issued, or, in the alternative, that Letters-in-Lieu of Transfer Orders be accepted.

Transfer Order. This document is generated by the Purchaser and resembles a
Division Order. It recites that the interest previously owned by the decedent is now to be
owned by the estate or by the parties named in the will. The executor will sign it as
transferor and the new owner will sign as transferee. The document is returned to the
Purchaser for processing.

Letter-In-Lieu of Transfer Order. This is a short form way to transfer the property
without a transfer order and avoids some of the back-and-forth document exchange with
the Purchaser. As the name indicates, a letter-in-lieu is in letter form but utilizes language
usually found in division orders. It essentially says that the signer agrees that the decedent
was being paid properly and directs that the same decimal interest continue to be paid to
the new owner. The letter-in-lieu is signed by the executor and by the new owner, and the
signature is witnessed as a division order or transfer order would be. The letter includes
a sheet for the Purchaser to sign and return if it agrees to accept the letter-in-lieu. If the
Purchaser will accept it, the letter-in-lieu speeds up the transfer process considerably. It
is a good way to handle transfers from deceased spouse to surviving spouse.

DISTRIBUTION DEEDS???

Most states using the Model Form Probate Code require recorded transfers of real
property, including oil and gas interests, from the estate to the new owner. Texas does not
follow the Model Form Probate Code. There is no requirement of any transfer document
except the filing of the will and the order admitting it to probate in the county where the real
property is located. Some file more than that, but as a practical matter, that is usually all
that will be filed except in the county where the will was probated. The title examiner has
to figure out when the administration is over and where the assets were distributed. If the
minerals are going to the surviving spouse or to the kids, it is fairly easy. If they are going
to the Marital Trust or the By-Pass Trust or the Family Trust, things get a little tricky. On
the title opinions I do, I mumble and say something like “Mrs. Smith, Trustee Under the Will
Of Mr. Smith.” I figure she will know where to put it.

While not required in Texas, you are seeing distribution deeds more often. They tell
persons examining title that the estate administration is over and done and who the new
owner is. That is good to know. However, distribution deeds can royally screw things up,
too, and that is unfortunate. This usually happens when the probate lawyer tries to
describe the interest being conveyed. It is much better to use quit-claim language (“all my
interest”) than to attempt to describe the interest.
Part of the description problem comes from doing the 706, the Estate Tax Form, on large estates. It is fine with the IRS if you described producing properties on the 706 using the information on the division order found in the decedent's filing cabinet or by calling the Purchaser to ask for the legal description on that lease. Mr. Smith is shown to own 0.001953125 interest in a forty-acre tract described on that division order. You draft a deed from your form book from Mrs. Smith as executor to Mrs. Smith, a widow, and convey to her 0.001953125 interest in the forty-acre tract. **WRONG TWICE.** You have not conveyed all of Mr. Smith's interest.

Let us speak of interests recited on Division Orders. They are the product of a mathematical computation:

**Mineral Interest Calculation**

The fractional interest owned x the royalty recited in the lease = decimal interest

*Example*

Mr. Smith owned 1/64 of the minerals. He signed a lease calling for 1/8 royalty.

\[
\frac{1}{64} \times \frac{1}{8} = 0.001953125
\]

**Pooled Mineral Interest Calculation**

The fractional interest owned x the royalty recited in the lease x tract participation factor = decimal interest

*Example*

Mr. Smith owned 1/64 of the minerals. He signed a lease calling for 1/8 royalty.

Mr. Smith's interest has been pooled or unitized with other properties. The Smith property is pooled with three other tracts, each contributing 40 acres to the 160 acre drill site. The Smith tract participation factor is 40/160. Then the calculation would be done this way:

\[
\frac{1}{64} \times \frac{1}{8} \times \frac{40}{160} = 0.00048828
\]

**Working Interest Calculation**

The interest owned in the leases x the net revenue of the leases = decimal interest

(net revenue is the interest in production after the royalty and overriding royalty owners have been paid)
Example

Mr. Smith owned 5% of the leases as a working interest.
The net revenue on those leases is 75%.

5% x 75% = .03750000

Warning: If you convey the decimal interest only, you have conveyed only part of what Mr. Smith owned, leaving the rest with the executor.

Let us also speak of descriptions on Division Orders. The description is usually limited to the producing proration unit around the well, usually forty acres for an oil well and 320 or 640 acres for a gas well. Mr. Smith may well own an identical 1/64 on the 40 acres adjacent to the producing proration unit, or maybe even throughout the entire section or several sections. Don't limit the conveyance to only 40 acres unless you are sure what and where Mr. Smith owned interests.

In an ideal world, you can locate the deed or assignment by which Mr. Smith acquired title, and you can quote it in the distribution deed. In an imperfect world, you can convey everything Mr. Smith owned in Andrews County or the State of Texas. Those work, too, and a lot better than those conveyances with division order decimals.

If Mr. Smith is a typical mineral owner, he owns properties which are non-producing as well as producing. Identifying these non-producers is more difficult than the producing properties because you have no division orders and there are no checks coming in. If the estate records are good, you can try to convey those, too, or add some coverall language to the distribution deeds of the producing properties. Or you can always wait for Larry Landman to call and tell you that Grandma owned minerals in Yoohoo County, and they are still in her name. That can be handled, too, even if she died years ago.

VALUATION OF MINERAL INTERESTS

We have discussed earlier that the Estate Tax Return requires a description and the interest owned by the decedent on producing properties. Giving a value to those interests is an item of concern, especially in the last couple of years.

On producing royalties, engineering reserve studies are routinely used on big estates. A mathematical formula is often used on small estates. For the past few years, that formula is to calculate the average monthly income from the property and multiply it times thirty-six (36) months. Some use 48 months, some 60 months. In divorce settlements, some attorneys are using 40 months for production valuations. The roller coaster ride of the price of oil and gas since 2007 has made formula estimates a guessing game. The IRS has not figured it out yet, either. Stay tuned.

On producing working interests, some use the monthly formula on a net income number (all income less the lease operating expenses), but most often an engineer is called in to analyze the reserves of the property.
TRANSFERRING OUT-OF-STATE OIL AND GAS INTERESTS

The method of transferring minerals in another state depends on the state. Some are easy, most are not. Some of them want to support members of their state bar generously.

NEW MEXICO – This one is easy. Take the Texas probate documents and send them over to the judge in the appropriate county with an application signed by a lawyer licensed in New Mexico. The application asks that the Texas executor be appointed as Foreign Personal Representative. The judge signs the order and sends it back. No hearing is required. You then do a Distribution Deed (required in New Mexico) signed by the Foreign Personal Representative, record it, and furnish the probate and the deed to the oil companies. Easy and cheap.

OKLAHOMA – This will require a full ancillary probate done by an Oklahoma attorney. Your executor won't have to attend. Distribution deed is required. There will be a state inheritance tax return, and there will be tax due (regardless of the property’s value). The executor will be irritated by the tax and the price.

MONTANA, KANSAS, MISSISSIPPI, ETC. – Full ancillary probate and distribution deed required.

LOUISIANA – Oh, Noooooooooooo! Hire a lawyer. Good luck.

If you have a chance before probate (that is, before the decedent dies) to do some estate planning, consider making gifts of out-of-state properties, or placing those properties in a trust to avoid probate. I am sure the grandchildren would enjoy owning the mineral rights to a swamp in Louisiana!

CONCLUSION

It is possible to transfer estate oil and gas properties without too much trouble, but shhhhh .... Don't tell the oil companies!
§ 91.402 Time for Payment of Proceeds

(a) The proceeds derived from the sale of oil or gas production from an oil or gas well located in this state must be paid to each payee by payor on or before 120 days after the end of the month of first sale of production from the well. After that time, payments must be made to each payee on a timely basis according to the frequency of payment specified in a lease or other written agreement between payee and payor. If the lease or other agreement does not specify the time for payment, subsequent proceeds must be paid no later than:

   (1) 60 days after the end of the calendar month in which subsequent oil production is sold; or

   (2) 90 days after the end of the calendar month in which subsequent gas production is sold.

(b) Payments may be withheld without interest beyond the time limits set out in Subsection (a) of this section when there is:

   (1) a dispute concerning title that would affect distribution of payments;

   (2) a reasonable doubt that the payee:

       (A) has sold or authorized the sale of its share of the oil or gas to the purchaser of such production; or

       (B) has clear title to the interest in the proceeds of production;

   (3) a requirement in a title opinion that places in issue the title, identity, or whereabouts of the payee and that has not been satisfied by the payee after a reasonable request for curative information has been made by the payor.