

MAY 2019, ISSUE 8

Oil & Gas In Trust: A Primer

The oil and gas industry is arguably the foundation of the modern Texas economy. Before the Spindletop discovery in Beaumont in 1901, the Texas economy was largely based on livestock, timber and cotton. After 1901, Texas (and particularly Houston) became “ground zero” for what is now the largest industry on earth—the production and distribution of energy. In keeping with the importance of petroleum production in Texas, private ownership of oil and gas interests is quite common among Texas families—and often these interests are owned by trusts. At Houston Trust Company, we encounter oil and gas interests and their related property rights in our daily work as a corporate fiduciary.

Introduction

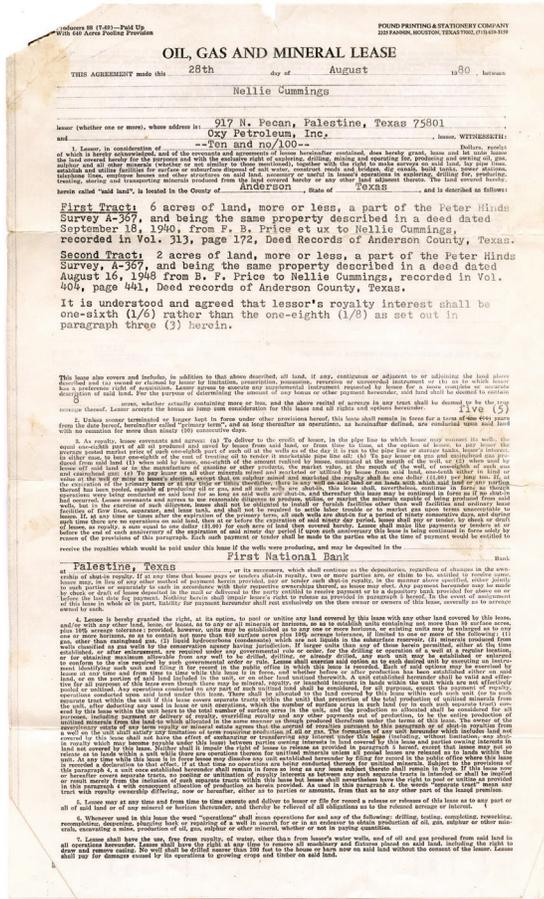
Many of the interests we administer are legacy holdings which can be traced back through several generations. In some cases, current beneficiaries’ ancestors acquired the interests through active oil and gas exploration. In others, the interests are

(or were) remnants of the family’s ancestral Texas homestead, sometimes severed from the surface years ago. And, in still other cases, title to the minerals may have been acquired in contemporary times incident to the purchase of the surface for recreational purposes.

Oil and gas interests are complicated assets to administer, involving legal concepts developed over decades, as well as operational, engineering, accounting, and tax issues that arise. A trustee who is charged with administration of oil and gas interests must understand not only fiduciary responsibilities at-large, but also how to manage these unique property rights. At minimum, the fiduciary must have a working understanding of the nature and extent of the interests owned, and how to administer them effectively. In this regard, the fiduciary's first task will be to collect the documents evidencing the trust estate's ownership. In cases where title is well established, this exercise might involve simply collecting the latest filed deed, copies of current oil and gas leases, and recent division orders. If title is not certain, the trustee must collect additional information and may need to hire a landman or consultant to trace title to the source deed. Property maps, diagrams of title history, and judicial orders might also help. In any case, the trustee must determine what is owned, what is currently paying royalties, and whether any payments are currently being withheld or "in suspense". Not infrequently, litigation is ultimately required to clarify title to productive minerals.

Types of Mineral Interests

The mineral holdings we administer generally fall into four categories: mineral interests, royalty interests, working interests, and overriding royalty interests.



Cummings, Nellie. [Lease for Use of Land by Oxy Petroleum, Inc.], legal document, August 28, 1980; (<https://texashistory.unt.edu/ark:/67531/metaph191161/m1/1/?q=oil%20leases>; accessed April 9, 2019), University of North Texas Libraries, The Portal to Texas History, <https://texashistory.unt.edu>; crediting Price Johnson Family Collection.

Mineral interests encompass the raw ownership of the minerals beneath the surface estate, which includes the "executive right", the right to grant a lease or execute a sale.

A royalty interest consists of the right to receive a portion of the resource or revenue derived from the extraction of the resource from the mineral estate, without the executive right or the right to receive other payments, such as lease bonus or delay rental payments. The royalty interest may or may not be subject to a lease and currently productive of income.

A working interest is created and carved out of the mineral interest when an oil and gas lease is executed and holds the mineral interest owner's rights to develop the minerals under the lease. The working interest retains the lion's share of the production profits, but it also bears the costs of production and must pay a royalty, usually expressed as a percentage of production, to the lessor. An overriding royalty interest is a right carved out of the working interest that entitles the holder to a portion of the oil, gas or other minerals produced under specific leases. An overriding royalty interest is attached to the specific underlying oil and gas lease from which it is carved out and expires upon termination of the lease.

In summary, mineral and royalty interests are attached to the land and working and overriding interests are derived from an oil and gas lease.

Working Interests and Liability

The fiduciary should be mindful of the added responsibilities associated with the trust estate owning a working interest. Although this interest type bears its pro-rata share of the net profits, it also bears a share of the expenses. The working interest is also exposed to the liabilities of the drilling and production activities, which can be significant and long-term, especially with regard to environmental claims. Therefore, the trustee should take steps to insulate the trust estate from these liabilities by placing such interests in a separate, sufficiently capitalized, corporate entity and procuring an appropriate liability insurance policy.

The working interest owner must also deal directly with the operator—another working interest owner who is conducting the actual drilling and production operations on the lease. This adds another layer of responsibility to the current fiduciary duty. The trustee will be asked to review and approve expenditures and will be responsible for paying the trust's share of these. The trustee may elect not to participate in these activities, in which case the trust could be subject to “non-consent” penalties, which are meaningful. The penalties typically range from 3 to 5 times the interest owner's pro-rata share of the expenses and are applied before the working interest owner is entitled to receive any economic benefit from the well. In many cases, the penalties can preclude the working interest owner from any further participation in that well.

Practical Aspects of Administration

Outlined below are some of the steps and issues involved in administering oil and gas interests in trust:

Leasing Considerations

The experienced fiduciary understands that mineral ownership may encompass resources other than oil and gas, such as sulfur, uranium, lignite, coal, or other substances ordinarily considered minerals. For this reason, the oil and gas lease should limit the lessee to production of oil, gas, and related hydrocarbons.

The mineral lease has been characterized not as a “true lease” in the sense that real property is being

rented for a term certain, but rather as a conditional sale of minerals. The term of the lease contains an expiration date, but the lease itself may remain in force perpetually—conditioned only on the lessee actually producing (and maintaining production of) the minerals. The trustee who has been approached for a lease must recognize that this opportunity may be a singular lifetime event, the benefits (or consequences) of which will impact the trust estate for decades to come.

The typical oil, gas, and mineral lease will entitle the lessor to collect payments of varying character, borne directly of the activities contemplated by the lease



agreement. The first of these payments is the “bonus”, the consideration a lessee is willing to pay the landowner upfront for mere execution of the lease agreement. From there, the lessor may expect to receive a “royalty”, the lessor's percentage of production under a lease, free of costs (other than production taxes). If drilling is not commenced during the first year of the lease, the lessor might be entitled to collect annual delay rentals during the primary term of the lease. Except for Louisiana, most oil and gas leases today are “Paid Up” leases which do not include a provision for delay rentals. Instead, those rental payments are factored into the bonus and paid up front.

For a trust estate which also owns the surface, additional considerations are present, as the lessee will require surface acreage to set up a well and conduct drilling operations. Of course, nobody wants a drilling rig in their backyard. However, attractive economic opportunities may present themselves for the surface owner to negotiate a surface use agreement. For instance, the surface owner can negotiate locations of drill sites, access roads, pipelines, and storage tanks, and the damages to be paid for alteration of the property.

If the lessee plans to engage in hydraulic fracturing (“fracking”) activities, additional considerations are



present. For instance, the lessee may want to drill a water well or construct a reservoir or “frac pit” for use in fracking the well. If the surface owner has a lake or pond, the lessee may be willing to pay for use of this resource. These items may be necessities for drilling and production operations, but they also present potentially valuable economic opportunities for the land owner. It is also common, particularly on properties used for recreational purposes, for land owners to benefit from these activities in the form of new fencing, improved ranch roads, and newly-constructed lakes or ponds.

The trustee who administers the surface estate should also be aware of the possibility of condemnation of trust property to make way for a pipeline or power line. These activities annoy the landowner, but they can also be economically beneficial to a well-informed, properly advised landowner. Of the various payments the lessor is entitled to, royalties are the most coveted by mineral owners, since they continue for so long

as there is production from the well and requires no investment from the royalty owner. Royalty payments may be paid as frequently as monthly, and depending on the well and its operator, they may continue for years. We have, in fact, encountered minerals in trust that have been paying regular monthly royalties for several decades. When the lease terminates, the interest reverts back to a mineral interest, and the mineral owner may then grant a new lease. In contrast, overriding royalties are much less desirable, as they are tied to a specific lease and are extinguished forever when the lease terminates, leaving the holder with nothing.

When the trustee is negotiating the lease of oil and gas interests, the following are important areas for negotiation:

- **Bonus amounts** – These can vary widely depending upon the attractiveness of the property, and whether a bidding war between prospective lessees breaks out.
- **Royalty percentage** – Often a point of contention during lease negotiations, as the obligation to pay royalties under the lease may continue for many years. The old “1/8th” standard has gone by the wayside, and the more normal range is presently 18%-25%.
- **Term of lease** – In general, it is preferable to obligate the lessee to explore and begin production in as short of a timeframe as possible.
- **Surface use** – The size and location of the drilling pad, placement of tanks and pits, and entry and exit points are all important considerations for the surface owner.
- **Conduct of drilling and fracking operations and clean-up** – An important aspect of this area includes assessing the financial strength and operational reputation of the lessee, as well as specifying their responsibilities in detail in the lease form.

In short, as this partial list indicates, there are many important issues to consider in leasing, some of which relate to the oil and gas operations, and some relating to what happens when these operations end. Many terms are negotiable, and it is the trustee’s duty to balance the interests of the current income beneficiaries with the long-term interests of the

remainder beneficiaries, particularly those who may be using the surface after oil and gas production has ceased. Due to the long-term impact of many of these issues, it is highly advisable to employ an experienced oil and gas consultant, attorney, and/or landman with familiarity with the area for which the lease is being negotiated. These professionals possess not only technical expertise, but also knowledge of current market conditions. That is the approach we take at Houston Trust Company.

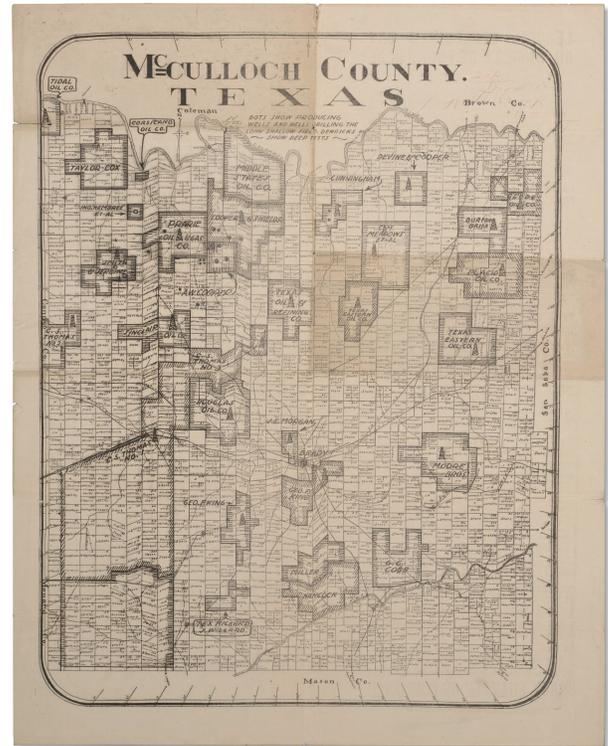
Trust Accounting

A fiduciary is duty-bound to collect mineral-related receipts and pay disbursements in accordance with the terms of the governing instrument or, in the absence of such specific guidance, applicable law. In Texas, the laws that apply to such allocations are found in Section 116.174 of the Texas Trust Code and are designed to aid the fiduciary in balancing the interests of current and future beneficiaries “equitably.”

Most payments commonly received, such as royalties, shut-in well payments, bonus, non-renewable water, and amounts received from a working interest should be applied equitably between trust income (the portion of the trust estate enjoyed by current beneficiaries) and trust principal (the portion of the trust estate generally held for future beneficiaries). Amounts received as delay rentals, annual rent, and renewable water should be allocated to income. An amount received from a production payment is to be allocated to income if and to the extent the agreement creating the production payment provides for interest or its equivalent, and the rest is to be applied to principal.

The portion of a royalty payment the trustee applies to principal, referred to as “depletion”, is generally considered a return of capital and accounts for the reduction of the remaining mineral resource. The U.S. tax code contains a statutory depletion allowance (currently 15% of the gross income from the property), which provides an income tax benefit for the trust estate, as the depletion amount may be deducted for income tax purposes. An allocation between principal and income is presumed to be “equitable” under Texas law if the amount allocated to principal is equal to the amount allowed under the US tax code as a deduction for depletion.

If the interest is a working interest, the trustee has to deal with, and account for, additional items.



Brady Chamber of Commerce. McCulloch County, Texas: dots show producing wells and wells drilling the Lohn Shallow Field, derricks show deep tests., map, [1910..1930]; Brady, TX. (<https://texashistory.unt.edu/ark:/67531/metaph252091/m1/1/?q=oil%20derricks>: accessed April 9, 2019), University of North Texas Libraries, The Portal to Texas History, <https://texashistory.unt.edu/>; crediting University of Texas at Arlington Library.

For instance, the interest will be responsible for paying its share of drilling and production expenses incurred on its behalf by the operator.

A fiduciary must maintain accurate books and records and owes a duty to keep beneficiaries reasonably informed of material facts relating to the trust estate. In practical terms, a trustee might satisfy this obligation by providing periodic accountings or statements to the beneficiary which include a detailed inventory of trust assets, liabilities, receipts and disbursements. The trustee must also fairly value the trust’s assets. A line item description of the holding and a notation of nominal value may suffice for dormant mineral interests. However, interests productive of income will have real value that should be ascertained, recorded, and periodically adjusted as necessary.

Different methods exist for valuing productive interests—property tax bills, formulaic calculations, and formal appraisals, to name a few.

Even if the trustee is well-organized and adept at maintaining financial records, generating financial statements, and issuing appropriate reports, the trustee will often lack the experience and subject-specific expertise needed to handle these oil and gas assets, especially if it involves a truly active operation with numerous producing properties. For this reason, a qualified agent may be needed to assist with these tasks.

Income Taxes

Trusts are subject to a compressed income tax rate schedule. Whereas an individual must earn several hundred thousand dollars before reaching the top marginal tax bracket (currently 37%), a trust estate reaches that threshold at a mere \$12,750 in taxable income. Thus, a substantial bonus payment or a strong royalty stream can guarantee significant taxable income—either to the trust or, if distributed, to the beneficiary.

The aforementioned depletion allowance can help ease the burden, but the trustee should understand during oil and gas lease negotiations that a properly



structured lease can also minimize the impact of taxes. Barring that opportunity, the trustee may consider distributions of income to the current beneficiaries, if it is permitted by the trust instrument and the current beneficiaries fall into a lower income tax bracket, since doing so shifts the income tax burden on the distributed income to the beneficiary

recipients. If the trust owns working interests, allowed deductions for expenses incurred in connection with operation of the well could offset revenues received from production in the computation of the taxable income for the trust.

The trust estate will receive tax reporting at year-end from each royalty payor—typically a Form 1099—which is to be used in preparing the trust's annual income tax return. For trusts that own considerable oil and gas holdings, tracking and organizing these reports can be challenging, especially if different operators are involved. A good consulting firm can assist with and streamline these tasks for the trustee, as we describe below.

Additional Management Considerations

A fiduciary who holds minerals in trust is responsible for all aspects of administration and management of these specialized interests, some of which are even beyond an experienced trustee's expertise. For this reason, the trustee should consider hiring an agent with the requisite expertise to assist with these activities. Houston Trust Company utilizes the services of Travis Property Management, a locally-owned and operated company experienced in mineral asset management. They provide a full range of mineral management services which include accounting support and land support and make recommendations based on sound research and local knowledge.

We frequently receive purchase offers for mineral interests we hold in trust, some of which appear lucrative at first glance. However, as long-term owners, we generally are not interested in selling, regardless of how attractive the offer may appear. First, we—and our beneficiaries—tend to view mineral holdings as part of our clients' family legacy. Second, it is nearly impossible to fairly quantify the value of these assets, even with modern tools and technology. Non-productive interests hold untapped value, while highly productive interests, though capable of being valued for the present day, may still hold as-yet-undiscovered potential.

Finally, the possibility also exists that currently non-marketable non-hydrocarbon-based minerals owned under the same interest may someday become commercially viable.

In rare cases when sale of minerals is necessary, we will try to structure the transaction in a way that ensures an ongoing interest for the trust beneficiaries. One way to accomplish this goal is to retain a non-participating royalty interest from the assets sold, or we may reserve an “overriding royalty” from the current leasehold. In other cases, we may negotiate for an equity stake in the purchaser or contribute the interests to a larger pool of minerals or royalty interests contributed by other owners in return for a stake in the merged pool of assets.

We also have encountered situations in which titling of the mineral interests does not tell the whole story of their ownership. One example of this is when the minerals are (or were) owned by a husband and wife, but title is held by one or the other. Since Texas is a community property state, the spouse who does not have title may nevertheless have an interest in the asset, even though the spouse in whose name title resides has apparent authority to manage the interest for the benefit of the community. This may not be picked up in the title search performed by the oil and gas company’s landman and can require litigation to clarify title if the interests become productive.

Another issue we experience results from the fact that, as title to oil and gas interests becomes fractionalized across generations and the resource depletes, administration becomes more burdensome—even uneconomical. We often find that consolidation of these interests into limited partnerships or limited liability companies is an attractive option for the continued management of these interests for the beneficial owners and eases the administrative burden. In addition, holding these assets in entity form allows for efficient and cost-effective transfer or assignment of ownership interests, eliminating the need to file deeds upon sale of interests or the costs associated with ancillary probate proceedings upon a beneficial interest owner’s death.

Conclusion

Private mineral ownership is a widespread phenomenon, particularly in Texas and surrounding states, so trustees need to be prepared for the likelihood that trusts under their administration may also own minerals. Minerals constitute a distinct asset class, bringing a unique set of administrative challenges for the trustee. Although education and experience in dealing with these assets are helpful attributes to have, we have found that teaming up with specialists to assist with mineral administration can be productive and beneficial to the trust estate.



Man by Drilling Rig, photograph,
Date Unknown; (<https://texashistory.unt.edu/ark:/67531/metaph49879/m1/1/?q=oil%20derricks>; accessed April 9, 2019), University of North Texas Libraries, The Portal to Texas History, <https://texashistory.unt.edu>; crediting Permian Basin Petroleum Museum, Library and Hall of Fame.

ABOUT THE AUTHORS

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Mark Herrin joined Houston Trust Company in 2015 after beginning his career in trust and estate administration in 1999. As Senior Vice President of Trust Administration, he specializes in personal trust administration and estate administration. Earlier in his career, he worked as an oil and gas landman and practiced law. Mark earned a B.S. in Economics from Southern Methodist University, received his Doctor of Jurisprudence degree from South Texas College of Law, and is a member of the Houston Estate and Financial Forum.

About Houston Trust Company

Houston Trust Company is the largest private, independent, full-service trust company in the state of Texas with \$6.5 billion in fiduciary assets. As a true fiduciary, the Company specializes in the transition of assets across generations, focusing on four highly personalized service areas: fiduciary administration of trusts and estates; independent, third-party investment and asset management; support services for charitable trusts, endowments, and foundations; and family office services.

**David D. Welsh**

*Founder, Owner, Manager, Landman
Travis Property Management, LLC*

David Welsh is the founder and owner of Travis Property Management. After graduating from the University of Texas with a BBA degree in Petroleum Land Management and Finance in 1984, David began his career as an independent landman in Midland, Texas performing land duties for several oil and gas companies which included title work and lease negotiations. He returned to his hometown of Houston in 1989 to continue his oil and gas work and founded Travis Property Management in 2004.

**Greg Crow**

*Manager, Landman
Travis Property Management, LLC*

Greg Crow joined Travis Property Management in 2008 as a Property Manager and Manager of the Land Group. As Property Manager, Greg analyzes title documents to determine ownership and oversees title transfer; negotiates leases, seismic agreements, and surface use agreements; handles ad valorem taxes; monitors income and expenses; and more. For 27 years, Greg worked in the Trust Oil and Gas group at Texas Commerce Bank and its predecessor banks. Greg graduated from the University of Texas with a BBA in Petroleum Land Management and International Business in 1981.

About Travis Property Management

Travis Property Management, LLC offers professional expertise as a boutique independent manager of oil and gas interests, including fee minerals, royalty, overriding royalty and working interests. Travis offers a variety of services, including negotiation and administration of mineral investment activities; performing revenue, expense and tax functions; maintaining property and accounting records; preparing client reports and summaries; and providing assistance with investment decision making.