

Ratification: Beware!

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Ratification Defined

An agreement ratifying and confirming a lease executed by a concurrent owner other than the original lessor or conduct by such person which by implication ratifies and confirms the lease.

Williams & Meyers, Oil and Gas Law § 505.2

- Applicable to documents other than oil and gas leases

Attributes of the Mineral Estate

“The Bundle of Sticks”

1. Executive right (authority to execute oil and gas leases).
2. Right of Self-Development (ingress and egress).
3. Right to receive royalty.
4. Right to receive bonus payments.
5. Right to receive delay rentals.

Severability of the Mineral Estate

The attributes of the mineral estate are capable of being severed from the others, through conveyance or reservation.

Exception: Right of Self-Development

- In *Lesley v. Veterans Land Bd.*, the Texas Supreme Court stated, “the right to develop is a correlative right and passes with the executive rights,” and concluded a non-executive mineral owner has no right to develop the property. 352 S.W.3d 479, 492 (Tex. 2011).
- See also *KCM Fin. LLC v. Bradshaw*, 457 S.W.3d 70, 76 (Tex. 2015)

Non-Executive Mineral Interest (“NEMI”)

What attributes are included?

- Right to royalty: Yes or No.
- Bonus and Delay Rentals: Yes or No.
- Executive right: NO (it’s literally in the name).
- Right to develop: (Currently) NO.

Non-Participating Royalty Interest (“NPRI”)

What attributes are included?

- Right to royalty: YES.
- Bonus and Delay Rentals: NO.
- Executive right: NO.
- Right to develop: (Currently) NO.

Creation of a Non-Executive Interest

How are non-executive interests created?

- Express Grant
 - Example: A mineral owner conveys a non-participating royalty interest.
 - *White v. White*, 830 S.W.2d 767 (Tex. App. 1992).
- Reservation
 - Example: A mineral owner conveys his/her interest; reserves a non-participating royalty.
 - *In Re Bass*, 113 S.W.3d 735 (Tex. 2003).

Reasons for Obtaining a Ratification

Why might you need a ratification?

- Unleased Party (a co-tenant mineral owner ratifies another lease)
- Adopting Document (an unleased mineral owner ratifies a pooled unit)
- Confirming an Instrument (a spouse ratifies a conveyance of homestead)
- **Pooling** (a non-executive mineral/royalty owners ratifies a lease)

This presentation focuses on the pitfalls of non-executive ratification of leases for purposes of pooling.

Limits of Ratification

Revivor

- Expressly recognize terms and validity of the expired instrument; AND
- Include present grant/lease language (ratification becomes a conveyance).

Void Instruments

- A ratification of a void instrument does not validate the void instrument.
- Whether a lease that was invalid at execution may be ratified once the reason for invalidity has been removed is uncertain in Texas.

Non-Executive Owners & Pooling

Methods of Pooling a Non-Executive Interest

- Ratification
 - Non-executive owner ratifies a lease (with pooling authority) or an existing unit.
- Prior Reservation of Right
 - The instrument creating the non-executive interest expressly reserves/conveys the right to pool the non-executive's interest in any existing or future pooled units.
- Mineral Interest Pooling Act
 - Statutory method of force pooling; limited usage within Texas.

Non-Executive Owners & Pooling

Who is Responsible for Obtaining a Ratification?

- Lessor:
 - Duty to notify non-executive that a lease has been executed which allows for pooling.
 - *De Benavides v. Warren*, 674 S.W.2d 353 (Tex. App.—San Antonio 1984).
- Lessee:
 - May be obligated to notify non-executive that a lease has been executed which allows for pooling.
 - Potential argument that Lessee participated in Lessor's breach by failing to notify non-executive.
 - *See* Fiduciary Obligations Under Oil and Gas Leases: The Standard of Conduct Owed by Executives and Lessees, Ernest Smith, 9/1985.

Non-Executive Owners & Pooling

To Ratify or Not to Ratify

- Wholly the choice of the non-executive owner – cannot be forced.
- Potential benefits (off-tract production) and risks (dilution of interest).
- Decision must be “timely” – No firm definition.
 - *See, e.g., DeBenavides v. Warren*, 674 S.W.2d 353 (Tex. App.—S.A. 1984, writ ref’d n.r.e.).
 - Non-executive owner was permitted to retroactively ratify a pooled unit which had ceased producing 7 years prior, based upon fact Lessor never notified non-executive owner regarding lease.

Non-Executive Owners & Pooling

Pooling = Cross-Conveyance

- In Texas, pooling is considered a cross-conveyance of the mineral interests of each party within the pooled lands.
- If the executive right owner was given the power to pool a non-executive's interest without the non-executive's consent, the executive right owner would be conveying the non-executive's interest without the non-executive's consent.
 - *Brown v. Smith*, 174 S.W.2d 43 (Tex. 1943).

Communitization

What is Communitization?

- Communitization (of royalty) occurs when separate tract owners jointly execute a single lease covering the separate tracts (a “Community Lease”).
- A community lease entitles each executing party to a proportionate share of royalty from production obtained anywhere within the leased premises, regardless of the location of the producing well(s).

Non-Executive Owners & Communitization

Checklist for possible lease communitization:

- The lease covers separate tracts
 - The lease includes a pooling provision
 - At least one tract includes a non-executive owner
- Ratification by a non-executive in this situation entitles the non-executive to proportionate share of royalty on *all* the lands covered by the lease, even if the oil and gas is produced from a well on another tract other than on the specific tract in which they owned a nonparticipating royalty interest.

Non-Executive Owners & Lease Ratification

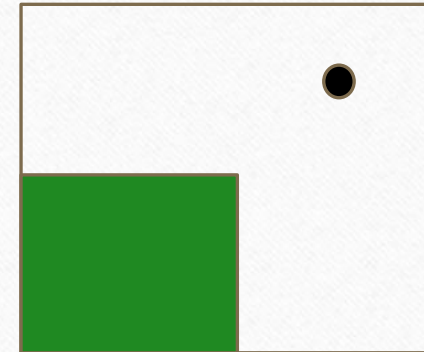
Example No. 1 - Hypothetical Facts:

- Abe: owns 100% MI in WA (300 acres) and GA (100 acres).
- Betty: own 1/8th floating NPRI in GA (100 acres).
- Abe executes lease with Supreme Oil Company covering both GA & WA.
 - Abe's lease includes a 25% lease royalty and a pooling clause.

Non-Executive Owners & Lease Ratification Scenario #1

No Ratification & Non-Drillsite

- Betty (GA) does not ratify Abe's lease (GA & WA).
- A vertical well is drilled on WA.
- Is Betty entitled to production from the well?



Non-Executive Owners & Lease Ratification Scenario #1

No Ratification & Non-Drillsite

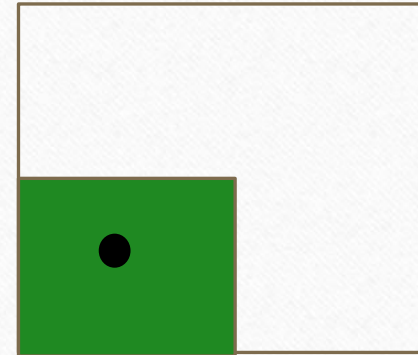
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Absent ratification of the lease, a non-executive owner is only entitled to a share of production when the drillsite is located on the lands burdened by the non-executive interest.

Non-Executive Owners & Lease Ratification Scenario #2

No Ratification & Drillsite

- Betty (GA) does not ratify Abe's lease (GA & WA).
- A vertical well is drilled on GA.
- Is Betty entitled to production from the well?



Non-Executive Owners & Lease Ratification Scenario #2

No Ratification & Drillsite

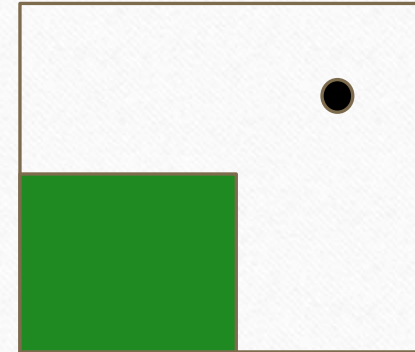
$1/8$ of 25%

Absent ratification of the lease, a non-executive owner is entitled to its full share of production when the well is located on the lands burdened by the non-executive interest.

Non-Executive Owners & Lease Ratification Scenario #3

Ratification & Non-Drillsite

- Betty (GA) ratifies Abe's lease (GA & WA).
- A vertical well is drilled on WA.
- Is Betty entitled to production from the well?



Non-Executive Owners & Lease Ratification Scenario #3

Ratification & Non-Drillsite

1/8 of 100/400 of 25%

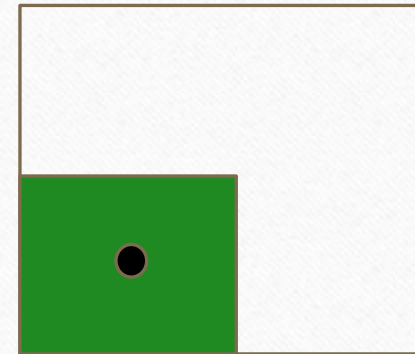
Ratification of a lease which covers separate tracts and includes a pooling provision effectively communitizes the non-executive's interest across all tracts covered by the lease.

As a result, the non-executive owner is entitled to a proportionate share of production, even if the drillsite is not located on the tract in which the non-executive owns an interest.

Non-Executive Owners & Lease Ratification Scenario #4

Ratification & Drillsite

- Betty (GA) ratifies Abe's lease (GA & WA).
- A vertical well is drilled on GA.
- Is Betty entitled to production from the well?



Non-Executive Owners & Lease Ratification Scenario #4

Ratification & Drillsite

1/8 of 100/400 of 25%

Ratification of a lease which covers separate tracts and includes a pooling provision effectively communitizes the non-executive's interest across all tracts covered by the lease.

As a result, the interest of the non-executive owner is diluted even though their interest burdens the drillsite tract.

Non-Executive Owners & Lease Ratification

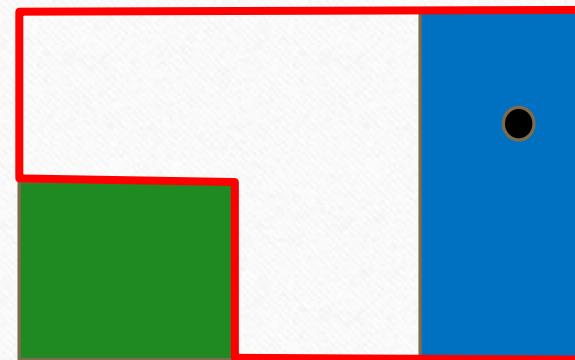
Example No. 2 - Hypothetical Facts:

- Abe: owns 100% MI in WA (300 acres) and GA (100 acres).
- Betty: own 1/8th floating NPRI in GA (100 acres).
- Carlos: owns 100% MI in BA (200 acres).
- Abe and Carlos each execute a lease with Supreme Oil Company covering their respective acreage, being a cumulative 600 acres (GA + WA + BA).
 - Each lease includes a 25% lease royalty and a pooling clause.

Non-Executive Owners & Lease Ratification Scenario #5

Lease Ratified - Non-Drillsite - Not Within Pool

- Betty (GA) ratifies Abe's lease (GA & WA).
- Supreme Oil forms Unit consisting of WA and BA.
- A vertical well is drilled on BA.
- Is Betty entitled to production from the well?



Non-Executive Owners & Lease Ratification Scenario #5

Lease Ratified - Non-Drillsite - Not Within Pool

1/8 of 100/400 of 300/500 of 25%

[NPRI] [Lease Tract Reduction] [Unit Tract Reduction] [Lease Royalty]

- Ratification of Abe's lease communitized Betty's NPRI throughout GA and WA.
 - Because WA is pooled with BA, Betty is entitled to production from BA.

Anti-Communitization Clause

Example of an Anti-Communitization Clause:

If this lease now or hereafter covers separate tracts, no pooling or unitization of royalty interest as between any such separate tracts is intended or shall be implied or result merely from the inclusion of such separate tracts within this lease but Lessee shall nevertheless have the right to pool as provided above with consequent allocation of production as provided. The phrase “separate tract” means any tract with royalty ownership differing, now or hereafter, either as to parties or amounts, from that as to any other part of the leased premises.

Anti-Communitization Clause

Texas Appellate Courts to Lessors: “Nice Try”

- Texas appellate courts have held that anti-communitization clauses are not effective to prohibit the ratification of the lease by non-executive owners.
- Communitization of royalty resulted from the lessor’s attempted authorization for the lessee to pool the non-participating royalty interest without their consent (by including a pooling provision in the lease), enabling the non-participating royalty interest owners to ratify the unauthorized pooling provision contained in the lease.
 - *London v. Merriman*, 756 S.W.2d 736 (Tex. Civ. App. – Corpus Christi, 1988, writ denied)
 - *Verble v. Coffman*, 680 S.W.2d 69 (Tex. Ct. App.—Austin 1984)

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Alternative to Ratification: Consent to Pooling Agreement

- Eliminates Communitization issue.
- Should include Non-Appportionment Clause.
- Can be customized to limit scope:
 - Consent to pooling of only acreage within a given pooled unit.
 - Consent to pooling of acreage assigned to a given well.
 - Not required to consent to all acreage covered by executive owner's lease.

Non-Appportionment Clause

What is the Rule of Non-Appportionment?

- Royalties paid only to owner of producing tract.
- Neighbors get nothing.
- Entireties Clause: counteracts the rule of non-apportionment.
 - “royalties shall be paid to each separate owner in the proportion that the acreage owned by him bears to the entire leased area.”

Ratification vs. Consent to Pool

Ratifications

- Only allows the non-executive to adopt terms already negotiated.
- Non-executive not included in the negotiation – unilateral effort by Lessor.

Consent to Pool Agreements

- Agreement directly negotiated by non-executive interest owner.
- Texas Courts more likely to uphold the agreement since non-executive an original party to the agreement.

Non-Executive Owners & Pooling Agreements

Example No. 2 - Hypothetical Facts:

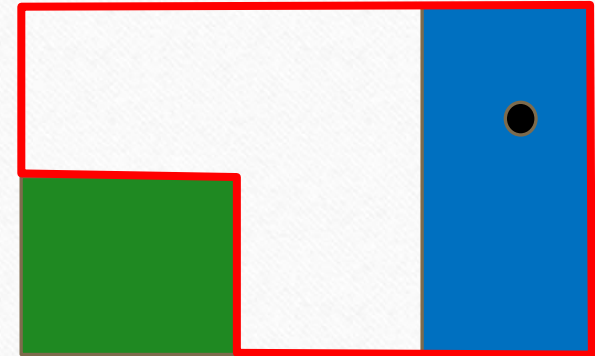
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- Abe and Carlos each execute a lease with Supreme Oil Company covering their respective acreage, being a cumulative 600 acres (GA + WA + BA).
 - Each lease includes a 25% lease royalty and a pooling clause.

Non-Executive Owners & Pooling Agreements

Scenario #6

Pooling Agreement - Non-Drillsite - Not Within Pool

- Betty (GA) executes Pooling Agreement with Supreme.
- Supreme Oil forms Unit consisting of WA and BA.
- A vertical well is drilled on BA.
- Is Betty entitled to production from the well?



Non-Executive Owners & Pooling Agreements

Scenario #6

Pooling Agreement - Non-Drillsite - Not Within Pool

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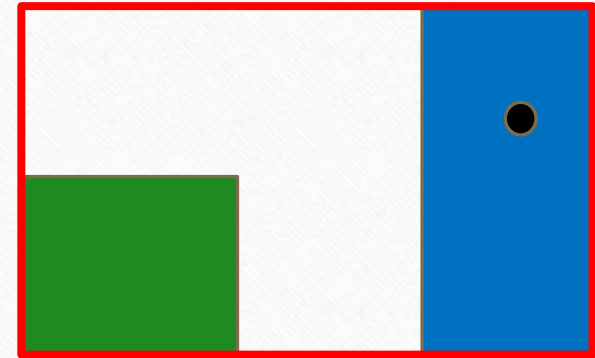
- Betty's NPRI in GA is not included in the pooled unit.
- Absent ratification of Abe's lease (covering GA and WA), Betty is not entitled to off-tract production.

Non-Executive Owners & Pooling Agreements

Scenario #7

Pooling Agreement - Non-Drillsite - Within Pool

- Betty (GA) executes Pooling Agreement with Supreme.
- Supreme forms Unit consisting of GA, WA, and BA.
- A vertical well is drilled on BA.
- Is Betty entitled to production from the well?



Non-Executive Owners & Pooling Agreements

Scenario #7

Pooling Agreement - Non-Drillsite - Within Pool

$1/8$ of $100/600$ of 25%

- Betty is entitled to a proportionate royalty on all lands included in the Unit.
- In this case, Betty would be entitled to the same proportionate share of royalty regardless of the location of the well within the Unit.

Conclusion

- Ratifications often result in royalty communitization.
 - Consent to Pool Agreements are a viable alternative to obtaining a ratification.
- Unanswered Question: Can a non-executive who has executed a pooling agreement subsequently execute a lease ratification?

Questions or Comments?

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