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A Closer Look

Managing Your Oil and Gas Interests

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In Brief

- **Leasing oil, gas, and mineral rights to energy producers can provide families with regular income from one generation to the next.**
- **Carefully negotiating these leases is essential to receiving an optimal return. Every situation is unique, and boilerplate leases provided by an oil or gas producer should be avoided.**
- **Over time, families may lose sight of mineral rights that they own, potentially forfeiting substantial royalty payments or even losing the rights altogether via tax sale.**
- **Whether it's negotiating a favorable lease, tracking and managing properties over time, or accurately valuing ownership for the purposes of wealth transfer or sale, Bessemer's mineral and energy resource management specialists can help you achieve your goals.**

Despite the inherent volatility of energy markets — vividly on display during the global coronavirus pandemic — producing mineral rights have provided regular income for generations of families and may be an important part of a family's overall assets.

Owning mineral rights differs from investing in, say, stock of an oil or gas company. Whereas stock represents partial ownership of a company, owners of oil, gas, and mineral rights realize a return by allowing those companies to produce minerals underlying their property. Energy companies gain the contractual right to do so by leasing the rights for a given period of time and under very specific terms.

While certain basic provisions are common to all leases, significant economic advantages (and potential disadvantages) can be found in the details. Leases have complex clauses and components with nuances that could make a significant difference in the amount of money a family receives over time. And as oil, gas, and mineral rights pass from one generation to the next, families — potentially to their financial detriment — may lose sight of crucial provisions or even be unaware that they own the rights at all.

Because of the high stakes and numerous complexities involved, careful management and attention to detail — by experienced, expert advisors — is essential when owning and managing these rights and negotiating leases.

The Elements of Leasing

In most instances, companies that drill for, produce, and sell oil and gas do not own the land they drill on. Since the mid-19th century, companies have leased their rights from landowners, and the history is colorful to say the least. In the early days of oil and gas

leasing, leases were typically handwritten, and fraud was common. Landowners, some of them unable to read or write, were ready targets for dishonest dealers.

As a body of law has developed around oil and gas leasing, fraud is much less common today. In major energy-producing states, mineral owners and producers have been happily coexisting, relatively speaking, for more than a century. Yet when issues do arise, it's essential that lessors (the mineral owners) have taken great care in negotiating with potential lessees (energy producers). The contractual details are complex, and the producers will naturally be looking out for their own interests.

It should be noted that an oil and gas lease differs from most other types of leases. While a conventional real estate lease, for example, imparts the right to occupy but not own a building or other property, an oil or gas lease confers to the producer ownership of the mineral rights, for as long as the lease remains in effect, subject to the landowners' retained royalty interest.

In consideration for granting the lease, the producer typically pays the lessor an upfront bonus as well as a percentage of the cash proceeds, termed "royalties," from the oil, gas, or minerals that come out of the ground. While the bonus represents a guaranteed payment, in some cases, the more substantial money to be earned is through future royalties. But royalties come with risks. Energy producers have the right but not the obligation to drill on land they lease. Not only will the royalty, paid out as a negotiated percentage of the cash proceeds from sales, rise or fall based on the price of gas or oil; it could be that no drilling occurs at all. If the lessee decides not to drill (as frequently happens), or if wells fail to produce, the bonus is the only payment the lessor will receive.

The length of the lease contract is another important consideration. Leases are valid for a specific number of years, known as the "primary" term. While five to 10 years was common in the past, today's primary terms tend to be shorter — one to three years. Energy companies with one or more wells operating at the end of the primary term move into what's known as the secondary term — with the right to maintain the lease as long as they maintain production. The definition of a lease-ending stop in production varies from contract to contract, so understanding the fine print and negotiating optimal terms is essential for any lessor. (See "The Value of Understanding the Fine Print" below).

Another complexity lies in the fact that people who own land don't always own the rights to oil or gas deposits underneath that land. As rights pass down through generations, they may be divided up among multiple beneficiaries, with ownership of the oil and gas rights "severed" from land ownership. In some areas of the country, such as Texas, such severed ownership has become more the rule than the exception. Without shared ownership of the surface, which obviously is visible, the "invisibility" of minerals-only ownership makes it even more prone to eventually slipping through the cracks.

Case Study: The Value of Understanding the Fine Print

Through a trust dating back to the 1930s, a family owned a 10 percent stake in mineral rights under 4,000 oil-rich acres. When the producer that had leased the rights from the family sold out to a much larger energy company, the new company asked that the family submit proof of its title to the interests and hence its right to receive royalties.

For the family's mineral managers, this was a tip that the company planned to or was already drilling on the property. A quick check on an online industry database confirmed that production had in fact started six months earlier. The new company had overlooked fine print in the lease's royalty clause, dictating that unless the lessor (the family) received royalties within 120 days of the start of production, the lease would terminate.

Since no royalties had been paid, the lease automatically expired, and the energy company was now technically guilty of mineral trespass, unjust enrichment, and conversion. Negotiations to revive the lease resulted in payment of several hundred thousand dollars to the family — money that might not have been realized without a detailed knowledge of the contract's terms and real-time knowledge of the operator's activities. As an added benefit, the lease "revivor" contract expressly waived the aforementioned title requirement.

Negotiating a Lease

As discussed, negotiating an optimal oil and gas lease is a complex process requiring a detailed knowledge of how such leases work and the specifics of the given situation. Owners may sign an energy company's boilerplate agreement, assuming that's the only option they have. It's not. Before signing anything, it's vital to take a step back and walk through each lease provision with an expert on your side to help you understand the nuances.

For example, while an energy company may seek to entice an owner with a sizeable upfront bonus, typically the most significant potential revenue comes from the regular royalty payments that occur in the event of successful drilling. Royalties of 20%–25% of sales are fairly standard, but much depends on the methods that will be used to value the product. An optimal contract for the lessor will expressly forbid the energy company from basing royalties on a low price they may charge to a subsidiary or affiliate before the oil or gas goes to market. Royalties should instead be based on the market price. And while energy companies may want to deduct a host of production costs from royalty payments, a lease contract should restrict deductions solely to production taxes (also known as severance taxes) paid to the state.

Many boilerplate leases drafted by the energy company will require the lessor to warrant title to his or her mineral rights. This is a way of potentially holding the landowner accountable if the energy company makes an error in its title due diligence, and then demands a full or partial refund of alleged overpayments. A contract that's optimal for the lessor will avoid such warranty language altogether.

The fracking revolution in oil and gas production has also increased the need for lessors to negotiate carefully. Unlike traditional vertical drilling, fracking involves drilling horizontally for pockets of oil and gas trapped in layers of shale. With this type of drilling, wellbores may stretch sideways literally for miles, potentially traversing property owned by multiple individuals or families. To cover horizontal wellbores, energy companies must commit far more acres of land than is required for conventional vertical drilling. State regulations determine a minimum acreage that must be committed to each well. Yet a decision by an energy company to commit additional acres could diminish the potential royalties of lessors who own a fixed portion of the drilling area. Thus lessors' careful negotiating may be required to help ensure that the overall acreage does not exceed the minimum required by the state.

Finally, lessors must take care in negotiating the fine print — lease clauses that can potentially make a sizeable difference in the amount of revenue the lessor receives. The "cessations clause," for example, dictates how long a lessee energy company can pause drilling operations between wells without the lease terminating. A company that exceeds the limits of the cessation clause may have to pay the owner to revive the lease.

Protecting a Family Legacy

While oil, gas, and mineral rights may provide a valuable legacy that helps support family members, as property passes from one generation to the next and ownership divides among multiple heirs, owners may lose sight of critical details or even overlook mineral rights they own entirely.

One risk in such cases is that owners lose out on royalties they are rightfully owed. When owners and energy companies lose track of one another, the law requires companies to turn over unclaimed mineral proceeds to the state government's unclaimed property fund through a process known as escheat.

For families whose landholdings and oil, gas, and mineral rights may stretch across multiple states, it's all too easy for unclaimed royalties to slip through the cracks. One way to prevent this is by searching unclaimed property databases maintained by individual states and/or using a nationwide database, such as MissingMoney.com. In some cases, these searches uncover substantial escheated royalties. As part of its due diligence in serving a client, an experienced oil, gas, and minerals team can conduct these searches and take steps to eventually recover these funds.

Another risk for owners is losing rights through failure to pay taxes. In most states, non-producing mineral rights aren't taxed. But once the energy company starts drilling and producing, the production generates a real estate tax liability. Families unaware they even own the property have

no way of knowing taxes are due. The energy company doesn't know where to reach them, and may not devote a great deal of time or effort to finding out. If the taxes go unpaid, a local government may eventually sell those rights at a tax sale. In most cases, there's a redemption period in which the original owners may reclaim rights by paying the overdue taxes, interest, and other fees.

The redemption period may last as long as several years. Though the penalties and back taxes may be onerous, paying them could help ensure a much larger return later on if the property remains in the owner's hands. A careful review with an oil, gas, and mineral expert can give you greater clarity about rights you own, help you fill out the proper paperwork on back taxes, pay the taxes and fees, and ensure you receive a redemption deed confirming that you're paid up and still own the property.

Transferring or Selling Mineral Rights

At some point, individuals may want to hand down their mineral rights to the next generation. Or, depending on their financial situation, they may want to explore selling. Though an old maxim held that mineral rights should never be sold, owners may in fact want to explore selling for a number of reasons — whether to simplify estate planning, reduce administrative requirements, or pursue other investment opportunities.

When an owner plans to transfer or sell mineral rights, proper timing is essential. A time when oil or natural gas prices are depressed may be a tax-efficient time to transfer assets, whether through lifetime gifts or through estate planning. For the same reason, times when prices are reduced may be disadvantageous for selling.

For any transfer or sale, accurate valuation is a must. And because mineral value is based on oil or gas production that may take place years from now, if ever, the process can be considerably more complex than estimating the value of, say, a house or piece of commercial real estate. It involves careful projections based on the discounted present value of the estimated future revenue stream from production. To protect the interests of the owner and to avoid complications with the IRS, such appraisals must be made by skilled professionals.

Case Study: Maximizing a Texas Windfall

A Bessemer client living on the East Coast received a surprise offer from an energy company wanting to drill on some Texas property under which she and her siblings owned oil and gas rights. The rights had come as part of an inheritance from their father, and the family was previously unaware they existed.

In this case, leasing was not a viable option. Due to the nature of the client's interest, termed "working" interest, her only options were to participate in the drilling costs (to the extent of her interest) or sell out to the operator. The participation option was prohibitively expensive, even with the client's relatively nominal interest, due to the very high cost of the proposed (horizontal) shale drilling. As an alternative, the oil company initially offered to purchase the working interest outright for $25,000.

Without expert guidance the family might have accepted the offer as a happy windfall. But as Bessemer's mineral and energy resource management team looked closer, it became clear that acquiring the client's interest was critical to the company's broader plans for horizontal drilling into potentially rich shale deposits. Subsequent sale negotiations resulted in a windfall for the family amounting to 10 times the original offer.

Finding the Right Guidance

For all of the potential advantages of owning and leasing oil, gas, and mineral rights, pitfalls abound at every stage. Signing a lease without understanding the myriad details could result in less-than-optimal returns, even if the property becomes a substantial producer of oil or natural gas. Likewise, losing track of mineral properties over the years could mean you or your heirs fail to realize the benefits that by all rights should be coming your way. All of which is another way of saying that oil, gas, and mineral rights require the same level of care and attention, and in many cases considerably more, as do all of one's other investment assets.

Bessemer's mineral and energy resource management specialists have extensive experience working with families of wealth and a deep knowledge of the complex workings of the energy industry. We can help ensure that the mineral properties you own work to the maximum benefit of you and your family, now and for years to come.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

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