

GOGL Case Summary



Oil & Gas Case Notice

Exercising the Executive Right – Redux

On April 12, 2019, the Texas Supreme Court opined, once again, on the duty of the executive rights holder. In *Texas Outfitters v. Nicholson*, 2019 WL 1575, Texas Outfitters (TxO) owned 4.16% of the minerals and the executive rights to 45.84% of the minerals under a 1,082-acre tract in Frio County, Texas. TxO used the tract as its owner's residence as well as a hunting business. The remaining 50% of the minerals was owned by another family which leased to El Paso. TxO rejected the offer from El Paso (and had rejected a previous, lower offer); TxO's owner testified that he thought the bonus was too low and he wanted to wait for prices to go up as the oil play matured. The Court noted that the owners of the non-executive 45.84% wanted TxO to accept the El Paso offer.

The oil play fizzled after offers to lease the TxO 50% were made and withdrawn (apparently because of the 50% already leased to El Paso) and Carter (Nicholson) (the owner of the 45.84%) sued. A bench trial resulted in a judgment against TxO for the amount the Carters would have received in bonuses from El Paso (\$867,654.32). The Court of Appeals affirmed.

Justice Lehrmann ably summarized the Texas law of executive rights:

1. The duty does not require an executive to subjugate his interest to those of the non-executive; rather, the executive must acquire for the non-executive every benefit that he exacts for himself. Citing *Lesley*, *Bradshaw* and *Manges*.
2. The executive is not wholly shielded from liability for inaction (failure to lease) and if the refusal to lease is arbitrary or motivated by self-interest to the non-executive's detriment the executive may have breached its duty. Citing *Lesley* for the proposition that an executive who imposed limitations (restrictive covenants) on future leasing that benefitted its interest in the surface to the detriment of the mineral owners, breached its duty.
3. The overarching principle is whether the executive engaged in acts of self-dealing that unfairly diminished the value of the non-executive interest, citing *Bradshaw* (executive agreed to a lower royalty rate in exchange for an enhanced bonus for the executive).
4. Deciding these cases is heavily dependent on the facts and circumstances.
5. *Bradshaw* and *Lesley* do not set different standards depending on whether the conduct complained of is leasing or refusing to lease.

TxO said it would not have purchased the ranch without the executive rights and the corresponding control over future mineral development. In March of 2010, TxO received and rejected an offer to lease its and the Carters' mineral interest (50%) to El Paso for \$450/acre and 22% royalty. In June of 2010, the owner of the other 50% leased to El Paso for \$1,750/acre and a 25% royalty. The same offer was made to TxO; the Carters wanted TxO to accept the offer. TxO rejected the offer. TxO said it was too low; Carter testified that TxO said it "planned not to lease because of his business." There were negotiations between TxO and Carter which were not fruitful.

Carter sued in June, 2011. TxO received two later offers but both were withdrawn (one because the other 50% had already been leased). Drilling was not as productive as anticipated and no further offers to lease were received. TxO sold the ranch in 2012 for \$3.5 million (it was purchased from the Carters in 2002 for \$1 million).

After a bench trial, the trial court rendered judgment for the Carters for the amount the Carters would have received in bonus money had the lease offer been accepted and found that TxO's willingness to gamble its 4.16% also resulted in a gamble for [Carter] of their 45.84%. The court emphasized that the Carters wanted TxO to lease and that the lease of the other 50% "unfavorably affected" the "pool of potential lessees" and that by refusing to lease TxO gained "unfettered use of the surface for its hunting operation, which was always the plan for the property." The court held that TxO breached its duty of utmost fair dealing to the Carters in refusing to enter the lease offered by El Paso. The court of appeals affirmed, holding that "the evidence supports a finding that [TxO] refused to execute the El Paso lease based on its arbitrary and self-motivated refusal to permit any lease for the purpose of protecting its use of the surface and to exact a benefit from the Carters." In the settlement discussion TxO sought a note reduction and deed restrictions as a condition for leasing.

The TxSCT found that an executive generally does not breach his duty by declining a lease in honest anticipation of obtaining better terms for all but, based on the trial court's findings, concluded that TxO refused the El Paso lease to benefit its surface interest. The Court addressed the competing interest of the surface owner with none or a small mineral interest and the mineral owner with no surface ownership and concluded that "an executive surface owner who engages in conduct that burdens the mineral interest to the benefit of the surface, notwithstanding existing legal safeguards [the Accommodation Doctrine], is at particular risk of violating his executive duty." While the executive rights holder does not necessarily breach its duty by engaging in conduct benefiting the surface but not the mineral estate, the trial court found that TxO did so in this case.

In a novel discussion, the Court discussed whether the executive had to lease its own mineral interest along with that of the non-executive and appeared to approve the trial court's finding that TxO's failure to lease its own interest along with the Carters' was a breach of TxO's duty but said that "we certainly do not hold that an executive must always accept an offer to lease both the executive's and the non-executive's mineral interests when the non-executive wishes to accept... but we also do not hold that an executive is never required to accept such an offer."

Cautions and Suggestions:

A. The executive can breach its duty by failing to lease as well as by extracting a benefit not shared with, or to the detriment of, the non-executive when it does lease.

B. The executive may separately lease its minerals and the non-executive's minerals. This concept was not analyzed by the Court, and may spring from the Court's conclusion that executive rights arose "in response to the fractionalization of the mineral fee ... so as to ease the leasing of oil and gas" by "providing potential lessees with the benefit of only having to wrangle over one lease instead of many." My experience is different and while there are many instances of trying to reduce the wrangling, more often, the patriarch who retained the surface, or the sibling who is farming the old homestead received or retained the executive rights for the purpose of protecting the surface.

C. The way to protect the surface is for the executive to negotiate a market value lease for itself and the non-executive and simultaneously negotiate surface protection provisions that we all see in leases today so long as those provision do not harm the non-executive's interest. This case holds that refusing to lease in order to protect the surface is a breach of the duty. The Court's reference to relying on the slender reed of the Accommodation Doctrine for surface protection seems misplaced.

D. The executive who leases the non-executive's minerals but not its own or vice versa treads on thin ice, either because having an unleased interest in the tract may inhibit development of the acreage (because of cotenancy rules) or may give to the executive the extra benefit (not always) of holding a cotenancy interest through which it may recover a greater share of production, unreduced by a royalty percentage.

E. The Court noted, several times, that the Carters wanted TO to accept the El Paso lease but did not discuss the part this plays in the executive's duty of good faith and fair dealing. Must the executive conduct a poll of the non-executives? If the executive executes a lease requested by the non-executive, is the liability of the executive extinguished? Remember, it's not a fiduciary duty but a duty of utmost good faith.

F. The Court said refusing to lease gave TxO unfettered control of the surface, but this ignores the fact that the lease on the other 50% allowed El Paso to use the surface anyway. Maybe the Court was thinking El Paso would not be willing to bear the burden of an unleased 50%?