Oil and Gas Executive Rights – Drilling Down on Your Duty

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He who has the gold makes the rules. However, when the "gold" includes oil and gas executive rights (the ability to lease, or not lease, a mineral interest), the rule-maker does not have unfettered discretion, especially when decisions appear to stem from self-interest. Over the past decade, the Texas Supreme Court has attempted to define and clarify exactly what duty is owed by an oil and gas executive right holder (the "executive") to the non-participating interest holders who are along for the ride, collecting royalty payments but having little to no ability to control how they are generated. While the executive right holder does not owe a fiduciary duty to non-participating royalty interest ("NPRI") holders (those royalty holders who do not share in bonus or rental payments and who also do not have the right to execute leases), it is clear that a certain level of consideration is required, and the failure to do so may be costly.

The first substantial step the Texas Supreme Court took towards pinning a duty on executives came in 2011, in *Lesley v. Veterans Land Bd. of State*. The Court in this case dealt with an executive's inaction, or refusal to lease, and stopped short of producing a bright-line test for holding executives accountable. Instead, it toed the line and put forth the idea that if the executive's refusal to lease was "arbitrary or motivated by self-interest, the executive *may* have breached his duty." *Lesley v. Veterans Land Bd. of State*, 352 S.W.3d 479, 491 (Tex. 2011).

Four years later, the Court in *KCM Fin. LLC v. Bradshaw* again examined the discretion an executive has concerning the right to lease. This time, the Court was faced with an executive's affirmative action, leasing to a third party at a sub-market rate (the rental payments being received by the executive and NPRI holders in their respective proportions), in exchange for an above-market bonus payment (received only by the executive right holder). This led the Court to promulgate a standard which considered whether "the executive engaged in acts of self-dealing that unfairly diminished the value of the non-executive interest." *KCM Financial LLC v. Bradshaw,* 457 S.W.3d 70, 74 (Tex. 2015).

At that point in time, executive and NPRI holders alike did not have a clear idea of either (a) the level of duty owed to NPRI holders, or (b) what circumstances – affirmative or passive lease decisions – triggered this duty. In April 2019, the Court in *Texas Outfitters Limited, LLC v. Nicholson* had the opportunity to further distill these questions. *Texas Outfitters Limited, LLC v. Nicholson*, 572 S.W.3d 647 (Tex. 2019).

In 2002, Texas Outfitters Limited, LLC purchased surface rights to 100% of the subject land to operate its hunting business. Below the surface, three parties were involved; the Hindes family owned 50% of the mineral interest, including the executive right to that portion, Texas Outfitters owned the executive right to the remaining 50% of the minerals in question (but only received 4% of the mineral interest, while the Carters retained the remaining 46%). Several years later, El Paso Oil Exploration & Production Company struck a deal with the Hindeses to lease their 50%, while Texas Outfitters declined to lease on the same terms, against the express wishes of the Carters. Texas Outfitters reasoned any lease of the minerals would diminish the value of the surface estate, and therefore its hunting business. If the above fractions and percentages did not turn you away, you see where this is headed: Which standard will be used to determine another case concerning an executive's "failure to lease"?

In reaching its decision, the Court applied what they deemed the "controlling inquiry" in all executive duty cases, the *KCM* standard, which up to this point only controlled affirmative lease decisions involving self-dealing. In doing so, they broadened this standard to encompass "refusal to lease" cases as well as cases involving actively leasing on favorable, self-dealing terms.

While we now have a clearer idea of the level of accountability an executive right holder has, a spotlight hovers over the executive right to lease mineral interests. Does this mean the value of an executive right may diminish? Will a potential executive be able to negotiate a lower price for this right now that it carries a broader, more stringent duty to NPRI holders? Will this lead to potential executives questioning whether such an obligation is worth buying? While the Court in *Texas Outfitters* did provide the clearest notion of an executive's duty to date, this explicit standard leads to uncertain implications.