UT LAW CLE THE UNIVERSITY OF TEXAS SCHOOL OF LAW

PRESENTED AT

45th Annual Ernest E. Smith Oil, Gas and Mineral Law Institute

March 29, 2019
Houston, Texas

WHAT'S OLD HAS BECOME NEW AGAIN: TRADITIONAL OIL AND GAS INTERESTS FINANCING

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WHAT'S OLD HAS BECOME NEW AGAIN: TRADITIONAL OIL AND GAS INTERESTS FINANCING[1]

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I. INTRODUCTION

In our practices we often represent clients that have large acreage positions in working interests or mineral fees who want to develop their properties, but who may be temporarily short on cash. Private equity capital is not available due to the lack of the requisite return on investment sought by the equity provider or is not acceptable to the client because of the potential control over the client's decisions sought by the equity provider. Bank loans may not be available because the assets are yet untested, so they cannot be used as a borrowing base, or simply because the client, having been caught in the tsunami of redeterminations a few years ago, is wary of getting trapped again. Equity offerings may not be practical for some, or all, of the foregoing reasons, *plus* the costs and expenses incurred in a public offering of equity, and the regulations applicable to the operations and activities of the company thereafter.

In other instances, we have represented clients who owned no interests in a prospect, but who were interested in getting into the play without having to do all the requisite preliminary seismic and title investigations. We also have had service company clients who wanted to provide economic assistance to their producer customers but without acting as a lender or a direct investor. Finally, we have also represented refiners and pipeline companies that wanted to acquire firm sources of feedstock or inventory for their plants and their pipeline systems.

There are several alternatives available to upstream parties with respect to these issues, but in our experience the ones most used are: term overriding royalty interests or production payments; farmout agreements; participation agreements; and carried interests. None of them are new, but we thought the discussion might be something that would benefit those practitioners, as well as those industry participants, whose only experience with oil and gas financing has been through private equity investments, bank loans, or in the equity markets.

II. TERM OVERRIDES/PRODUCTION PAYMENTS

A. Overriding Royalty Interest

An overriding royalty interest[2] is an interest in oil and gas, free of the expense of production, and in addition to the usual landowner's royalty reserved to the lessor in an oil and gas lease,[3] meaning that the override has no effect upon the royalty reserved by the lessor in the

[1] The views expressed by the authors in this paper are their personal views based on their past experiences in the transactions described in this paper. Those views do not constitute the opinions or views of their respective firms.

[2] In oil and gas vernacular, an "**overriding royalty interest**" is often called an "**override**"; the terms are used interchangeably in this paper.

[3] *Southwestern Energy Prod. Co. v. Berry-Hefland,* 491 S.W.3d 699 (Tex. 2016); *Dernick Resources, Inc. v. Wilstein*, 471 S.W.3d 468 (Tex. App. – Houston [1st Dist.] 2015, pet. denied); *Paradigm Oil, Inc. v. Retamco Operating, Inc.*, 330 S.W.2d 342 (Tex. App. – San Antonio 2010), rev'd. on other grounds, 372

underlying lease; instead, the override is a new or additional royalty interest created by an assignment from the working interest owner. It is either "carved out" of the working interest by the lessee and transferred to a third party, or it is "reserved" by the transferor in an assignment of the working interest to the transferee.[4] An override may be created in exchange for goods, services, or money. For instance, a reserved override is often created by a farmout agreement in exchange for services.[5]

The overriding royalty interest is a non-possessory non-executive interest,[6]

There is no required uniformity in the size of the interest. I have seen them range from a 1/64th interest up to a 10% interest.

Unless a shorter term is provided, the duration of the override is limited by the term of the oil and gas lease under which it is created.[7] Unless otherwise expressed there is no duty to keep the lease in effect, nor does the owner of the override have any power to keep the lease (and therefore the override) alive. Absent a contractual provision to the contrary, an overriding royalty interest does not create a fiduciary duty between the working interest owner and the owner of the override;[8] nor is the working interest owner required to act in good faith when deciding whether to let the lease expire.[9] As a result, it is common now in assignments creating an overriding royalty to provide for notice by the assignee to the assignor of the intention to allow the underlying lease to lapse, and to require the reassignment of the lease within a specified period prior to its expiration date. It is also common to provide that the override affects the described lease as well as any renewals or extensions of that lease taken by the assignee, or its affiliates, successors or assigns; sometimes the parties will agree that any lease taken within a specified period after expiration or termination of the underlying lease will be deemed to be a renewal or extension of the underlying lease if it covers all or portions of the same lands or depths.

Because it is a royalty, unless otherwise agreed, an override is free of the same costs as the lessor's royalty. and is subject to the same costs as the lessor's royalty.[10] However, even though

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S.W.3d 177 (Tex. 2012); *Boyles v. Exxon Corp*., 2005 WL 309950 (Tex. App. - Corpus Christi February 10, 2005, no pet.); *EOG Resources, Inc. v. Hanson Petroleum Co.*, 94 S.W.3d 697 (Tex. App. – San Antonio 2002, no pet.); *Stable Energy, L.P. v. Newberry*, 999 S.W.2d 538 (Tex. App. – Austin 1999, pet. denied); *In re ATP Oil & Gas Corp.*, 2014 WL 61408 (S.D. Tex. January 6, 2014).

[4] *See EOG Resources, Inc. v. Hanson Petroleum Co.*, 94 S.W.3d 697 (Tex. App – San Antonio 2002, no pet.).

[5] *See* discussion in Article III below.

[6] *Ridge Oil Co. v. Guinn Investments, Inc.*, 148 S.W.3d 143 (Tex. 2004); *Texas Independent Exploration, Ltd. v. Peoples Energy Production – Texas L.P.*, 2009 WL 767037 (Tex. App. – San Antonio 2009, no pet.).

[7] *EOG Resources, Inc. v. Hanson Petroleum Co.*, 94 S.W.3d 697 (Tex. App. – San Antonio 2002, no pet.).

[8] *See Pellegrini v. Cliffwood-Blue Moon Joint Venture, Inc.*, 115 S.W.3d 577 (Tex. App.- Beaumont 2003, no pet.).

[9] *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798 (Tex. 1967); *Stroud Production L.L.C. v. Hosford,* 405 S.W.3d 794 (Tex. App. – 2013 Houston [1st Dist.] 2013, no pet.); *Exploration Co. v. Vega Oil & Gas Co.*, 843 S.W.2d 123 (Tex. App. – Houston [14th Dist.] 1992, writ denied). *See also Ridge Oil Co. v. Guinn Investments, Inc.*, 148 S.W.3d 143 (Tex. 2004).

[10] *Chesapeake Exploration, L.L.C. v. Hyder*, 483 S.W.3d (Tex. 2016).

Title search: What's Old Has Become New Again: Traditional Oil And Gas Interests Financing

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First appeared as part of the conference materials for the
45th Annual Ernest E. Smith Oil, Gas and Mineral Law Institute session
"Traditional Oil and Gas Interests Financing"