

**INTRODUCTION TO
COTENANCY ACCOUNTING**

**WILLIAM B. BURFORD
KELLY HART & HALLMAN LLP
500 W. Illinois, Suite 800
Midland, Texas 79701**

**2020 Fundamentals of Oil, Gas and Mineral Law
University of Texas School of Law
Continuing Legal Education
March 26, 2020**

TABLE OF CONTENTS

| | | |
|------|---|----|
| I. | INTRODUCTION | 1 |
| II. | COTENANTS' RIGHTS CONCERNING MINERAL DEVELOPMENT | 1 |
| | GENERALLY | |
| A. | Background | 1 |
| B. | Cotenant's Right to Develop..... | 2 |
| III. | ACCOUNTING BY PRODUCING COTENANT | 3 |
| A. | Reimbursement Out of Production | 3 |
| B. | Value of Oil and Gas Produced | 5 |
| C. | Deductibility of Costs | 6 |
| 1. | Reasonable and Necessary Standard..... | 6 |
| 2. | Unsuccessful Operations..... | 6 |
| 3. | Capital Expenditures..... | 8 |
| 4. | Indirect Costs | 8 |
| 5. | Costs Not Attributable to Nonoperating Cotenant's Interest..... | 10 |
| 6. | Costs Incurred Under Expired Lease | 11 |
| D. | Application to Horizontal Development..... | 11 |
| E. | Accounting to Royalty Owners..... | 13 |
| IV. | LEASE RATIFICATION | 16 |
| V. | EFFECT OF NONPARTICIPATION ON NONJOINING LESSEE'S | 16 |
| | LEASEHOLD | |
| A. | Lease Perpetuation | 16 |
| B. | Duties to Lessor | 19 |
| VI. | CONCLUSION..... | 19 |

INTRODUCTION TO COTENANCY ACCOUNTING

William B. Burford

I. Introduction

Anyone with even a fleeting familiarity with oil and gas development in Texas is well aware that undivided fractional ownership of minerals among more than one owner, and often a great many owners, is the rule rather than the exception, at least in historically producing areas. Even relatively small mineral interests may be valuable in a tract in the heart of a prolific oil or gas field, and the desire of owners, sellers, and purchasers all to hold and realize a piece of the potential value has tended to multiply undivided ownership.

For reasons that should become clear from this discussion, it is ideal for the drilling and development of a tract of land for oil and gas production to be performed only by mutual consent of all undivided owners or their oil and gas lessees. Drilling by a cotenant without such mutual consent was once relatively rare, and the cases that arose typically involved drilling operations by a person who believed himself to be the sole owner or the lessee of the sole owner of the premises, only to discover later that there was an outstanding undivided interest. Because increasingly fragmented ownership has made the assembly of 100% ownership more difficult to achieve while technology enhances the predictability of the results, deliberate drilling without agreement among all cotenants has become more common. The purpose of this paper is to point out some of the legal consequences.

This is of course not the first investigation of the topic. A still-relevant discussion, with some different areas of emphasis, is H. Philip Whitworth, Jr., *How to Deal with Non-Consenting Mineral Interests*, Univ. of Tex. School of Law 15th Annual Oil, Gas & Min. L. Inst. (Mar. 31, 1989). Caleb A. Fielder, *Blood and Oil: Exploring Possible Remedies to Mineral Cotenancy Disputes in Texas*, 50 Tex. Tech L. Rev. 173 (2017), focuses on practical approaches.

II. Cotenants' Rights Concerning Mineral Development Generally

A. Background

Since the enactment in England in 1285 of the Statute of Westminster II, under which one cotenant might have an action for waste against another, courts in common law jurisdictions have faced the question of whether mineral extraction by one cotenant without the consent of all is wrongful waste or instead constitutes reasonable use. See 1 Eugene Kuntz, *The Law of Oil and Gas* § 5.2 (1987). In some American jurisdictions, notably Illinois, Michigan, and West Virginia, mineral development without the consent of all cotenants is regarded as waste, so that except as the law has been modified by statute, a nonconsenting cotenant may enjoin development or sue for damages. Much the same is true in Louisiana under its civil law tradition, although the result is not predicated upon the theory of waste. *Id.* § 5.4.

The law in the majority of American jurisdictions, including Texas, is otherwise. *Id.* § 5.3; 2 Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers Oil and Gas Law* § 502 (2019). This discussion will focus on Texas law and its consequences for Texas producers and nonjoining mineral owners and lessees.

B. Cotenant's Right to Develop

At least since *Burnham v. Hardy Oil Co.*, 147 S.W. 330 (Tex. Civ. App.—San Antonio 1912), *aff'd*, 195 S.W. 1139 (Tex. 1917), the unquestioned rule in Texas has been that a cotenant has the right to produce oil and gas regardless of any arrangement with other cotenants, accounting to cotenants for the net profits of production. The court reasoned that this rule is necessary for the realization of the land's mineral value:

It seems to us that the peculiar circumstances of a cotenancy in the land upon which oil is discovered warrant one cotenant to proceed and utilize the oil, without the necessity of the other cotenants concurring. Oil is a fugitive substance and may be drained from the land by well on adjoining property. It must be promptly taken from the land for it to be secured to the owners. If a cotenant owning a small interest in the land had to give his consent before the others could move towards securing the oil, he could arbitrarily destroy the valuable quality of the land. He could, of course, have partition; but such property would not be susceptible of partition in kind, and it would seem to be equally impracticable, with justice to all, to make partition by sale, for the reason that it would be impossible to know the extent and value of the oil in the ground.

Id. at 335.

Although the *Burnham* court emphasized the fugitive nature of oil, the same rule has been applied to solid minerals. *See White v. Smyth*, 214 S.W.2d 967 (Tex. 1948); *see also Wilderness Cove, Ltd. v. Cold Spring Granite Co.*, 62 S.W.3d 844 (Tex. App.—Austin 2001, no pet.). Regardless of the likelihood of imminent drainage, the value of ownership of an interest in minerals lies in the ability to produce them, and the right of possession, it would seem, would be meaningless without the right of removal and sale. Thus, the rule that any mineral cotenant may produce the oil and gas is founded on the distinctive relationship that exists between cotenants, that is, that each cotenant has a right to enter upon the common estate and a corollary right to possession. *Byrom v. Pendley*, 717 S.W.2d 602, 605 (Tex. 1986). Once it is established that one desiring to drill has an undivided mineral interest, or a lease on an undivided interest, his cotenant has no right to interfere with development and may be enjoined from doing so. *Garcia v. Sun Oil Co.*, 300 S.W.2d 724 (Tex. Civ. App.—Beaumont 1957, writ ref'd n.r.e.).

As the court in *Cox v. Davison*, 397 S.W.2d 200 (Tex. 1965), recognized, the rule allowing one cotenant to develop the minerals without the consent of other cotenants sanctions the producing cotenant's right to appropriate the property of another. This is done only because the mineral estate is such that necessarily the right of one cotenant must be interfered with if another cotenant is to be permitted to exercise those rights properly belonging to him. *Id.* at 203.

Oil and gas development is, of course, most often accomplished pursuant to oil and gas leases from the fee mineral owners. The lessee of a cotenant in the mineral fee acquires the lessor's right to drill. *Powell v. Johnson*, 170 S.W.2d 273, 276 (Tex. Civ. App.—Texarkana), *aff'd sub nom. Rancho Oil Co. v. Powell*, 175 S.W.2d 960 (Tex. 1943), citing *Simpson-Fell Oil Co. v. Stanolind Oil & Gas Co.*, 125 S.W.2d 263, 267 (Tex. 1939). Thus, an oil and gas lessee becomes the cotenant of the owner of any unleased mineral interest and of the lessee under oil and gas leases

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](https://utcle.org/elibrary)

Title search: Introduction of Co-Tenancy Accounting

Also available as part of the eCourse

[2020 Fundamentals of Oil, Gas, and Mineral Law eConference](#)

First appeared as part of the conference materials for the
2020 Fundamentals of Oil, Gas and Mineral Law session
"Introduction of Co-Tenancy Accounting"