GOING THROUGH THE DRILL:
A BRIEF OVERVIEW OF OIL AND GAS IN ESTATES AND TRUSTS

Alvin J. Golden
Ikard & Golden, P.C.
Austin, Texas
(512) 472-6695
(512) 472-3669 fax

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ALVIN J. GOLDEN

IKARD & GOLDEN, P. C.
106 East Sixth Street, Suite 500
Austin, Texas 78701
(512) 472-6695

EDUCATION:

- B.B.A., The University of Texas (Major: Accounting) (1962)
- LL.B., The University of Texas School of Law (1965)

PROFESSIONAL ACTIVITIES:

- Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
- Fellow, American College of Trust and Estate Counsel (Admitted 1980)
- Past Chair, Estate and Gift Tax Committee, American College of Trust and Estate Counsel (1995-1998)
- Board of Regents, American College of Trust and Estate Counsel (1994-2000)
- Texas State Chairman, American College of Trust and Estate Counsel (1989-1994)
- Member, International Academy of Trust and Estate Law (Admitted 1990)
- Past Chair, Council of Real Estate, Probate and Trust Law, State Bar of Texas
- Legislative Chairman, Council of Real Estate, Probate and Trust Law, State Bar of Texas (1991-1997)
- Treasurer, Texas Academy of Probate and Trust Lawyers (1990-1995)
- Certified Public Accountant
- Who's Who in American Law (1986-)
- Who's Who in America (1985-)
- Best Lawyers' in America (1987-)

***PUBLICATIONS &
SPEAKING ENGAGEMENTS:***

Extensive speaking in estate planning and employee benefits areas, including programs for University of Notre Dame, American Law Institute-American Bar Association (ALI-ABA), American Bar Association, New York University Institute on Federal Tax, New York University Estate Planning Institute, State Bar of Texas, Southwestern Legal Foundation, UCLA-CEB, University of Texas, American Institute on Federal Taxation, Texas Society of Certified Public Accountants, and the American College of Trust and Estate Counsel.

COMMUNITY ACTIVITIES:

President, Zachary Scott Theatre Center (1969-1972)
Chair, Austin Arts Commission (1975-1981)
President, Paramount Theatre (1985-1988)

LEGISLATIVE ACTIVITIES:

Active in the legislative activities for the Real Estate, Probate & Trust Law Section and the Texas Academy of Probate Lawyers.

FAMILY:

Wife - Mary Ann Golden. Married February 5, 1966. Mary Ann has been active in the Austin Women's Symphony League, Laguna Gloria Art Guild, and the Women's Club. She is a breast cancer survivor.
Son - Phillip T. Golden is a Vice-President of CDMEM, LLP in Austin, Texas.
Pamela E. Golden is married and is a Project Manager of SCORE in Guilford, Connecticut.

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I. **Purpose and Scope.** The purpose of this paper is to provide the reader with a basic understanding of oil and gas law particularly as it pertains to trust and estate administration. This is by no means an exhaustive coverage of the material nor is it intended to be. You will discover that there are some basic concepts which are particular to the oil and gas industry, and an understanding of them is necessary in order to understand many of the concepts in this area of the law. Clients with oil and gas interests will have particular tax and non-tax planning needs because of how such property is handled. Attention to how oil and gas properties are transferred during a client's lifetime is also necessary given some of the unique issues of such properties. The same is true with respect to certain issues which must be addressed after the death of a client. And finally, the challenges fiduciaries face in managing oil and gas properties including environmental liability as it relates to fiduciaries will be discussed.

II. **Basic Concepts and Definitions.** The area of oil and gas law has a vocabulary all its own.

A. **Real Property.** Ownership of real property can range from ownership of a tract of land in its entirety (referred to as a "fee interest" or "fee simple absolute ownership") or any number of partial interests in a tract of land such as ownership of the surface estate, minerals, or a subdivision thereof.

B. **Surface Estate.** Ownership of the surface estate gives the owner the right to use the surface of the property in question subject to certain rights of the mineral interest owner.

C. **Mineral Interest.** The owner of a mineral interest owns the minerals which are in place on a particular tract of land. Ownership of a mineral interest gives the holder the right to search for, develop and produce those minerals, and includes an easement over the surface estate which allows the owner the right to use the surface in ways which are necessary to access those minerals.

D. **Executive Right.** The executive right gives the holder the right to explore, produce or develop minerals or the right of a mineral interest owner to lease the minerals to others. This may be held by one or more of the owners of the mineral estate.

E. **Royalty Interest.** A royalty interest is an interest in mineral production which is free of production costs and is held by a lessor of the mineral interest.

F. **Nonparticipating Royalty.** A royalty interest in minerals with no executive rights and no right to share in lease bonus payments or delay rentals.

G. **Mineral Lease.** A mineral lease is the conveyance of a mineral interest from an owner which creates a working interest in favor of a lessee. A mineral lease will grant a lessee an interest in those minerals which are specified in the lease (*e.g.* oil, gas, gravel, coal). The lessee will have the right

to develop the minerals covered by the lease. A mineral lease will contain two terms, a primary term and a secondary term.

1. **Lease Bonus.** A lease bonus is the amount a lessee usually pays a lessor at the inception of a lease and is essentially a signing bonus.

2. **Delay Rentals.** Delay rentals are an amount paid by lessee to the lessor for the privilege of deferring development.

3. **Working Interest.** A working interest entitles the holder to all production from the property net of all landowner royalties, overriding royalties and production payments. Operating and exploration expenses are paid by the working interest.

4. **Primary Term.** The primary term of a mineral lease is a stated number of years or months that the lease will be in effect. During the primary term, the lessee must either develop the lease or pay delay rentals to the lessor. The primary term may be extended if drilling operations have begun or they cannot begin due to force majeure.

5. **Secondary Term.** If at the end of the primary term, there is production of oil and/or gas in paying quantities, the lease will continue for the secondary term which is an indefinite period of time which will continue until production ceases.

6. **Production in Paying Quantities.** The term production in paying quantities means that an oil or gas well is producing operating revenues which exceed operating costs (over a reasonable period of time). If revenues do not exceed costs over such a period, and if a reasonably prudent operator who expected to make a profit would continue operations then there is deemed production in paying quantities. This issue may become very important when determining if a Lease has expired.

7. **Pooling.** Pooling is the combination of a number of smaller leases together to create a larger tract of land which may be required to comply with well spacing regulations. A pooling clause in a lease will allow the lessee to combine adjacent tracts for this purpose. The pooled tracts are referred to as a "unit", and such a clause will allow a lease to be held by drilling on only one of the pooled tracts.

8. **Take-or-Pay Payments.** Take or pay payments relate to gas contracts where a purchaser must pay for a percentage of the gas which a gas producer can produce regardless of whether the purchaser actually takes it. Usually, payments allow the purchaser to take gas paid for at a later date, but this is not always the case.

H. **Overriding Royalty.** An overriding royalty interest is created where the owner of a lease subleases the property to another and retains a percentage interest payable out of production. If it bears a portion of operating costs it is known as a net profits interest.

I. **Shut-in Royalty.** In some leases, the lessee may reserve the right to cease production due to falling market prices or other instances. Cessation of production in such an instance will not cause the lease to terminate provided that shut-in royalty payments are made.

J. **Division Orders.** Once minerals are being produced in paying quantities, the lessee will pay the proceeds to the respective mineral owners. Before such payments are made, a division order will be prepared. The division order will list all mineral owners of the lease as well as their ownership interest. Upon any change of ownership, a new division order must be drawn.

K. **Production Payments.** A production payment is a right to a specific share of production (if, as and when produced). It is similar to a royalty interest, but its duration is generally shorter than the economic life of the well and usually is a sum certain plus interest. It is a nonoperating interest and is generally used for financing development.

L. **Intangible Drilling Costs.** Intangible Drilling Costs include expenditures for wages, fuel, repairs, hauling, supplies and other items related to the preparation of a well for the production of oil and gas.

M. **Depletion.** Depletion is capitalization of certain expenditures including the cost of exploration and intangible drilling costs. There are two methods of capitalizing these expenditures: cost depletion and percentage depletion.

1. **Cost Depletion.** Cost depletion is determined by allocating a portion of the adjusted basis of a property by using the number of units estimated to be producible from the property multiplied by the units sold during the year, Internal Revenue Code ("IRC") §612, Treasury Regulations ("Regs.") §1.611-2(a).

2. **Percentage Depletion.** Percentage depletion is computed by multiplying a statutory fixed percentage by the gross income from a property. IRC §613. It is unrelated to the anticipated production from the property and may exceed the taxpayer's adjusted basis in the property. This form of depletion is permitted only for certain types of oil and gas wells and only certain taxpayers may use percentage depletion. IRC §§613A(b) and (c). The depletion deduction for oil and gas may not exceed 100% of the taxpayer's taxable income from the property. IRC §613(a).

3. **Special Rules Related to Trusts and Estates.** Cost depletion is computed under IRC §611 at the trust and estate level. The determination of whether cost or percentage depletion is used is made at the estate or trust level. This determination does not result in the loss of cost depletion to a beneficiary where cost depletion exceeds percentage depletion. *See*, Regs. §1.613A-3(g) and examples. Limitations applied under IRC §613A(c) (exemption for independent producers and royalty owners) and IRC §613A(d), except IRC §613A(d)(1) (65% taxable income limitation), apply at the trust or estate level in computing percentage depletion and shall be applied by a beneficiary with respect to any percentage depletion apportioned to the beneficiary. Regs. §1.613A-3(g).

4. **Depletion for Trusts and Estates Is Impacted by the Governing Instrument.** Regardless of whether cost or percentage depletion is used, trusts and estates must look to IRC §642 for special rules for credits and deductions. In particular, IRC §642(e) and the related regulations state that an estate or trust only gets the deduction not allowable to beneficiaries. For an estate, the depletion deduction is apportioned between the estate and the beneficiaries and the heirs, legatees and devisees on the basis of fiduciary accounting income allocable to each. For trusts, it is apportioned between the trust and income beneficiaries by first looking to the provisions of the trust instrument. Where the trust instrument is silent, accounting income, not tax income, is used to allocate depletion among the beneficiaries. *See,* Section III.G for a discussion of the Uniform Principal and Income Act ("UPAIA").

N. **Surface Damages.** Although a mineral interest owner is granted an easement over the surface estate, such easement is not without cost. The surface owner is entitled to damages for such use. This may include the destruction of crops, inability to use the surface estate for an existing use (permanently or otherwise).

III. **Estate Planning Considerations.**

A. **Marital Property Issues.** Marital property issues frequently arise in the estate planning context. The ownership of an interest in oil and gas properties becomes important in many situations, such as in a second marriage situation. Separate property is that property that is acquired prior to marriage or during marriage by gift, bequest, devise or descent. Cal. Fam. Code §770. Additionally, all rents, issues and profits from separate property are the property owner's separate property as well. *id*. This will include all bonus payments, delay rentals, royalties and other income from the production of minerals.

B. **Multi-state Estate Planning with Oil and Gas Interests.** Conflicts of laws problems arise because of ownership of oil and gas interests in both community property and common law states. A New York or Texas domiciliary may invest in oil and gas properties in California, a California investor may purchase oil and gas interests in a common law state, or married couples may change domicile from a common law state to a community property state or vice versa. It is generally accepted that the law of marital domicile will determine the characterization of the property interest at the time of acquisition. A broad survey of these problems is beyond the scope of this paper; however, the practitioner needs to be aware of their existence and to research the law of other jurisdictions. For further information, see Kasner and Golden, *An Overview of Community Property Law*, presented at the 1999 ACTEC Annual Meeting. A copy may be found at http://www.ikardgolden.com.

C. **Non-Tax Drafting Considerations.** To maximize the authority and flexibility of the trustee, you should consider including in the trust instrument one or more of the following provisions.

1. **Authorization to Form and Invest in Business Entities.** Consider authorizing the trustee to participate in joint ventures, joint operating agreements, limited or general partnerships, limited liability companies, or other business entities for the purpose of owning, developing, operating and marketing mineral interests.

2. **Modification of Certain Fiduciary Duties.** It may also be advisable to modify the duty of loyalty, duty of impartiality and the duty to manage the property prudently to provide the fiduciary more flexibility, especially in dealing with undeveloped mineral properties in areas which have not generated current interest in oil and gas exploration. Instructions to the trustee that it is not required to incur significant expense in the form of consulting fees, petroleum engineering fees, brokerage fees or other expenses in order to market undeveloped property or to determine the marketability of the property for oil and gas development purposes, may be appropriate as well.

3. **Addressing Environmental Concerns.** You should also address certain environmental concerns. See Article VII of this paper.

D. **Gifts of Oil and Gas Interests.**

1. **Reason for Gifts.** Clients may wish to reduce the size of their gross estate and minimize estate tax due on their death by making transfers to various family members. Another desire may be to provide for the needs of a younger generation. Alternatively, clients may desire to benefit a charity by making a gift of an oil and gas interest and at the same time achieve an income tax deduction for themselves.

2. **Federal Gift Taxation.** The same gift tax rules apply to gifts of oil and gas properties as to gifts of other property. Clients may consider making gifts that qualify for the $11,000 per donee annual exemption from gift tax or using a portion of their unified credit against gift tax (which presently would allow up to $1,000,000 in otherwise taxable gifts to pass free of gift tax).

3. **Certain Gifts Provide Exception from IDC Recapture Rules.** The rule requiring recognition of gain on disposition of a natural resource recapture property does not apply to gifts or to transfers between spouses in which no gain or loss is recognized pursuant to IRC §1041. Regs. §1.1254-2(a)(1). The recapture rules, however, do carry over to the donees who are then subject to the rules on a subsequent disposition unless an exception or limitation applies. Regs. §1.1254-3(b).

4. **Appropriate Interests for Gifts and Methods of Transfer.**

a. Some oil and gas interests may not be appropriate for gifts. Usually donors want to gift properties that will appreciate in value to remove such property from their estates. Therefore, those assets that will be consumed or reduced greatly in value by the time of a donor's death are not appropriate for gifts. Because of the stepped-up basis of assets acquired from a decedent pursuant to IRC §1014, it also may be more appropriate to hold some assets until death rather than to give them away during lifetime.

b. Different types of mineral interests obviously require varying degrees of expertise in managing. A simple royalty interest may require very little specialized knowledge while working interests and unleased mineral interests which are suitable for development will require a greater understanding. A donor must be mindful of the degree of expertise which a donee has with respect to the mineral interests being given. Donors must gauge the donee's experience in such matters as well has his or her willingness to devote time and energy to either developing the required expertise or employing expert assistance. If a donee exhibits neither, a gift in Trust with an experienced fiduciary may be appropriate.

c. Donors should be careful to transfer all or an undivided portion of all of the donor's rights to mineral properties and not to retain certain rights, such as the right to bonuses or delay rentals, in order to prevent the possibility of retaining the enjoyment of the oil and gas interests gifted. IRC §2036(a)(1). If a donor retains any control over the transferred interests, he or she may run the risk of the interests being included in his or her estate. Rev. Rul. 76-331, 1976-2 C.B. 52 dealt with a corporation's gift of land to a charity. The corporation retained all mineral rights, including the right to exploit and sell all minerals produced from the property. The IRS ruled that the corporation retained a substantial right in the property and therefore disallowed a charitable deduction

d. If a donor makes a gift of a life estate in certain oil and gas interests, the practitioner must draft the document conveying such interest with an awareness of the "unopened mine rule." *See, Haskell v. Wood*, 256 Cal. App. 2d 799 (3rd Dist. 1967). This doctrine applies to leases of oil and gas interests which are in effect at the time of a donor's gift or a testator's death. The doctrine presumes that the donor or testator who gave no instruction as to the disposition of proceeds from "unopened mines" intended for the life tenant to have the same control over the proceeds that the donor or testator had. Therefore, all royalties, bonuses and income from the royalties and bonuses are not treated as corpus but belong to the life tenant. The court in *Haskell* stated that the unopened mine rule is an application of the common law rule of waste. The court further stated that when neither the life tenant nor the remainder beneficiary could make a new lease, the parties could do so jointly, and the life tenant would be entitled only to what constitutes the income share of the proceeds. This rule of law has been abolished and replaced by provisions of UPAIA. Cal. Prob. Code §16363(c)[1]. This is certainly an issue which must be addressed prior to drafting conveyances or testamentary documents as the result of UPAIA may not be the intended result.

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[1] The NCCUSL commentaries to UPAIA state that the purpose of this section "is to abolish the 'open mine doctrine' as it may apply to the rights of an income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Instead, such receipts are to be allocated to or between principal and income in accordance with the provisions of this Act." *See* Exhibit C attached hereto for the full text of this comment.

5. **Gifts to Trusts.**

a. The donor may want to ensure some measure of control over the oil and gas interests transferred to the donee. For this reason, a trust may be an appropriate vehicle for such a gift. If the interests transferred require management expertise, the donor may provide for a professional corporate trustee with expertise in this area. If the donor is a parent who is making a gift to a child, and the parent continues to exercise powers over the interest as trustee, the parent may risk that the interest be included in his or her gross estate even though the transfer is a completed gift for gift tax purposes. *See*, Regs. §25.2511-2(b). Using trusts with Crummey withdrawal powers may be an appropriate way of transferring oil and gas interests to qualify as gifts of present interests. The income tax cost of accumulating ordinary income in trust should be considered before transferring significant oil and gas properties to the trust. Accumulation trusts can be a particularly unattractive vehicle for holding properties producing significant income.

b. As noted above, in drafting a trust to hold oil and gas interests, the practitioner must carefully delineate the powers of the trustee in regard to such assets.

c. The Internal Revenue Code provides in §642(e) that the trust may claim a depletion deduction only to the extent the deduction is not allowable to the beneficiaries. IRC §611(b)(3) provides that provisions within the trust agreement prevail on the allocation issue, or, if there are no such provisions, the depletion deduction is allocated "on the basis of the trust income allocable to each."

6. **Transfer of Wealth Strategies for Oil and Gas Properties.**

a. One effective method of transferring wealth can be accomplished by allowing family members, limited partnerships or trusts to acquire royalty or overriding royalty interests properties before they are proven. The transfer of such nonoperating interests in unproven properties provides the greatest potential for shifting the maximum appreciation at the minimal tax cost.

(1) The transfer of non-income producing oil and gas properties has been recognized by the Internal Revenue Service as a gift of a present interest. See Rev. Rul. 67-172, 1967-1 C.B. 276.

(2) Such transfers are often made after a well is drilled and before the well is productive. While there is certainly some incremental value over totally undeveloped properties to be added to an operating interest transferred at such a late date, the valuation criteria would still indicate that a significant discount should apply to the nonoperating interest until the property is actually a proven producing property.

(3) While the transfer of non-income producing properties is an appropriate method of transferring wealth, the taxpayer should avoid a pattern of selective assignment of productive non-operating interests to the donee immediately completion of a successful well. Such a practice invites

a valuation dispute with the Internal Revenue Service if no interests in "dry holes" are ever assigned.

(4) It is important not to overburden the working interest with nonoperating interests so that the donor has adequate income to continue development and to utilize available IDC and percentage depletion deductions at the individual or entity level which is the source of the nonoperating interests.

b. The mineral interest owner should consider transferring an undivided fraction or all of the donor's right, title and ownership in and to the minerals (rather than a mere royalty interest in an existing lease which would terminate upon the lease termination) to the donees prior to any leasing of property. This will enable the donees to receive a portion of the ordinary income attributable to the seismic option payments, lease bonuses and delay rentals, as well as a future stream of royalty income.

(1) In some situations, it is the desire of the donor not to transfer all of donor's rights to the mineral interest, but to retain bonus rights, delay rentals, advance royalties or rights to execute mineral leases. The donor may be treated as having retained an interest in the donated property, IRC §2036(a). Conveyance of the mineral interest to a family limited partnership where the donor is the managing general partner provides a mechanism for avoiding any such challenge, while accomplishing an even better financial and tax result. But *see, Harper v. Commissioner*, T.C. Memo. 2002-121 and *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, where the benefits were lost because partnership formalities were not observed.

(2) It is normally advisable to have intangible drilling costs borne by and, therefore, deductible by the donor. To be entitled to deduct such costs, the donor must directly or indirectly own all or part of the working interest of the property in question. To enable the donor to take all or part of the IDC deduction incurred in the development of the property, the donor must retain some working interest in the property which will be includable in his gross estate and income from which will be taxable to him rather than the donee. If the donor retains too much control over the property, however, the entire value may be includable in donor's estate under IRC §§2036(a)(2) and 2038.

E. **Marital Deduction Planning.**

1. **In General.** By their nature, oil and gas properties may generate significant income during the estate administration. Such properties are subject to wide swings in value – radical appreciation (in the case of the development of unproven properties) or significant depletion (in the case of producing properties) during that same period. Prices also may fluctuate significantly during the period of administration, thereby causing a significant change in value of producing properties. In the event the estate contains a bypass trust or is divided between the surviving spouse and other beneficiaries (especially in a second marriage situation), careful analysis should precede any decision concerning allocation of mineral interests among the various shares. For example, from a tax standpoint, undeveloped or underdeveloped properties with significant appreciation potential should be allocated to the bypass trust, while producing properties, a depleting asset (at least theoretically), should be used to fund the marital share. However, the decision is not always driven solely by tax

issues, and thus the allocation might also take on fiduciary liability issues. In both cases, the difficulty is compounded because of the volatility and uncertainty surrounding this kind of interest.

2. **QTIPs and Mineral Interests.** The regulations for qualified terminable interest trusts provide that the all income principles of Regs. §20.2056(b)-5(f) and 25.2523(f)-1(c)(1) apply to qualified terminable interest trusts. Because the all income test is met based upon state law fiduciary income, and because UPAIA applies as a default, careful consideration should be given to the definition of income in the trust document, particularly in light of the UPAIA allocations. Since every situation is different, a careful discussion with the client should be had about the client's desire to allocate income to the spouse or accumulate for the remainderman through depletion and depreciation reserves. Remember, that a substantial departure from state law may disqualify the trust from QTIP treatment. And, should the property be or become unproductive, the surviving spouse (who may or may not have any expertise in oil and gas properties) must have the power to direct the trustee to make the property productive or pay from principal an amount to compensate for that income lost from the holding of unproductive or underproductive property. Regs. §20.2056(b)-5(f)(4); 25.2523(e)-1(f)(4).

3. **Use of Partnerships Owning Oil and Gas Properties to Facilitate Funding of Marital Trusts.** If the oil and gas property is held in limited partnership form, then the income allocation rules of UPAIA concerning oil and gas do not apply and all actual distributions from the partnership (other than in exchange for partnership interests) will be income to the trust. This may or may not be consistent with the testator's desire, and again, care in drafting the income and principal allocation provisions of the QTIP must be exercised. The surviving spouse would be entitled to receive only that income which is actually distributed by the partnership to the marital trust. Income accumulations and reinvestments can be made at the partnership level, thereby preserving the principal value of the marital trust. The marital trust's share of partnership taxable income will be taxable to the spouse.

a. If the Partnership interest with non-producing minerals is the principal asset of the trust, and if the restrictions on transferability are too stringent, then the trust may fail to meet the all income test since the spouse would have no legal power to compel the trustee to make the property productive.

b. If the Trustee determines to contribute the property to a limited partnership, then care must again be taken to permit the trustee sufficient latitude in disposing of such interest to make sure that the trustee can make the property productive.

c. If the Trustee decides to create a limited partnership to diminish the value of the marital trust, then the Trustee must also keep in mind that it is reducing the value for fiduciary purposes. And, if the trustee has only limited partnership interests, has it given up the right to manage the trust property and thereby made an impermissible delegation.

4. **Marital Bequest Formats.** In selecting the form of the marital deduction bequest, it is important to focus on the character of producing oil and gas properties as wasting assets and

generating significant income, as contrasted with unleased, undeveloped or underdeveloped leases having substantial appreciation potential during the estate administration. Many planning scenarios are possible depending on the size of the estate and the nature of estate assets. One such scenario would be the use of a date of distribution value pecuniary bequest for the marital share which requires funding to be at date of distribution values and will shift the overall appreciation or depreciation of asset values and income to the residuary beneficiaries, but can result in gain recognition by the estate at the time of funding. Avoid funding such a bequest with undeveloped properties that have the potential to significantly appreciate prior to the earliest practical date for distribution.

F. **Revocable Management Trusts.**

1. **Popularity of Revocable Management Trusts.** The revocable management trust has received a great deal of attention particularly because of the ability to eliminate many of the problems related to the probate process particularly in states such as California. Some features of ownership of oil and gas interests make the establishment of a revocable management trust even more attractive.

2. **Advantages of Conveying Oil and Gas Properties to a Revocable Management Trust.**

a. If a client owns oil and gas interests in a number of states, a revocable trust established during the client's lifetime may well ease the probate process (including ancillary probate in other jurisdictions) if the trust agreement contains dispositive provisions. In such a situation, the practitioner should ascertain that the dispositive provisions of the trust agreement will be viable as a "will substitute" in the jurisdiction where the oil and gas interests are located. *See*, Florida Probate Code §731.111 (the dispositive provisions of a revocable management trust are invalid unless the trust instrument is executed by the grantor with the formalities required for the execution of a will).

b. By placing the interests in a revocable trust, the client may also insure continuity in the management of those mineral interests after death, if the agreement appoints a trustee with experience in managing oil and gas interests. If the client becomes disabled during his or her lifetime, the revocable trust enables the management of oil and gas interests to continue without interruption. Conveying title to mineral properties to a living trust will avoid the suspension of runs and all the problems attendant with title transfers after the date of death or incapacity, which can place a significant burden on an estate heavily dependent on that income.

G. **Uniform Principal and Income Act.** UPAIA as enacted by the State of California requires the following allocation of receipts from an interest in oil and gas:

1. Nominal bonus payments, nominal delay rentals and nominal rent paid on a lease are allocated to income.

2. Production payments, to the extent the agreement creating the production payment provides for a factor of interest (or its equivalent) shall be allocated to income.

3. Royalties, shut-in well payments, take-or-pay payments, bonus payments or delay rentals which are more than nominal shall be allocated 90% to principal and the remainder to income.

4. With respect to working interests or any other mineral interest, 90% of any such payments shall be allocated to principal and the remainder to income.

Cal. Prob. Code §16363; *See also*, Bogert, *Trusts and Trustees*, 2nd Edition Revised, §612. California did not adopt subsection (d) of UPAIA which states: "If a trust owns an interest in minerals, water or other natural resources [on the effective date of this [Act]], the trustee may allocate receipts from the interest provided in this [Act] or in the manner used by the trustee before [the effective date of this [Act]]."[2]

IV. **Tax Effect of Transfers of Mineral Interests.** The income tax effect on a transfer of an interest in minerals will depend upon how the transaction is characterized.

A. **Sales.** A transfer will receive sale or exchange treatment when the owner of a mineral interest sells an entire interest or an undivided portion on an interest, when the owner of a working interest conveys a royalty, overriding royalty or other nonoperating interest, or when the owner of a working interest or royalty interest assigns that interest and retains a production payment or a similar noncontinuing interest. Income or loss resulting from such a transaction may be taxed as a capital gain or loss, gain subject to IRC §1231, or ordinary income to the extent of recapture of capitalized expenditures, IRC §1245.

B. **Leases and Subleases.** When a mineral interest owner conveys a working interest in those minerals and reserves a royalty or other nonoperating interest, bonus and delay rentals are characterized by the IRS as a lease. The conveyance of a working interest with a retained overriding royalty or other nonoperating economic interest in the mineral property is likewise treated as a lease. If the mineral property conveyed is undeveloped, the payment made for the property would be characterized as lease bonus (ordinary income not subject to depletion in the hands of the grantor) and must be capitalized as a leasehold cost by the grantee. Rev. Rul. 69-352, 1969-1 C.B. 34.

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[2] The NCCUSL commentary states, "Section 411(d) permits a trustee to use either the method provided by this Act or the method used before the Act takes effect....[T]his provision permits trustees to decide...[to] apply this provision retroactively if they conclude that to do so is in the best interest of the beneficiaries. For the complete Uniform Act section, the proposed Texas changes and the NCCUSL and Texas commentary, see Exhibit C.

V. **Post Mortem Considerations.**

A. **Application of IRC §6166.**

1. Various post mortem decisions may affect estates with oil and gas interests. One such decision is whether to elect the application of IRC §6166. An estate that consists largely of oil and gas interests may lack the liquidity necessary to pay estate taxes. As a result, the personal representative may consider the possibility of applying the provisions of IRC §6166, which allows the extension of time for payment of estate tax where the estate consists largely of an interest in a closely-held business.

2. In order for the estate to qualify for IRC §6166 treatment, the decedent must have actively participated in the business. The value of any portion of the interest attributable to "passive assets" held by the business is excluded from the determination of value. The term "passive asset" means any asset other than an asset used in carrying on a trade or business. IRC §6166(b)(9).

3. In Rev. Rul. 61-55, 1961-1 C.B. 713, the IRS ruled that working interests in oil and gas properties, which the decedent owned, operated, explored and developed, constituted a 6166 trade or business but that the "mere ownership" of royalty interests did not. The IRS concluded that the 40% of the decedent's estate which were working interests would be considered in testing for the availability of IRC §6166 but that the royalty interests, which were 60% of the estate, would not be. *See Also*, PLR 9214010.

4. In PLR 8625005, the decedent was the sole proprietor of an oil and gas business that consisted of fractional working interests which qualified as a business under IRC §6166. Also included in the decedent's estate were other royalty and working interests which he inherited from his sister but which had not actually been distributed to him at the time of his death. The IRS took the position that the undistributed interests from his sister's estate did not constitute an interest in a closely held business for the purposes of IRC §6166.

5. Today, a number of clients are in the business of buying and selling royalties and maintain an office for this purpose. It may be possible to argue that these assets constitute a trade or business and thus avoid the application of Rev. Rul. 61-55.

B. **Application of IRC §2032.**

1. The personal representative may elect, under IRC §2032, to have estate assets valued as of a date six months after the decedent's death, or, in the case of assets sold or distributed during the six-month period, as of the date of sale or distribution. Such election cannot be made unless it decreases both the value of the gross estate and the amount of federal estate tax. IRC §2032(c).

2. If the price of oil and gas declines significantly during the estate administration, the alternate valuation date may offer some estate tax relief.

3. If the estate has received proceeds of sale of oil and gas interests during the six-month period, a portion of these proceeds must be included in the estate for estate tax purposes. The practitioner should be aware of the current state of the law which has created some uncertainties in the valuation of the proceeds to be included in the estate.

a. The IRS in Rev. Rul. 71-317, 1971-2 C.B. 328, ruled that the value of proceeds from production during the six-month period is determined by applying an appropriate discount factor to the net income from this period. The discount factor is based on the economic factors involved in the case, such as the types of economic interests, interest rates, and other factors. The discounted value of the proceeds is included in the estate for estate tax purposes, and the remainder of the net profit is taxed as estate income.

b. In *Estate of Johnston v. United States*, 779 F.2d 1123, 1128 (5th Cir. 1986), the Fifth Circuit questioned the in-place valuation techniques set forth in Rev. Rul. 71-317. The Fifth Circuit found the application of "an appropriate discount factor" in Rev. Rul. 71-317 to be inadequate, but did not address what an appropriate discount factor is.

c. In *Estate of Hall v. Comm'r*, 967 F.2d 1437, 1439 (10th Cir. 1992), the Tenth Circuit reversed a Tax Court decision which was based on Rev. Rul. 71-317. The court stated that the appropriate valuation should be based on the value of unextracted oil and gas rather than on the proceeds from production, with an "appropriate discount factor" to be applied. The opinion also gives little guidance on how this valuation should be done. *See*, Wacker, *The In-Place Valuation of Oil and Gas Reserves Under the Alternate Valuation of Estate Property Method: The Tenth Circuit Invalidates Rev. Rul 71-317 in the Estate of Hall Case*, 41 Oil & Gas Tax Q. 285 (1993).

VI. **Fiduciary Challenges in the Management of Oil and Gas Properties.**

A. **Oil and Gas Properties Present A Unique Management Challenge.** Oil and gas properties are inherently difficult to manage because they are depleting assets, risky investments and involve the use and disposal of hazardous substances for environmental law purposes. Many owners of oil and gas properties do not have the sophistication or background of a petroleum engineer and do not understand the nature or value of the property. In other situations, the person or entity with the requisite knowledge of oil and gas properties has become legally incapacitated or has died. The person or entity receiving such properties as an executor, administrator or trustee assumes significant management responsibilities and fiduciary duties. This section will focus primarily on the duties and obligations of a trustee. It should be assumed, however, that executors and administrators are subject to many of the same duties and obligations.

1. **Authority of Trustees to Deal with Oil and Gas Properties.** In many states there is considerable pressure placed on fiduciaries to dispose of oil and gas properties because of the character of those assets. The scope of the fiduciary's authority, including the handling of oil and gas properties, can be established with proper drafting. Particular attention should be given to modifying some of the fiduciary duties that would otherwise be imposed upon the fiduciary.

2. **General Duties of Trustees.** The duties imposed upon trustees are imposed as a matter of common law, by virtue of the state law and by the terms of the instrument creating the trust.

3. **Due Diligence in the Exercise of Discretion.** It is incumbent upon the trustee to obtain adequate information to exercise the discretion granted to that trustee in making investment decisions, decisions regarding the allocation of receipts and disbursements of principal, determinations to allocate reserves for depletion and depreciation and decisions to invade principal. Generally, courts will not substitute their own discretion for that of a trustee in the absence of an abuse of discretion. An abuse of discretion is much more difficult to prove than a nonexercise of discretion. Abuse of discretion does not usually occur unless the trustee acts outside the bounds of "reasonable judgment." *See*, A. Scott & W. Fratcher, *The Law of Trusts*, 4th Edition, §187. One of the critical factors in making this determination is whether the trustee exercised due diligence in obtaining the facts necessary to reasonably exercise its discretion. The court will also review the circumstances surrounding the decision and the factors that the trustee considered in making that decision. It is important to recognize that it is always an abuse of discretion for a trustee to fail to exercise judgment at all. Scott, *supra*, 187. It is incumbent on a trustee to be constantly informed concerning oil and gas properties subject to its management. It is especially important to monitor the potential for leasing or development of undeveloped or underdeveloped mineral properties and to investigate potential environmental problems. The following is a summary of some of the fiduciary duties imposed upon trustees that are relevant to the proper management and development of oil and gas properties.

B. **Duties of a Trustee Relevant to Management of Oil and Gas Properties.**

1. **The Duty to Exercise Ordinary Skill and Diligence ("Prudent Person" Standard).** "The trustee shall administer the trust with the reasonable care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and with the like aims to accomplish the purposes of the trust as determined from the trust instrument," Cal. Prob. Code §16040. *See also*, Bogert, *supra*, §543.

2. **Duty of Impartiality.** A trustee holding property for successive beneficiaries owes a duty to them to administer the trust with impartial consideration for interests of all of the beneficiaries, Bogert, *supra*, §541.

3. **Duty of Loyalty.** The common law duty of loyalty is stated as follows: "Perhaps the most fundamental duty of the trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary, and must exclude all selfish interest and all consideration of the interests of third persons." Bogert, *supra*, §543. Additionally, "a trustee is in a fiduciary relation to a beneficiary and as to matters within the scope of the relation he is under a duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so by the terms of the trust or by a proper court." Restatement, Second, Trusts, §170. An individual who is experienced in the oil and gas industry may be an appropriate selection as a trustee or a co-trustee. Before making or accepting such appointment,

however, a determination should be made whether that person has an inherent conflict of interest and if so, whether the duty of loyalty can be modified. Planning considerations may include specifically authorizing the fiduciary to invest for his own account in the same area of interest as the trust if the fiduciary is already in the oil and gas business. It is advisable for a trustee to scrupulously avoid such situations. Examples of situations where a trustee has breached the duty of loyalty include the following:

a. A trustee leasing trust property to himself. Bogert, *supra,* §543(B).

b. A trustee buying trust property. Bogert, *supra*, §§543(C) and 543(D).

c. A trustee selling his own property to the trust. Bogert, *supra*, §543(E)

d. A trustee under a lease taking a renewal or buying a reversion for himself. Bogert, *supra*, §543(I).

e. A trustee of a business entity engaging in a competing business on his own behalf. Bogert, *supra,* §543(O).

f. A trustee securing incidental benefits personally while being engaged in Trust business. Bogert, *supra*, §543(Q).

g. A trustee with a duty to buy for the trust purchasing for himself, Bogert, *supra*, §543(R).

4. **Duty to Preserve and Protect the Trust Property.** A trustee is under a common law duty to use reasonable care and skill to protect the trust property. Bogert, *supra*, 582. This includes the duty to maintain suits and actions in the protection of such property, Bogert, *supra*, §594 It is incumbent upon the trustee to compile the information necessary to manage oil and gas properties in a manner to avoid drainage of the property and to take advantage of sale or leasing opportunities that may be subsequently lost by condemnation of adjoining properties (by exploration and drilling). Under common law, the trustee is under a duty to use reasonable care and skill to make the trust property productive. Bogert, *supra*, 611. The application of this duty to developed and undeveloped oil and gas properties places a difficult burden on the trustee and requires the trustee to seek expert advice and support in determining the development potential of a property. UPAIA has modified this duty somewhat.

5. **Duty to Keep the Beneficiaries Informed and to Account to Them.** The trustee has a common law duty to inform the beneficiary of important matters concerning the trust and the beneficiary is entitled to demand of the fiduciary information about the trust. The fiduciary is under a duty to notify the beneficiary of the existence of the trust so that the beneficiary may exercise his or her rights to secure information about trust matters and so that the beneficiary may compel an accounting from a fiduciary. The trustee must have adequate current information regarding the properties subject to its management to satisfy this obligation, Bogert *supra*, §961

6. **Duty to Keep Beneficiaries Informed about Material Non-routine Transactions.** The trustee has a duty to keep beneficiaries informed about material non-routine transactions. Bogert, *supra*, §961. A fiduciary should inform beneficiaries of any proposed transaction relating to the leasing or sale of oil and gas properties. Adequate current information concerning comparable leases or sales in the same general area of interest must be compiled by the trustee to satisfy this duty. Adequate knowledge of potential environmental hazards impacting the trust property and disclosure of both the problem and proposed remedies also can be encompassed within this duty.

C. **Estate Administration with Respect to Oil and Gas Properties.** The personal representative of an estate must receive court authorization prior to entering into any lease in which the term exceeds one year or rental payments of greater than $5,000 per month, Cal. Prob. Code §9941. With respect to court approval of leases, the court cannot authorize a lease for a period of greater than ten years if any heir or devisee who has an interest in the property objects at the hearing on such matter. The court may, however, approve an oil and gas lease for a fixed period plus (i) a period where oil and gas are produced in paying quantities or drilling operations are conducted on the leased property, (ii) where the lease provides for the payment of a compensatory royalty (*e.g.* delay rental), so long thereafter as such compensatory royalty is paid, and (iii) where the land covered by the lease is covered by Section 3301 of the California Public Resources Code (pooling and unitization), so long as oil or gas is produced in paying quantities from any of the lands included in any such agreement or drilling operations are conducted on any such property, Cal. Prob. Code §9947

D. **Due Diligence in Recordkeeping for Oil and Gas Properties.** Organizing records for oil and gas properties subject to the trustee's management and control is essential to avoid breaching one or more of a trustee's fiduciary duties. Most trustee files are inadequate in this regard. In order to satisfy its fiduciary duties, the trustee acquiring oil and gas properties is faced with the immediate task of compiling and organizing vital records. The following is an outline of one approach to recordkeeping that a trustee may find useful.

1. **Identify the Property Interests.** The first step in compiling records is to determine the identity, location, description, and particular interest (royalty, working interest, etc.) of all real property owned. The best sources of this information include deeds, wills and other muniments of title. The executor or trustee should look for reservations or conveyances of minerals and/or royalties, grants of or limitations on executive rights, and term limitations. This information is necessary not only for the purpose of managing these assets, but also will be needed in connection with the preparation of any inventory and appraisement or estate tax return.

2. **Obtain Complete Lease Records.** The next step is to obtain copies of the applicable oil, gas and/or other mineral leases covering all or any portion of the estate and any amendments to those leases. The express terms of the leases will dictate the rights, duties and obligations of the respective parties, particularly in the area of accounting for royalties. A trustee may very well discover that an operator deducted post-production transportation charges from royalty payments

where the leases involved specifically prohibited the deduction of such charges, or any number of other errors or omissions by the operator.

3. **Review All Division Orders.** Most oil and gas operators require the execution of division orders by all interest owners prior to disbursing proceeds from the sale of production. If any part of the estate has been or is currently productive, division orders should be located and organized both according to lease and chronologically. Division orders can vary the express terms of the applicable lease while they are in effect, and thus can affect the rights, duties and obligations of the respective parties.

4. **Retain and Review All Check Stubs.** Royalty payments are typically accompanied by check stubs which contain information that will be helpful in conducting any audit of royalty payments, including any lease, the property and wells names and identification numbers, the amount of production by month, the severance taxes paid, and any other deductions or adjustments.

5. **Seek Assistance to Obtain Needed Information.** These documents, including deeds and leases, may or may not be available in the owner's records. Some of them may need to be obtained from public records. Petroleum landmen are trained to compile this type of information, from scratch, if necessary. The use of a competent petroleum landman is a cost effective method especially if any significant records search is required.

6. **An Audit of Oil and Gas Properties May Be Necessary.** With respect to fiduciaries holding significant oil and gas holdings, a review of such holdings and an audit of the current operators may be necessary. A partial checklist with comments is included in Exhibit A.

VII. **Environmental Concerns for Fiduciaries and Beneficiaries in Connection with Oil and Gas Properties.** Environmental liability can arise by common law or statute.

A. **Environmental Statutes.** Environmental Statutes are a relatively recent phenomenon with the Clean Air Act of 1970 being the first significant piece of environmental legislation. Now there is an ever increasing number of laws which relate to the environment.

1. **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).** CERCLA (42 U.S.C.A. §§9601 et seq.) was enacted in 1980 and is commonly referred to as the Superfund statute.

a. CERCLA grants the Environmental Protection Agency ("EPA") the authority to identify contaminated sites, to quantify when releases of hazardous materials must be reported, to provide procedures for remediation of contaminated sites, to identify who the potentially responsible parties are and to assess damages against responsible parties.

b. Oil and gas are specifically excluded from the definition of a hazardous material, 42 U.S.C.A. §4601(14), which limits the applicability of CERCLA with respect to the production of

petroleum products, but some materials used in the petrochemical industry are not excluded. This includes drilling muds, drilling mud additives, produced waters, certain chemical solvents, fracturing acids and painting wastes.

c. CERCLA defines "potentially responsible parties" ("PRPs") as (i) the current owner and operator, (ii) prior owners and operators from the time of the release, (iii) persons who arrange for the disposal or treatment of hazardous substances, and (iv) persons who transport hazardous substances to a facility for treatment or disposal. 42 U.S.C.A. §9607(a). The parties who are eventually determined to be responsible will be held jointly and severally liable pursuant to §9607(b). The costs associated with environmental investigations, removal, cleanup, monitoring, and health studies can be assessed to the responsible parties.

d. Fiduciaries must understand their potential exposure to liability under CERCLA. A fiduciary's liability is limited by 42 U.S.C.A. 9607(n), a copy of which is attached as Exhibit B.

e. Additionally, there are penalties for failing to report a release of a hazardous material. 42 U.S.C.A. §9603.

f. There are defenses if the contamination was caused due to an act of God, War, or the actions of a third party. 42 U.S.C.A. §9607(b).

2. **Resource Conservation and Recovery Act (RCRA).** RCRA (42 U.S.C.A. §§6901 *et seq.*) was enacted in 1976. Of particular interest in this statute is the regulation of underground storage tanks as well as the generation, transportation, storage and disposal of hazardous material. While RCRA uses the same definition of a regulated substance as CERCLA, it does not exclude petroleum products. RCRA requires the owner of underground storage tanks to register them with the state.

3. **Clean Water Act (CWA).** The CWA, 33 U.S.C.A. §§1251 et seq., was enacted in 1972. It established the basic structure for regulating the discharge of pollutants into the waters of the United States. It gave EPA the authority to implement pollution control programs such as setting wastewater standards for industry and set water quality standards for all contaminants in surface waters. The CWA also requires the identification and regulation of wetlands. Additionally, the CWA prohibits the discharge of pollutants into navigable waters without a permit. A violation of the act requires that the party in charge of the facility which is in violation must immediately notify the appropriate federal agency. Failure to give such notice is punishable by fine and imprisonment.

4. **Endangered Species Act (ESA).** The ESA, 16 U.S.C.A. §1531 was enacted to protect certain plants and wildlife. The act prohibits the harming of any endangered species (identified by the Secretary of the Interior). Violations of the ESA can subject a violator to civil and/or criminal penalties so an understanding of the broad definition by the ESA of an endangered species is important.

B. **Common Law Causes of Action.** Additionally, causes of action for operating a dangerous activity, trespass, negligence, nuisance and fraud may be brought. Such causes of action may subject a defendant to strict liability regardless of it's degree of care.

C. **Powers of Trustee Regarding Environmental Laws.** Many proposed fiduciaries may be concerned about accepting an appointment to serve as trustee of a trust with oil and gas holdings due to the fact that they do not wish to be held liable for the acts of a predecessor. One option available would be to allow a trustee or a proposed trustee the power to inspect or investigate the property in question, and provide that such trustee or proposed trustee shall have the right to be reimbursed for any expenses related to such inspection and/or investigation. In Texas, this has been made a matter of law. *See*, Tex. Prop. Code §§113.025 (right to inspect) and 114.063 (right to reimbursement).

VIII. **Conclusion.** The ownership and management of oil and gas properties presents many unique problems. As stated throughout this paper, it is very important that competent advice is obtained with respect to these properties with respect to planning, implementation as well as administration. It is the author's hope that readers will have a better understanding and appreciation of the complexities of this area of the law.

Exhibit A -- Audit of Significant Oil and Gas Holdings by a Fiduciary

I. **Pre-audit Activities.** Once the foregoing documents have been obtained and organized, a preliminary review of the information should be undertaken.

A. **A Review Should Be Made of Leased Lands.** Leases should be associated with specific tracts or parcels of land owned by the estate. Different leases will contain different provisions, and thus the rights and obligations of the parties may vary from lease to lease. Also, separate leases to the same operator will likewise create different rights and obligations, even if their terms are identical. For example, with respect to the royalty clause, many leases require calculation of royalties on the basis of the "net proceeds" received by the operator for natural gas sold "at the well" (meaning on the leased premises), and on the basis of the "market value" if the gas is sold or used off the leased premises (meaning after being transported away from the leased premises). If the operator delivers natural gas produced from both leases to a purchaser at a common delivery point on one of the leases, the royalty obligations will differ between the leases. The gathering of natural gas for processing in or near the field where produced followed by delivery of residue gas to a purchaser can sometimes create this same problem. An operator's reasonable development and protection obligations can be increased by ownership of separate leases covering properties with common ownership.

B. **Unleased Lands Should Be Reviewed.** An analysis should be made to determine whether the trust owns any land that is not covered by a lease. The acreage may be open because it has never been leased, or it may have been previously covered by a lease that has expired in whole or in part. Open acreage creates the possibility of future leasing activity which could generate bonus, rental and other income to the estate. If a larger tract of land is involved, steps may need to be taken to market the property, rather than simply waiting for a lease broker to knock on the fiduciary's door. If such property has not been leased for a 3D seismic survey, the possibility should be explored. Companies active in 3D seismic exploration are often looking for new prospects to shoot and lease. Open acreage not only creates the possibility of future leasing activity, but it also increases the obligation of the fiduciary to take the proper steps to make the estate productive, and in turn could give rise to fiduciary liability for failing to do so.

C. **Expired Leases Should Be Reviewed.** The analysis of whether the estate owns land covered by any lease includes a review of existing leases to determine whether they may have expired in whole or in part. A lease may expire as a result of a complete cessation of production and operations for the time prescribed in the lease (usually 60 or 90 days), a cessation of production in paying quantities over time, or by express lease terms which, for example, require continuous drilling or a release of acreage not specifically allocated to any particular well. The analysis should include both vertical as well as horizontal (depth) expirations. The determining event may have occurred in the past without the owner's knowledge. Releases should be obtained and recorded for any lease which has expired. This will help prospective lessees know that lands are open and available for lease.

D. **All Operators Should Be Identified.** By reviewing check stubs and division orders, the fiduciary should be able to determine who is responsible for operating properties owned by the

estate. The identity of the operator is important since the operator and its working interest participants will have the primary responsibility for complying with both the express and the implied terms of any lease. Audit inquiries will be addressed to the operator or operators. The payor under the check stubs or the division order may not necessarily be the operator, but those documents should nevertheless identify the operator.

II. **Data Review to Determine Advisability of an Audit of Operators.** After reviewing the data, a determination should be made concerning the necessity of an audit of current operators.

A. **A Team Approach Is Most Effective.** The most efficient approach to a review of the preliminary data, as well as to conduct the audit, is to hire a knowledgeable team of engineers/landmen/accountants with a background of working for and/or running oil and gas operations, as opposed to hiring a team focused primarily on accounting. In any event, the team should have a strong background in data processing and an emphasis on database and large spreadsheet manipulation capabilities.

B. **Public Records Review.** A considerable amount of information is available from public records that can readily be obtained by knowledgeable people trained in the various disciplines.

C. **Review Correspondence.** Files should be reviewed for correspondence both to and from the operator. Many times these can be used to determine whether an operator has been truthful and honest in dealing with the royalty owner once the true facts become known during the audit.

III. **The Audit Report.** Upon completion of the records compilation and a review of the existing data, the fiduciary should consider addressing an audit request to the operator or operators. The initial audit request may be addressed to each operator by a letter requesting specific information. To increase the impact of the request, the audit should letter come from legal counsel rather than the consultant. The information requested will be dictated by information either found or not found by counsel and the consultant during the records compilation and review of existing data phases of the audit. Areas of inquiry typically include the following items.

A. **Reporting Issues Related to Payment.** Interpret production codes that appear on the check stubs (i.e., 1 = oil, 2 = gas, 3 = condensate, etc.). Explain the basis for calculating deductions found on the check stubs. Does the operator report wellhead, plant or residue gas sales volumes on the check stubs? Are gas plant liquids included in the revenues reported on the check stubs? If so, how are the volumes handled? Where is the gas processed? During what time frame was the gas processed? If the gas is not processed, explain the reasons for not processing. Explain how the operator arrived at the prices shown on the check stubs. Do the prices represent an average, or does the price differ for each well? Ask the operator to explain one month's check stub from the base production reports.

B. **Request Duplicate Information.** If the operator maintains a data base containing the information shown on the check stubs, request a duplicate of the information on computer diskettes.

C. **Review Crude Oil and Condensate Pricing.** Request an explanation of the marketing arrangements for all crude oil and condensate produced and sold from the leases, including any delivery or sales to affiliates. Determine the monthly prices per barrel received during the audit period and compare the prices to the average spot prices for comparable oil and gas or to other leases and pipelines in the area.

D. **Review Gas Contracts and Processing Agreements.** Request copies of all gas contracts and processing agreements as well as all amendments. If prices have been regulated, request the pricing category for each well over time. If gas is being processed, determine whether any liquids are being retained by the processing plant and not credited back to the lease. Determine the operator, the location and the ownership of any processing plant at which lease gas is processed. Determine the monthly BTU ("British Thermal Units") of the gas produced and the monthly BTU of the gas sold that was used in calculating the average price on the monthly check stubs. Determine what type of BTU testing is done for allocation purposes. Request access to all well charts and pay charts for sample months (i.e., January and July) during the audit period. This should include any plant statements upon which the operator relies to calculate royalties. Request a sketch of the gathering system, including the common meter points and meter numbers.

E. **Review Settlements from Gas Contract Disputes.** Determine whether there were any settlements of gas contract disputes, including the identity of the parties involved, the key issues and the terms of the settlement. If litigation was involved, request copies of all pleadings and any judgment or other orders disposing of the litigation. Request copies of all settlement agreements. Identify the total amount claimed and received for underpayment, contract price buy-down and take-or-pay claims. Request an explanation for any allocations of the settlement proceeds between these claims. Determine whether the settlement was "global" (i.e., multiple contracts). If so, determine whether prices under the various contracts involved were adjusted in a different manner, and request an explanation for the difference. Determine whether the operator received any other non-cash benefits, including transportation deductions and other intangibles. Determine to what extent the settlement proceeds and other benefits were shared with the royalty owners.

F. **The Audit Period Will Vary Depending on the Circumstances of Each Case.** A suggested period for the foregoing request is the preceding ten years. Many operators will resist furnishing any information beyond the term which coincides with the statute of limitations. A discussion of the need for information beyond the limitations period is discussed below.

G. **Operator Resistance May Occur.** Many operators will also resist an audit request on the basis of annoyance, time and expense, confidentiality of the information requested, and/or lack of any express contractual provision requiring the operator to respond. They will sometimes ask for a specific complaint or claim for underpayment before responding. Until the audit is complete, it will be difficult if not impossible to identify any particular complaint or claim for underpayment.

The operator who resists an audit should be informed that all of the information requested is easily discoverable in litigation, and that such litigation will be initiated unless a prompt response is forthcoming. With respect to confidentiality, all information furnished by the operator can be protected with an appropriate confidentiality agreement executed by all parties as well as their counsel and consultants. The confidentiality issue can be defused at the outset by furnishing a confidentiality agreement with the initial audit request.

IV. **Common Audit Issues.**

A. **Deductions from Royalty Checks Should Be Confirmed.** While a royalty interest under a lease is typically free of production expenses (*i.e.*, the costs to drill and complete a well), it will normally bear its share of post-production expenses, such as production or gathering taxes, costs of treating production to make it marketable, and costs of transportation to market (particularly where the royalty is calculated on the basis of the "market value at the well"). Many operators, for administrative convenience or otherwise, make arbitrary deductions from royalty payments which bear little or no relation to either reasonable or actual post-production expenses. Operators have even been known to charge a royalty owner for gas used in lease operations, notwithstanding the fact that the gas was furnished free of charge to the operator under the terms of the lease! A careful analysis of charges deducted from royalty payments should be undertaken as part of any audit.

B. **Proper Reporting to the Royalty Owner Should Be Verified.** If payment is made to a royalty owner from proceeds derived from the sale of oil or gas production pursuant to a division order, a lease or other agreement, the person making the payment is required to include certain information on the check stub or an attachment to the payment.

C. **Has the Lessee Satisfied its Marketing Obligations?** The marketing duty is two-pronged: the lessee must market the production with due diligence and obtain the best price reasonably possible. Under a market value royalty clause, the lessee has an obligation to obtain the best current price reasonably available. The standard of care applied to test the performance of the lessee in marketing is that of a reasonably prudent operator under the same or similar circumstances. Where gas royalties are paid by larger companies with integrated operations (production, transportation and/or refining), the possibility of sales below market as a result of self dealing increases. While a lease creates a contractual relationship and does not normally impose a duty of good faith and fair dealing, some courts have suggested a somewhat higher level of responsibility where the operator has a pecuniary interest in downstream operations. Even though a transaction with an affiliate is not a *per se* breach of the operator's duty to market, the transaction is inherently suspect and should be reviewed on its merits.

D. **Gas Processing Arrangements Should Be Examined.** A significant amount of gas produced is processed for the recovery of natural gas liquids prior to sale. Processing can occur on the lease, in or near the field where the gas is produced, or at a plant located some distance from the lease. The plant can be owned and operated by the lessee or its affiliate, or by a third party. Compensation arrangements, which normally involve some form of allocation or "net back" to the lease for liquids extracted from the natural gas stream, also vary. Careful attention should be given

to all processing arrangements. The fiduciary should determine if and to what extent the estate has shared in revenues received from the sale of natural gas liquids. It has been suggested that a royalty owner is not entitled to participate in natural gas liquids absent express provisions in the lease. However, the issue has not been addressed in the context of the operator's implied covenant to market gas production, which turns on what a reasonably prudent operator would do under the same or similar circumstances. Natural gas liquids which are easily extracted from gas by the use of known and readily available technology constitute a valuable component of the production. This is particularly true when gas prices are low relative to liquids prices. Under these circumstances, the sale of production to a third party without processing may in and of itself constitute a breach of the implied marketing duty. Processing by an affiliate, of course, is also suspect and should be reviewed.

E. **Gas Contract Settlements Should Be Reviewed.** The scope of this paper does not permit a discussion of the historical context in which gas contract settlements between operators and gas purchasers arose.

F. **The Price Paid for Oil/condensate Royalties Should Be Verified.** Royalty audits have recently begun to focus on the marketing of oil and condensate. While the royalty owner typically retains title to the royalty oil under a lease, oil is normally sold by the lessee. Purchasers pay a "posted price" which theoretically represents a market price for the oil. Abuses similar to those involving the sale of gas production to an affiliate have occurred. A royalty owner may find that the "posted price" is lower than the price paid by a transportation affiliate of the lessee a short distance from the lease. For this reason, a comparison of crude oil and condensate prices should be made to other benchmark prices, or prices paid by other crude oil gathered in the area.

G. **Review the Express Lease Terms.** As stated previously, express lease terms will first determine the relative rights and obligations of the parties to a lease. Express lease terms which can impact an audit include the royalty clause, express drilling and development obligations, information and reporting covenants, surface protection provisions, and the like. Any audit should include a determination that the operator is complying with the express lease terms.

H. **Consider All Implied Lease Covenants.** In addition to the implied covenant to market production discussed above (as part of the implied covenant to manage the lease), an operator under an oil and gas lease is under an implied obligation to both (1) reasonably develop the leased premises, and (2) protect the leased premises from drainage. Consideration should be given to these covenants during the audit. The fiduciary may uncover either unrealized development possibilities, or unanswered drainage of the leased premises, or both, particularly in a case where the operator has become comfortable with its operation and the lack of vigilance by the royalty owner.

V. Limitations and the Discovery Rule in the Audit Context.

A. **Statute of Limitations.** Claims under oil and gas leases are subject to statutes of limitations like any claim arising under a contract. A statute of limitations is a defense in civil litigation. A

litigant is required to file suit on a claim within the time proscribed by the applicable statute. Otherwise, the claim is barred.

B. **A Claim May Not Be Barred If the "Discovery Rule" Is Applicable.** The "discovery rule" has evolved through case law to provide relief from the sometimes harsh results of the statutes of limitations. Under the discovery rule, the commencement of the running of the statute of limitations may be delayed until (1) the date the injury is actually discovered, or (2) the date the injury should have been discovered in the exercise of reasonable diligence.

C. **Discovery Rule Not Automatic.** It should be noted that the application of the discovery rule is not automatic, and first involves a question of law concerning whether the discovery rule should be applied in a particular case. Many oil and gas practitioners representing royalty owners in audits have generally assumed that the discovery rule would be applied, and that the audit could proceed at a modest pace. However, as the invocation of the "discovery rule" involves a question of law, Trustees should promptly determine whether it is, in fact, available as to the instance in question.

D. **A Tolling Agreement May Be Necessary.** Many contract claims uncovered during the course of an audit may have accrued beyond the standard statute of limitations period as it relates to the date of discovery, particularly if the audit period covers a period greater than the limitations period. If that is the case, the discovery rule must be invoked, or the claim may be barred by limitations. In addition, audits of any complexity can consume a period of months and even years from the time they are initiated. Even operators who are cooperative are sometimes slow to respond. For these reasons, the initial audit request should include a request for an agreement tolling the running of the applicable statute of limitations to allow the audit to proceed in an orderly manner. If the operator refuses to enter into a tolling agreement, consideration should be given to filing suit immediately.

Exhibit B -- CERCLA §9607(n)

(n) Liability of fiduciaries

(1) In general, the liability of a fiduciary under any provision of this chapter for the release or threatened release of a hazardous substance at, from, or in connection with a vessel or facility held in a fiduciary capacity shall not exceed the assets held in the fiduciary capacity.

(2) Exclusion Paragraph (1) does not apply to the extent that a person is liable under this chapter independently of the person's ownership of a vessel or facility as a fiduciary or actions taken in a fiduciary capacity.

(3) Limitation Paragraphs (1) and (4) do not limit the liability pertaining to a release or threatened release of a hazardous substance if negligence of a fiduciary causes or contributes to the release or threatened release.

(4) Safe harbor A fiduciary shall not be liable in its personal capacity under this chapter for-

(A) undertaking or directing another person to undertake a response action under subsection (d)(1) of this section or under the direction of an on scene coordinator designated under the National Contingency Plan;

(B) undertaking or directing another person to undertake any other lawful means of addressing a hazardous substance in connection with the vessel or facility;

(C) terminating the fiduciary relationship;

(D) including in the terms of the fiduciary agreement a covenant, warranty, or other term or condition that relates to compliance with an environmental law, or monitoring, modifying or enforcing the term or condition;

(E) monitoring or undertaking 1 or more inspections of the vessel or facility;

(F) providing financial or other advice or counseling to other parties to the fiduciary relationship, including the settlor or beneficiary;

(G) restructuring, renegotiating, or otherwise altering the terms and conditions of the fiduciary relationship;

(H) administering, as a fiduciary, a vessel or facility that was contaminated before the fiduciary relationship began; or

(I) declining to take any of the actions described in subparagraphs (B) through (H).

(5) Definitions As used in this chapter:

(A) Fiduciary The term "fiduciary" -

(i) means a person acting for the benefit of another party as a bona fide-

(I) trustee;

(II) executor;

(III) administrator;

(IV) custodian;

(V) guardian of estates or guardian ad litem;

(VI) receiver;

(VII) conservator;

(VIII) committee of estates of incapacitated persons;

(IX) personal representative;

(X) trustee (including a successor to a trustee) under an indenture agreement, trust agreement, lease, or similar financing agreement, for debt securities, certificates of interest or certificates of participation in debt securities, or other forms of indebtedness as to which the trustee is not, in the capacity of trustee, the lender; or

(XI) representative in any other capacity that the Administrator, after providing public notice, determines to be similar to the capacities described in subclauses (I) through (X); and

(ii) does not include -

(I) a person that is acting as a fiduciary with respect to a trust or other fiduciary estate that was organized for the primary purpose of, or is engaged in, actively carrying on a trade or business for profit, unless the trust or other fiduciary estate was created as part of, or to facilitate, 1 or more estate plans or because of the incapacity of a natural person; or

(II) a person that acquires ownership or control of a vessel or facility with the objective purpose of avoiding liability of the person or of any other person.

(B) Fiduciary capacity The term "fiduciary capacity" means the capacity of a person in holding title to a vessel or facility, or otherwise having control of or an interest in the vessel or facility, pursuant to the exercise of the responsibilities of the person as a fiduciary.

(6) Savings clause
Nothing in this subsection -

(A) affects the rights or immunities or other defenses that are available under this chapter or other law that is applicable to a person subject to this subsection; or

(B) creates any liability for a person or a private right of action against a fiduciary or any other person.

(7) No effect on certain persons
Nothing in this subsection applies to a person if the person -

(A)(i) acts in a capacity other than that of a fiduciary or in a beneficiary capacity; and

(ii) in that capacity, directly or indirectly benefits from a trust or fiduciary relationship; or

(B)(i) is a beneficiary and a fiduciary with respect to the same fiduciary estate; and

(ii) as a fiduciary, receives benefits that exceed customary or reasonable compensation, and incidental benefits, permitted under other applicable law.

(8) Limitation This subsection does not preclude a claim under this chapter against-

(A) the assets of the estate or trust administered by the fiduciary; or

(B) a nonemployee agent or independent contractor retained by a fiduciary.

Exhibit C -- Proposed Texas UPAIA §411

Draft Dated June 21, 2002

SECTION 411. MINERALS, WATER, AND OTHER NATURAL RESOURCES.

(a) To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them as follows:

(1) If received as nominal delay rental or nominal annual rent on a lease, a receipt must be allocated to income.

(2) If received from a production payment, a receipt must be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance must be allocated to principal.

(3) If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, ~~90 percent must be allocated to principal and the balance to income~~ the trustee shall allocate such receipts equitably.

(4) If an amount is received from a working interest or any other interest not provided for in paragraph (1), (2), or (3), ~~90 percent of the net amount received must be allocated to principal and the balance to income~~ the trustee shall allocate such receipts equitably.

(b) An amount received on account of an interest in water that is renewable must be allocated to income. If the water is not renewable, ~~90 percent of the amount must be allocated to principal and the balance to income~~ the trustee shall allocate such receipts equitably.

(c) This [Act] applies whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

(d) If a trust owns an interest in minerals, water, or other natural resources on [the effective date of the [Act]], the trustee may allocate receipts from the interest as provided in this [Act] or in the manner used by the trustee before [the effective date of the [Act]]if such allocation did not violate law applicable prior to [the effective date of this [Act]].

If the trust acquires an interest in minerals, water, or other natural resources after [the effective date of this [Act]], the trustee shall allocate receipts from the interest as provided in this [Act}.

(e) An allocation under this Section 411 is presumed to be equitable if the amount allocated to principal equals the amount allowed as a deduction by the Internal Revenue Code for depletion of the interest.

Uniform Principal and Income Act Comment

Prior Acts. The 1962 Act allocates to principal as a depletion allowance, 27-1/2% of the gross receipts, but not more than 50% of the net receipts after paying expenses. The Internal Revenue Code no longer provides for a 27-1/2% depletion allowance, although the major oil-producing States have retained the 27-1/2% provision in their principal and income acts (Texas amended its Act in 1993, but did not change the depletion provision). Section 9 of the 1931 Act allocates all of the net proceeds received as consideration for the "permanent severance of natural resources from the lands" to principal.

Section 411 allocates 90% of the net receipts to principal and 10% to income. A depletion provision that is tied to past or present Code provisions is undesirable because it causes a large portion of the oil and gas receipts to be paid out as income. As wells are depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of the receipts to principal enables the trustee to acquire other income producing assets that will continue to produce income when the mineral reserves are exhausted.

Application of Sections 403 and 408. This section applies to the extent that the trustee does not account separately for receipts from minerals and other natural resources under Section 403 or allocate all of the receipts to principal under Section 408.

Open mine doctrine. The purpose of Section 411(c) is to abolish the "open mine doctrine" as it may apply to the rights of an income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Instead, such receipts are to be allocated to or between principal and income in accordance with the provisions of this Act. For a discussion of the open mine doctrine, see generally 3A Austin W. Scott & William F. Fratcher, The Law of Trust §239.3 (4th ed. 1988), and *Nutter v. Stockton*, 626 P.2d 861 (Okla. 1981).

Effective date provision. Section 9(b) of the 1962 Act provides that the natural resources provision does not apply to property interest held by the trust on the effective date of the Act, which reflects concerns about the constitutionality of applying a retroactive administrative provision to interest in real estate, based on the opinion in the Oklahoma case of *Franklin v. Margay Oil Corporation,* 153 P.2d 486, 501 (Okla. 1944). Section 411(d) permits a trustee to use either the method provided for in this Act or the method used before the Act takes effect. Lawyers in jurisdictions other than Oklahoma may conclude that retroactivity is not a problem as to property situated in their States, and this provision permits trustees to decide, based on advice from counsel in States whose law may be different from that of Oklahoma, whether they may apply this provision retroactively if they conclude that to do so is in the best interest of the beneficiaries.

If the property is in a State other than the State where the trust is administered, the trustee must be aware that the law of the property's situs may control this question. The outcome turns on a variety of questions: whether the terms of the trust specify that the law of a State other than the situs of the property shall govern the administration of the trust, and whether the courts will follow the terms of the trust; whether the trust's asset is the land itself or a leasehold interest in the land (as

it frequently is with oil and gas property); whether a leasehold interest or its proceeds should be classified as real property or personal property, and if as personal property, whether applicable state law treats it as a movable or an immovable for conflict of laws purposes. See 5A Austin W. Scott & William F. Fratcher, The Law of Trusts §§648, at 531, 533-534; §657, at 600 (4th ed. 1989).

State Bar Committee Comments

The State Bar Committee determined that the changes included in Section 411 of the Uniform Principal and Income Act from the provisions of Section 113.107 of the Texas Trust Code could produce unfairness. If Texas adopted the change, income beneficiaries who were receiving 72-1/2% of royalty payments could have their allocation reduced to 10% of the royalty payments. Because of this, the committee has deleted the allocation of calling for 90% of the payments to be allocated to principal and 10% to be allocated to income and have replaced that allocation with a direction for the trustee to allocate the receipt equitably. The State Bar committee has provided a presumption of what is equitable in a new paragraph (e). Additionally, the committee determined that it was appropriate to retain Section 411(d) to allow the trustee to continue to allocate these types of receipts as they have done so prior to the enactment of the Uniform Principal and Income Act.