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University of Houston Law Center
100 Law Center
Houston, TX 77204-6060
lhoffman@uh.edu

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THE EXECUTIVE DUTY: HERE WE GO AGAIN

BY STUART HOLLIMON

I. Introduction

In Texas oil and gas law, the “executive right” is the right to take or authorize all actions that affect the exploration and development of the mineral estate, including the right to execute leases of the mineral estate. *Smith & Weaver*, Texas Law of Oil and Gas, Vol. 1 § 2.6 (1998). It is one of the five “sticks” that together comprise the “bundle” of attributes of mineral ownership. *Altman v. Blake* 712 S.W.2d 117 (Tex. 1986). The executive right is frequently severed from other incidents of mineral ownership and when that occurs, the non-executive owns the minerals in place, but does not have the right to lease them. *Lesley v. Veterans Land Board of Texas*, 352 S.W.3d 479, 487 (Tex. 2011). The owner of the executive right owes the non-executive mineral owner a duty of utmost good faith and fair dealing, but the standard for determining when the duty has been breached is less clear. *In re Bass*, 113 SW3d 735 (Tex. 2003); *Manges v. Guerra*, 673 S.W.2d 180 (Tex. 1984); and *Schlitter v. Smith*, 128 Tex. 628, 101 S.W.2d 543, 545 (1937).

In March 2015, the Supreme Court addressed the standard for determining a breach of the executive’s duty in *KCM Financial LLC v. Bradshaw*, 457 S.W.3d 478 (Tex. 2015) and appeared to establish a single, uniform test for determining when the executive’s duty has been breached. The standard adopted in *Bradshaw* was whether the executive has engaged in acts of self-dealing that have unfairly diminished the value of the non-executive’s interest. The Court also stated that although the executive is prohibited from self-dealing, it is not required to subjugate its interests to those of the non-executive.

In May 2017, however, the Fourth Court of Appeals in *Texas Outfitters Limited, LLC v. Nicholson*, 534 S.W.3d 65 (Tex. App.—San Antonio 2017, pet. granted), a case involving an alleged breach of the executive duty based on the executive’s refusal-to-lease, declined to apply *Bradshaw*, holding that a different test governs refusal-to-lease cases. The Supreme Court granted petition for review in June of this year.

II. Texas Outfitters

Prior to 2002, the Carter family (collectively, “Carter”) owned the surface and 50% of the minerals in a 1082-acre tract situated in Frio County, Texas known as the Derby Ranch. In 2002, Texas Outfitters Limited, LLC (“TOL”) purchased the surface, 4.16% of the minerals and the executive right to Carter’s 50% mineral interest for \$1 million. The sale was partially owner financed. TOL commenced a commercial hunting and deer breeding operation on the surface and the owner of the company, Frank Fackovec, made plans to construct a home for his family on the property.

In 2010, TOL received two offers to lease the 50% mineral interest it controlled in the ranch. The initial offer, received in March 2010, provided for a \$450 per-acre bonus and a 22% royalty. TOL rejected the offer because oil and gas professionals advised that the terms were too low. In June 2010, El Paso Exploration & Production Company (“El Paso”) offered to lease the minerals for a \$1,750 per acre bonus and a 25% royalty. TOL rejected this offer as well based on advice from oil and gas

professionals and the upward trend in lease values observed in the area. El Paso made the same offer to Carter’s relatives who owned the other 50% of the ranch’s minerals and they accepted. Carter and TOL then discussed leasing Carter’s mineral interest, but according to Carter, Fackovec stated that no lease of the minerals would be granted because he wanted to protect his hunting and deer breeding operation.

In August 2010, the parties and their attorneys met regarding the situation. According to Carter, the parties reached an agreement that Carter would forgive \$263,000 on TOL’s outstanding note in exchange for TOL executing a lease with El Paso. According to TOL, Carter proposed to buy back the executive rights in exchange for forgiving part of the note and TOL demanded that surface protection provisions be included in any re-conveyance of the executive rights. The parties were supposed to finalize an agreement by October

The Court also stated that although the executive is prohibited from self-dealing, it is not required to subjugate its interests to those of the non-executive.

15, 2010, but failed to do so. Ultimately, Carter filed suit against TOL alleging that it had breached its duty of good faith and fair dealing by refusing to lease the minerals to El Paso. After suit was filed, TOL received two more offers to lease from other companies. One of the offers included a bonus of \$2,000 per acre, but was withdrawn when the company learned that the other 50% of the minerals had already been leased by El Paso. The other offer was also withdrawn. In 2012, TOL sold the surface of the ranch and its executive rights to a third party for more than three times the price it paid for the property.

Trial was to the court. At the conclusion of the trial, the court ruled in favor of Carter and thereafter issued written findings of fact and conclusions of law. The court found that TOL had breached its executive duty by refusing to lease to El Paso and that Carter had suffered damages equal to the bonus that would have been received had the El Paso lease been executed by TOL. In reaching this result, the trial court ruled that in a failure-to-lease case, if the executive's refusal to lease is motivated by self-interest to the non-executive's detriment, the executive has breached his duty. Though it did not make any specific findings regarding TOL's motives for refusing to execute a lease with El Paso, the trial court did issue conclusions of law which stated that by refusing to lease, TOL "gained for itself unfettered use of the surface for its hunting operation" (COL 9), and the "ability to sell its land at a large profit free of any oil and gas lease." (COL10).

The court of appeals affirmed. In reaching its opinion, the court discussed *Bradshaw* and the standard laid down by the Supreme Court in that case. However, the court observed that *Bradshaw* concerned self-dealing in the context of the executive having executed a lease, not the refusal to execute a lease, and for that reason declined to follow *Bradshaw*. The court held that the trial court had correctly stated that the applicable duty in a refusal-to-lease case as being "the refusal [must not be] arbitrary or motivated by self-interest to the non-executive's detriment," and cited *Lesley v. Veterans Land Board of Texas* as support. The court then construed the trial court's findings as including a finding that TOL intended to never lease the minerals in order to protect its surface operations. The court also stated that TOL had improperly withheld leasing of the minerals as leverage to gain monetary and other benefits from Carter during the unsuccessful settlement negotiations. Based on its view of the record, the court held that the evidence was sufficient to support the trial court's finding that TOL had breached its duty by refusing to execute the El Paso lease and affirmed the judgment.

III. *Bradshaw*

The significance of *Texas Outfitters* is best understood when viewed in the context of *Bradshaw*. In *Bradshaw*, the non-executive claimed that the executive had breached its duty by leasing the mineral interest involved for a sub-market royalty, which the executive and non-executive would share equally, in exchange for an above-market bonus payable only to the executive. The trial court entered summary judgment for the non-executive, but on appeal the Supreme Court reversed and remanded finding the existence of fact issues. In reaching that result, the Supreme Court made two critical holdings. First, the Court held that although the executive owes the non-executive a duty of utmost good faith and fair dealing, the executive is not required to subordinate its interests to those of the non-executive if their interests conflict. Second, the Court held that in determining whether the executive has breached its duty, the applicable standard is whether the executive engaged in acts of self-dealing that unfairly diminished the value of the non-executive interest. In the words of the Court:

If the semantics surrounding the nature of this duty have shifted subtly over the years, this much is clear: An executive owes a non-executive a duty that prohibits self-dealing but does not require the executive to subjugate its interests to those of the non-executive. Thus, in ascertaining whether the executive breached its duty to the non-executive, the controlling inquiry is whether the executive engaged in acts of self-dealing that unfairly diminished the value of the non-executive interest.

457 S.W.3d at 82.

After the decision in *Bradshaw*, it was generally believed that the Court had established a single, uniform test for determining alleged breaches of the executive duty that applied to all breach of executive duty cases. See, E. Johnson and R. Park, "Bradshaw, Bradshaw and Bradshaw: The Executive's Duty to the Non-Executive and What It Means to Avoid Self-Dealing," 39 Oil, Gas & Energy Resources Law 73 (2015). It was likewise believed that an executive was not required to subjugate his interests to those of the non-executive when exercising the executive right.

IV. Analysis

The decision in *Texas Outfitters* has created confusion with regard to the scope of the duty owed by the executive rights owner in two major respects: (1) whether the executive is required to subordinate his interests to those of the non-

executive when exercising the executive right; and (2) whether there is a single standard that governs the duty owed by the executive in all breach of duty cases.

With regard to the former, prior to *Texas Outfitters* practitioners understood that the executive was *not* required to subordinate his interests to those of the non-executive. Indeed, the words of the Court in *Bradshaw* were clear on the point. The decision in *Texas Outfitters*, however, is at war with this concept. In *Texas Outfitters*, TOL, as a surface owner with an established business, clearly had an interest in preserving its surface use from interference by oil and gas operations. However, the court found a breach of the executive duty because TOL, by refusing to sign the El Paso lease, gained for itself the “unfettered use of the surface for its hunting operation.” This suggests that the executive is required to subjugate his interests to those of the non-executive, contrary to the holding in *Bradshaw*. Of course, an executive who absolutely refuses to lease the minerals under any circumstances may have breached his duty. *See Lesley* at 491. But TOL did not refuse to lease under any circumstances and in fact agreed to lease to El Paso as part of an overall resolution of the dispute, and then later accepted two other offers to lease only to have them withdrawn by the prospective lessees. Under these circumstances, practitioners are left to wonder whether an executive is required to subordinate its own interests to those of the non-executive.

The issue becomes further complicated when, as in *Texas Outfitters*, the executive owns a portion of the mineral estate. Suppose the executive does not wish to lease his own mineral interest, but is willing to lease the non-executive’s mineral interest. And suppose further that the offer to lease is conditioned upon the lease covering all the minerals. Under these circumstances, is the executive obligated to lease his own mineral interest simply to satisfy his duty to the non-executive? This was precisely the situation in *Texas Outfitters* as the offer presented by El Paso was for the entire 50% mineral interest controlled by TOL. The logical extension of *Bradshaw*’s holding that an executive is not required to subordinate his interests to those of the non-executive suggests that an executive is not required to lease its own mineral interest in order to satisfy the wishes of the non-executive. Yet, *Texas Outfitters* found liability for TOL’s refusal to sign the El Paso lease even though El Paso’s offer did not allow TOL to exclude its own 4.16% mineral interest from the lease.

The second area of confusion created by *Texas Outfitters* concerns whether there is a single standard that governs the duty owed by the executive. In this regard, the decision

in *Bradshaw* was understood to have formulated a unified standard for determining breaches of the executive’s duty, which was that the executive is prohibited from engaging in acts of self-dealing that unfairly diminish the value of the non-executive interest. 457 S.W.3d at 74. *Bradshaw* did not limit the application of this standard to cases where the executive has executed a lease, so it was surprising when *Texas Outfitters* held that *Bradshaw* does not apply to refusal-to-lease cases and that such cases are controlled by *Lesley v. Veterans Land Board*.

Lesley was an action brought by non-executive mineral interest owners against the developer of a subdivision who also owned the executive right, alleging that restrictive covenants imposed by the developer breached the developer’s duty as executive. The restrictive covenants limited oil and gas development in order to protect the lot owners from drilling and production activities. The trial court granted summary judgment in favor of the non-executive mineral owners. The court of appeals reversed on the grounds that the developer, having never leased the minerals, had not exercised the executive right and had no duty to the non-executive mineral owners until it did so. The court further held that if the developer ever did lease the minerals, its only duty would be to obtain for the non-executives the same benefits it obtained for itself.

The Supreme Court in *Lesley* reversed the court of appeals, holding that the developer actually had exercised its executive right to limit future leasing by imposing the restrictive covenants. On that basis, the court held that the developer had breached the executive right by obtaining benefits for himself from its exercise to the exclusion of the non-executives. 352 S.W.3d at 491. In reaching this result, the Court *in dicta* stated that “if the [executive’s] refusal to lease is arbitrary or motivated by self-interest to the non-executive’s detriment, the executive may have breached his duty.” This was the language relied upon by the court in *Texas Outfitters* as establishing the standard applicable to the executive in refusal-to-lease cases. The standard is much different than the standard in *Bradshaw* and more favorable to the non-executive. Under *Texas Outfitters*, the non-executive only needs to show self-interest on the part of the executive rather than self-dealing, and only needs to show a detriment to his interest caused by the executive rather than a reduction in the value of his interest.

Given the decisions in *Bradshaw* and *Texas Outfitters*, guidance is needed from the Supreme Court with respect to the applicable standard for determining whether the

executive duty has been breached. Is the standard in *Bradshaw* to be applied to all alleged breaches of the duty? Or is *Bradshaw* to be applied only in cases alleging a breach based on the execution of lease, and *Lesley/Texas Outfitters* in cases alleging a breach based on a refusal to lease? Practitioners need to know which approach is the law in Texas. Guidance is also needed with regard to whether an executive must subordinate his interests to those of the non-executive.

Of the two approaches, it seems that *Bradshaw* would be the better alternative because it would likely avoid some undesirable consequences that may result if the approach in *Texas Outfitters* is followed. For example, under *Texas Outfitters* the executive would never be able to consider his own self-interest when exercising the executive right because that would expose him to liability. This would transform the duty of the executive into a classic fiduciary standard, which is not the standard articulated by the court in *Bradshaw* only three years ago when it stated that an executive is not required to subjugate his interests to those of the non-executive.

Further, if *Texas Outfitters* is followed it will put the executive at risk virtually every time he declines an opportunity to lease, even if he does so in the good faith belief that the market is rising and lease terms will improve. This is so because if the executive's market sense proves to be incorrect and the market declines (or disappears), the non-executive is likely to assert a claim on the basis that the executive's refusal to lease has been "detrimental" to his interest. On the other hand, if the executive elects to execute a lease early in the negotiating cycle in order to avoid a possible decline in the market but the market later rises, the executive may face a claim by the non-executive that he should have waited for the market to mature before leasing and his failure to do so has been "detrimental" to the non-executive's interest.

These consequences are less likely to occur under the *Bradshaw* standard. First, the standard of conduct required of the executive under *Bradshaw* is clearly not a classic fiduciary standard because the executive is not required to subjugate his interests to those of the non-executive. Second, the exposure of the executive to claims of breach under *Bradshaw* is not as extreme as under *Texas Outfitters* because *Bradshaw* requires proof of self-dealing on the part of the executive rather than mere self-interest, and proof that the value of the non-executive's interest has been unfairly diminished by the executive's action, rather than

proof of a mere "detriment" to the non-executive's interest.

V. Conclusion

The decision of the court of appeals in *Texas Outfitters* has created confusion for practitioners with regard to the standard for determining whether an executive has breached his duty to a non-executive, and whether an executive is required to subordinate his interests to those of the non-executive. The Supreme Court has granted the petition for review and it is hoped will provide guidance to practitioners on both of these issues.

Stuart Hollimon is a Partner with Hunton Andrews Kurth LLP. He is the former Chairman of the Oil, Gas and Mineral Law Section of the State Bar of Texas and was named Lawyer of the Year in Oil and Gas Law in Houston by Best Lawyers in 2015. ★