

# Fractionalization *What in the world does that mean?!*

“Fractionalization” and “dilution of interest” are terms used to describe the transfer and/or division of mineral interest into increasingly smaller pieces, sometimes to the point where the owners end up with a miniscule or almost zero interest. What starts as a large interest can become of little or no value to its owner as it is divided from one generation to the next.

Mineral interest owners are an important part of the oil and gas industry. However, many interest owners have not considered the fractionalization problem and just assume that the interests will pass on to their children and continue to hold their value. The more an interest is divided, the less valuable it becomes and the less power the owner has in a mineral lease negotiation.

Here is a common example of how these mineral interests shrink from one generation to the next:

**1860** – John Smith acquires a 200-acre family farm and holds 100% of the mineral interest. (200 net mineral acres)

**1870** – John Smith dies and the farm passes to his wife, Mary Smith.

**1875** – Mary Smith needs some money, so she sells half of the farm and the accompanying mineral interest to an unrelated person. She retains 100 acres with the minerals until she dies in 1880. (100 net mineral acres)

**1880** – Mary Smith dies and leaves the farm, undivided to her 4 children, Bob, Ann, Sally, and Rob. (They each have 25 net mineral acres)

**1900** – Bob, Ann, and Sally decide to sell their interests in the farm. Rob can't afford to buy their interests. So they divide the 100 acres so that Rob has 25 acres and the rest is sold.



**1930** – Rob is struggling to recover from the Great Depression. He sells 20 acres (with minerals) to make ends meet and only keeps 5 acres with minerals.

**1938** – Rob executes a lease for his 5 acres, which is included in a 160-acre unit. He negotiates a 1/8 royalty. ( $5/160 \times 1/8 = 0.00390625$ )

**1940** – Rob dies (after his wife) and leaves his interest to his 5 children. ( $5/0.00390625 = 0.0078125$ ).

**1970** – One of Rob's children, Martha, dies and leaves her interest 1/2 to her husband and half to her 3 children. (Each child gets  $1/3 \times 1/2 \times 0.0078125 = 0.00013020832$ ).

**2000** – One of Martha's children, Zachary, dies and leaves his interest to his 5 children. ( $1/5 \times 0.00013020832 = 0.000026041664$ ).

As these mineral interests become fractionalized, it is easy to see how the oil and gas payments get smaller and smaller. If the production has continued under the 1938 lease, the payments would likely be miniscule compared to the paperwork required to properly pay the fractionalized mineral interest owners. If all of the other owners of the 160-acre unit became this fractionalized, the company would likely just shut down production on an otherwise marginal old well due to the ridiculous amount of paperwork required to properly pay the fractionalized owners. If the well produced 50 barrels/day, that would be 1500 barrels/month. If the sale price was \$60/barrel, that would mean the well made \$90,000 per month. Each one of Zachary's children would be due a check for ( $0.000026041664 \times \$90,000 =$ ) \$2.34.

If this was the only family that fractionalized, those checks may keep coming for a while; if most were this fractionalized, it is unlikely they would continue producing this well. So, what can be done?

There are a lot of ways to prevent and/or repair the “fractionalization” of a family's minerals.

1. A family can create a Family Limited Partnership to hold the mineral interest during their lifetime. This keeps the interest intact and can offer some estate tax and liability benefits as well.
2. Mineral interests may remain intact by creating a trust in one's will which provides that the interest remains intact for the benefit of the heirs.
3. Whole interests may be transferred at the time of death or during a person's lifetime to a single person.
4. If a group of siblings wants to reconsolidate their interests, they can do so by creating a family limited partnership to hold the interest.
5. If the interest is just too small to justify doing any of the above, a family can consider:
  - a. donating small interests to charities; or
  - b. accepting royalty buy-back offers;
  - c. selling the interests outright.

It's great to be a mineral interest owner, but it is a blessing that comes with some work. To keep mineral interests valuable for yourself and the following generations, it is important to be a good steward and retain your negotiating strength by using the strategies listed above. It is important to speak with a knowledgeable oil and gas attorney to determine which strategy makes the most sense for your family. In one county, it may not make sense to pursue a family limited partnership for 50 net mineral acres owned; in another, it may be imperative that you do so. Every mineral interest is as different as every family. Do your research.