Unclaimed Property in the Oil and Gas Industry: What Companies Need To Know About Mineral Proceeds Suspense Accounts

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Oil and gas companies hold mineral proceeds or royalties in suspense accounts for a variety of reasons. As oil and gas companies are increasingly becoming the target of state unclaimed property audits, mineral proceeds and suspense accounts are usually a key part of these audits. 1 State escheat laws present a challenge to every holder of mineral proceeds. As stated by the Texas State Comptroller’s Office in its instructions to its own auditors, "royalty suspense ledgers are a necessary part of any accounting system and here, as elsewhere, unclaimed property appears as an exception to the normal flow of business." 2 Although unclaimed property statutes have been in existence for several decades, companies that may have inadvertently chosen to ignore them are beginning to take serious initiative towards addressing the effects unclaimed property has on firm operations. Three key factors have contributed to this trend. First, as a majority of states struggle with budget deficits, unclaimed property revenues afford a politically expedient way to increase cash flow without raising taxes. Delaware, which is an attractive state of incorporation for many companies, boasts unclaimed property as the third-largest source of revenue in the state. 3 Second, a considerable rise in third-party contract auditors has had a significant impact on the number of companies undergoing unclaimed property audits in recent years. 4 Finally, as companies seek to increase the accuracy of their financial statements as a result of the Sarbanes-Oxley Act, the importance of complying with unclaimed property laws has become increasingly important. 5 This article provides an overview of unclaimed property, discusses specific issues holders of mineral proceeds are forced to face, summarizes global challenges oil and gas companies typically encounter, and concludes by discussing how oil and gas companies can mitigate unclaimed property exposure risk.

Unclaimed Property Overview

The types of property covered by state unclaimed property law generally involve intangible personal property and may include unredeemed gift cards, uncashed checks, outstanding customer accounts receivable credit balances, unclaimed stock and dividend obligations, mineral proceeds, and customer deposits.

Unclaimed property generally has four basic characteristics:
(1) The property is intangible personal property (e.g., uncashed checks, outstanding customer credit balances, unclaimed stock certificates) subject to certain narrow exceptions for certain types of tangible personal property, such as contents of safe deposit boxes.

(2) Owner-generated activity ceases to occur with respect to the property.

(3) The property remains unclaimed by the owner for a period of time prescribed in the statutes as the "dormancy" or "abandonment period."

(4) There is a "fixed and certain obligation" owed by the holder to the owner.

Although the 1954 Unclaimed Property Uniform Act first set forth the rights of the states in a comprehensive fashion, it was not until the late 1970s that states began to prioritize efforts to determine if holders were in compliance with the unclaimed property laws.

Under the rules of jurisdiction or "priority rules" promulgated by the U.S. Supreme Court in the seminal case of Texas v. New Jersey, the state with the first right to claim the property is the state of the owner's last known address, as shown on the holder's books and records. If the holder does not have the last known address of the owner, which would be sufficient for the delivery of mail, then the state with the secondary right to claim the property is the state of the holder's "domicile," which generally is the state of the holder's incorporation for corporations, and state of formation or organization for holders other than corporations. The priority rules allow the state to hold the property in a custodial capacity until claimed by the owner.

**Unclaimed Property Issues Unique to Mineral Proceeds**

By way of background, the leasing or purchasing of minerals involves contractual and/or property obligations pertaining to the underlying mineral interest, which involve the disbursement of mineral proceeds. A mineral interest is fundamentally an interest in real property, while proceeds from the sale of oil and gas production are considered intangible personal property subject to unclaimed property statutes. The unclaimed periodic payment stream that emanates from the mineral interest itself is the property that the states expect to acquire in a custodial capacity. Our understanding is that traditionally, state unclaimed property authorities have preferred to receive the periodic payments associated with the mineral interest, as opposed to taking title to the underlying mineral interest themselves. Thus, as stated by one analyst, "With few exceptions, most state escheat laws do not include the underlying mineral interest in descriptions of the property abandoned."

First, the issue of whether the mineral proceeds in suspense give rise to a "fixed and certain" obligation should be considered. As stated by the Commentary of the Uniform Law Commissioners to Section 1 of the 1995 Uniform Unclaimed Property Act, one of the key elements in determining whether property should be classified as an unclaimed property liability is that the obligation must be "fixed and certain," which the Commentary further states "excludes unliquidated claims from the coverage of the Act, such as disputed tort claims."

Oil and gas companies will suspend royalties for a variety of reasons, including, but not limited to title
disputes, clouded titles, unexecuted division orders, and/or pending litigation. These companies are routinely faced with the question of whether suspended royalty payments represent fixed and certain obligations during title disputes and/or pending litigation. Oil and gas companies will commonly move funds out of pay status and place them in suspense until the title dispute and/or pending litigation is resolved. As mentioned above, oil and gas companies will use "suspense funds" as an accounting tool to hold royalty payments and other unclaimed funds that do not necessarily belong to the company.  

Second, due to the numerous reasons why funds may be placed in suspense, we recommend that an advisor with experience in this area—such as a law firm or a consulting firm—be consulted to determine if each category of suspended funds should be coded as "reportable" or "non-reportable." For example, the Oklahoma court, in the Phillips Petroleum Co. ("Phillips") v. Oklahoma Tax Commission ("OTC") case, ruled in part that mineral proceeds suspended due to "title requirements" should be considered unclaimed property. However, commentators discussing the ruling have stated as follows: "In some instances, such as a "stale" title problem, this may make sense. However, in other situations, where an ongoing, bona fide title dispute exists, there may not be a "fixed and certain" obligation to pay any identifiable person until the title dispute is resolved. The Commentary to Section 1 of the 1995 Uniform Unclaimed Property Act states in pertinent part: "The requirement that the right be fixed and certain excludes unliquidated claims from the coverage of the Act, such as disputed tort claims." Clearly disputed contract claims would be another type of unliquidated claim that should not be subject to a state's unclaimed property law. In that case, escheatment would be premature and would improperly intrude on the orderly determination of the issue. As long as measures are being taken to resolve the title dispute/pending litigation, the monies associated with the dispute should not be considered unclaimed property."  

Moreover, a review of the Utah State Treasurer's website on January 24, 2013, indicates, under the heading "FAQs-Holder Information," a question that asks "Is Disputed Property Reportable?" They conclude that "When the holder is aware that the ownership interest is in dispute or unsettled, the property is not reportable."  

Third, it is important to note that oil and gas is a mature industry. As such, many division orders have gone through three generations, and the related decimal interests are getting smaller, further complicating the associated division of interests. In terms of unclaimed property, this leads to more "owner unknown" property, or to smaller amounts in the title disputes area that may not merit an attorney cleaning up via a title opinion.  

Fourth, oil and gas companies should be aware that about half of the states have "current pay" or "current balance" rules that apply to the payment of mineral proceeds. As stated by authors of a leading treatise in this area: "Current pay refers to a series of payments to be made by a holder to an owner as a result of an owner's interest in unclaimed property (such as a series of...mineral interest payments.) Once the abandonment period for the first such payment has run, all subsequent payments due, held or owing for that owner (referred to as "current pay funds") become reportable as unclaimed property, despite the fact that the abandonment
period for all payments in the series have not fully run. Simply put, once any single mineral proceeds payment has met the prescribed abandonment period for that state, residual payments are then "currently due," regardless of whether the residual payments have individually met the stipulated abandonment period. While easy to articulate, the reporting of mineral proceeds on a "current pay" basis can be complex and requires a careful review of each state's reporting form and attendant reporting instructions. For example, the Texas State Comptroller's office has now indicated reporting code MI10 is to be used solely for the reporting of mineral proceeds on a current pay basis.

Finally, there are a number of "miscellaneous" oil and gas statutes that indirectly have a bearing on how unclaimed mineral proceeds are handled by a company. Although a detailed analysis of these laws is beyond the scope of this article, a brief mention will be made of escrow account laws, which can apply to certain types of outstanding mineral proceeds. For example, the Oklahoma Unclaimed Pooled Monies Act ("Act"), 52 O.S. Sections 551 et seq., regulates the disposition of unclaimed mineral proceeds emanating from forced pooled oil and gas interests located in Oklahoma, where the owners of such proceeds cannot be located or are unknown. If a holder, such as the company, identifies mineral proceeds due and owing to an unlocatable or unknown owner, which are required to be paid under a pooling order issued pursuant to Section 87.1 of Title 52 of the Oklahoma Statutes, then the holder generally is required to establish an escrow account for the benefit of the rightful recipient of the monies and report and remit the funds to the Oklahoma Corporation Commission's ("OCC") Mineral Owners Fund. Significantly, perhaps unlike any other state, a holder of unclaimed monies in Oklahoma may be required to deal with two separate state agencies in terms of its escheat responsibilities, assuming it also has unclaimed "forced pooled" funds. The OCC is responsible for administering unclaimed mineral proceeds subject to the Act, while other unclaimed funds, such as mineral proceeds not subject to the Act, are subject to the Oklahoma Uniform Unclaimed Property Act, 60 O.S. Sections 651 et seq., administered by the Oklahoma State Treasurer.

**Unclaimed Property Challenges**

Oil and gas companies face a variety of industry-wide challenges in attempting to stay fully apprised of unclaimed property developments and best practices. Typically, these companies are very active in merger and acquisition transactions. Companies are challenged with carefully managing unclaimed property risks when integrating another company into their operations. Failure to investigate unclaimed property as an area of concern prior to closing may result in unanticipated liabilities and non-compliance. Therefore, before entering into any mergers or acquisitions, companies should consider performing due diligence above and beyond normal areas of concern to determine if the entity being acquired is in absolute compliance with the multitude of unclaimed property laws. Once in possession of the facts, the purchaser can make an informed decision regarding whether to exclude certain suspense accounts from the purchase or take other appropriate action to protect its interests.
As previously mentioned, many states have found unclaimed property audits to be a major source of revenue. Therefore, it is very common for states to outsource examinations to contract auditors, who conduct contingent fee unclaimed property audits on their behalf. Mineral proceeds represent unchartered territory for unclaimed property auditors in the sense that there is no standard approach to test this area. It is not uncommon to run across significant variations of audit methodology within the same examination. Unfortunately, having a selection of methodologies results in a less than favorable situation for holders—it usually boils down to employing the method that yields a significant assessment—and can cause audits to last three to five years or longer. In addition, auditors generally take the position that everything in their large testing sample is unclaimed property—companies are then tasked with the burden of proving the ultimate disposition of each potential unclaimed property obligation, regardless of the cost/benefit relationship to research.

There are generally no statutes of limitation in the unclaimed property arena, and a number of states reserve the right to “look-back” for extended periods on audit. When a lack of records for historical periods deems a holder unable to furnish actual data, state auditors typically rely on estimation techniques to estimate the unclaimed property liability. Perhaps the most important defense an oil and gas holder can have to diminish estimation exposure is to have reliable records going back in time, specifically (but not limited to) suspended mineral proceeds.

**Recommendations and Best Practices**

Unclaimed property, specifically mineral proceeds suspense accounts, is a serious issue that needs to be addressed by all oil and gas companies. It is important to note that unclaimed property, while technically not a tax, "is enforced by state regulatory bodies like a tax, and, like a tax return, must be reported every year." Companies should strive to be compliant and diligent, just as they are with their tax returns, as states are becoming more and more aggressive on examinations or audits of companies. Proper accounting and proactive maintenance of records will help limit the exposure.

Adverse unclaimed property ramifications associated with mineral proceeds suspense accounts can be avoided by taking necessary precautions and enacting best practices to remain informed. At a minimum, holders of mineral proceeds suspense accounts should regularly request the detail for the suspense ledger used in preparing unclaimed property reports in order to review which accounts are being reported and which are not; documentation should be obtained for any accounts that are not being reported. Best practices may include:

- Performing an internal unclaimed property risk assessment at the direction of the company's legal counsel,
- Engaging the company's legal advisor to periodically perform title work when appropriate,
• Reviewing any suspense accounts acquired in a merger or acquisition transaction as part of the due diligence process before the deal closes and carefully monitoring suspense accounts thereafter, and

• Ensuring that the individuals responsible for escheating mineral proceeds held in suspense have periodic training—for example, by attending an educational conference such as the Unclaimed Property Professionals Organization conference.

These best practices, along with a robust set of internal controls, can mitigate unclaimed property exposure risk for oil and gas companies.

In summary, unclaimed property continues to grow in importance to both state regulators and companies in the oil and gas industry. By understanding this area and ensuring compliance with applicable laws, oil and gas companies can mitigate unclaimed property exposure—minimizing financial risk and avoiding adverse publicity.

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As used herein, the term "Mineral Proceeds" is used broadly to refer collectively to the property types represented by NAUPA codes currently in use by most states for categorizing Mineral Proceeds for purposes of unclaimed property reporting (i.e., MI01-net revenue interests, MI02-royalties, MI03-overriding royalties, MI04-production payments, MI05-working interests, MI06-bonuses, MI07-delay rentals, MI08-shut-in royalties, and MI09-minimum royalties). We note that the term "Mineral Proceeds" is also defined in Section 1(9) of the 1995 Uniform Unclaimed Property Act. Also, as used herein, the term "suspense accounts" refers to those Mineral Proceeds that have been placed in a holder's internal suspense account pursuant to procedures of a particular company or holder.

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See F.D. Spiegelberg, Esq., S. Schaunaman, and A. Andreoli, The American Oil & Gas Reporter, What Oil & Gas Companies Need to Know About Unclaimed Property: A Primer for the Industry, Vol. 47 No. 5,6, and 7 (June-July 2004) at p. 2.


See P. Smith, “Unclaimed Property Statutes and the Management of Production Proceeds,” Rocky Mountain Mineral Law Forty-Fourth Annual Institute (1998), at pp.7–8. Such analyst further states: “One reason that most state laws do not include the underlying mineral interest is that state unclaimed property administrators are traditionally not staffed or funded to undertake all the responsibilities that taking custody of such property would entail. The duties of maintaining custody of cash or securities are minimal and passive, for the most part. The responsibilities of negotiating leases for development of the minerals or responding to a tort action would add a significant level of administration to state unclaimed property programs.”

The Uniform Acts were created by the National Conference of Commissioners on Uniform State Laws (“NCCUSL”). As indicated on their website—www.nccusl.org—the goal of the NCCUSL is to “study and review the laws of the states to determine which areas of law should be uniform...and to promote the principle of uniformity by drafting and proposing specific statutes in areas of the law where uniformity between the states is desirable.” Note: The uniform acts are normative in nature (i.e., they are not the law in any jurisdiction unless and until adopted by a particular state legislature).


See Michael Houghton et al., Unclaimed Property, 74-2nd C.P.S. (BNA), Worksheet 10. This treatise was co-authored by representatives of the Morris, Nichols, Arsh & Tunnell LLP law firm and Ryan, LLC.

See *American Petrofina v. Nance*, 859 F.2d 840 (10th Cir. 1988). Note: In the American Petrofina opinion, it was ruled that "unclaimed property" is not a tax; rather, the opinion indicated, it is a "property right."