

**Oil & Gas:  
Valuation, Surface Rights and Mineral Interests**

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**33<sup>rd</sup> ANNUAL ADVANCED FAMILY LAW COURSE**

August 6-9, 2007

San Antonio

**CHAPTER 6**

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## **EDUCATION:**

1946-1949: Attended TWU (back when it was T.S.C.W.) in Denton

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1965-1967: Attended John Carroll University in University Heights, Ohio. Graduated from JCU in 1967 with bachelors in mathematics

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1954-1964: Employed by a geophysical contract company on seismic crews, primarily in South Louisiana, including offshore crews

1964-1965: Self employed as geophysical consultant in Ohio

1976-1980: Self employed practicing oil and gas law in Ohio, with office location in Shaker Heights, Ohio

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"Top Evidentiary Problems in Family Law", Nunneley, Barbara, Family Law on the Front Lines, University of Texas School of Law, June 2007, Galveston, Texas.

"Prescription for Divorce", Drug and Disorder Issues in Family Law, Nunneley, Barbara & Robinson, Laurie, 30<sup>th</sup> Annual Marriage Dissolution Institute, State Bar of Texas, May 2007, El Paso, Texas.

"Practical Custody Litigation Strategies", Nunneley, Barbara, Family Law Practice Seminar, University of Houston, November 2006, Dallas, Texas.

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"Legislative Changes and Case Law Update", Nunneley, Barbara, Texas Center for the Judiciary, Associate Judges Conference, July 2006, Austin, Texas.

"Child Custody", Nunneley, Barbara, State Bar College Summer School 2006, State Bar of Texas, July 2006, Galveston, Texas.

"Discovery", Nunneley, Barbara, Family Law on the Front Lines, University of Texas School of Law, June 2006, Galveston, Texas.

"Handling the Custody Case on a Shoestring", Nunneley, Barbara, Texas Bar Journal, Vol. 69, No. 5, May 2006.

"Family Law Update", Nunneley, Barbara and Emerson, Sally, Texas Center for the Judiciary, 2006 Winter Regional Conference, February 2006, Horseshoe Bay, Texas.

"Pretrial Preparation", Nunneley, Barbara, 20<sup>th</sup> Annual Texas Academy of Family Law Specialists Trial Institute (TAFLS), January 2006, Reno, Nevada.

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## OIL & GAS: VALUATION, SURFACE RIGHTS AND MINERAL INTERESTS

### I. INTRODUCTION

The purpose of this paper is to set forth the basic principles and concepts in handling oil and gas matters. It is not intended to be an oil and gas law short course.

### II. NATURE OF INTERESTS IN OIL AND GAS CLASSIFICATIONS AND CONSEQUENCES

#### A. Classification of Oil and Gas Interests in Texas.

Texas law holds that the nature of a landowner's interest in oil and gas in place beneath an owner's land is "ownership in place" as opposed to the "non-ownership" theory held in other states.

#### B. Landowner's Interests are Real Estate.

Oil and Gas are minerals and are part of the realty. *Texas Co. v. Daugherty*, 176 S.W. 717 (Tex, 1915). The Supreme Court stated:

It is no longer doubted that oil and gas within the ground are minerals . . . In place, they lie within the strata of the earth, and necessarily are a part of the realty.

In *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923), Greenwood, J., made the following oft-quoted comments:

We do not regard it as an open question in this state that oil and gas in place are minerals and realty, subject to ownership, severance, and sale while embedded in the sands or rocks beneath the earth's surface, in like manner and to the same extent as is coal or any other solid mineral.

#### C. What May Be Done with Respect to Oil and Gas by the Owner of the Land in Fee Simple Absolute.

A landowner has a fairly complex bundle of rights, powers, privileges and immunities vis-à-vis other persons with respect to the land, including, without limitation, the following:

1. drill a well and produce and dispose of any oil and gas recovered;

2. prohibit other persons from using the land for the purpose of exploring and producing oil and gas;
3. grant to another a mineral interest, a royalty interest, a leasehold interest (discussed below);
4. convey the land to another, excepting or reserving from the grant a mineral interest, royalty interest, or a leasehold interest;
5. by an appropriate instrument, the ownership of certain of the rights, powers, privileges and immunities may be separated from the estate in fee simple absolute in the land.

#### D. Mineral Interest.

A mineral interest may be created by grant or by reservation or exception. (1) the landowner may by an instrument usually described as a mineral deed, create in another a mineral interest, or (2) the landowner may convey land, excepting and reserving to herself a mineral interest. The mineral interest created by grant or reservation may be the entire mineral interest in the land or it may be an undivided interest in a part of the mineral interest; it may be in fee, fee simple defeasible, for life or for years.

The owner of a full mineral interest has the right to go on the land for the purpose of prospecting for, severing and removing all minerals; absent express negation in the instrument creating the interest, the mineral owner has certain easements in the surface of the land necessary or appropriate for exploiting the minerals. The owner of an undivided interest is a concurrent owner.

A severed mineral interest normally includes development and executive rights; however, the instrument creating interests in oil and gas may grant or reserve the executive rights for the entire tract of land.

The owner of a mineral interest, whether a full interest or an undivided part thereof, has the right (absent negation thereof in the instrument) to execute and deliver oil and gas leases; to receive bonuses and delay rentals and royalties.

#### E. Severance of Mineral Estate from Surface Estate.

The owner of land in fee simple absolute by appropriate instrument may sever the mineral estate from the surface estate by grant or reservation or

exception. The most common method of accomplishing the severance is by reservation or exception, e.g., the owner conveys the land reserving or excepting the oil, gas and other minerals from the grant. Severance may be accomplished by an instrument granting all of the oil, gas and other minerals to another.

**F. Royalty Interest.**

A royalty interest may be created by grant or by reservation or exception, just as a mineral interest. The interest differs from a mineral interest in that the owner of a royalty interest is not authorized to go upon the lands in which the royalty interest exists; is not authorized to execute oil and gas leases; is not entitled to share in bonuses or delay rentals. The royalty interest owner is entitled only to the owner's share of the royalty reserved in an oil and gas lease. The owner may grant all or a portion of her royalty interest to another. A royalty interest also differs from a mineral interest in that a royalty interest is not real property.

**G. Leasehold Interest.**

A mineral owner (as lessor) may create a leasehold interest in another by executing and delivering an instrument generally described as an oil and gas lease. The lessee under the oil and gas lease is given the exclusive right to go upon the land for the purpose of prospecting for oil and gas. The duration of lessee's authorization is for a stated term of years (the "primary term") and as long thereafter as oil or gas is produced from the land in paying quantities. Sometimes the term may be extended by operations other than production, e.g., by continuous drilling operations. The consideration for the authorization is an agreement by the lessee to deliver to lessor a share of the product of the land, or the proceeds thereof, free of costs, described as a royalty. The lessor usually receives a cash consideration (the "bonus") upon execution of the lease and be given the benefit of certain covenants or promises by lessee relating to lessee's operations on the land. If the lease is not a "paid up" lease, the lessor will receive annual payments known as delay rentals. The lease will terminate upon either the expiration of the primary term or the cessation of continuous drilling operation, whichever event occurs last. Upon termination, the rights granted to the lessee revert to the lessor.

**III. MINERAL-ROYALTY DISTINCTION**

The instrument creating the mineral and royalty interests may vary the usual distinction between the two. Such variations are beyond the scope of this paper and

are not necessary for understanding the basic principles of oil and gas law. The following chart should make the distinctions clear.

Right and/or Privilege	<u>Mineral Owner</u>	<u>Royalty Owner</u>
Prospect for oil and gas on the land	Yes	No
Create a leasehold interest, i.e., execute and deliver an oil and gas lease	Yes	No
Possess a possibility of reverter	Yes	No
Receive bonus	Yes	No
Receive delay rentals	Yes	No
Receive royalty (share or proceeds of product)	Yes	Yes

**IV. SEVERANCE OF MINERAL AND SURFACE ESTATES**

The landowner of land in fee simple absolute may by appropriate instrument sever the minerals from the surface, creating two separate estates — a Mineral Estate and a Surface Estate.

The mineral estate is the dominate estate and the surface estate the subservient estate. The owner of the mineral estate has the right to use as much of the surface estate as is reasonably necessary to prospect for, drill, produce, treat and remove the minerals.

The lessee of the land may pay the owner of the surface estate for damages caused by lessee's operations. Such damage payments are negotiated by the lessee and the surface owner. The mineral estate owner will not be a party to the agreement.

**V. LAND TITLE FROM THE SOVEREIGNTY — TEXAS UNDER SPANISH, MEXICAN, REPUBLIC AND STATE GOVERNMENTS**

Because oil and gas are minerals and are real estate, a brief discussion of land titles is appropriate. Transactions in minerals are governed by and subject to all of the laws relative to real property transactions.

Inception of title to land is with the sovereignty. What is now Texas was, from 1727 to 1821, a province of New Spain, subject to the Spanish monarchy. In 1821, Iturbide declared the Mexican Independence from Spain. By a series of Acts, Coahuila and Texas became

a state of the Mexican Confederacy. Texas made several abortive attempts to become accepted as an independent state of the Mexican confederacy. The revolutionary movements in Mexico resulted in the replacement of the republican form of government with a succession of dictatorships.

A consultation of the representatives of all Texas was called, and on November 7, 1835, the convention adopted a declaration refusing to recognize the existing authorities of the Mexican confederacy. On November 13, 1835, the provisional government adopted its "plans and powers" and required all persons concerned with the locations of lands to cease their operations.

The Republic of Texas, as a new government declared her independence on March 2, 1836. After a few years as a Republic, Texas became a part of the United States on December 29, 1845, and its state government which has continued to the present, became initially organized on February 16, 1846, with the acts of the officers of the Republic of Texas prior to that date being held valid.

The vested rights in property, acquired under the former governments having dominion over what is now Texas, were not disturbed when Texas separated from Mexico (as part of Coahuila and Texas). When it later became a republic and finally a state, Texas had the unique distinction of having retained title to its unappropriated and vacant lands.

There are acts and statutes, supported by court decisions, which may be looked to for the validation or confirmation by the governments of Texas concerning land titles issued by former governments exercising sovereign rights over lands in Texas.

Examination of title to land to ascertain the record owners begins with the Spanish land grants, continues with the Mexican and Republic of Texas and state grants.

The grants, sales by the original grantee and subsequent sales are recorded in the office of the county clerks wherein the lands are located, except for counties that were not in existence in the early days of statehood. Examples of those counties in South Texas are Brooks and Jim Hogg counties, and the early records will be found in Hidalgo and Starr counties.

In order to ascertain record title to a specific tract of land, one must prove a continuous chain of title from the sovereign to the present.

Mineral interests are subject to all of the laws relating to conveyances, exceptions, reservations, recording, etc., of real property.

### *Appendix*

#### **EXHIBIT I:**

Warranty Deed conveying the surface and reserving all oil, gas and other minerals. The Deed accomplishes a severance of the Mineral and Surface Estates.

#### **EXHIBIT II:**

Warranty Deed reserving an undivided 1/4 of Grantor's oil, gas and other minerals. It is an example of creation of a mineral interest by reservation (in Grantor) and by grant (in Grantee).

#### **EXHIBIT III:**

Mineral Deed creates a mineral interest by grant.

#### **EXHIBIT IV:**

Royalty Deed creates a royalty interest by grant.

#### **EXHIBIT V:**

Term Royalty Deed creates a royalty interest for a term of 20 years and as long thereafter as oil, gas or other minerals are produced in paying quantities. If, at the expiration of the 20 year period there is no production, the deed is null and void.

#### **EXHIBIT VI:**

Term Mineral Deed creates a mineral interest for a term of 20 years and as long thereafter as oil, gas or other minerals are produced in paying quantities. If, at the expiration of the 20 year period there is no production, the interest terminates; but if there is a valid lease covering the lands at the end of 20 years, the interest continues as long as the lease is in full force and effect.

#### **EXHIBIT VII:**

Gift Mineral Deed With Reservation of Life Estate grants a mineral interest to Grantee, but possession and benefits of the minerals are postponed until Grantor dies. The language "Grantor excepts and reserves for Grantor and Grantor's assigns . . . as well as the rents, issues and profits from it, for and during Grantor's natural life" means that Grantor is entitled to all of the of payments which accrue. Ordinarily, a life tenant does not share in the bonuses paid upon execution of an oil and gas lease.

#### **EXHIBIT VIII:**

Mineral Deed of Life Estate With Remainder Over creates a life estate in Grantee during Grantee's natural life, with the remainder over at Grantee's death to Grantee's heirs at law.

#### **EXHIBIT IX:**

Waiver and Release of Surface Rights. Waives Mineral Owner's right of ingress, egress and use of the surface so Surface Owner has complete use of the surface.

## VI. CHARACTERIZATION

Our Texas case law is rich in oil and gas traditions as illustrated by some of our seminole cases. A review of these early cases in Texas law finds that the courts were making determinations of the character of oil and gas, delay rentals, bonuses, royalties and minerals in place as early as the 1950's.

*Norris v. Vaughan*, 152 Tex. 491, 260 S.W. 2d 676 (1953).

In this case, the respondent, Hal H. Vaughan and Beulah Hunsaker were married on August 16, 1941, and they lived together as husband and wife until the death of Mrs. Vaughan on May 17, 1947. The petitioner, Mrs. Norris, is the daughter of Mrs. Vaughan by a former marriage. Mrs. Vaughan died intestate, and Mrs. Norris is her sole and only heir. Petitioner admits in her pleadings that respondent was the owner of certain properties in his own separate right, but contends that this property was natural gas producing and that the income, as the result of gas production, after the date of marriage of her mother to Mr. Vaughan, was and is community property. It was further alleged by petitioner that all the property involved was in the possession of the respondent, and that a full and complete accounting, which she requested be made by respondent, would disclose that she owned an interest in the property acquired between the dates of August 16, 1941 and May 17, 1947.

Prior to his marriage to petitioner's mother, the respondent owned as his separate estate:

1. A 7/8ths determinable fee, as lessee, in seven producing gas wells, known as the "Pakan Wells";
2. A 1/4th interest in the Shamrock Gas Co., a partnership;
3. A 1/4th interest in the Vaughan Well Co., a partnership;
4. A 1/2 interest in the partnership of Pendleton & Vaughan.

During the marriage the partnership drilled ten gas wells, seven of which were producers.

It is well established in Texas that the lessee in the usual oil and gas lease obtains a determinable fee in the oil and gas in place, and thus an interest in realty. *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923); *Hager et al. v. Stakes, Tex Collector, et al.*, 116 Tex. 453, 294 S.W. 835 (1927); *Stephens v. Stephens*, 292 S.W. 290 (Texas Civ.

App.- - Amarillo 1927). The lessee's determinable fee interest will last only so long as oil or gas is produced, and it is a matter of judicial knowledge that oil and gas producing territory will become exhausted in time. *U.S. v. Ludey*, 274 U.S. 295, 47 S.Ct. 608 (1927). Therefore. Production of this natural gas will in time exhaust the gas reserves which comprise the separate estate. Production and sale of the natural gas in this instance is equivalent to a piecemeal sale of the separate corpus, and funds acquired through a sale of separate corpus, if traced, will remain separate property. *Love v. Robertson*, 7 Tex. 6; *Rose v. Houston*, 11 Tex. 324 (1854); *Gleich et al v. Bongio et al.*, 128 Tex. 606, 99 S.W. 2d 881 (Comm'n App. 1937). When royalty is paid for oil or gas produced from the separate property of the lessor, the courts of this state have held that such royalty is payment for the extraction or waste of the separate estate and therefore remains separate property. *Lessing v. Russel*, 234 S.W.2d 891 (Tex. Civ. App.- - Austin 1950, writ refused n.r.e.). *Texas Co. v. Parks*, 247 S.W.2d 179 (Tex. Civ. App.- - Fort Worth 1952 writ refused n.r.e.). *Bantuelle v. Bantuelle*, 195 S.W. 2d 686 (Tex. Civ. App.- - Texarkana 1946).

The next asset to be considered is the respondent's one-fourth interest in the Shamrock Gas Co. This partnership maintained distribution facilities and retailed natural gas to residences in and around Shamrock, Texas. This Company buys its natural gas from the Vaughan Well Co. and owns no gas producing property of its own. Respondent acquired his interest in this partnership prior to his marriage and his interest therein would be his separate property. During the period of coverture the respondent drew some \$ 28,100 in salary and profits from the Shamrock Gas Co. Such sums were community funds as income and salary from a business enterprise, but respondent's interest in the partnership retains its separate nature. *Hardee v. Vincent*, 136 Tex. 99, 147 S.W. 2d 1072 (Comm'n App. 1941).

*Cone v. Cone*, 266 S.W.2d 480 (Tex. Civ. App.- - Amarillo 1953 writ dism'd).

Appellant, Adeline Z. Cone, and appellee, S. E. Cone, were married on February 6, 1938. The parties are now divorcing and their property rights have been settled other than the 7/8 working interest in a oil and gas lease in Hockley County, Texas, and containing 111.5 acres. It is the wife's contention that this leasehold interest was acquired during her marriage to appellee and was therefore community property in which she owned one-half interest. In the alternative she

pleaded that if such leasehold was acquired by appellee prior to the marriage and constituted his separate property, that by the expenditure of community time, effort, skill, and funds the leasehold had been enhanced in value and that the community estate was entitled to reimbursement as to the enhanced value.

The trial court found that appellee had acquired the leasehold interest by the payment of the sum of \$ 550 and that such payment was made prior to appellee's marriage to appellant. The court further found that the community estate had expended the sum of \$ 105,899.60 in developing and equipping said property for the production oil and gas and that there were four producing oil wells on the land. Appellee was awarded title to the leasehold interest and appellant was awarded the sum of \$ 52,949.80 as one-half of the community funds expended in developing the lease. Appellant was allowed the further sum of 6 percent interest on the sum awarded her.

Appellant claims the trial court erred in not holding that the leaseholds interest was community property of appellant and appellee. This point is based upon appellant's proposition that since the leasehold was acquired during the marriage it was presumed to be community property and that such presumption was not rebutted by the evidence presented by appellee as to the separate character of the leasehold. The sole issue to be determined under this point of error is whether there is evidence of probative force in the record to support the trial court's finding that the title to the leasehold had its inception prior to the marriage of appellant and appellee. The character of appellee's title "whether separate or community, depends alone upon the existence, or nonexistence, of the marriage at the time of the incipency of the right in virtue of which he acquired title." *Colden v. Alexander*, 141 Tex. 134, 171 S.W. 2d 328 (1943).

Appellee contended that the incipency of his right and title to the leasehold was prior to his marriage to appellant and supported this contention by two elements of proof. Appellee introduced into evidence that H.L. Lowe on the 30<sup>th</sup> day of March, 1937, delivered to him an instrument which was in fact an assignments on the oil and gas lease in question. Appellee further introduced evidence that H. L. Lowe was not in fact the owner of the leasehold at any time but that the appellee had obtained the transfer from Rodgers to Lowe prior to the marriage of appellant and appellee and had paid the entire consideration and that Lowe merely held title to the lease in trust for him, the appellee. The trial court found that the incipency of the right in virtue of which

appellee acquired his title had its inception prior to the marriage of appellant and appellee.

*Read v. Read*, 634 S.W.2d 343 (Tex. App.- - Amarillo 1982, writ dism'd).

The parties were married on May 31, 1977. The marriage was dissolved on December 1, 1980. No children were born to or adopted by the parties during the marriage. Prior to the marriage, appellant was engaged in the oil and gas business, and appellee Carol Duborg Read was employed as a dental hygienist.

The husband asserts error in the award to appellee of a one-half interest in the oil and gas leases denominated as Banks-Nielson and Banks-Booth. Appellant argues that the award constituted a divestiture of his separate property prohibited by law. The appellant was engaged in exploration and production of oil and gas as his business and profession.

Property on rights acquired by one of the spouses after marriage by toil, talent, industry or other productive faculty is community property. *Norris v. Vaughan*, 152 Tex. 491, 260 S.W. 2d 676 (1953). It follows, we think, that when the acquisition and development of oil and gas interests are engaged in as a business, the profits therefrom are community. *Id.*, 260 S.W.2d at 682. The fact that separate funds may have been used in the development or operation of such oil and gas interest does not change the separate or community status of the property but only, if properly proved, entitles the separate estate to reimbursement. *Id.*

Delay rentals are rents that accrue by mere lapse of time and do not depend on the finding of production of oil or gas and do not exhaust any substance from the land.

Delay rentals paid on separate property are community income. *McGarraugh v. McGarraugh*, 177 S.W.2d. 296 (Tex. Civ. App. - Amarillo 1943, writ dism'd).

Bonus payments made for entering into oil and gas leases upon separate property remain separate. *Lessing v. Russel*, 234 S.W.2d 891 (Tex. Civ. App.- - Austin 1950, writ refused n.r.e.)

## VII. VALUATION

Although the family lawyer is not tasked with valuing a client's oil and gas property, he/she must be familiar with the methodologies used to calculate those valuations. This is the part where lawyer's eyes usually glaze over, but a working knowledge of discounting oil and gas income is essential when representing the client

with mineral interests or with an oil and gas business/company. We'll leave the valuating up to the experts, however, you need to be reasonably familiar with the various terms and methods in order to understand and advocate for fair market value.

The Texas Comptroller of Public Accounts (Susan Combs) is required by Section 23.175 of the Property Tax Code, enacted by the 73<sup>rd</sup> legislative, to distribute to each county appraisal district an appraisal manual that specifies the methods and procedures to calculate the present value of oil and gas properties using discounted future income. That will be our focus in this section of the paper. Following are excerpts from the manual and our thanks is given to the Comptroller's office for the use of the manual. This author's comments are in *italics*.

### A. Techniques

According to the manual there are three acceptable techniques for estimating discount rates:

1. market surveys,
2. oil and gas sales analysis and
3. weighted average cost of capital (WACC), also called "band of investment."

Together, these techniques provide a range of discount rates. The appraiser must estimate the risk for each oil or gas property to assign a discount rate from the discount rate range.

### B. Discounting

Because investors prefer immediate cash returns over future cash returns, investors pay less for future cash flows--they "discount" them. The amount investors discount the future cash flows depends on the length of time until the cash is due, the amount of risk that the cash will not be tendered when due and the rate of return available from other comparably risky investments. This discounting procedure converts future income to present value usually using annual discount factors. The discount factor for each successive year declines to reflect the reduced value of revenue received in the future. The appraiser calculates the present worth of the forecast revenue stream by multiplying the projected net income (cash flow) for each year by the calculated discount factor for that year. These discount factors are derived from the discount rate (also known as the yield rate), and the process is known as discounted cash flow (DCF) analysis.

The International Association of Assessing Officers in *Property Appraisal and Assessment Administration* (1990) defines "discount rate" as:

The rate of return on investment; the rate an investor requires to discount future income to its present worth. It is made up of an interest rate and an equity yield rate. Theoretical factors considered in setting a discount rate are the safe rate earned from a completely riskless investment (this rate may reflect anticipated loss of purchasing power due to inflation) and compensation for risk, lack of liquidity, and investment management expenses. The discount rate is most often estimated by band-of-investment analysis or a sales comparison analysis that estimates typical internal rates of return.

The discount rate is a key variable in discounted cash flow analysis, making correct rate selection crucial. The market's expectations are critical when estimating a discount rate. According to the *Appraisal of Real Estate* by the Appraisal Institute (1992):

The selection of a yield [discount] rate is critical to DCF analysis. To select an appropriate rate an appraiser must verify and interpret the attitudes and expectations of market participants, including buyers, sellers, advisers, and brokers. Although the actual yield on an investment cannot be calculated until the investment is sold, an investor may set a target yield for the investment before or during ownership. Historical yield rates derived from comparable sales may be relevant, but they reflect past, not future, benefits in the mind of the investor and may not be reliable indicators of current yield. Therefore, the selection of yield rates for discounting cash flows should focus on the prospective or forecast yield rates anticipated by typical buyers and sellers of comparable investments. An appraiser can verify investor assumptions directly by interviewing the parties to comparable sales transactions or indirectly by estimating the income expectancy and likely reversion for a comparable property and deriving a prospective yield rate.

### C. Discounted Cash Flow Appraisal

The DCF method is versatile and widely used to appraise income producing property. An appraiser using DCF first projects an anticipated net income for each year of the property's remaining economic life. Each annual cash flow is discounted to present value, and then all the present values are added to obtain the total market value of the real property interest being appraised. (*Remember: oil and gas are part of the land.*) The DCF equation is expressed as follows:

$$PV = CF_1 \times (PWF_1) + CF_2 \times (PWF_2) + \dots + CF_n \times (PWF_n)$$

where:

- $PV$  = present value, \$;  
 $CF$  = the cash flow or income for the period specified, \$;  
 $PWF$  = the end of period present worth factor, equals  $1/((1+i)^n)$ ;  
 $i$  = discount rate (the period compound interest rate);  
 $n$  = the period for the present worth factor being calculated

To estimate the present value (PV), an estimate of the income (cash flow) to be received in each period is necessary. The number of periods,  $n$ , (usually years) used in the analysis is determined by the number of years that the mineral property is expected to produce a positive net income.

There are many variations on the DCF formula. The formulas vary based on the time the money is received, i.e. continuously, beginning of period, middle of period or end of period. The period may be continuous, daily, monthly, quarterly, bi-annual or annual. Many oil properties are evaluated using an annual mid-period discounting variation of the DCF formula. The appropriate present worth factor for mid-year DCF analysis is:

$$PWF_{MY} = 1/((1+i)^{(n-.5)})$$

where:

$PWF_{MY}$  = mid-year present worth factor.

### D. Discount Rate Components

The discount rate used in discounted cash flow

analysis has several components. These include:

1. **The Inflation Rate** -- The annual rate of price change for a basket of consumer goods. Inflation is normally measured by the Consumer Price Index for All Urban Consumers (CPI-U), calculated by the U.S. Bureau of Labor Statistics. The inflation rate is the most basic component of a discount rate. An investor's rate of return must equal the rate of inflation just to break even in real dollar terms.
2. **The Risk-free Component** -- A return to compensate the investor for a loss of liquidity. This component can also be defined as the risk-free rate minus the inflation rate. The risk-free rate is made up of the inflation rate plus a return to reimburse the investor for a loss of liquidity and is measured by the yield to maturity on Federal government securities with a maturity period comparable to the investment under consideration (oil or gas reserves in this case). The market perceives these securities as risk-free for all practical purposes since they are issued by the United States government.
3. **General Risk Premium** -- A return to compensate the investor for assuming diversified company-wide risk. The weighted average cost of capital (WACC) minus the risk-free rate is the general risk premium. The WACC is measured by weighting the typical oil company debt and equity costs by the typical oil company debt and equity capital structure percentages, and then adding the weighted costs. If one were appraising companies, the WACC would be the discount rate since it reflects the market's expected yields from the stock and debt of a company. Calculation of a WACC will be explained in more detail later in this manual.  
 For example, for property tax purposes, appraisers estimate the value of individual mineral reserves, not the value of oil companies. Buyers of mineral reserves usually perceive these individual reserves as riskier than the stock and debt of an entire company. Companies can spread their risk over many individual mineral reserves and often over several kinds of assets (some of which are unrelated to the oil or gas business). This asset diversification reduces the company's risk and, as a result, the WACC derived from company financial data is usually lower than an individual producing property's discount rate. However, the WACC is always higher than the risk-free rate. This increase in the rate is a general risk premium to reward investors for assuming

the diversified company-wide risk.

4. **Property-specific Risk Premium** -- A return that compensates the investor for assuming the unique risks associated with a particular mineral producing property. The discount rate minus the WACC is the property-specific risk premium. Investors demand a premium above the WACC to compensate them for this individual property risk. For certain high-risk properties, this premium can be quite high. *In Texas this risk varies greatly from county to county and pay zone to pay zone.*

5. **Component Summary** -- These discount rate components can be summarized:

$$\begin{aligned}
 & \text{INFLATION RATE} \\
 + & \text{ RISK FREE COMPONENT} \\
 + & \text{ GENERAL PREMIUM RISK} \\
 + & \text{ PROPERTY SPECIFIC RISK PREMIUM} \\
 = & \text{ DISCOUNT RATE}
 \end{aligned}$$

There are other ways to "build up" a discount rate. This method's advantage is that the first three components are quantifiable from public data. The property-specific risk premium may be derived from available data in some cases, but in general the appraiser must estimate it.

#### E. Using the Three Techniques for Estimating Discount Rates

The first two techniques, market surveys and sales analysis, result in rates that include all of the discount rate components. However, in these two techniques, the rate included for the property-specific risk premium is the typical rate for the properties included in the survey or sales analysis. The appraiser must estimate the property-specific risk premium (unless the sales sample is directly comparable to the property being appraised) and adjust for atypically high or low risk. This means that the appraiser must reduce the risk premium for properties with less than the typical risk and increase the risk premium for properties with more than the typical risk.

The third technique (WACC) produces a rate that does not contain a component for property-specific risk. Because it lacks this component, the typical WACC of potential purchasers sets a minimum value for a discount rate and the appraiser must calculate the typical WACC of potential purchasers to know this lower limit. On a

case-by-case basis, the appraiser should exclude oil companies from the WACC calculation if they cannot participate in the market for the property he or she is currently appraising. For instance, small companies may not be able to bid on certain very valuable oil and gas properties because of insufficient capital. A typical WACC for larger oil companies would establish an appropriate minimum discount rate for appraising these properties. An investor should not buy a property at a lower discount rate than his or her WACC; otherwise the investor's net worth will decrease. The appraiser must add the property-specific risk premium to the typical WACC of potential purchasers to develop a discount rate.

1. **Developing a Range** -- Ideally, the appraiser should use these three techniques simultaneously to develop a range of discount rates. The typical WACC sets the lower limit, while surveys and direct sales analysis provide a set of discount rates that the appraiser can use as a database that will help to estimate a midrange discount rate and an upper limit to the discount rate.

Some mineral properties may appear to sell at or below the purchaser's WACC. There are several reasons that a mineral property may appear to change hands at a discount rate equal to or less than the WACC. When a buyer (or appraiser) reduces the cash flows to account for reserve recovery risk the discount rate will not reflect the risk, but the purchase price will. To calculate a discount rate that is comparable to discount rates from other sales, the appraiser must quantify the risk adjustment and add it back to the cash flow. This discount rate will be higher than the non-risk inclusive rate.

Atypical income tax deductions, or abnormally high or low overhead can also create an artificially high or low discount rate. When faced with market evidence that would indicate a discount rate at less than a company's cost of capital, the appraiser should review all other appraisal parameters to determine why an abnormally low discount rate is indicated. An understated income stream is the most obvious reason. The appraiser may be able to adjust the cash flows and derive a market discount rate or may delete the sale from consideration.

#### F. Market Surveys

An appraiser may use market surveys as an indicator of the discount rate. Many studies and surveys are published to help the appraiser estimate an appropriate discount rate or range of rates for appraising

oil and gas properties. The Society of Petroleum Evaluation Engineers' (SPEE) Annual Survey and the Western States Petroleum Association's (WSPA) *Analysis of Oil and Gas Property Transfers and Sales and Derivation of a Band of Investment* are good examples.

The SPEE survey asks producers', consultants' and bankers' opinions on future prices, cost escalation and economic indices (including the discount rate) used in petroleum property evaluation.

The WSPA study, conducted by Richard J. Miller & Associates, consists of two parts: an analysis of oil and gas property transactions and sales occurring in California from 1984 through the current year and an analysis of the weighted average cost of capital (WACC) or "Band of Investment" of a representative group of companies for the same years. The WACC analysis is based on public data.

## G. Developing a Discount Rate from Sales

1. **Basic steps** -- To develop a discount rate from sales requires three basic steps:

- a. Obtain recent sales prices from a variety of oil and gas producing properties,
- b. Develop cash flow projections for each property and
- c. Calculate the internal rate of return (IRR) for each sale. This is also known as the discounted cash flow return on investment (DCFROI).

2. **Sales Sources** -- Information about sales can be obtained from a variety of sources, but the best source is the buyer or seller. Other sources that list sales of oil and gas property include the Texas Railroad Commission, *Oil & Gas Journal 300*, Strevig & Associates, private firms and oil and gas companies. It is important to remember that the sale of an oil or gas property must be a market transaction when developing a discount rate from sales.

3. **Cash Flow Projections** -- After obtaining verified sales prices, the appraiser develops cash flow projections for each property. To the extent possible, the appraiser must talk with the parties to each sale to determine their expectations of the property and take those into account when making projections. The validity of the derived discount rate is a direct function of the amount of information obtained from the buyer and seller about their cash flow projections. The appraiser must incorporate this information into his or

her projections. If the appraiser's projections differ from the buyer's and seller's expectations, the discount rate derived from the sale will be invalid.

4. **Calculating the IRR** -- The third step in developing a discount rate from sales is to calculate the internal rate of return (IRR) for each sale. The IRR is the yield (discount) rate at which the present value of a cash income stream equals the present value of the cash expenditures (the sales price in our analysis) necessary to produce that income stream. This discount rate is prospective; it does not depend on the historical performance of the property, but on the market participants' expectations of future performance. The discount rate at which the present value of the cash flows equals the sales price can be determined by trial and error. However, there are several calculators and personal computer software packages that can solve for the discount rate (IRR).

Although computational procedures may vary slightly, this measure is also referred to as the profitability-index and investor's method. The IRR recognizes that funds received now are more valuable than those received at some future time. The investment outlay can be regarded as borrowed funds and the pre-tax cash flow as the payment of principle plus compound interest on the investment.

## H. Weighted Average Cost of Capital

A widely used method for deriving a pre-tax base discount rate for valuation purposes is the band of investment, or WACC technique. The basis for this analysis is the financial data from a broad sample of oil companies that derive a majority of their operating revenues from oil and gas production.

Since petroleum property valuation typically involves discounting cash flows over a long period of time, a long-term cost of capital is most appropriate for developing an oil or gas property discount rate. Thus, the appraiser should incorporate a broad time series of data to approximate a long-term cost of capital.

1. **Required Calculations** -- Four sets of calculations are required to determine the WACC.

- a. The typical capital structure is derived and expressed as a proportion of debt and equity.
- b. The typical cost of outstanding debt is calculated based on bond yields.
- c. The typical cost of equity is computed using

the *Capital Asset Pricing Model* (CAPM) or another method such as the DCF model.

- d. Debt and equity costs are weighted according to the typical capital structure percentages and added to derive a typical cost of capital.

2. **Capital Structure** -- "Capital structure" describes in percentage terms the sources of funds (capital) used to purchase the assets necessary to operate a company. The capital structure of any company consists of debt and equity. The debt portion consists of long-term debt (represented by outstanding bonds) and preferred stock, while the equity portion consists of outstanding common stock. If the company is funded by debt and equity of equal value, the capital structure is 50 percent debt and 50 percent equity.

3. **Cost of Debt** -- The yield-to-maturity is the best approximation of the cost of debt capital. This yield is observable in the marketplace and can be found by referring to Standard & Poor's Corporation's *Bond Guide*, *Moody's Bond Report* or a comparable publication.

4. **Cost of Equity** -- The Capital Asset Pricing Model (CAPM) is the preferred approximation of equity cost since it considers both historical market yields and current expectations, plus a market-derived equity risk factor. The CAPM method measures the cost of equity by considering that an investor's required rate of return on common stock is comprised of a risk-free return plus a risk adjustment factor related to the specific stock. This is represented by the following equation:

$$K = R_{fc} + B(R_m - R_{fh})$$

where:

- K = cost of equity (after tax), %/year
- R<sub>fc</sub> = current risk-free rate, %/year
- R<sub>m</sub> = historic market return on equities, %/year
- R<sub>fh</sub> = historic market return on long-term government bonds, %/year
- B = BETA coefficient

The current risk-free rate (R<sub>fc</sub>) is typically based on current long-term government securities, i.e., the yield-to-maturity observed on an annual basis on a default-free treasury bond, note or bill of the relevant time period. For oil and gas property appraisal, the

yield on a long-term bond is an appropriate measure of the risk-free rate.

The historical market return on equity (R<sub>m</sub>) of common stocks and the historical arithmetic mean on long-term government bond income returns (R<sub>fh</sub>) can be obtained from Ibbotson Associates' *Stock, Bonds, Bills and Inflation*. The beta coefficient (B) measures market risk by regressing the stock's total return against the market's total return. A more detailed description of the beta calculation can be found in the Ibbotson Associates report. The beta coefficient value can be obtained from Value Line Publishing, Incorporated's *The Value Line Investment Survey*, Standard and Poor's Corporation's S&P Stock Reports and similar investment services.

The difference between the historical risk-free (R<sub>fh</sub>) and market (R<sub>m</sub>) rates of return is a measure of the non-systematic or non-market related risk caused by changes specific to the companies comprising the stock rate of return sample and is, in effect, an equity risk premium. Note that two different risk-free rates of return are used in the CAPM. The current risk-free rate (R<sub>fc</sub>) is used to acknowledge the expectational function of the model. The historical risk-free rate (R<sub>fh</sub>) is used in conjunction with the historical market return for the same time period when calculating the equity risk premium.

The cost of equity resulting from this model is a nominal (current dollar) after tax rate. Conversion to a nominal, pre-tax rate requires dividing the equity cost (K) by 1 minus the federal statutory income tax rate for petroleum companies. The income tax rate is presently 35 percent. This is represented by the following equation:

$$K(\text{pre-tax}) = K / (1 - .35).$$

If the appraiser calculates a typical effective income tax rate from a representative sample of petroleum companies that could participate in the market for the property that he or she is appraising, he or she may substitute that typical effective income tax rate for the statutory rate.

5. **Weighting Debt and Equity Costs** -- Once capital structure, debt and equity costs are determined, the final step in deriving the WACC is to weight the cost of debt and equity by the proportional share each has in the overall capital structure. This is represented by the following equations:

$$\begin{aligned} & \text{Wtd Avg Cost of Equity} \\ = & (\text{Cost of equity percentage}) \times (\text{Equity fraction}) \\ & \text{Wtd Avg Cost of Debt} \\ = & (\text{Cost of debt percentage}) \times (\text{Debt fraction}) \\ & \text{WACC} \\ = & \text{Wtd Avg Cost of Equity} + \text{Wtd Avg Cost of Debt} \end{aligned}$$

The WACC can also be described as follows:

$$\begin{aligned} & \text{INFLATION RATE} \\ + & \text{RISK FREE COMPONENT} \\ = & \text{RISK FREE RATE} \\ & \text{RISK FREE RATE} \\ + & \text{GENERAL RISK PREMIUM} \\ = & \text{WEIGHTED AVERAGE COST OF CAPITAL} \end{aligned}$$

**6. Final Discount Rate Selection** -- As discussed earlier, the typical WACC of potential customers sets the lower end of the discount rate range. To help establish the upper end of the discount rate range, the appraiser can calculate a standard deviation of all the discount rates indicated by the sales in the sales sample and the survey. One standard deviation above and below the mean contains 68 percent of all the observations in a normally distributed set of data. Two standard deviations above and below the mean contains over 99 percent of all the observations in a normally distributed set of data. The data may not be normally distributed. Even so, this kind of analysis may help the appraiser to establish the upper end of the discount rate range.

Very high-risk properties (for example, a one-well lease with high water production near the end of its economic life) may be discounted by the market at two standard deviations above the mean. Properties with less risk will have correspondingly lower discount rates. One standard deviation above the mean may establish an upper limit for properties in a typical risk range. The mean or median of the discount rates from the sales analysis and the survey indicates the mid-range discount rate.

For a standard deviation analysis to have meaning in selecting an upper limit to the discount rate range, the

survey or sales data set must contain properties with broadly varying risk. A high-end discount rate selected by this method will not apply to very risky properties (it will be too low) unless very risky properties are represented in the sales data set used in the analysis. To select a discount rate for an individual property, the appraiser must assess the property-specific risk inherent in the property.

*[For an in depth discussion on valuation of natural resource stocks (mineral stocks) see "Valuation Methods of Mineral Resources" Estrella V. Domingo and Edward Eugenio P. Lopez-Dee, 11<sup>th</sup> Meeting of the London Group on Environmental Accounting, Johannesburg, 26-30 of March, 2007.]*

**EXHIBIT I**

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

**WARRANTY DEED**

**Date:**

**Grantor:**

**Grantor's Mailing Address** (including county);

**Grantee:**

**Grantee's Mailing Address:**

**Consideration:**

**Property:** Situated in Hidalgo County, Texas, the Property described in Exhibit A, attached and made a part of this Deed;

SAFE AND EXCEPT all of the oil, gas and other minerals in, under and that may be produced from the Property, together with the right of ingress and egress at all times for the purpose of mining, drilling and exploring the lands for oil, gas and other minerals and removing the same from the lands.

**Reservations from and Exceptions to Conveyance and Warranty:**

1. Reservation of all oil, gas and other minerals.
2. Subject to valid and subsisting oil, gas and mineral leases and all unit designations of record.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, grants, sells, and conveys to Grantee the property, together with all and singular the rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee, Grantee's heirs, executors, administrators, successors, or assigns forever. Grantor binds Grantor and Grantor's heirs, executors, administrators, and successors to warrant and forever defend all and singular the

property to Grantee and Grantee's heirs, executors, administrators, successors, and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty.

When the context requires, singular nouns and pronouns include the plural.

\_\_\_\_\_  
(Grantor)

(Acknowledgment)

THE STATE OF TEXAS       §  
County of Hidalgo       §

This instrument was acknowledged before me by (Grantor) on the \_\_\_\_ day of \_\_\_\_\_, 2007.

\_\_\_\_\_  
Notary Public, State of Texas

AFTER RECORDING RETURN TO  
(Grantor)  
(Grantor's Address)

**EXHIBIT II**

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

**WARRANTY DEED**

**Date:**

**Grantor:**

**Grantor's Mailing Address** (including county);

**Grantee:**

**Grantee's Mailing Address:**

**Consideration:**

**Property:** Situated in Hidalgo County, Texas, the Property described in Exhibit A, attached and made a part of this Deed;

SAFE AND EXCEPT an undivided 1/4 of Grantor's interest in all of the oil, gas and other minerals in, under and that may be produced from the Property, together with the right of ingress and egress at all times for the purpose of mining, drilling and exploring the lands for oil, gas and other minerals and removing the same from the lands.

**Reservations from and Exceptions to Conveyance and Warranty:**

1. Reservation of 1/4 of Grantor's interest in all oil, gas and other minerals.
2. Proportionally subject to prior exceptions and reservation of record, of any.
3. Subject to valid and subsisting oil, gas and mineral leases and all unit designations of record.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, grants, sells, and conveys to Grantee the property, together with all and singular the

rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee, Grantee's heirs, executors, administrators, successors, or assigns forever. Grantor binds Grantor and Grantor's heirs, executors, administrators, and successors to warrant and forever defend all and singular the property to Grantee and Grantee's heirs, executors, administrators, successors, and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty, when the claim is by, through or under Grantor, but not otherwise.

When the context requires, singular nouns and pronouns include the plural.

\_\_\_\_\_  
(Grantor)

(Acknowledgment)

THE STATE OF TEXAS           §

County of Hidalgo           §

This instrument was acknowledged before me by (Grantor) on the \_\_\_ day of \_\_\_\_\_, 2007.

\_\_\_\_\_  
Notary Public, State of Texas

AFTER RECORDING RETURN TO

(Grantor)

(Grantor's Address)

**EXHIBIT III**

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

**MINERAL DEED**

**Date:**

**Grantor:**

**Grantor's Mailing Address** (including county);

**Grantee:**

**Grantee's Mailing Address:**

**Consideration:**

**Property:** Situated in Hidalgo County, Texas, an undivided ½ of Grantor's interest in the oil, gas and other minerals in, on under and that may be produced from Grantors Property described in Exhibit A, attached and made a part of this Deed, together with the right of ingress and egress at all times for the purpose of mining, drilling and exploring the lands for oil, gas and other minerals and removing the same from the lands.

**Reservations from and Exceptions to Conveyance and Warranty:**

1. Proportionally subject to prior exceptions and reservation of record, of any.
2. Subject to valid and subsisting oil, gas and mineral leases and all unit designations of record.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, grants, sells, and conveys to Grantee the property, together with all and singular the rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee, Grantee's heirs, executors, administrators, successors, or assigns forever. Grantor binds Grantor and Grantor's

heirs, executors, administrators, and successors to warrant and forever defend all and singular the property to Grantee and Grantee's heirs, executors, administrators, successors, and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty, when the claim is by, through or under Grantor, but not otherwise.

When the context requires, singular nouns and pronouns include the plural.

\_\_\_\_\_  
(Grantor)

(Acknowledgment)

THE STATE OF TEXAS       §  
County of Hidalgo       §

This instrument was acknowledged before me by (Grantor) on the \_\_\_ day of \_\_\_\_\_, 2007.

\_\_\_\_\_  
Notary Public, State of Texas

AFTER RECORDING RETURN TO  
(Grantor)  
(Grantor's Address)

**EXHIBIT IV**

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**ROYALTY DEED**

**Date:**

**Grantor:**

**Grantor's Mailing Address** (including county);

**Grantee:**

**Grantee's Mailing Address:**

**Consideration:**

**Property:** Situated in Hidalgo County, Texas, an undivided 1/4 interest in the oil, gas and mineral royalty or royalties deliverable or payable on production of oil, gas and other minerals, or any one of them, under the terms of any existing or future lease leases insofar as such lease or leases cover the lands, or any portion thereof, described in Exhibit A, attached and made a part of this Deed.

Grantor shall have the power to execute any and all future leases for the development of the lands, or any portion thereof, for oil, gas and other minerals, or any one or more of them, without the joinder of Grantee, but no lease shall be executed which provides for a royalty of less than the following amounts upon any mineral covered by the lease or leases: 1/8 of all oil produced and saved from the lands; 1/8 of the value of all gas produced and sold or used by lessee off the leased premises; 1/8 of the value of any other mineral produced or mined from the premises and sold or used for commercial purposes. Grantee shall have no right to participate in the bonus or bonuses paid or payable for any existing or future lease, nor in the delay rentals payable thereunder for the privilege of deferring the commencement of a well, but, with the exception of the foregoing, shall be entitled to receive an undivided 1/4 in all payments or considerations of every kind and nature, except payments made for the use of or damage to the surface estate, paid or payable to Grantor by any lessee of the premises, or any part thereof, under the terms of the lease, including the following: all royalties (including royalties in excess of the minimum amounts stated above); all payments

made in lieu of production from any well or wells that are shut in for want of a market or other cause; and all oil or production payments or other payments or considerations, the accrual of which is contingent upon production, payable under any lease hereafter executed.

**Reservations from and Exceptions to Conveyance and Warranty:**

- 1. Subject to valid and subsisting oil, gas and mineral leases and all unit designations of record.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, grants, sells, and conveys to Grantee the property, together with all and singular the rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee, Grantee's heirs, executors, administrators, successors, or assigns forever. Grantor binds Grantor and Grantor's heirs, executors, administrators, and successors to warrant and forever defend all and singular the property to Grantee and Grantee's heirs, executors, administrators, successors, and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty, when the claim is by, through or under Grantor, but not otherwise.

When the context requires, singular nouns and pronouns include the plural.

\_\_\_\_\_  
(Grantor)

(Acknowledgment)

THE STATE OF TEXAS        §  
County of Hidalgo        §

This instrument was acknowledged before me by (Grantor) on the \_\_\_\_ day of \_\_\_\_\_, 2007.

\_\_\_\_\_  
Notary Public, State of Texas

AFTER RECORDING RETURN TO  
(Grantor)  
(Grantor's Address)

**EXHIBIT V**

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

**TERM ROYALTY DEED**

**Date:**

**Grantor:**

**Grantor's Mailing Address** (including county);

**Grantee:**

**Grantee's Mailing Address:**

**Consideration:**

**Property:** Situated in Hidalgo County, Texas, an undivided 1/4 interest in the oil, gas and mineral royalty or royalties deliverable or payable on production of oil, gas and other minerals, or any one of them, under the terms of any existing or future lease or leases insofar as such lease or leases cover the lands, or any portion thereof, described in Exhibit A, attached and made a part of this Deed.

This grant shall run, and the rights, titles and privileges granted shall extend to Grantee, to Grantee's heirs, administrators, executors and assigns, for a period of twenty (20) years from the date of this deed and as long thereafter as oil, gas or other minerals, or either of them, is produced or mined from the lands in paying or commercial quantities. If at the expiration of twenty (20) years from date hereof, oil, gas or other minerals, or either of them, is not being produced or mined from the land, or any portion thereof in paying or commercial quantities, this contract shall be null and void and Grantee's rights hereunder shall terminate.

Grantor shall have the power to execute any and all future leases for the development of the lands, or any portion thereof, for oil, gas and other minerals, or any one or more of them, without the joinder of Grantee, but no lease shall be executed which provides for a royalty of less than the following amounts upon any mineral covered by the lease or leases: 1/8 of all oil produced and saved from the lands; 1/8 of the value of all gas produced and sold or used by lessee off the leased premises; 1/8 of the value of any other mineral produced or mined from the premises and sold or used for commercial purposes. Grantee shall have no right to participate in the bonus or bonuses paid or payable for any existing or future lease, nor in the delay rentals payable thereunder for the

privilege of deferring the commencement of a well, but, with the exception of the foregoing, shall be entitled to receive an undivided 1/4 in all payments or considerations of every kind and nature, except payments made for the use of or damage to the surface estate, paid or payable to Grantor by any lessee of the premises, or any part thereof, under the terms of the lease, including the following: all royalties (including royalties in excess of the minimum amounts stated above); all payments made in lieu of production from any well or wells that are shut in for want of a market or other cause; and all oil or production payments or other payments or considerations, the accrual of which is contingent upon production, payable under any lease hereafter executed.

**Reservations from and Exceptions to Conveyance and Warranty:**

- 1. Subject to valid and subsisting oil, gas and mineral leases and all unit designations of record.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, grants, sells, and conveys to Grantee the property, together with all and singular the rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee, Grantee's heirs, executors, administrators, successors, or assigns for the full term herein above provided. Grantor binds Grantor and Grantor's heirs, executors, administrators, and successors to warrant and forever defend all and singular the property to Grantee and Grantee's heirs, executors, administrators, successors, and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty, when the claim is by, through or under Grantor, but not otherwise.

When the context requires, singular nouns and pronouns include the plural.

\_\_\_\_\_  
(Grantor)

(Acknowledgment)

THE STATE OF TEXAS §

County of Hidalgo §

This instrument was acknowledged before me by (Grantor) on the \_\_\_ day of \_\_\_\_, 2007.

\_\_\_\_\_  
Notary Public, State of Texas

AFTER RECORDING RETURN TO

(Grantor)

(Grantor's Address)

**EXHIBIT VI**

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

**TERM MINERAL DEED**

**Date:**

**Grantor:**

**Grantor's Mailing Address** (including county);

**Grantee:**

**Grantee's Mailing Address:**

**Consideration:**

**Property:** Situated in Hidalgo County, Texas, an undivided 1/4 interest in all of the oil, gas and other minerals in, on or under and that may be produced from Grantor's lands described in Exhibit A, attached and made a part of this Deed, together with the right of ingress and egress at all times for the purpose of mining, drilling and exploring the lands for oil, gas and other minerals and removing the same from the lands.

This grant shall run, and the rights, titles and privileges granted shall extend to Grantee, to Grantee's heirs, administrators, executors and assigns, for a period of twenty (20) years from the date of this deed and as long thereafter as oil, gas or other minerals, or either of them, is produced or mined from the lands in paying or commercial quantities. If at the expiration of twenty (20) years from date hereof, oil, gas or other minerals, or either of them, is not being produced or mined from the land, or any portion thereof, in paying or commercial quantities but if there is outstanding a valid lease of oil, gas or other minerals covering all or any part of the land, this grant shall continue as long as the lease remains in effect. If at the expiration of the twenty (20) year period, there is no production and there is no outstanding valid lease in effect, this contract shall be null and void and Grantee's rights hereunder shall terminate.

**Reservations from and Exceptions to Conveyance and Warranty:**

- 1. Subject to valid and subsisting oil, gas and mineral leases and all unit designations of record.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, grants, sells, and conveys to Grantee the property, together with all and singular the rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee, Grantee's heirs, executors, administrators, successors, or assigns for the full term herein above provided. Grantor binds Grantor and Grantor's heirs, executors, administrators, and successors to warrant and forever defend all and singular the property to Grantee and Grantee's heirs, executors, administrators, successors, and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty, when the claim is by, through or under Grantor, but not otherwise.

When the context requires, singular nouns and pronouns include the plural.

\_\_\_\_\_  
(Grantor)

(Acknowledgment)

THE STATE OF TEXAS       §  
County of Hidalgo       §

This instrument was acknowledged before me by (Grantor) on the \_\_\_\_ day of \_\_\_\_\_, 2007.

\_\_\_\_\_  
Notary Public, State of Texas

AFTER RECORDING RETURN TO  
(Grantor)  
(Grantor's Address)

**EXHIBIT VII**

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

**GIFT MINERAL DEED WITH  
RESERVATION OF LIFE ESTATE**

**Date:**

**Grantor:**

**Grantor's Mailing Address** (including county);

**Grantee:**

**Grantee's Mailing Address:**

**Consideration:**

**Property:** Situated in Hidalgo County, Texas, all of Grantor's undivided interest in and to all oil, gas and other minerals in, under and that may be produced from Grantor's lands described in Exhibit A attached and made a part of this Deed; together with the right of ingress and egress at all times for the purpose of mining, drilling and exploring the lands for oil, gas and other minerals and removing the same from the lands;

SAVE AND EXCEPT, however, Grantor excepts and reserves for Grantor and Grantor's assigns the full possession, benefit and use of the property, as well as the rents, issues and profits from it, for and during Grantor's natural life.

**Reservations from and Exceptions to Conveyance and Warranty:**

1. Subject to the Life Estate in Grantor excepted above.
2. Subject to valid and subsisting oil, gas and other mineral leases and unit designations of record.
3. Subject to all matters of record.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, grants, sells, and conveys to Grantee the property, together with all and singular the rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee, Grantee's heirs, executors, administrators, successors, or assigns forever. Grantor binds Grantor and Grantor's heirs, executors, administrators, and successors to warrant and forever defend all and singular the property to Grantee and Grantee's heirs, executors, administrators, successors, and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty, when the claim is by, through or under Grantor, but not otherwise.

When the context requires, singular nouns and pronouns include the plural.

\_\_\_\_\_  
(Grantor)

(Acknowledgment)

THE STATE OF TEXAS §

County of Hidalgo §

This instrument was acknowledged before me by (Grantor) on the \_\_\_ day of \_\_\_\_\_, 2007.

\_\_\_\_\_  
Notary Public, State of Texas

AFTER RECORDING RETURN TO

(Grantor)

(Grantor's Address)

**EXHIBIT VIII**

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

**MINERAL DEED OF LIFE ESTATE WITH  
REMAINDER OVER**

**Date:**

**Grantor:**

**Grantor's Mailing Address** (including county);

**Grantee:**

**Grantee's Mailing Address:**

**Consideration:**

**Property:** For and during Grantee's natural life, with remainder over at Grantee's death to Grantee's heirs at law, situated in Hidalgo County, Texas, all of Grantor's undivided interest in and to all oil, gas and other minerals in, under and that may be produced from Grantor's lands described in Exhibit A attached and made a part of this Deed; together with the right of ingress and egress at all times for the purpose of mining, drilling and exploring the lands for oil, gas and other minerals and removing the same from the lands, full possession, benefit and use of the property, as well as the rents, issues and profits from it, for and during Grantee's natural life.

**Reservations from and Exceptions to Conveyance and Warranty:**

1. Subject to prior exceptions and reservation of record, of any.
2. Subject to valid and subsisting oil, gas and mineral leases and all unit designations of record.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, conveys to Grantee for and during Grantee's natural life, with remainder over at Grantee's death to Grantee's heirs at law, the property, together with all and singular the rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee and Grantee's assigns for and during Grantee's natural life, and upon Grantee's death the remainder over to Grantee's heirs at law, their heirs, successors and assigns forever. Grantor binds Grantor and Grantor's heirs, executors, administrators and successors to warrant and defend during Grantee's natural life all and singular the property to Grantee and Grantee's and assigns, and upon Grantee's death to warrant and forever defend all and singular the property to the Remaindermen, their heirs, successors and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty, when the claim is by, through or under Grantor, but not otherwise.

When the context requires, singular nouns and pronouns include the plural.

\_\_\_\_\_  
(Grantor)

(Acknowledgment)

THE STATE OF TEXAS            §  
County of Hidalgo            §

This instrument was acknowledged before me by (Grantor) on the \_\_\_\_ day of \_\_\_\_\_, 2007.

\_\_\_\_\_  
Notary Public, State of Texas

AFTER RECORDING RETURN TO  
(Grantor)  
(Grantor's Address)

**EXHIBIT IX**

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVER'S LICENSE NUMBER.

**WAIVER AND RELEASE OF SURFACE RIGHTS**

**Effective Date:**

**Surface Owner:**

**Mineral Owner:**

**Surface Owner Property:**

**Additional Property:**

**Property:** The Surface Owner Property and the Additional Property

**BACKGROUND**

The Surface Owner has acquired and is the owner of the surface estate of the Surface Owner Property. Kerr-Pearson Development, Ltd., and other third parties, are the owners of the Additional Property. The mineral Owner acquired a portion of the mineral estate in and under the Surface Owner Property and the Additional Property by Mineral Deed dated November 7, 2003, recorded in Instrument No, 2003-191554 of the Deed Records of Denton County, Texas (the "Mineral Deed"). The Mineral Owner owns an undivided interest in the minerals, together with executive rights on an additional portion of the mineral estate. The Surface Owner, for himself and on behalf of the owners of the Additional Property, have requested the Mineral Owner to release and waive all rights of ingress and egress and all other rights of every kind and character whatsoever to enter upon or to use all or any part of the surface of the Property or the Additional Property for purposes of exploration, development and production of the oil, gas and other minerals in, on, or under the Property, so that the Surface Owner and the owners of the Additional Property shall have full, complete and uninterrupted use of the surface of the Property. The mineral Owner desires to evidence its agreement to release and waive the surface rights upon the terms, conditions and provisions in this agreement.

AGREEMENTS

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which is acknowledged, the Surface Owner and the Mineral Owner agree as follows:

1. Waiver of Surface Rights. The mineral Owner, on behalf of itself and its successors and assigns, as to its mineral ownership and as to all mineral ownership for which it holds exclusive and/or leasing rights, expressly releases and waives all rights to use all or any part of the surface of the Property, including, without limitation, the right to enter upon the surface of the Property for purposes of exploring for, developing, drilling, producing, transporting, mining, treating, storing or any other purposes incident to the development or production of the oil, gas and other minerals in and under the property.

2. Pooling and Directional Drilling. Nothing contained in this Agreement shall ever be construed to prevent the Mineral Owner from developing or producing the oil, gas and other minerals in and under the Property by pooling or by directional drilling under the Property from well sites located on tracts other than the Property.

3. Future Agreements. The mineral Owner agrees that any oil, gas or mineral lease subsequently executed by the Mineral Owner in favor of any person or entity covering or affecting any portion of the mineral estate of the Property shall be expressly made subject to the terms and provisions of this Agreement.

4. Representations of Mineral Owner. The Mineral Owner represents and warrants that it is the owner of and has not alienated or conveyed the mineral rights conveyed to it by the Mineral Deed.

5. Binding Effect; Multiple Counterparts. The provisions of the Agreement shall be binding upon and shall inure to the benefit of the Mineral Owner, the Surface Owner and to the owners of the Additional Property and their respective heirs, legal representatives, successors and assigns. This Agreement may be executed in multiple counterparts and shall be binding upon any party who executes a counterpart without the necessity of all signatories executing the same counterpart.

MINERAL OWNER:

KPD OIL & GAS, LTD., a Texas limited partnership

By: \_\_\_\_\_

By: \_\_\_\_\_

SURFACE OWNER:

\_\_\_\_\_  
\_\_\_\_\_

THE STATE OF TEXAS            §  
COUNTY OF \_\_\_\_\_        §

This instrument was acknowledged before me, the undersigned notary public, on the \_\_\_\_\_ day of \_\_\_\_\_, 2007, by \_\_\_\_\_, general partner of KPD Oil and Gas , Ltd., on behalf of said partnership.

[SEAL]

\_\_\_\_\_  
Notary Public, State of Texas

\_\_\_\_\_  
Printed Name of Notary Public  
My commission expires: \_\_\_\_\_

THE STATE OF TEXAS            §  
COUNTY OF \_\_\_\_\_        §

This instrument was acknowledged before me, the undersigned notary public, on the \_\_\_\_\_ day of \_\_\_\_\_, 2007, by \_\_\_\_\_,

[SEAL]

\_\_\_\_\_  
Notary Public, State of Texas

\_\_\_\_\_  
Printed Name of Notary Public  
My commission expires: \_\_\_\_\_

THE STATE OF TEXAS            §  
COUNTY OF \_\_\_\_\_        §

This instrument was acknowledged before me, the undersigned notary public, on the \_\_\_\_\_ day of \_\_\_\_\_, 2007, by \_\_\_\_\_,

[SEAL]

\_\_\_\_\_  
Notary Public, State of Texas

\_\_\_\_\_  
Printed Name of Notary Public  
My commission expires: \_\_\_\_\_

AFTER RECORDING RETURN TO  
Capital Title of Texas  
403 U.S. Hwy 377 South  
Argyle, Texas 76226