AUTHORITY TO POOL OVERRIDING ROYALTY INTERESTS

By: Andrew Potts

AS LARGE, MULTI-TRACK units become the norm, rather than the exception, the necessity of pooling has never been greater for Texas operators. It is well-settled in Texas that a nonparticipating royalty interest cannot be pooled without the consent of the owner of such interest. *MCZ, Inc. v. Triolo,* 708 S.W.2d 49 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.). This prompts the questions: Does this principle apply equally to overriding royalty interests as it does to nonparticipating royalty interests and, if so, what authority is required to pool the interests present in each tract within a proposed pooled unit? This article focuses exclusively on the authority required to pool overriding royalty interests.

Texas caselaw concerning the pooling of overriding royalty interests is limited, but the following two cases do address the authority of an operator to pool overriding royalty interests:

1. *PYR Energy Corp. v. Samson Res. Co.*
   456 F. Supp. 2d 786 (E.D. Tex. 2006)

In *PYR,* the instrument creating an overriding royalty interest did not provide express authority to pool the overriding royalty interest. The *PYR* court held that "notwithstanding declared policy in favor of pooling, repeated judicial rulings hold that a lessee has no power to pool royalty interests without express consent of their owners. These rulings apply to overriding royalties and to nonparticipating royalty interests." *Id.*

Although the decision in *PYR* was not overturned, the *PYR* court did issue a subsequent Memorandum Opinion for Clarification, Reconsideration and Rehearing ("*Revised PYR*"). See *PYR Energy Corp. v. Samson Res. Co.,* 470 F. Supp. 2d 709 (E.D. Tex. 2007). In this Memorandum Opinion, the PYR court included the following statements:

> For reasons stated below, the court now adheres to its original analysis. However, each issue is close, and could be decided differently without doing violence to reason, interests of justice, or Texas policy generally favoring pooling...The court is confident that its analysis is faithful to precedent and the contracts' language, but is somewhat less confident that the Texas Supreme Court would feel it necessary to take as strictly literal an approach. A Texas court might be swayed by Samson's arguments, and conclude that the assumption of pooling implicit in almost all of the instruments used in the various transactions amounted to tacit pooling authority and hold, as Samson urges this court to do, that nothing more is required when dealing with transactions between "sophisticated oil companies." *Revised PYR* at 712-13, 718.

The above comments included in the *Revised PYR* decision cast doubt upon the potential persuasiveness the *PYR* decision would have upon a Texas trial court. Moreover, the *PYR* decision was issued by a federal district court, a jurisdiction which does not typically have authority to hear and determine issues of state law, absent diversity jurisdiction. Nevertheless, the *PYR* opinion is one of only two cases addressing the issue of pooling overriding royalty interests.

2. *Union Pacific Resources Co. v. Hutchison*
   990 S.W.2d 368 (Tex.App.–Austin, 1999)

In *Union Pacific,* the original lessee of an oil and gas lease assigned "all right, title and interest" in the lease to an assignee "together with the rights incident thereto or used or obtained in connection therewith," and also reserved an overriding royalty interest in the lease assigned. In concluding that the assignee was not required to obtain the consent of the original lessee to pool the overriding royalty interest, the *Union Pacific* court stated "the legal effect of [the lessee's] unqualified assignment was to vest in [the assignee] the identical rights, privileges, and benefits [the lessee] possessed under the lease, which included an express power to pool."

The decision in *Union Pacific* has been criticized by some as a departure from the established principle that an overriding royalty is an interest in land, and a royalty owner's consent to pooling is required because pooling effects a cross-conveyance, and a cross-conveyance requires a conveyance from the owner of the land. *See, e.g.* SMU Law Review; Oil, Gas, and Mineral Law, by Richard F. Brown, 53 SMULR 1167 (2000). Additionally, the *Union Pacific* court did not address whether a different decision would have resulted in the event the overriding royalty was created by *conveyance* rather than *reservation.* In the event the overriding royalty interest was created by conveyance, the overriding royalty owner would not own the right to pool as granted by the lease in the *Union Pacific* case, and presumably, the *Union Pacific* court's analysis would not apply. Nevertheless, the *Union Pacific* opinion is the only Texas state court appellate opinion on the matter at this time.

The available case law regarding the effect of failing to properly pool overriding royalties is limited. However, it is likely that a Texas court would find that the unpooled overriding royalty interest owner is to be paid in a similar fashion to that of an unpooled non-participating royalty interest owner. In that case, the overriding royalty interest owner would be paid based on participation in the tract, without dilution from the pooled interests. The following should provide some practical guidelines to follow when encountering an overriding royalty interest:

Overrides created by Reservation:

An operator may choose to rely upon the decision in *Union Pacific,* and pool the overriding royalty interest without the express consent of the owners of same, provided the leases which are burdened by the overriding royalty interests contain sufficient unilateral pooling provisions.

Overrides created by Conveyance:

An operator should obtain consent to pooling agreements from each overriding royalty interest owner within the proposed pooled unit.

In the event an overriding royalty interest owner cannot be found, it is possible a receiver could be appointed. Texas Civil Practice & Remedies Code section 64.093 is entitled "Receiver for Royalty Interests Owned by Nonresident or Absentee." This section of the code does not expressly identify or limit the type of royalty interests for which a receiver may be appointed. However, the Code defines "royalty interest" as "any interest in the lands entitled to share in the production of oil, gas, or other minerals that is not required to execute a mineral lease or any other instrument in order to vest in the mineral interest owner or *mineral leasehold interest owner* the right and power, as to that interest, to develop oil, gas, or other minerals produced solely from those lands" (emphasis added). See CPRC Section 64.093(j)(4). The above-described definition of "royalty interest," purportedly authorizes the appointment of a receiver on behalf of an absentee overriding royalty interest owner.

Similar to a receiver for a non-participating royalty interest, the receiver of an overriding royalty interest would be authorized to 1) ratify a pooling agreement executed by a person owning an undivided mineral interest in the property or an undivided leasehold interest in the property; and 2) enter into a unitization agreement authorized by the Railroad Commission of Texas. See CPRC Section 64.093(f)(2-3).

In conclusion, current Texas case law provides very limited judicial guidance regarding the pooling of overriding royalty interests. Until such time as the Texas Supreme Court renders an opinion on same, the prudent Operator should err on the side of caution.

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