AN OVERVIEW OF OVERRIDING ROYALTY INTERESTS

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CHAPTER 21

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I. INTRODUCTION

One generally sees three types of oil and gas royalty interests in practice: a lessor's royalty, a non-participating royalty, and an overriding royalty. All of these royalties are similar in that their owner is entitled to a share of oil and gas production, usually free of drilling, completion, and operating costs.[1] That common trait is, however, where the similarities end. An overriding royalty interest ("ORRI") is particularly dissimilar from a lessor's royalty interest and a non-participating royalty interest because an ORRI is carved out of, and constitutes a part of, the leasehold interest created by an oil, gas, and mineral lease ("OGL").[2] An operator–lessee can create an ORRI either by outright conveyance or as a reservation in an assignment of the OGL.[3]

An ORRI is also a nonpossessory real property interest; therefore, the ORRI owner is not entitled to certain possessory rights, including without limitation, a right to enter the lands covered by the ORRI to develop and produce minerals.[4] Thus, the ORRI depends on the lessee–operator to develop, operate, and produce oil and gas from the lands covered by the ORRI. Another unique characteristic of an ORRI, as opposed to a lessor's royalty and a non-participating royalty, is that the ORRI is limited in duration to the life of the OGL, absent contrary language in the instrument creating the ORRI.[5]

The ORRI has become fairly common in the oil and gas industry. There are thousands of OGL assignments recorded in courthouses whereby landmen have reserved ORRIs in their assignments of OGLs, and oil and gas companies often assign ORRIs to employees as compensation.[6] Although many in number, ORRIs, like OGLs, are not all similar, as a standard ORRI does not exist.[7] The below topics constitute a summary of what, in the opinion of the author, each ORRI granting instrument should address.

II. WASHOUTS

A washout is often a primary concern for any lessee reserving an ORRI or any assignee of an ORRI.[8] The operator–lessee controls whether drilling or pooling will occur under the lands leased, extending the life of the OGL, and thereby controls also whether the OGL (and the ORRI) will be perpetuated because the ORRI exists only so long as the OGL exists.[9] Additionally, the ORRI reduces the net revenue interest ("NRI") of the operator–lessee because the ORRI is carved from the leasehold interest.[10] Consider, for example, a typical scenario in which a mineral owner leases his minerals to a lessee for a one-fourth royalty. If the operator–lessee achieves oil and gas production on the lands leased, it is contractually required to deliver to the mineral owner one-fourth of the oil and gas production, and the operator–lessee may retain the remaining three-fourths of production for itself. If the operator–lessee grants a landman or other third party a 2% ORRI in the OGL, however, absent any pooling of the lands covered by the OGL, the operator–lessee's NRI is reduced from 0.75 to 0.73.[11] May the operator–lessee, after the OGL primary term has expired, simply shut off its well until the sixty or ninety-day deadline under the temporary cessation of production clause of the OGL has passed, thereby causing the OGL to terminate, all with the understanding that the mineral owner will re-lease the

1. Bruce A. Ney, Note, *Protecting Overriding Royalty Interests in Oil & Gas Leases: Are the Courts Moving to Washout Extension or Renewal Clauses*, 31 WASHBURN L.J. 544, 545 (1992).

2. Gruss v. Cummins, 329 S.W.2d 496, 501 (Tex. Civ. App.—El Paso 1959, writ ref'd n.r.e.).

3. *See* Ney, *supra* note 1, at 545–46.

4. T-Vestco Litt-Vada v. Lu-Cal One Oil Co., 651 S.W.2d 284, 291 (Tex. App.—Austin 1983, writ ref'd n.r.e.).

5. *See* Keese v. Continental Pipe Line Co., 235 F.2d 386, 388 (5th Cir. 1956).

6. Edward M. Fenk, Comment, *Are Overriding Royalty Interests Becoming the Clay Pigeons of the Texas Oil and Gas Industry? The Assignor-Assignee Relationship After* Sasser v. Dantex Oil & Gas, 5 TEX. WESLEYAN L. REV. 231, 250 (1999).

7. In any ORRI granting instrument, one typically prefers to see, at a minimum, the following clauses:

a. The minerals covered by the ORRI;
b. What costs are borne by the ORRI, such as taxes and treating, transportation, and marketing costs of the minerals produced;
c. Proportionate reduction provisions corresponding with whether (i) the OGL covers less than the entire mineral interest, and (ii) the interest of the assignor of the ORRI in the OGL covers less than the entire leasehold interest in the OGL;
d. Renewal and extension of the ORRI if and when the original OGL terminates (washouts);
e. Pooling of the ORRI; and
f. The effect of implied covenants with respect to the ORRI assigned.

8. *See* Ney, *supra* note 1, at 546–47.

9. Ridge Oil Co. v. Guinn Invs., Inc., 148 S.W.3d 143, 155 (Tex. 2004).

10. Transamerican Natural Gas Corp. v. H.S. Finkelstein, 933 S.W.2d 591, 594 n.1 (Tex. App.—San Antonio 1996, writ denied) (en banc).

11. *See id.* at 594.

same minerals no longer burdened by a 2% ORRI?[12] That single issue constitutes the washout dilemma for the ORRI owner.[13]

Given that the operator–lessee's acts can eliminate the ORRI, and that the ORRI owner usually gives consideration for the ORRI—either monetary or performance of a valuable service—washouts are typically a concern to ORRI owners.[14] While washouts may be an important issue to ORRI owners, however, it is an area in which Texas courts afford them little protection.[15] Thus, it is particularly important for ORRI owners to contractually protect themselves against washouts.[16]

A. Sunac v. Parkes

The seminal case regarding washouts is *Sunac Petroleum Corp. v. Parkes*.[17] Although the *Sunac* court did not find the operator–lessee liable, the court's reasoning remains influential in washout case law.[18] The original lessee, Parkes, assigned the OGL and reserved a one-sixteenth ORRI.[19] Eventually, Sunac Petroleum Corporation ("Sunac") became the lessee by assignment.[20] Three days prior to the expiration of the OGL's primary term, Sunac pooled the leased premises and completed an oil well on the lands pooled therewith.[21] The OGL, however, only allowed pooling for gas.[22] Sunac later completed an oil well on the leased premises three months after the expiration of the primary term.[23] Approximately one year later, the mineral owners questioned whether Sunac had kept the OGL alive from the end of the primary term to the completion of the oil well on the leased premises by pooling the lands covered by the OGL with lands where an oil well was located thereon because the OGL only permitted pooling for gas.[24] In response, Sunac executed a new OGL covering the same land.[25]

After finding that the original OGL terminated after the expiration of the primary term, the *Sunac* court considered whether Parkes's ORRI attached to the new OGL, or if it also terminated when the original OGL terminated.[26] The court first recognized that other jurisdictions had imposed an ORRI on a new OGL using a constructive trust theory.[27] A constructive trust would occur where the lessee had either acted in bad faith to "washout" the ORRI or otherwise owed the ORRI owner a fiduciary duty.[28] After finding that neither of these situations applied to the case at bar, the court held that Parkes's ORRI terminated when the original OGL terminated, and thus, would not burden the new OGL.[29] As a result of the court's holding in *Sunac*, certain commentators discerned that arguments based on a bad faith washout or a breach of a fiduciary duty might be used under possibly different facts to burden a new OGL taken by the operator–lessee with an ORRI from an expired OGL.[30] As subsequent ORRI plaintiffs have come to learn, however, *Sunac* provides little hope to a washed-out ORRI.[31]

1. <u>Bad Faith Washout</u>

The *Sunac* court differentiated between the facts in that case and what it described as a bad faith washout:

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12. *See* Ney, *supra* note 1, at 546–48. A temporary cessation of production clause is an OGL savings clause, which allows the operator–lessee to keep the OGL alive after the primary term by additional drilling or reworking operations of an oil or gas well within sixty or ninety days after a cessation of production from the well. *See* Mohan Kelkar, Comment, *The Effect of the Cessation of Production Clause During the Secondary Term of an Oil and Gas Lease*, 22 TULSA L.J. 531, 532 (1987). So long as production of oil or gas resumes within said time period, the OGL will not terminate. *See id.*

13. *See* Ney, *supra* note 1, at 546–48.

14. *See id.*

15. Fenk, *supra* note 6, at 250.

16. *See id.*

17. Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798, 798 (Tex. 1967).

18. *Id.* at 805.

19. *Id.* at 799.

20. *Id.*

21. *Id.*

22. *Id.*

23. *See id.* at 800.

24. *See id.*

25. *See id.*

26. *See id.* at 802–03.

27. *See id.* at 803.

28. *See id.* at 803–04.

29. *See id.* at 804–05.

30. *See* Terry I. Cross, Overriding Royalty—Heir to the Throne or Second Class Citizen? Implied Covenants, Washouts and Pooling, Presented at the 15th Annual Advanced Oil, Gas and Mineral Law Course (SBOT/OGML) (Sept. 25–26, 1997).

31. *See* Stroud Prod., L.L.C. v. Hosford, 405 S.W.3d 794, 797–98 (Tex. App.—Houston [1st Dist.] 2013, pet. denied); Sasser v. Dantex Oil & Gas, Inc., 906 S.W.2d 599, 600–01 (Tex. App.—San Antonio 1995, writ denied); Exploration Co. v. Vega Oil & Gas Co., 843 S.W.2d 123, 126–27 (Tex. App.—Houston [14th Dist.] 1992, writ denied).

> Another situation in which some courts have protected the holder of the overriding royalty is called a "washout" transaction, generally involving some bad faith on the part of the lessee. In this type of situation, the operator takes a new lease before the expiration of the old lease and then simply permits the old lease to expire.[32]

The court implied that Sunac lacked bad faith because it made substantial efforts to keep the OGL alive and took a new OGL only after the mineral owner questioned the original OGL's validity.[33] Subsequent cases have proven that it is difficult for an ORRI owner to successfully argue that an operator–lessee has washed out the ORRI in bad faith.[34]

The ORRI owner in *Sasser v. Dantex Oil & Gas, Inc.* cited *Sunac* in its unsuccessful argument that the lessee terminated the OGL and washed out the ORRI in bad faith.[35] In *Sasser,* Newsom owned the minerals leased, Dantex Oil & Gas ("Dantex") owned the OGL covering Newsom's mineral interest, and Sasser owned an ORRI burdening Dantex's OGL.[36] The original OGL contained a surrender clause, which allowed the lessee to forfeit the OGL at any time.[37] When production dwindled, Newsom alleged that the OGL had expired for lack of sufficient production.[38] Considering Newsom's allegation to be valid, Dantex asked Newsom to ratify the original OGL.[39] After Newsom refused to ratify the OGL, Newsom and Dantex entered into a new OGL, which gave Newsom additional concessions.[40]

Sasser claimed that Dantex's actions constituted the bad faith washout situation cited by *Sunac*.[41] The *Sasser* court claimed, however, that the *Sunac* washout was distinguishable because Sasser's ORRI instrument lacked an extension and renewal clause, thereby implying the necessity of an extension and renewal clause for Sasser's ORRI to attach to the new OGL.[42] Moreover, the court specified that Dantex did not owe Sasser a duty of good faith and fair dealing or any other fiduciary-type duty because no facts in the case provided a basis for a holding that a confidential or special relationship existed.[43] The court also noted that Dantex's acts would have been in bad faith only if its contractual right to surrender the OGL was subject to a duty of good faith, which it was not, a finding that resulted in another setback for ORRI owners in terms of the ability to burden a new OGL with their ORRIs as specified in the expired OGL.[44]

The most recent washout case, *Stroud Production, L.L.C. v. Hosford*, exemplifies an ORRI's vulnerability resulting from the rule that a lessee owes no duty to the ORRI owner.[45] Although the facts of *Stroud* are identical to, if not more egregious than, *Sunac*'s bad faith washout, the court left the ORRI owner without redress.[46] Hosford owned an ORRI in an OGL that Stroud subsequently acquired by assignment.[47] A month after Stroud acquired the OGL, and a few days after it received notice that Hosford's ORRI instrument did not have an extension and renewal clause, a mechanical problem halted production on the only producing well on the lands covered by the OGL.[48] As Stroud was aware that the original OGL would terminate within ninety days if the well did not come back online by producing oil or gas in commercial quantities pursuant to the terms of the temporary

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32. *Sunac*, 416 S.W.2d at 804.

33. *See id.*

34. *See Stroud*, 405 S.W.3d at 797–98; *Sasser*, 906 S.W.2d at 600–01.

35. *Sasser*, 906 S.W.2d at 607.

36. *Id.* at 601.

37. *Id.* The surrender clause in *Sasser* read: "The lessee [can] 'at any time or times execute and deliver to [Newsom] . . . a release or releases of this lease as to all or any part of the above-described premises . . ., and thereby be relieved of all obligations as to the released land or interest." *Id.* (alterations in original). A typical surrender clause in a "Producer's 88 Paid-Up OGL" is as follows:

Lessee may at any time or times execute and deliver to Lessor, or to the depository above named, or place of record a release covering any portion or portions of the above described premises and thereby surrender this Lease as to such portion or portions and be relieved of all obligations as to the acreage surrendered, and thereafter the rentals payable hereunder shall be reduced in the proportion that the acreage covered hereby is reduced by said release or releases.

Oil and Gas Legal Forms, MONEY IN OIL (last visited Apr. 2, 2014), *available at* http://moneyinoil.com/legalform45x.html.

38. *Sasser*, 906 S.W.2d at 601.

39. *Id.*

40. *Id.*

41. *Id.* at 605–07.

42. *Id.* at 606.

43. *Id.* at 607.

44. *Id.*

45. Stroud Prod., L.L.C. v. Hosford, 405 S.W.3d 794, 811 (Tex. App.—Houston [1st Dist.] 2013, pet. denied).

46. *Compare id.*, *with* Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798, 798 (Tex. 1967).

47. *Stroud*, 405 S.W.3d at 798. The court referred to a group of ORRI owners collectively as "Hosford." *Id.*

48. *Id.* at 799.

cessation of production clause therein, Stroud obtained a new OGL covering the same land.[49] By Stroud's own admission, Stroud refrained from making repairs because it wanted to avoid expenses, had already offered interests in the new OGLs to potential investors, and "did not want any overriding royalty interest on the new leases."[50] Stroud repaired the well a month after the original OGL expired.[51]

The *Stroud* court explicitly recognized that Stroud intentionally terminated the OGLs to terminate Hosford's ORRI.[52] In surveying the applicable law, the *Stroud* court recognized *Sunac*'s bad faith washout as well as the holding in *Sasser*.[53] Without explicitly evaluating any act or standard of bad faith, however, the court reframed the issue as to whether Stroud's intentional termination of Hosford's ORRI amounted to an actionable wrong.[54] The court concluded that a lessee does not generally owe any type of duty to an ORRI owner and that the circumstances in the case at bar, including the absence of a surrender clause, did not warrant the creation of a duty thereunder.[55] As a result, Stroud did not "commit[] an actionable wrong by intentionally terminating the [original] leases to extinguish the overriding royalty interests and acquiring new leases with the lessors."[56] The holdings in *Stroud* and *Sasser* show that *Sunac*'s bad-faith washout scenario generally does not, and will not, constitute the basis for a successful argument for an ORRI owner.[57]

2. Fiduciary Duty

In addition to a bad faith washout, *Sunac* recognized that an ORRI may attach to a new OGL if the lessee owes a fiduciary duty to the ORRI owner.[58] Because the lessee does not generally owe an ORRI owner a fiduciary duty, however, it must be otherwise created.[59]

In considering whether Sunac owed Parkes a fiduciary duty, the *Sunac* court highlighted the importance of two clauses: the extension and renewal clause and the surrender clause.[60] The *Sunac* court stated that an extension and renewal clause, which was present in that case, is "often pointed to by the courts as creating a fiduciary relation" between the lessee and ORRI owner.[61] The court emphasized that the facts in *Sunac* were materially distinguishable because the OGL assignment also had a surrender clause, which allowed Sunac to release the OGL at any time.[62] The court construed the provisions together "as relieving the lessee from the duty to perpetuate the lease, and thus the overriding royalty."[63]

Similar to the bad-faith washout argument, the *Sunac* opinion appeared possibly to open the door to a fiduciary duty argument under which an extension and renewal clause existed without a surrender clause.[64] The court in *Exploration Co. v. Vega Oil & Gas Co.*, however, appears to have closed the door on such an argument.[65] In *Vega*, Exploration Company ("Exploration") owned an ORRI subject to an extension and renewal clause; the original OGL,

49. *Id.* at 799–800.

50. *Id.* (internal quotation marks omitted).

51. *See id.*

52. *Id.* at 804.

53. *See id.* at 803–06.

54. *See id.* at 809.

55. *Id.* at 809–10.

56. *Id.* at 811.

57. *See id.* at 803–10. The Supreme Court of Texas, however, has alluded to the possibility of a bad faith argument in *Ridge Oil Co. v. Guinn Investments Inc.* Ridge Oil Co. v. Guinn Invs., Inc., 148 S.W.3d 143, 153–54 (Tex. 2004). *Ridge* did not involve an ORRI, but rather, two lessees—Ridge Oil Co. ("Ridge") and Guinn Investments ("Guinn")—each of which acquired adjacent tracts by separate assignments of the same OGL. *Id.* at 146–47. The dispute arose after Ridge halted production of the wells on its tract. *Id.* at 148. Because the wells on Ridge's tract were the only producing wells on the land covered by the OGL, the OGL terminated with respect to both tracts. *See id.* As a result, Guinn alleged "that Ridge could not 'washout' its interest under the [original] lease." *Id.* at 153. The court first discussed *Sasser* before addressing Guinn's specific allegation "that a lessee cannot surrender or terminate a lease to destroy the rights of another partial assignee of the lessee's interest." *Id.* at 153–54. The court rejected "such a blanket rule of law," but further provided that "[e]ven if such a rule of law might be appropriate in the context of overriding royalty interests when the underlying lease does not contain an express release provision, a question we do not address, there is a material distinction between an overriding royalty interest and that of a lessee." *Id.* at 155. The material distinction is that Guinn could have entered the tract in which it owned the OGL and drilled an oil well to perpetuate the OGL; however, an ORRI owner would not have this option because an ORRI is a non-possessory real property interest as discussed above. *See id.*

58. Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798, 804 (Tex. 1967).

59. *See id.* at 804–05; *Stroud*, 405 S.W.3d at 809–10.

60. *Sunac*, 416 S.W.2d at 804.

61. *Id.*

62. *Id.*

63. *Id.*

64. *See* Cross, *supra* note 30.

65. Exploration Co. v. Vega Oil & Gas Co., 843 S.W.2d 123, 126 (Tex. App.—Houston [14th Dist.] 1992, writ denied).

however, did not contain a surrender clause.[66] Exploration claimed that Vega Oil & Gas Company ("Vega") owed a fiduciary duty to Exploration because of the extension and renewal clause in the OGL—a claim that the court refuted.[67] The *Vega* court interpreted *Sunac* as holding that an extension and renewal clause did not create a fiduciary duty and held that the inclusion of a surrender clause only strengthened, but was unnecessary for, the conclusion that a fiduciary duty did not exist.[68] Thus, under such a reading, the court held that merely because a surrender clause "is not in the lease . . . does not mean that a fiduciary relationship exists."[69] In light of the *Vega* holding, it is apparent that the mere inclusion of an extension and renewal clause in an ORRI assignment, even if a surrender clause is not included in the OGL subject to the ORRI, does not give rise to a fiduciary relationship.[70]

B. Contracting as to Washouts

As previously discussed, the law does not generally protect ORRI owners against washouts.[71] This lack of protection creates a need and magnifies the importance—for the ORRI attorney—to contractually protect the ORRI owner while drafting the instrument creating the ORRI.

An extension and renewal clause is the typical method to prevent washouts, with the drafter intending that the ORRI burdening the original OGL will attach to a subsequent OGL that extends or renews the original OGL.[72] Courts have interpreted these clauses narrowly and often hold that the ORRI was extinguished because the subsequent OGL was not an "extension" or "renewal" of the original OGL.[73] As a result, an extension and renewal clause should specify its application to new OGLs, as well as extensions and renewals of the original OGL:

> [The ORRI] is to apply to all amendments, extensions and renewals of the lease or any part of it or to a new lease taken by the Assignee herein or his heirs and assigns on the same lease premises or any part thereof within twelve (12) months after termination of the present lease.[74]

Contractually addressing washouts is not a priority for the operator–lessee. First, the operator–lessee should negotiate to prevent the inclusion of any extension and renewal clause in the instrument creating the ORRI. Second, so that the operator–lessee does not need to rely on only a surrender clause in an OGL as discussed above, the operator–lessee should consider negotiating the addition of the following provision to the ORRI granting instrument:

> Any development of the lands covered by the Leases and the continuation of the Leases, by conducting drilling operations, paying delay rentals or otherwise, shall be in the Assignor's sole and absolute discretion.

III. POOLING THE ORRI

The operator-lessee—whose central goal is development—may want to pool the land covered by the ORRI in an attempt to maximize production.[75] As to the ORRI owner, pooling affects the ORRI in the same fashion as it does other mineral royalty interests.[76] The impact on the ORRI owner depends on the location of the well relative to the location of the land covered by the ORRI.[77] If the land covered by the ORRI is pooled with other land on which a well is drilled, the ORRI owner realizes a benefit that he would not otherwise have.[78] Conversely, if a well is drilled on the land covered by the ORRI, pooling would dilute the ORRI owner's royalty because the ORRI owner would only receive the proportion of the ORRI covered by the burdened OGL that was placed in the pooled unit, with the total acreage in the pooled

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66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *See supra* notes 59–69 and accompanying text.

71. *See supra* Part II.A.

72. Fenk, *supra* note 6, at 234–35.

73. *Id.* at 232; *see also* Ney, *supra* note 1, at 544 (explaining that the Tenth Circuit is moving to extension or renewal clauses).

74. Sutton v. SM Energy Co., No. 04-12-00772-CV, 2013 WL 5989445, at *1 (Tex. App.—San Antonio, Nov. 13, 2013, no pet.). It may be disputed whether the "new lease" language is sufficient. *See* McCormick v. Krueger, 593 S.W.2d 729, 731 (Tex. Civ. App.—Houston [1st Dist.] 1979, writ ref'd n.r.e.). *But see Sutton*, No. 04-12-00772-CV, 2013 WL 5989445, at *3.

75. Laura H. Burney, *The Texas Supreme Court and Oil and Gas Jurisprudence: What Hath* Wagner & Brown v. Sheppard *Wrought?*, 5 TEX. J. OIL GAS & ENERGY L. 219, 224–26 (2009–2010).

76. *See* Union Pac. Res. Co. v. Hutchison, 990 S.W.2d 368, 372 (Tex. App.—Austin 1999, pet. denied).

77. *See id.* at 369–70.

78. *See* James E. Key, *The Right to Royalty: Pooling and the Capture of Unburdened Interests*, 17 TEX. WESLEYAN L. REV. 69, 70–71 (2010) (discussing the general application of the non-apportionment rule).

unit diluting the royalty interest.[79] Therefore, if the ORRI covers the drill site tract, the ORRI owner would prefer not to dilute his royalty by pooling his ORRI.[80] This raises the question of whether the operator–lessee can pool the land covered by the ORRI without the ORRI owner's consent.[81]

As discussed above, the practical relevance of this issue turns on dilution.[82] Whether the ORRI owner's consent is necessary may not be an issue in which, due to financial incentive, the ORRI owner is nearly certain to consent because the ORRI covers a non-drill site tract.[83] In contrast, an ORRI owner has no interest in consenting to pooling if the ORRI covers the drill site tract, thereby pitting the ORRI owner against the operator–lessee and raising the issue of whether the ORRI owner's consent is necessary.[84] May the ORRI owner withhold consent and possibly impede the operator–lessee's development or can the operator–lessee proceed over the ORRI owner's objection, thereby diluting the owner's ORRI?

A. Union Pacific v. Hutchison

Union Pacific Resources Co. v. Hutchison is the only Texas case to address the issue of whether the ORRI owner's consent is necessary to pool his interest.[85] In *Hutchison*, Hutchison was the original lessee under an OGL that contained a pooling clause.[86] Hutchison reserved a 3% ORRI in a subsequent assignment of the OGL, which was ultimately assigned to Union Pacific Resources Company ("Union Pacific").[87] After Union Pacific acquired its leasehold interest, and without obtaining the express consent of Hutchison, Union Pacific pooled sixty-five acres of a 692-acre OGL, which was burdened by Hutchison's 3% ORRI, with additional land to form the 336-acre Knebel Unit.[88] Union Pacific drilled a horizontal well, which traversed the above-described sixty-five-acre tract.[89] On appeal, Hutchison alleged that Union Pacific failed to obtain Hutchison's consent to pool and, as a result, was owed 3% of all production from the undiluted Knebel Unit.[90] After considering the language in the original OGL and Hutchison's assignment, the *Hutchison* court held that Hutchison gave consent to pool and was thus entitled to only a diluted royalty.[91]

Commentators and practitioners dispute the effect of *Hutchison* with respect to the issue of consent.[92] This lack of consensus with respect to *Hutchison* makes the determination of the issue of pooling without the consent of the ORRI owner uncertain.[93] A close reading of *Hutchison* and a subsequent federal case, *PYR Energy Corp. v. Samson Resources Co.*, however, supports the conclusion that consent is necessary, but may be implied in certain cases.[94]

1. <u>What Constitutes Consent?</u>

The rule in *Hutchison* provides that an operator–lessee cannot pool an ORRI without the consent—express or implied—of the ORRI owner.[95] The confusion among commentators and practitioners probably stems from the failure of the *Hutchison* court to first expressly state that an ORRI owner must consent to the pooling of its interest.[96] *Hutchison*'s recognition of certain principles regarding pooling and use of particular language, however, dictates that consent to pool an ORRI is necessary.[97]

The *Hutchison* court recognized that an ORRI is an interest in land and the resulting applicability of the cross-conveyance principle:

> That principle holds that a pooling of royalties and minerals under different tracts of land effects cross-conveyances among the owners of minerals under the several tracts

79. *See Hutchison*, 990 S.W.2d at 372.

80. *See id.*

81. *See id.* The typical curative instrument used by an operator–lessee to obtain the consent of the ORRI owner to pool his ORRI is a Ratification of Oil and Gas Lease. Benjamin Holliday, *New Oil and Old Laws: Problems in Allocation of Production to Owners of Non-Participating Royalty Interests in the Era of Horizontal Drilling*, 44 ST. MARY'S L.J. 771, 800 (2013).

82. *See supra* notes 78–79 and accompanying text.

83. *See* Key, *supra* note 78.

84. *See id.* at 78.

85. Hutchison, 990 S.W.2d at 370–71.

86. *Id.* at 369.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 369–70.

91. *Id.* at 371–72.

92. Key, *supra* note 78, at 78.

93. *See Hutchison*, 990 S.W.2d at 371–72.

94. *See* PYR Energy Corp. v. Samson Res. Co., 456 F. Supp. 2d 786, 794 (E.D. Tex. 2006) (mem. op.), *opinion clarified on denial of reconsideration by* 470 F. Supp. 2d 709 (E.D. Tex. 2007).

95. *See Hutchison*, 990 S.W.2d at 370–71.

96. *See generally id.* (failing to expressly state that an ORRI owner must consent to the pooling of its interest).

97. *Id.*

> pooled, so that they all own undivided interests under the pooled unit in the proportion their contribution of acreage bears to the acreage of the entire unit.[98]

Thus, a royalty owner must consent to pooling "because only an owner may convey his interest in land."[99] After recognizing the cross-conveyance principle, the determinative issue for the court was whether Hutchison's assignment instrument authorized pooling because, if it did, "then no *additional* consent on Hutchison's part was required."[100] After establishing the necessity of consent, the court addressed the difference between express and implied consent.[101] The court examined the parties' intention as evidenced in the assignment instrument and OGL to ultimately hold that Hutchison's implied consent was sufficient.[102]

Subsequently, the court in *Samson* backed *Hutchison* in holding that an ORRI owner must consent, either expressly or impliedly, to pooling the minerals covered by the ORRI.[103] Recognizing the long-standing principle as in *Hutchison*, the *Samson* court first recognized the cross-conveyance theory and its underlying principle that "[s]uch a significant change in ownership rights . . . requires express authorization of the [mineral royalty] owner."[104] The court acknowledged the theory's application to ORRIs by clarifying that it "appl[ies] to overriding royalties (ORRIs) and to nonparticipating royalty interests (NPRIs)."[105] After confirming that an ORRI owner must consent to pooling, the court cited *Hutchison* in support of an implied consent exception to express consent.[106] The *PYR* court noted that in *Hutchison*, although the ORRI owner did not expressly consent to pooling, the legal effect of the ORRI owner's unqualified assignment gave the benefits possessed under the OGL, which included the power to pool.[107]

2. Practically Important but Limited to Its Facts

Hutchison has a substantial practical impact because of the commonality of the particular facts involved.[108] In finding implied consent to pool, the court emphasized two points: the original OGL allowed for pooling, and the OGL assignment was absolute—it assigned all of the right, title, and interest of the lessee to the assignee thereof.[109] Importantly, most OGLs allow for some form of pooling and industry practice dictates that most assignees prefer for OGL assignments to include "all right, title and interest" language to make the assignment absolute.[110] Thus, if an ORRI is created by reservation in an assignment of an OGL and the OGL contains a pooling clause, it is probable that the ORRI owner has consented to pooling by implication.[111] In that case, the operator–lessee need not obtain the express consent of the ORRI owner because the ORRI owner has already impliedly consented and no additional consent is necessary.[112]

Although *Hutchison* has a great practical impact, its holding cannot be expanded to hold more than that an ORRI owner may, under certain situations, give the requisite consent to pool by implication.[113] Many commentators and practitioners, however, interpret *Hutchison* to have a broader impact.[114] Some commentators and practitioners contend that an ORRI owner's consent is unnecessary to pool if the lease allows for pooling.[115] Such a sweeping statement is misleading, however, for two reasons: the ORRI owner's consent is always necessary, and the existence of a pooling clause is not automatically outcome-determinative to permit pooling of the ORRI.[116]

It is incorrect—even if only in a technical sense—to say that the *Hutchison* court allowed Union Pacific to pool without Hutchison's consent.[117] The court

98. *Id.* at 370.

99. *Id.*

100. *Id.* (emphasis added).

101. *Id.* at 370–71.

102. *Id.*

103. PYR Energy Corp. v. Samson Res. Co., 456 F. Supp. 2d 786, 793 (E.D. Tex. 2006) (mem. op.), *opinion clarified on denial of reconsideration by* 470 F. Supp. 2d 709 (E.D. Tex. 2007).

104. *Id.* at 792.

105. *Id.* at 791.

106. *Id.* at 793.

107. *Id.*

108. Richard F. Brown, *Oil, Gas, and Mineral Law*, 53 SMU L. REV. 1167, 1171 (2000).

109. Union Pac. Res. Co. v. Hutchison, 990 S.W.2d 368, 371 (Tex. App.—Austin 1999, pet. denied).

110. *See id.*

111. *Id.* at 370–71.

112. *Id.* at 371.

113. *Id.*

114. *See* John K. H. Akers, Jr., *Overriding Royalty Interests: Pitfalls, Precedent, and Protection*, 50 ROCKY MTN. MIN. L. INST. § 21.05 (2004); Key, *supra* note 78, at 78.

115. *See* Akers, *supra* note 114, § 21.05; Key, *supra* note 78, at 78.

116. *Hutchison*, 990 S.W.2d at 370–71.

117. *See id.*

recognized that the cross-conveyance theory required consent and, although Hutchison did not expressly consent to pooling, he impliedly consented because the instruments showed intent to authorize pooling.[118] So, although Hutchison's consent at the time of pooling was unnecessary, it was only because Hutchison had already impliedly consented to pooling his ORRI.[119]

Furthermore, some commentators and practitioners cite *Hutchison* for the proposition that any requisite consent is satisfied if the OGL contains a pooling clause.[120] This too would be an overstatement, however, because it ignores the court's analysis of intent.[121] The court found that the particular instruments showed intent to authorize pooling, which evidenced implied consent.[122] "[I]n arriving at the parties' intention," the court noted that the OGL authorized Hutchison, as the original lessee, "to pool the land covered by the lease."[123] Further, Hutchison's unqualified assignment gave "all right, title and interest in and to the [Morgan Lease] together with the rights incident thereto or used or obtained in connection therewith."[124] As a result of the unqualified assignment, Hutchison assigned "the identical rights, privileges, and benefits Hutchison possessed under the Morgan [OGL], which included an express power to pool."[125] Thus, the assignment in *Hutchinson* made the OGL language relevant to determine Hutchinson's intent to pool his ORRI.[126] It is not always the case that a pooling clause in the OGL is relevant to determine the intent to pool.

A pooling clause in an OGL does not show an ORRI owner's intent to authorize pooling when the ORRI was created by an outright assignment rather than by reservation in an assignment of the OGL.[127] When an ORRI is created by an outright assignment, the same basis that the *Hutchison* court relied upon to find implied consent is absent.[128] First, the unqualified assignment of OGL language that made the pooling clause relevant in *Hutchison* does not apply.[129] An outright assignment of an ORRI will not have language assigning "all right, title and interest" of the assignor under the OGL, thereby eliminating any reason to look at the OGL language and any pooling clause it may have.[130] Furthermore, as compared to an ORRI owner whose ORRI was created by reservation in an OGL assignment, an ORRI owner whose ORRI is created by outright assignment is not in the same position to make a pooling clause in the OGL relevant to discern his intent.[131] Unlike the ORRI owner who assigns an OGL that he was privy to, the ORRI owner of an outright ORRI assignment is not a party to the OGL and may not be aware of some or all of the OGL terms.[132] Without any connection to the underlying OGL, how can the terms of the OGL—pooling clause or otherwise—evidence the ORRI owner's intent?[133] The result in such a situation is that an operator–lessee must obtain the consent of the assignee to pool its ORRI unless the instrument creating the ORRI provides otherwise.[134]

B. Contracting as to Pooling

The ORRI-creating instrument can contractually eliminate the uncertainty over whether an ORRI owner's consent is necessary to pool. Although *Hutchison* found that the ORRI owner had impliedly given the requisite consent, many industry professionals read *Hutchison* more broadly, as discussed above.[135] Proper drafting can eliminate any confusion over differing opinions regarding the holding in *Hutchison*.[136]

The ideal provision for an ORRI owner in an ORRI assignment or reservation would make consent expressly necessary by providing as follows:

> Assignee shall not pool the ORRI without the prior written consent of the Assignor, which may be withheld in Assignor's sole and absolute discretion.

118. *Id.*

119. *Id.*

120. *See* Key, *supra* note 78, at 78; *see also* Akers, *supra* note 114, § 21.05.

121. *See Hutchison*, 990 S.W.2d at 370–71.

122. *See id.*

123. *Id.* at 371.

124. *Id.* (alteration in original) (internal quotation marks omitted).

125. *Id.*

126. *Id.*

127. *See id.* at 370–71.

128. *See id.*

129. *See id.*

130. *See* PYR Energy Corp. v. Samson Res. Co., 456 F. Supp. 2d 786, 791–92 (E.D. Tex. 2006) (mem. op.), *opinion clarified on denial of reconsideration by* 470 F. Supp. 2d 709 (E.D. Tex. 2007).

131. *Id.* at 792.

132. *See id.*

133. *Id.*

134. *Id.*

135. *See* discussion *supra* Part III.A.

136. *See* discussion *supra* Part III.A.2.

While this provision best protects the ORRI owner, it is unlikely that the operator–lessee would agree to such a provision. Perhaps a more reasonable approach would be to permit pooling to the extent permitted by the OGL, but not to permit any additional pooling subsequently agreed to by amendment to the OGL by and between the lessor and the lessee in the future:

> Assignee shall not, without the prior written consent of Assignor, pool or unitize the overriding royalty herein reserved in any manner or to any extent not permitted by the Subject Lease, and any future amendments to the Subject Lease with respect to pooling and unitization shall not apply to the interest reserved herein unless Assignor hereby expressly approves such amendment to the Lease.

This provision effectively limits the ORRI owner's consent to the pooling terms as they exist at the time of assignment. While it does not protect the ORRI owner from pooling under present pooling provisions in an existing OGL, it does protect him from unfavorable subsequent changes to the pooling clause that the lessee might agree to at a later date—either in a new OGL or in an amendment to the existing OGL that reserves the ORRI.

As to the operator–lessee, he would prefer to expressly reserve the power to pool without having to confer with the ORRI owner. One may accomplish this goal by expressly giving the operator–lessee authority to pool the ORRI with the least restriction on that authority:

> Assignor is hereby authorized to create or form pooled units and thereby pool or unitize the overriding royalties herein assigned without the consent of the Assignee. In the event of such pooling or unitization, in lieu of the overriding royalty herein assigned, Assignee shall receive only such proportion of the overriding royalty stipulated herein as the amount of the acreage covered by the lease and placed in the unit bears to the total acreage in the unit.

Another broad pooling provision example would be as follows:

> Assignor, or its successors or assigns, shall have the exclusive right without the joinder or consent of Assignee, to consent to pooling of the overriding royalty interest herein assigned by ratifying the pooling of the Lease and the lands covered thereby, or any part thereof, with other lands and leases as presently or hereafter provided by the terms of the leases or otherwise consented to by the mineral owners. In the event of pooling and for so long as there is pooling, Assignee shall receive on pooled production from a stratum or strata unitized under the provisions of the Lease, only such portion of the overriding royalty herein assigned, as the amount of acreage (surface acres) covered by such Lease and included in the unit as to the unitized stratum or strata bears to the total acreage (surface acres) so pooled in the particular unit involved.

Neither of the examples ties the authority of the operator–lessee to pool the ORRI to the underlying OGL and its pooling clause. Alternatively, the authority to pool can be qualified:

> Assignor is authorized to pool or unitize the overriding royalty herein assigned in the same manner and to the same extent as provided in the Subject Leases, without any further consent, ratification or approval of Assignee.

This clause is susceptible, however, to an ORRI owner arguing that the operator–lessee did not pool in the manner provided in the underlying OGL. An operator–lessee can prevent this contention by using the examples of the broader pooling clause forms above.

Facts involving the above clause and a subsequent amendment to the OGL could create an interesting dilemma for an operator–lessee. Such a situation would occur if the operator–lessee entered into an OGL with a pooling provision, but after the grant of the ORRI to a third party, entered into a subsequent amendment to the OGL with the lessor or its assigns amending the pooling provision of the OGL. If the ORRI instrument only allows for pooling on the same terms as set forth in the OGL but is silent as to any amendments to the OGL, is the ORRI owner subject to later OGL amendments regarding pooling? A cautious operator–lessee would obtain the ORRI owner's consent to prevent the ORRI owner from later claiming the ORRI was wrongfully diluted. To prevent this issue, the operator–lessee should consider adding the following additional provision to the ORRI instrument:

> The overriding royalty interest conveyed herein is subject to any and all amendments of said lease, now and in the future.

Inclusion of this provision is another example of how prescient drafting of the ORRI instrument may close the door on future conflict.

IV. IMPLIED COVENANTS

Implied covenants are generally OGL covenants—obligations that a lessee owes a lessor in an OGL.[137]

A covenant will not be implied unless it appears from the express terms of the contract that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it, and therefore they omitted to do so, or "it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument."[138]

The mineral owner leases his mineral interests to the OGL lessee so that the operator–lessee may produce minerals from the land or lands pooled therewith in consideration for a share of the minerals produced free of all drilling, completion, and operating costs.[139] In such a situation, the law requires that the lessee act as a reasonably prudent operator.[140] This duty to act as a reasonably prudent operator is subdivided into three implied covenants.[141] These implied covenants are generally classified as covenants to develop the premises, protect the leasehold, and manage and administer the OGL.[142]

OGL covenants—including without limitation implied covenants—are for the benefit of the lessor, and because the ORRI owner is not a party to the OGL, all OGL covenants do not benefit the ORRI owner without an express provision in the instrument creating the ORRI to the contrary.[143] Therefore, the ORRI owner who wants the benefits of implied covenants must normally obtain them by implication in the instrument creating the ORRI and the circumstances surrounding that instrument.[144] Indeed, some Texas courts have held that a lessee may owe an ORRI owner some implied covenants.[145] Although the courts have recognized certain implied covenants for the benefit of the ORRI owner, the lack of relevant judicial precedent, and the courts' inability to distinguish such covenants from OGL covenants, leaves many unanswered questions.[146]

Furthermore, many practitioners consider implied covenants irrelevant with respect to ORRIs because no Texas court has held an OGL lessee liable to an ORRI owner for the breach of an implied covenant. Despite this uncertainty and possible irrelevance, practitioners should not disregard this topic because the law is clear that in certain situations, a lessee owes an ORRI owner certain duties under the implied covenants.[147] As such, an ORRI owner should be aware of his rights, and an operator–lessee should be aware of the corresponding potential responsibility, and more importantly, the resulting possible liability arising therefrom.

A prudent ORRI owner is usually able to protect his ORRI by contracting to prevent washouts and pooling without his consent. It is improbable, however, that an operator–lessee will expressly covenant to develop the lands covered by the OGL, protect the leasehold, and manage and administer the OGL. To the contrary, it is more customary for an operator–lessee to expressly eliminate any implied covenant by contract.[148]

A. Implied Covenants to Market and Protect Against Drainage

Texas courts have recognized that an operator–lessee may owe an ORRI owner implied covenants to market[149] and to protect against drainage.[150] In finding these implied covenants, the courts often discuss them interchangeably with implied OGL covenants.[151] Furthermore, it is uncertain whether an operator–lessee owes an ORRI owner all the same duties that a lessee owes a lessor in implied OGL covenants.[152]

137. Cabot Corp. v. Brown, 754 S.W.2d 104, 106 (Tex. 1987).

138. HECI Exploration Co. v. Neel, 982 S.W.2d 881, 888 (Tex. 1998) (quoting Danciger Oil & Refining Co. of Tex. V. Powell, 154 S.W.2d 632, 635 (Tex. 1941).

139. *Powell*, 154 S.W.2d at 635–36.

140. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 567–68 (Tex. 1981).

141. *Id.*

142. *Id.* Some commentators categorize the implied covenants differently. *Id.* at 567.

143. Bolton v. Coats, 533 S.W.2d 914, 916 (Tex. 1975); Cross, *supra* note 30.

144. *Bolton*, 533 S.W.2d at 916.

145. *Id.*; Condra v. Quinoco Petroleum, Inc., 954 S.W.2d 68, 72 (Tex. App.—San Antonio 1997, writ denied) (en banc).

146. *See* Cross, *supra* note 30.

147. *See infra* Part IV.A.

148. *See infra* Part IV.A.

149. *See* Cole Petroleum Co. v. U.S. Gas & Oil Co., 41 S.W.2d 414, 416 (Tex. 1931); *Condra*, 954 S.W.2d at 72; Transamerican Natural Gas Corp. v. H.S. Finkelstein, 933 S.W.2d 591, 596 (Tex. App.—San Antonio 1996, writ denied).

150. *See Bolton*, 533 S.W.2d at 916; H.G. Sledge, Inc. v. Prospective Inv. & Trading Co., Ltd., 36 S.W.3d 597, 606 (Tex. App.—Austin 2000, pet. denied).

151. *H.G. Sledge, Inc.*, 36 S.W.3d at 606.

152. *See* Cross, *supra* note 30.

1. Implied Covenant to Reasonably Market

As part of the implied covenant to manage and administer the OGL,[153] an operator–lessee owes an ORRI owner an implied covenant to reasonably market the minerals.[154] This covenant requires the operator–lessee to market the "production with due diligence and obtain[] the best price reasonably possible."[155] With respect to an OGL, a lessor may possibly allege a breach of this covenant if the operator–lessee has shut in a well for a long period of time, and thus has allegedly failed to market any minerals produced within a reasonable time.[156] A lessor may also allege that an operator–lessee failed to obtain the best price reasonably possible when the operator–lessee benefits at the expense of the lessor by selling the minerals at a low price.[157]

With respect to take-or-pay gas contracts, plaintiffs who are ORRI owners have argued that the operator–lessee's settlement of take-or-pay gas contracts violated a duty to reasonably market.[158] While both cases cited herein expressly recognize an implied covenant to reasonably market in favor of the ORRI owner, the parties did not trigger the implied covenant to reasonably market in these cases because no production of minerals had occurred under the take-or pay-gas contracts.[159] These rulings comport with the ruling of the Supreme Court of Texas in *Exxon Corp. v. Middleton* with respect to whether the settlement of a take-or-pay gas contract violates the implied covenant to reasonably market gas production under an OGL.[160]

2. Implied Covenant to Protect Against Drainage

An operator–lessee may owe an ORRI owner an "implied[] covenant[] to protect the premises against drainage."[161] The operator–lessee should take measures that "a reasonably prudent operator under the same or similar circumstances" would take to prevent drainage.[162]

In the OGL lessor–lessee relationship, a lessor–plaintiff seeking to recover from the lessee must prove substantial drainage and potential profitability.[163] The substantial drainage requirement avoids petty claims that might arise as a result of insignificant drainage that occurs due to the nature of oil reservoirs and migration.[164] Furthermore, a lessor must prove potential profitability because a reasonably prudent operator would only drill a well to offset such drainage if it would be profitable.[165] The lessor would need to show that the lessee would realize a reasonable profit after paying all costs, including drilling costs, operating costs, and the lessor's royalties.[166] Although all Texas cases researched have been silent as to the impact of an ORRI as a cost in calculating a reasonable profit for the operator–lessee, it is probable that the ORRI, like the lessor royalty, would be deducted as a cost.[167]

B. The Application of Implied Covenants Possibly Turns on Whether the ORRI is Reserved or Assigned

The issue of implied covenants may turn on whether the ORRI is created as a reservation in an OGL assignment or by an outright assignment. Although Texas courts have failed to expressly establish any such dichotomy, judicial precedent dictates that implied covenants may only be applicable to ORRIs created by reservation.[168]

The only Supreme Court of Texas cases considering implied covenants between an operator–lessee and an ORRI owner dealt with an ORRI reserved in the assignment of an OGL.[169] In *Cole*

153. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 568 (Tex. 1981).

154. *Cole*, 41 S.W.2d at 417; *Condra*, 954 S.W.2d at 72; *Transamerican*, 933 S.W.2d at 600.

155. *Transamerican*, 933 S.W.2d at 596.

156. Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What Is The "Product"?*, 37 ST. MARY'S L.J. 1, 23 (2005).

157. *Id.* at 24.

158. *See Condra*, 954 S.W.2d at 73. A "take-or-pay" gas contract provides a means of alternative performance because a gas purchaser can either buy the gas or pay a deficiency amount. *Transamerican*, 933 S.W.2d at 599.

159. *Condra*, 954 S.W.2d at 73; *Transamerican*, 933 S.W.2d at 599.

160. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 243 (Tex. 1981).

161. Bolton v. Coats, 533 S.W.2d 914, 916 (Tex. 1975); H.G. Sledge, Inc. v. Prospective Invs. & Trading Co., Ltd., 36 S.W.3d 597, 606 (Tex. App.—Austin 2000, pet. denied).

162. *Bolton*, 533 S.W.2d at 917.

163. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 568 (Tex. 1981).

164. 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 5.3(A)(1) (1989).

165. *Amoco*, 622 S.W.2d at 568.

166. *Id.*

167. *See* Cross, *supra* note 30.

168. *See* discussion *infra* notes 169–177.

169. Bolton v. Coats, 533 S.W.2d 914, 916 (Tex. 1975); Cole Petroleum Co. v. U.S. Gas & Oil Co., 41 S.W.2d 414, 417 (Tex. 1931). *But see* Danciger Oil &

Petroleum Co. v. United States Gas & Oil Co., the court held that, in the assignment of an OGL, the assignee owed the assignor–ORRI owner an implied covenant to market.[170] The court did not consider the source of the implied covenant because the assignment instrument expressly provided for the covenant to reasonably market.[171] Regardless, the court concluded that even if the assignment lacked "an express covenant for reasonable diligence in marketing the output of gas . . . still such covenant would be implied."[172]

The ruling in *Bolton v. Coats* provides further support for the proposition that implied covenants are limited to ORRIs reserved in OGL assignments.[173] As in *Cole*, the ORRI in *Bolton* was created by reservation in an OGL assignment.[174] In *Bolton*, the court stated that, "[u]nless the assignment provides to the contrary, the assignee of an oil and gas lease impliedly covenants to protect the premises against drainage when the assignor reserves an overriding royalty."[175]

One court of appeals case, *Transamerican Natural Gas Corp. v. H.S. Finkelstein*, has recognized an implied covenant owed to an ORRI owner created by an outright assignment.[176] It should be noted that the court in *Transamerican* ignored the two Supreme Court of Texas cases of *Cole* and *Bolton*, however, and based its holding on lessor–lessee cases involving implied OGL covenants instead of ORRI-related cases involving implied covenants.[177] Other than *Transamerican*, all other Texas courts of appeals in similar cases have cited the rulings in *Cole* and *Bolton* with respect to the application of implied covenants, and these cases had analogous facts in that the ORRIs discussed were reserved in the OGL assignments.[178]

Refining Co. of Tex. v. Powell, 154 S.W.2d 632, 633 (Tex. 1941) (mislabeling an NPRI as an ORRI).

170. *Cole Petroleum*, 41 S.W.2d at 416.

171. *Id.*

172. *Id.*

173. *Bolton*, 533 S.W.2d at 917–18.

174. *Id.* at 915.

175. *Id.* at 916.

176. *See* Transamerican Natural Gas Corp. v. H.S. Finkelstein, 933 S.W.2d 591, 593–94 (Tex. App.—San Antonio 1996, writ denied).

177. *See id.* at 596.

178. *See* H.G. Sledge, Inc. v. Prospective Inv. & Trading Co., Ltd., 36 S.W.3d 597, 606 (Tex. App.—Austin 2000, pet. denied); Condra v. Quinoco Petroleum, Inc., 954 S.W.2d 68, 72 (Tex. App.—San Antonio 1997, no pet.).

C. Contracting as to Implied Covenants

As previously mentioned, contractually addressing implied covenants is practically different than addressing washouts and pooling.[179] The difference is practical because it stems from industry custom and bargaining power, not contract law. The ideal situation for the ORRI owner would be for the operator–lessee to transform the implied covenants to express covenants. While the parties may negotiate and agree upon such express covenants, the operator–lessee will probably not do so because he does not want to break from the dictates of industry custom.

In contrast, the operator–lessee will probably address implied covenants by limiting its liability.[180] In doing so, the operator–lessee is looking to negate any implied covenants to prevent an ORRI owner from relying on *Cole* and *Bolton*.[181] The operator–lessee should consider using the following provision, which is similar to the operator–lessee provision regarding washouts, discussed above:

> Assignor and its successors and assigns shall not be under any obligation to develop or maintain the Lease through operations, delay rental payments or any other method, and in the event production is obtained on the lands covered hereby or pooled herewith, all implied covenants, if any, with respect to the interest herein assigned are expressly waived by Assignee and of no force or effect.

Another provision to consider is:

> Assignor shall have no obligation to preserve and maintain the Lease by the payment of rentals, the drilling of wells or by means of other operations. Furthermore, all implied covenants, if any, with respect to the interest herein assigned are expressly waived by Assignee and of no force or effect.

The result of either provision is the same: the express denial of any implied covenants with respect to the ORRI-creating instrument.

V. COSTS THAT BURDEN THE ORRI

Just as with a landowner's royalty and non-participating royalty, the Supreme Court of Texas has made clear that the ORRI similarly should not bear any

179. *Supra* Part IV.A.

180. *See supra* Part IV.A.

181. *See supra* notes 169–174 and accompanying text.

production costs.[182] Differentiating from production costs, post-production costs include taxes, treating, transportation, and marketing of the minerals produced.

Obviously, the ORRI owner and operator-lessee have conflicting goals in allocating costs—the ORRI owner hoping to minimize and the operator-lessee hoping to maximize all costs borne by the ORRI. While the ORRI owner would prefer to avoid all costs, industry practice dictates that the most practically advantageous clause would disclaim all but tax related costs:

> The overriding royalty interests herein assigned shall be delivered or paid free and clear of all costs and expenses of development or operations, except that said overriding royalty interests shall bear their proportionate share of any ad valorem, gross production, severance and other taxes levied upon such overriding royalty interests or measured by the production of oil or gas attributable thereto.

Conversely, the operator-lessee should negotiate for the ORRI to bear as many post-production costs as possible:

> The overriding royalty interests herein assigned shall bear their proportionate share of all costs and expenses of development and operations, all costs and expenses of treating, compressing, gathering, transporting and dehydrating such production or rendering the same merchantable, and any ad valorem, gross production, severance and other taxes levied upon such overriding royalty interests or measured by the production of oil or gas attributable thereto.

VI. PROPORTIONATE REDUCTION CLAUSES

Typically, one sees a proportionate reduction clause ("PRC") in an OGL. In that context, a PRC serves to protect the lessee from paying royalties on a greater interest than the lessor actually owns. PRCs in ORRI instruments similarly serve to protect the operator-lessee from paying royalties on a greater interest than is covered by the OGL.

There are two separate PRCs, each addressing different circumstances. The first PRC protects the operator-lessee from paying on the entire mineral fee in the event that the OGL, out of which the ORRI is paid, covers less than the entire mineral fee:

> If any of the Leases cover less than the entire and undivided mineral fee interest in the land described therein, then the overriding royalty interest assigned herein shall be proportionately reduced as to such lease, so that the overriding royalty interest assigned herein shall be paid only in the proportion that the mineral interest in the land which is covered by such lease bears to the full mineral interest in the land described therein.

The second PRC protects the operator-lessee in the event that the ORRI assigning party's leasehold interest is less than the full leasehold interest in the OGL:

> If the collective interests of Assignors in any of the Leases is less than the full leasehold interest created by the lease, then the overriding royalty interest assigned herein shall be proportionately reduced as to such lease, so that the overriding royalty interest assigned herein shall be paid only in the proportion that the collective leasehold interest in the lease owned by Assignors bears to the full leasehold interest created in the lease.

VII. MINERALS COVERED

One of the most basic issues is drafting what minerals are covered by the ORRI assignment instrument. In most situations, the ORRI covers the same minerals and the same lands covered by the OGL. This is accomplished with language setting forth the ORRI assigned and the leases and minerals covered thereby as follows:

> THAT, **OIL EXPLORATION, INC.** ("Assignor") for Ten Dollars ($10.00) and other valuable consideration, the receipt and sufficiency of which are hereby acknowledged, do hereby BARGAIN, SELL, TRANSFER, CONVEY and ASSIGN unto **SOUTH TEXAS OIL, INC.,** ("Assignee") the following:
>
> (1) an overriding royalty equal to .01 of 8/8ths of all oil, gas and associated minerals and hydrocarbons which may be produced, saved and marketed from the oil and gas leases described in the attached Exhibit "A," reference to which is herein made for all purposes;

[182] Paradigm Oil, Inc. v. Retamco Operating, Inc., 372 S.W.3d 177, 180 n.1 (Tex. 2012).

(2) an overriding royalty equal to .025 of 8/8ths of all oil, gas and associated minerals and hydrocarbons which may be produced, saved and marketed from the oil and gas leases described in the attached Exhibit "B," reference to which is herein made for all purposes.

THE OIL AND GAS LEASES DESCRIBED IN THE ATTACHED EXHIBITS "A" AND "B" ARE COLLECTIVELY REFERRED TO HEREIN AS THE "LEASES."

If the parties intend to convey an ORRI interest that covers less than all of the minerals covered by the OGL, then the ORRI instrument should expressly describe which minerals are included in the ORRI assignment. For example, while the OGL may cover "oil, gas and other minerals," the ORRI may only cover gas produced under such OGL. Additionally, the ORRI interest may be limited to cover less real property than what is covered by the OGL, such as in the following example clause:

an overriding royalty equal to .01 of 8/8ths of all oil, gas and associated minerals and hydrocarbons which may be produced, saved and marketed solely from Section 4 of the Leased Lands.

VIII. CONCLUSION

As discussed, an ORRI raises several key issues, some of which have been heavily litigated. Operator-lessees and ORRI owners alike should be aware of when the law is either uncertain or unfavorable to them. Parties can then contractually address in the ORRI-creating instrument many of the issues discussed in this Article to protect their interests and increase certainty.

APPENDIX A

SAMPLE FORM 1
[operator favorable]

ASSIGNMENT OF OVERRIDING ROYALTY INTEREST

STATE OF TEXAS §
§ KNOW ALL MEN BY THESE PRESENTS:
COUNTY OF ___________ §

THAT, **OIL EXPLORATION, INC.**, hereinafter referred to as "Assignor," for Ten Dollars ($10.00) and other valuable consideration, the receipt and sufficiency of which are hereby acknowledged, do hereby BARGAIN, SELL, TRANSFER, CONVEY and ASSIGN unto **SOUTH TEXAS OIL, INC.,** hereinafter referred to as "Assignee," whose address is ___________________________________, the following:

(1) an overriding royalty equal to .01 of 8/8ths of all oil, gas and associated minerals and hydrocarbons which may be produced, saved and marketed from the oil and gas leases described in the attached Exhibit "A," reference to which is herein made for all purposes;

(2) an overriding royalty equal to .025 of 8/8ths of all oil, gas and associated minerals and hydrocarbons which may be produced, saved and marketed from the oil and gas leases described in the attached Exhibit "B," reference to which is herein made for all purposes.

The oil and gas leases described in the attached Exhibits "A" and "B" are collectively referred to herein as the "Leases."

[COSTS BURDENING THE ORRI CLAUSE]

The overriding royalty interests herein assigned shall bear their proportionate share of all costs and expenses of development and operations, all costs and expenses of treating, compressing, gathering, transporting and dehydrating such production or rendering the same merchantable, and any ad valorem, gross production, severance and other taxes levied upon such overriding royalty interests or measured by the production of oil or gas attributable thereto.

The overriding royalties herein assigned are further subject to the following provisions:

[PROPORTIONATE REDUCTION CLAUSES]

[MINERAL ESTATE]

(a) If any of the Leases cover less than the entire and undivided mineral fee interest in the land described therein, then the overriding royalty interest assigned herein shall be proportionately reduced as to such lease, so that the overriding royalty interest assigned herein shall be paid only in the proportion that the mineral interest in the land which is covered by such lease bears to the full mineral interest in the land described therein;

[LEASEHOLD ESTATE]

(b) If the collective interests of Assignor in any of the Leases is less than the full leasehold interest created by the lease, then the overriding royalty interest assigned herein shall be proportionately reduced as to such lease, so that the overriding royalty interest assigned herein shall be paid only in the proportion that the collective leasehold interest in the lease owned by Assignor bears to the full leasehold interest created in the lease;

[FREE OIL AND GAS USE CLAUSE]

(c) Oil or gas used in operations upon the lands covered by the Leases, including lands pooled therewith, and in the handling of production therefrom, shall be deducted before computing the overriding royalties due to be paid hereunder to Assignee;

[SUGGESTED POOLING CLAUSE ALTERNATIVES]

(d) Assignor is hereby authorized to create or form pooled units and thereby pool or unitize the overriding royalties herein assigned without any further consent of, or consultation with, Assignee. In the event of such pooling or unitization, Assignee shall receive only such proportion of the overriding royalty stipulated herein as the amount of the acreage covered by the Leases and placed in the unit bears to the total acreage in the unit;

(d) Assignor is hereby authorized to create or form pooled units and thereby pool or unitize the overriding royalties herein assigned in the same manner and to the same extent as provided in the Leases, without any further consent of, or consultation with, Assignee. In the event of such pooling or unitization, Assignee shall receive only such proportion of the overriding royalty stipulated herein as the amount of the acreage covered by the Leases and placed in the unit bears to the total acreage in the unit;

[WASHOUT AND IMPLIED COVENANT CLAUSE]

(e) Any development of the lands covered by the Leases and the continuation of the Leases shall be in the sole and absolute discretion of Assignor, and no obligation with regard to maintaining the Leases, by conducting drilling operations, paying delay rentals or otherwise, shall exist by reason of this assignment. Further, all implied covenants, if any, with respect to the interests herein assigned are expressly waived by Assignee and of no force or effect;

(f) The overriding royalty interests assigned herein are subject to any and all instruments appearing of record affecting the Leases to the extent, and only to the extent, that such instruments are valid and remain in full force and effect;

(g) The terms, covenants and conditions of this assignment shall be binding upon, and shall inure to the benefit of, Assignor and Assignee and their respective successors and assigns; and

(h) The overriding royalty interests herein assigned is subject to any and all amendments of the Leases, now and in the future.

This assignment may be executed in several original counterparts, all of which are identical. Each of the executed counterparts hereof shall for all purposes be deemed to be an original, and all such counterparts shall together constitute but one and the same assignment.

TO HAVE AND TO HOLD said overriding royalty interests unto Assignee, and Assignee's successors and assigns forever; provided, however, that this assignment is executed without any warranty of title, express or implied.

DATED this ______ day of ____________________________, 2014.

OIL EXPLORATION, INC.

By: ____________________________
Name: _________________________
Title: __________________________

"ASSIGNOR"

SOUTH TEXAS OIL, INC.

By: ____________________________
Name: _________________________
Title: __________________________

"ASSIGNEE"

STATE OF TEXAS §
§
COUNTY OF BEXAR §

This instrument was acknowledged BEFORE ME on this ____ day of _____________, 2014, by _________________________, the _______________ of OIL EXPLORATION, INC., a Texas corporation, on behalf of said corporation.

____
Notary Public, State of Texas

STATE OF TEXAS §
§
COUNTY OF BEXAR §

This instrument was acknowledged BEFORE ME on this ____ day of _____________, 2014, by _________________________, the _______________ of SOUTH TEXAS OIL, INC., a Texas corporation, on behalf of said corporation.

____
Notary Public, State of Texas

APPENDIX B

SAMPLE FORM 2
[ORRI owner favorable]

ASSIGNMENT OF OVERRIDING ROYALTY INTEREST

STATE OF TEXAS	§	
	§	KNOW ALL MEN BY THESE PRESENTS:
COUNTY OF ___________	§	

THAT, **OIL EXPLORATION, INC.,** hereinafter referred to as "Assignor," for Ten Dollars ($10.00) and other valuable consideration, the receipt and sufficiency of which are hereby acknowledged, do hereby BARGAIN, SELL, TRANSFER, CONVEY and ASSIGN unto **SOUTH TEXAS OIL, INC.,** hereinafter referred to as "Assignee," whose address is ____________________________________, the following:

(1) an overriding royalty equal to .01 of 8/8ths of all oil, gas and associated minerals and hydrocarbons which may be produced, saved and marketed from the oil and gas leases described in the attached Exhibit "A," reference to which is herein made for all purposes;

(2) an overriding royalty equal to .025 of 8/8ths of all oil, gas and associated minerals and hydrocarbons which may be produced, saved and marketed from the oil and gas leases described in the attached Exhibit "B," reference to which is herein made for all purposes.

The oil and gas leases described in the attached Exhibits "A" and "B" are collectively referred to herein as the "Leases."

[COSTS BURDENING THE ORRI CLAUSE]

The overriding royalty interests herein assigned shall be delivered or paid free and clear of all costs and expenses of development or operations, except that said overriding royalty interests shall bear their proportionate share of any ad valorem, gross production, severance and other taxes levied upon such overriding royalty interests or measured by the production of oil or gas attributable thereto.

The overriding royalties herein assigned are further subject to the following provisions:

[PROPORTIONATE REDUCTION CLAUSES]

[MINERAL ESTATE]

(a) If any of the Leases cover less than the entire and undivided mineral fee interest in the land described therein, then the overriding royalty interest assigned herein shall be proportionately reduced as to such lease, so that the overriding royalty interest assigned herein shall be paid only in the proportion that the mineral interest in the land which is covered by such lease bears to the full mineral interest in the land described therein;

[LEASEHOLD ESTATE]

(b) If the collective interests of Assignor in any of the Leases is less than the full leasehold interest created by the lease, then the overriding royalty interest assigned herein shall be proportionately reduced as to such lease, so that the overriding royalty interest assigned herein shall be paid only in the proportion that the collective leasehold interest in the lease owned by Assignor bears to the full leasehold interest created in the lease;

[EXPRESS NO FREE OIL AND GAS USE CLAUSE]

(c) Oil or gas used in operations upon the lands covered by the Leases, including lands pooled therewith, and in the handling of production therefrom, shall not be deducted before computing the overriding royalties due to be paid hereunder to Assignee;

[SUGGESTED ANTI-POOLING CLAUSE ALTERNATIVES]

(d) Assignor shall not pool or unitize the overriding royalties herein assigned without the prior written consent of Assignee, which may be withheld in Assignee's sole and absolute discretion;

(d) Assignor shall not, without the prior written consent of Assignee, pool or unitize the overriding royalties herein assigned in any manner or to any extent not permitted by the Leases, and any future amendments to the Lease with respect to pooling and unitization shall not apply to the interest herein assigned, unless Assignee expressly approves such amendment;

[EXTENSION CLAUSE]

(e) The overriding royalty interests herein assigned shall extend to any and all renewals or extensions of the Leases and to new leases taken by the Assignor, Assignor's heirs and assigns on the same lease premises, or any part thereof, within twenty-four (24) months after the expiration or termination of the Leases;

(f) The overriding royalty interests assigned herein are subject to any and all instruments appearing of record affecting the Leases to the extent, and only to the extent, that such instruments are valid and remain in full force and effect;

(g) The terms, covenants and conditions of this assignment shall be binding upon, and shall inure to the benefit of, Assignor and Assignee and their respective successors and assigns; and

This assignment may be executed in several original counterparts, all of which are identical. Each of the executed counterparts hereof shall for all purposes be deemed to be an original, and all such counterparts shall together constitute but one and the same assignment.

TO HAVE AND TO HOLD said overriding royalty interests unto Assignee, and Assignee's successors and assigns forever; provided, however, that this assignment is executed without warranty of title, express or implied.

DATED this ______ day of ____________________________, 2014.

OIL EXPLORATION, INC.

By: _________________________
Name: _______________________
Title: ________________________

"ASSIGNOR"

SOUTH TEXAS OIL, INC.

By: ________________________
Name: ______________________
Title: ______________________

"ASSIGNEE"

STATE OF TEXAS §
§
COUNTY OF BEXAR §

This instrument was acknowledged BEFORE ME on this ____ day of ____________, 2014, by ______________________, the ______________ of OIL EXPLORATION, INC., a Texas corporation, on behalf of said corporation.

____
Notary Public, State of Texas

STATE OF TEXAS §
§
COUNTY OF BEXAR §

This instrument was acknowledged BEFORE ME on this ____ day of ____________, 2014, by ______________________, the ______________ of SOUTH TEXAS OIL, INC., a Texas corporation, on behalf of said corporation.

____
Notary Public, State of Texas

APPENDIX C

SAMPLE FORM 3
[ORRI owner favorable]

OVERRIDING ROYALTY RESERVATION IN OIL AND GAS LEASE ASSIGNMENT

As to the Subject Lease, Assignor hereby excepts and reserves unto itself, its successors or assigns, an overriding royalty on oil, gas, casinghead gas, condensate, and/or distillate equal to the difference between twenty-five percent (25%) and the sum of all current lease burdens on production existing and of record as of October 3, 2014 (inclusive of landowner royalty and all overriding royalty and production payments of record).

[COSTS BURDENING THE ORRI CLAUSE]

Said overriding royalty interest shall be delivered or paid free and clear of all costs and expenses of development or operations, except that said overriding royalty interest shall bear its proportionate part of any ad valorem, gross production, severance and other taxes levied upon such overriding royalty or measured by the production of oil or gas attributable thereto.

The overriding royalty herein reserved and excepted is further subject to the following provisions:

[PROPORTIONATE REDUCTION CLAUSES]

[MINERAL ESTATE]

(a) If the Subject Lease covers less than the entire and undivided mineral interest in the land described therein, then the overriding royalty interest reserved herein shall be proportionately reduced as to such lease, so that the overriding royalty interest reserved herein shall be paid only in the proportion that the mineral interest in the land which is covered by such lease bears to the full mineral interest in the land described therein.

[LEASEHOLD ESTATE]

(b) If the interest of Assignor in the Subject Lease is less than the full leasehold interest created in the lease, then the overriding royalty interest reserved herein shall be proportionately reduced as to such lease, so that the overriding royalty interest reserved herein shall be paid only in the proportion that the leasehold interest in the lease now owned by Assignor bears to the full leasehold interest created in the lease.

[EXPRESS NO FREE OIL AND GAS USE CLAUSE]

(c) Oil or gas used in operations upon the leased premises shall not be deducted before computing the overriding royalty interest reserved herein.

[SUGGESTED ANTI-POOLING CLAUSE ALTERNATIVES]

(d) Assignee, or Assignee’s heirs, personal representatives, successors and assigns, shall not pool or unitize the overriding royalty herein reserved, without the prior written consent of Assignor, which may be withheld in Assignor’s sole and absolute discretion.

(d) Assignee, or Assignee’s heirs, personal representatives, successors and assigns, shall not, without the prior written consent of Assignor, pool or unitize the overriding royalty herein reserved in any manner or to any extent not permitted by the Subject Lease, and any future amendments to the Subject Lease with respect to pooling and unitization shall not apply to the interest reserved herein unless Assignor expressly approves such amendment.

[EXTENSION CLAUSE]

(e) The overriding royalty interest reserved herein shall extend to any extensions or renewals of the Subject Lease and to new leases taken by the Assignee, Assignee’s heirs and assigns on the same lease premises or any part thereof within twenty-four (24) months after the expiration or termination of the Subject Lease.