WEST VIRGINIA CONFIRMS ITS ADHERENCE TO THE CONTRACT THEORY FOR POOLING OF NON-PARTICIPATING ROYALTY INTERESTS

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INTRODUCTION

Recently, the Supreme Court of Appeals of West Virginia clarified an important issue for the oil and gas industry in *Gastar Exploration, Inc. v. Contraguerro*, affirming West Virginia's adherence to the contract theory of pooling and explicitly rejecting the cross-conveyance theory adopted by Texas and other jurisdictions.[1],[2] The Court held that, in West Virginia, pooling is the consolidation of contractual and financial interests; it does not create joint or undivided property interests in the oil and gas underlying the pooled tract. As a result, consent or ratification of pooling by the holders of nonparticipating royalty interests ("NPRI") is not required in West Virginia.[3]

In terms of oil and gas leasing and development, the decision reinforces the contract theory in West Virginia and avoids multiple controversial aspects of the cross-conveyance theory, such as (i) requiring consent of each NPRI within a given tract for pooling or unitization purposes and (ii) arguably turning each NPRI holder into an indispensable party to any litigation affecting the pool or unit. Furthermore, under a cross-conveyance theory, problems could arise with "the validity of earlier pooling agreements, increased royalty litigation, and complications for the lease acquisition process."[4] In the Court's view, such a scheme is undesirable to both producers and landowners because pooling helps "to prevent waste, facilitate the orderly development of the minerals, to preserve correlative rights and to effect equitable participation within the pooled unit to be formed."[5]

THEORIES OF POOLING

According to the cross-conveyance theory, a voluntary pooling agreement leads to a unitization of property ownership such that each interest holder gains a proportional interest in every other interest holders' interest. That is, "[u]nder cross-conveyance theory, the lessors would each own an undivided interest in the others' interest, and each would thereby have conveyed to the others a similar interest in the premises originally owned."[6]

The leading cross-conveyance case from Texas is *Veal v. Thomason*.[7]In that case, Thomason sought to recover title and possession from Veal for a parcel of land that was subject to a voluntary pooling agreement.[8] However, the trial court held, and the Texas Supreme Court affirmed, that the case should be dismissed on the ground that Thomason had failed to join indispensable parties—i.e., the NPRIs.[9] The Court reached that conclusion by finding that the pooling agreement gave each interest holder in the pooled tract a property interest in the disputed parcel proportional to his or her fractional interest in the larger tract.[10] Therefore, any action by

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Thomason to recover title and possession from Veal necessarily had an effect on the possession and title of each of the other interest holders within the unit, rendering each interest holder an indispensable party to any litigation affecting any portion of the pooled tract.[11]

The contract theory of pooling, on the other hand, holds that pooling agreements do not convey property interests, but rather seeks to apportion the contractual rights to royalty payments among the several interest holders within a tract.[12] As such, the contract theory does not entail the joinder or ratification problems that attend the cross-conveyance theory.[13]

Ultimately, as discussed below, the West Virginia Supreme Court of Appeals determined that the contract theory is most aligned with West Virginia law. [14]

BACKGROUND OF *GASTAR V. CONTRAGUERRO*

The NPRI holders in *Gastar* possessed a one-fourth nonparticipating royalty interest (the "NPRI holders") in the mineral rights of a 105.9 acre parcel, which was pooled with other tracts by Gastar Exploration, Inc. ('Gastar") to form a 700 acre unit.[15] Gastar created the unit pursuant to a lease it had obtained from PPG Industries, Inc. ("PPG") for more than 3,000 acres.[16]

PPG and Gastar traced their oil and gas interest and executive rights to a 1946 conveyance by the ancestors of the NPRI holders. After transferring the rights to the oil and gas in place and the executive rights to discover and produce oil and gas, the ancestors of the NPRI holders passed on only a non-participating royalty interest to their heirs. In 2011, PPG entered into an operations agreement with Gastar, including the acreage in which the NPRI holders hold their interest. In 2012, Gastar designated a pooled unit and five wells in the unit have well bores reaching the minerals underlying the NPRI holders' parcel.

In their Complaint filed in the Circuit Court of Marshall County, the NPRI holders alleged that Gastar had diluted their royalty interests when it created the 700 acre unit and pooled the NPRI holders' interests with others' interests.[17] In addition to seeking damages against PPG and Gastar, the NPRI holders sought a declaration invalidating the PPG-Gastar lease to the extent it permitted Gastar to pool or unitize the NPRI holders' interests with those of others.[18]

The circuit court granted partial summary judgment in favor of the NPRI holders.[19] Finding Texas precedent persuasive, the circuit court applied the cross-conveyance theory of pooling to the applicable lease and held that "the consent or ratification of the NPRI holders to the pooling was required."[20] The circuit court described the situation, with regard to the oil and gas interests involved, "[t]his is exactly the situation contemplated by the cases which have found that non-participating royalty interests may not be pooled without consent."[21] Accordingly, the circuit court granted the NPRI holders' motion for partial summary judgment.[22] PPG and Gastar appealed the decision.[23]

SUPREME COURT OF APPEALS DECISION

On appeal, the Supreme Court of Appeals reversed the circuit court and found that West Virginia oil and gas precedent supports the express adoption of the contract theory rather than the cross-conveyance theory with regard to pooling and its effect on NPRI holders.[24] Therefore, the PPG-Gastar lease resulted only in a

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consolidation of leasehold interests but no merger of titles among the interest holders of the 700 acre unit.[25] The Court's decision was notable in at least two respects.

First, the Court clarified that extant West Virginia precedent is in line with the contract theory of pooling, and the Court expressly rejected the cross-conveyance theory. In its analysis of West Virginia precedent, the Court stated that it had previously recognized that an oil and gas unitization agreement alone "was a merger of contractual obligations" and "does not effect a merger of title."[26] Furthermore, the Court also noted that it had previously stated the oil and gas executive right, or "an agency coupled with an interest," is often a necessary and reasonable mechanism to address complicated business transactions that can become "unwieldly and uncertain" when seeking approval from numerous persons.[27] Accordingly, the Court held that "pooling of nonparticipating royalty interests with the interests of other individuals or entities for the horizontal drilling and production of oil and gas from the Marcellus Shale Formation does not create a joint or undivided property interest in the oil and gas underlying the tract pooled."[28] Specifically, "the cross-conveyance theory resulting in such a joint or undivided interest is rejected" and "consent or ratification by the holders of the nonparticipating royalty interests is not required" for pooling.[29]

Second, the Court emphasized a principle of law that was designed to foster efficient development of oil and gas. That is, the Court emphasized that adoption of the cross-conveyance theory would "inject uncertainty in this State's oil and gas jurisprudence" and allow any NPRI holder, by withholding consent, to "unilaterally void an entire pooling agreement involving thousands of acres and the bargained-for rights of dozens of other interest holders."[30] The Court noted that the circuit court had "effectively reconveyed executive right authority to the NPRI holders."[31] According to the Court, such a legal regime would be especially detrimental in the context of horizontal drilling and production, where the efficient development of mineral resources is in part dependent on the ability to combine parcels into contiguous units.[32] Thus, the Court's decision was a reaffirmance of legal principles that facilitate, not hinder, the efficient development of oil and gas.

CONCLUSION

With the Court's decision in *Gastar v. Contraguerro*, an important issue of law has now been clarified with regard to West Virginia oil and gas jurisprudence and any associated burdens on the efficient development of oil and gas. Companies facing royalty litigation with regard to nonparticipating royalty interests should carefully consider the applicable theories with regard to pooling and seek counsel knowledgeable in the nuances of this area of law.

Notes:

[1] No. 16-0429, 2017 WL 2418399 (W.Va. May 31, 2017).

[2] *See e.g. Minchen v. Fields*, 345 S.W.2d 282 (Tex. 1961) (holding that unitization or pooling results in a cross-conveyance of title such that the interest holders "all own undivided interests under the unitized tract in the proportion their contribution bears to the unitized tract."); *see also Ragsdale v. Superior Oil Co.*, 237 N.E.2d 492, 494 (Ill. 1968) (stating unitization "creates a single ownership of the entire unit by the owners of the several tracts making up the unit, subject to the terms of the oil and gas leases.").

[3] *Gastar* at *10.

[4] *See Id.* at *10 n.15.

[5] *Id.* at *10 n.16.

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[6] Bruce M. Kramer and Patrick H. Martin, The Law of Pooling and Unitization, §19.02[1][a] (LexisNexis Matthew Bender 2016).

[7] 159 S.W.2d 472 (Tex. 1942).

[8] *Id.* at 474.

[9] *Id.* at 477.

[10] *Id.* at 476.

[11] *Id.* at 476 (finding that "a contract affecting land in this State, which grants or reserves mineral royalty in such land, constitutes the owner of such royalty the owner of an estate in such land.").

[12] *Gastar* at *9 (citing 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 Saint Mary's L.J. 771, 796 (2013)).

[13] *See Kramer and Martin at §19.01[1]* (discussing the choice between contract and cross-conveyance, noting that it affects "who may effect a pooling of interests; who will be indispensable parties to litigation regarding the pooled unit; and what is the appropriate venue for litigation, and concluding that the best approach is to treat pooling as a special area of contract law that grows out of, and affects, property rights.)

[14] This is not to say that pooling could never convey a property interest. The parties can always expressly convey a property interest as part of any pooling agreement. The cross-conveyance and contract theories of pooling come into a play as a judicial gap-filler, applied in cases where the pooling agreement itself is silent as to whether property interests or contractual rights have been combined. *See Id.* (suggesting that "when the parties expressly state their preference, the courts will follow that language and not resort to the choice made by that state when the parties have left the issue undecided.").

[15] *Gastar* at *2.

[16] *Id* at *1.

[17] *Id.* at *5.

[18] *Id.*

[19] *Id.*

[20] *Id*.

[21] *Id*.

22] *Id.*

[23] *Id*.

[24] *See Boggess v. Milam*, 34 S.E.2d 267 (W.Va. 1945) (finding that unitization does not result in merger of title); *see also Donahue v. Bills*, 305 S.E.2d 311 (W.Va. 1983) (finding that a lease clause reserving executive right provided an "agency coupled with an interest" which has the benefit of "guarantee[ing] in advance . . . that parties who must acquiesce to the consummation of a business deal will do so at the appropriate time and in the appropriate form.").

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[25] *Gastar* at *9.

[26] *Id*. (citing *Boggess*, 34 S.E.2d at 270).

[27] *Id*. (citing *Donahue*, 305 S.E.2d at 312).

[28] *Id*. at *10.

[29] *Id*.

[30] *Id*.

[31] *Id*.

[32] *See Id.* at *10 n.16 (discussing West Virginia public policy as embracing the responsible and economically beneficial development of the State's natural resources).

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