

Texas Ruling Challenges Oil And Gas Anti-Washout Provisions

By **Michael Reer**

On May 15, the Texas Supreme Court issued an opinion in *Yowell v. Granite Operating Co.*, which concerned a dispute over the continued validity of an anti-washout provision. The anti-washout provision at issue purported to extend overriding royalty interests to future leases. The Texas Supreme Court held that the anti-washout provision violated the rule against perpetuities, and must be reformed, if possible, in accordance with the Texas Property Code.



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An overriding royalty interest is a nonpossessory share of production, or revenue from production, carved out of the lessee's interest under an oil and gas lease, free of production costs. Because an overriding royalty interest is carved out of the lessee's interest in the minerals, it generally lasts only so long as the lease continues.

An anti-washout provision attempts to save the overriding royalty interest under certain circumstances, even after the lease terminates, by extending the interest to future lease extensions, lease renewals or new leases. In *Yowell*, the anti-washout provision at issue specifically purported to extend the overriding royalty interest to any extension, renewal or new lease executed by the lessee or the lessee's successors-in-interest.

The Texas Supreme Court considered whether the anti-washout provision in *Yowell* violated the rule against perpetuities. Texas common law holds that the rule against perpetuities provides that no property interest is valid unless it must vest, if at all, within 21 years after the death of some life or lives in being at the time of the conveyance.

In other words, a conveyance is generally subject to the rule against perpetuities if the conveyance (1) concerns real property, and (2) is not certain to vest within the timeframe prescribed by the rule against perpetuities.

The court first concluded that overriding royalty interests — like other royalty interests in production — are nonpossessory property interests, and therefore subject to the rule against perpetuities. The court also concluded that the overriding royalty interest holder's interest in production from future leases was not certain to vest within the timeframe of the rule against perpetuities.

An interest in real property vests once the owner of the interest has an immediate, fixed right of present or future enjoyment. Conversely, if the interest only vests upon the happening of a condition or event, then the interest is executory and has not vested.

The anti-washout provision in *Yowell* purported to create an overriding royalty interest in certain new leases, an interest that was contingent upon the happening of several events, including the termination of the existing lease, and the lessor's execution of a new lease with the lessee or the lessee's successors-in-interest.

Because the conveyance purported to create a real property interest that was not certain to vest within the rule against perpetuities' timeframe, the overriding royalty interest, as applied to new leases, violated the rule. When an interest violates the rule against perpetuities, Texas courts typically hold that the provisions of the instrument creating it are void — unless doing so would not serve the purpose of the rule.

For example, in *ConocoPhillips Co. v. Koopman*,^[1] the Texas Supreme Court held that certain "future interests in the oil and gas context in which the holder of the interest is ascertainable and the preceding estate is certain to terminate" are not subject to the rule against perpetuities. Because the overriding royalty interest in *Yowell* was subject to multiple contingencies not certain to occur — including the termination of the preceding estate and the execution of a new lease with the lessee or the lessee's successors-in-interest — the *Koopman* exception did not apply.

The Texas Supreme Court also clarified that Texas Property Code Section 5.043 requires reformation of commercial instruments creating property interests that violate the rule. Among other items, the reformation provision requires Texas courts to, "[w]ithin the limits of the rule against perpetuities ... reform or construe an interest in real or personal property that violates the rule to effect the ascertainable general intent of the creator of the interest."

The Texas Supreme Court reversed and remanded *Yowell* for further proceedings to determine if reformation consistent with the statute is possible. The court also provided limited guidance on drafting anti-washout provisions that comply with the rule against perpetuities.

The court expressly agreed with precedent from the U.S. Court of Appeals for the Tenth Circuit that concluded that lease extensions and renewals do not violate the rule against perpetuities. A lease extension is an agreement that prolongs or continues the term of an existing lease.

The court also cautioned that its definition of lease renewals has historically been narrow. For example, in *Sunac Petroleum Corp. v. Parkes*,^[2] the Texas Supreme Court characterized a lease as a "new lease," not a renewal, "[s]ince the new lease was executed under different circumstances, for a new consideration, upon different terms, and over a year after the expiration of the old lease."

Yowell confirms that the rule against perpetuities presents a unique challenge for overriding royalty interest owners who wish to utilize anti-washout provisions to carry an interest forward to new leases. The anti-washout provision has historically been used to protect overriding royalty interest owners — whose interest is generally carved out of the lessee's estate — from lessee activities that would result in the termination of the current lease, and subsequent execution of a new lease unburdened by the overriding royalty interest.

Yowell reiterates that anti-washout provisions are most likely to comply with the rule against perpetuities (depending on the exact language used) if limited in time, or if applied only to extensions and renewals.

It is also possible that additional case law regarding the rule against perpetuities is forthcoming, as Texas courts begin to apply the reformation statute to anti-washout provisions and other instruments that do not comply with the rule. And the development of case law concerning the rule has the potential to impact other oil and gas conveyances,

including top leases and nonparticipating royalty interests.

Correction: A previous version of this article's headline inaccurately described anti-washout provisions. The error has been corrected.

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[1] *ConocoPhillips Co. v. Koopman*, 547 S.W.3d 351 (Tex. 2000).

[2] *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 802-803 (Tex. 1967).