

October 24, 2019

TEXAS SUPREME COURT TO ADDRESS “ANTI-WASHOUT” CLAUSES FOR OVERRIDING ROYALTY INTERESTS

To Our Clients and Friends:

On October 4, 2019, the Texas Supreme Court agreed to hear a case addressing the extent to which “anti-washout” provisions can prevent overriding royalty interests from lapsing when the lessee of an oil and gas lease enters into a new lease for the same assets.

Overriding royalty interests are “carved out” of an oil and gas lease and entitle the interest holder to some portion of a leased asset’s production without subjecting the interest holder to the expense of developing, operating, or maintaining the leased asset. These interests are tied to the lease from which they are carved out, meaning that these interests are limited in duration to the leasehold interest’s life. See *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 804 (Tex. 1967). Thus, absent specific language to the contrary, when the lease terminates or is renewed/extended, the overriding royalty interest does not survive. To prevent an overriding royalty interest from lapsing in such an event, interest holders often include “anti-washout” clauses in the instrument creating the overriding royalty interest. While these provisions typically prevent an overriding royalty interest from lapsing when a lease is renewed or extended, some seek to prevent the interests from lapsing even when the lessee enters into an entirely new lease with different terms for a particular mineral interest. For decades, Texas courts have confirmed that these anti-washout provisions are valid and enforceable as applied to lease extensions and renewals.

But on July 26, 2018, a Texas Court of Appeals addressed for the first time whether anti-washout provisions could extend existing overriding royalty interests to completely new leases. In *Yowell v. Granite Operating Co.*, 557 S.W.3d 794 (Tex. App.—Amarillo 2018, pet. granted), a group of overriding royalty interest owners argued that broad anti-washout provisions allowed the group to retain ownership of their interests after new leases were entered into for a particular mineral interest. The Court rejected this argument, finding that anti-washout provisions cannot extend overriding royalty interests to a completely new lease—which in this case contained materially different terms and different lessees—when there is any uncertainty as to when the interest in the new lease would vest. The Court rested its decision on a principle of property law called the “rule against perpetuities.” Under this rule, “no interest is valid unless it must vest, if at all, within twenty-one years after the death of some life or lives in being at the time of the conveyance.” *BP Am. Prod. Co. v. Laddex, Ltd.*, 513 S.W.3d 476, 479 (Tex. 2017). In *Yowell*, because (1) the underlying lease was of indeterminate duration and (2) the time between the expiration of the underlying lease and the creation of a new lease was also an indeterminate period, the Court of Appeals held that the anti-washout provision at issue violated the rule against perpetuities and was void.

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The overriding royalty interest owners sought discretionary review from the Texas Supreme Court, which the Court granted. The overriding royalty interest owners argue that the appellate court's rule against perpetuities holding is incorrect. Instead, they assert that their overriding royalty interests vested *immediately* when they were reserved in the original lease—the timing of the new lease is irrelevant. The new lessees disagree. They argue that any “vesting” of an interest in potential, future leases must necessarily be delayed until those leases actually exist; therefore, the overriding royalty interest provisions at issue violated the rule against perpetuities because there was no way to know if or when a new lease would be entered.

The Texas Supreme Court has scheduled oral arguments on the case for January 9, 2020. Gibson Dunn will continue to monitor this matter over the coming months, and, should the Texas Supreme Court agree with the Court of Appeals that the rule against perpetuities applies and can bar certain anti-washout provisions, we stand ready to advise our clients on whether and to what extent this decision may impact their businesses.



The following Gibson Dunn lawyers assisted in preparing this client update: Michael Raiff, Justin Stolte, Michael Darden, Christine Demana, Collin Ray, Nathan Zhang and Jordan Silverman.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work or any of the following members of the firm's Oil and Gas practice group:

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