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# Texas Supreme Court Rules That “Anti-Washout” Clause Purporting to Extend Overriding Royalty Interests to a “New Lease” Violates Rule Against Perpetuities

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On May 15, 2020, the Texas Supreme Court held that a broad “anti-washout” provision extending overriding royalty interests to a new lease for the same assets was invalid under Texas’s “rule against perpetuities,” though such a provision is subject to judicial reformation under Texas property laws.

As we noted in our October 24, 2019 alert when the Texas Supreme Court agreed to hear *Yowell v. Granite Operating Co.*, No. 18-0841 (Tex. 2020), overriding royalty interests are “carved out” of an oil and gas lease. They 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. Absent specific language to the contrary, these interests are “limited in duration to the leasehold interest’s life” and terminate with the lease. *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 804 (Tex. 1967). Interest holders thus often include “anti-washout” clauses in the instrument creating the overriding royalty interest to prevent the interest from lapsing when a lease is renewed or extended, and some seek to prevent the interests from lapsing even when the lessee enters into an entirely new lease on different terms. For decades, Texas courts confirmed that these anti-washout provisions are valid and enforceable as applied to lease extensions and renewals but did not address their validity as applied to “new leases.” That changed on May 15, 2020, when the Texas Supreme Court considered and held for the first time that an anti-washout provision could not extend an existing overriding royalty interest to new leases when it was not clear that the interest would vest within a certain period of time.

In *Yowell*, the Court reviewed the validity of an anti-washout provision that purported to cover any “extension, renewal, *or new lease*” executed by the mineral interest holder for the same assets. The Court confirmed that the “extension” and “renewal” provisions were valid, but concluded that the “new lease” provision violated the Texas Constitution because, at the time of execution, there was uncertainty as to when (or whether) the purported interest in a theoretical “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). The Court first concluded that the overriding royalty interest did not vest at the time of creation because it provided no “immediate, fixed right of present or future enjoyment as to new leases because those leases were not yet in existence.” The Court then noted that it was possible for the interest to vest outside the timeframe allowed by the rule against perpetuities. Specifically, the holder’s interest in a “new lease” was contingent on events that may not occur, including that (1) the existing lease must terminate, (2) the mineral interest owner must execute a new lease, and (3) the new lease must be obtained by the same lessee or its successor. In light of these

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contingencies, the overriding royalty interest would vest, if at all, after an indeterminate amount of time. The Supreme Court thus held that the provision was invalid as written.

Nonetheless, the Court also held that the anti-washout provision should be "reformed" under section 5.043 of the Texas Property Code to "reflect the creator's intent." This statute provides that "[w]ithin the limits of the rule against perpetuities, a court shall reform or construe an interest in real property that violates the rule to effect the ascertainable general intent of the creator of the interest." Tex. Pro. Code § 5.043(a). The Court concluded that the reformation statute applied to corporate conveyances of property interests, including anti-washout provisions, and remanded the case for further proceedings related to reformation of the specific clause at issue.

After *Yowell*, it is unclear whether anti-washout provisions that purport to cover "new leases" are simply void pursuant to the rule against perpetuities, or whether adding time limits and specifying other contingencies can save such clauses. Similarly, it remains to be seen whether and how Texas trial and intermediate courts will reform anti-washout provisions that purport to cover "new leases" to comply with the rule. In the meantime, lessees and overriding royalty interest holders who wish to include anti-washout provisions covering "new leases" should carefully and clearly draft such provisions so that the interest vests with certainty within the limited time period proscribed by the rule, or risk that such a provision will be void or subject to judicial intervention and reformation. Gibson Dunn stands ready to advise our clients in drafting these provisions and otherwise advise our clients on the extent to which the Court's decision may impact existing oil and gas leases.

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The following Gibson Dunn lawyers assisted in preparing this client update: Mike Raiff, Mike Darden, Allyson Ho, Christine Demana and Collin Ray.

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 or Appellate and Constitutional Law practice groups:

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