

The Interplay of Anti-Washout Clauses and the Rule Against Perpetuities

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The Texas Supreme Court recently held in *Yowell v. Granite Operating Co.*, No. 18-0841, 2020 Tex. LEXIS 425 (May 15, 2020), that an overriding royalty interest ("ORRI") is a real property interest subject to the rule against perpetuities (the "Rule"), and an anti-washout provision which extends an ORRI to new leases violates said Rule. However, the Court also held that Texas Property Code §5.043 mandates judicial reformation of any such instrument that violates the Rule, and such reformation is not subject to a statute of limitations. The Court made additional findings regarding indemnity agreements and the payments of attorneys' fees, but those findings are outside the purview of this article.

Background

In 1986, Aikman Oil Corp. ("Aikman") obtained an oil and gas lease covering a section of land in Wheeler County, Texas ("1986 Lease"). Aikman subsequently assigned its interest to Jay Haber, but reserved a 2.25% ORRI, and including the following anti-washout provision:

Should the Subject Leases... terminate and in the event, Assignee obtains an extension, renewal, or new lease or leases covering or affecting all or part of the mineral interest covered and affected by said lease or leases, then the overriding royalty interest reserved herein shall attach to said extension, renewal, or new lease or leases...

Through a series of conveyances, Tommy Yowell and others (collectively, "the Yowells") became vested with Aikman's ORRI and Upland Resources Inc. ("Upland") became vested with Jay Haber's leasehold interest in the 1986 Lease.

In May 2007, Amarillo Production Co. ("Amarillo") executed a top lease ("2007 Lease") with the same mineral owner and covering the same property as the 1986 Lease. Subsequently, Amarillo sued Upland, alleging that Upland's 1986 Lease terminated and that the 2007 Lease was in effect. Pursuant to a settlement between Amarillo and Upland, it was agreed that: the 1986 Lease terminated; the 2007 Lease was in effect; Upland was assigned the leasehold interest in the 2007 Lease; and Amarillo was vested with an ORRI in the 2007 Lease. Subsequently, Upland changed its corporate identity to Granite Operating Company ("Granite"). Following the settlement agreement, Granite stopped paying the Yowells ORRI under the 1986 Lease. The Yowells filed suit against Granite to reinstate payment of their ORRI, seeking a judicial declaration of ownership and recovery of payments owed.

Application of the Rule to the Yowells' ORRI

The Court noted that in order for the Rule to be implicated, the Yowells' reservation of an ORRI in new leases must first be determined to be an interest in real property. In concluding that the Yowells' interest

was indeed an interest in real property, the Court stated:

An ORRI is a share of production created and paid out of a lessee's interest under an oil and gas lease. See *supra* note 1. We have long held that ORRI's, like other royalty interests in production, are non-possessory property interests. See *State v. Quintana Petroleum Co.*, 134 Tex. 179, 133 S.W.2d 112, 114-15 (Tex. 1939) (citing *Tennant v. Dunn*, 130 Tex. 285, 110 S.W.2d 53, 57 (Tex. [Comm'n Op.] 1937) (rejecting the argument that ORRI did not create an interest in land)). *Yowell v. Granite Operating Co.*, No. 18-0841, 2020 Tex. LEXIS 425, at *9 (May 15, 2020).

Accordingly, the Court found that the Yowells' reservation of ORRI in new leases (i.e., the 2007 Lease) was also subject to the Rule. In order to determine whether the Yowells' ORRI under future leases violated the Rule, the Court examined whether 1) the ORRI vested at the time of its creation, or 2) the ORRI would vest within the Rule's prescribed timeframe (21 years after a life-in-being).

The Court held that at the time the ORRI was reserved, it provided no immediate, fixed right of present or future enjoyment as to future leases because those leases were not yet in existence. Consequently, the Court held that Yowells' ORRI in future leases did not vest at the time of its creation, but was instead an executory interest.

Furthermore, the Court held that the ORRI in future leases would not vest within the 21 years prescribed by the Rule. This is because the Yowells' ORRI in a future lease was contingent on three (3) events that might not occur within the Rule's timeframe: first, the 1986 Lease would not terminate "as long thereafter as either oil, gas, ... or other mineral ... is produced from said land hereunder," meaning that the 1986 Lease could continue indefinitely; second, it was not certain the mineral owner would sign a new lease; and lastly, it is not certain that the lease would be obtained by a successor of leasehold owner of the 1986 Lease. Thus, the Court found that the Yowells' ORRI in new leases violated the Rule.

The Court also differentiated between overriding royalty interests and non-participating royalty interests when applying the Rule in that a non-participating royalty interest remains with the land irrespective of the lease's lifetime; whereas, the owner of an ORRI in a potential future lease does not have a present right to a share of future production.

Application of Texas Property Code §5.043 – Reformation of Interests Violating the Rule

The Court also held that the Texas Property Code §5.043 is "a judicial mandate to which statute limitations do not apply, and it requires reformation of commercial instruments creating property interests that violate the Rule," including the Yowells' ORRI in future leases. The Court's rationale was that §5.043 extends to instruments other than trust and wills, including commercial instruments, based on the language in §5.043(d), which states in part, that §5.043 "applies to legal and equitable interests,

including noncharitable gifts and trusts." (emphasis added). Furthermore, the language used in §5.043(d) was inclusive, and that noncharitable gifts and trusts are only examples of instruments to which the statute applies. Accordingly, the Court construed the statute as non-exhaustive.

Finally, the Court held that the language used in §5.043 "is an instruction to courts on how to remedy a violation of the Rule, not a cause of action that would be subject to a statute of limitations." Accordingly, the Court rejected the argument that §5.043 did not apply to the Yowells' ORRI due to the running of the applicable statute of limitations based on the fact that "the Yowells' ORRI [was] a real property interest, and they [the Yowells] [sought] a judicial declaration of ownership of that interest in the 2007 Lease" rather than a cause of action subject to a statute of limitations.

Despite the Court's conclusion that §5.043 applied to the reformation of the Yowells' ORRI, it left open the question whether or not the ORRI could successfully be reformed under the statute. Specifically, the Court remanded for further proceedings because "the parties disagree, however, about whether – and, if so, how – the Yowells' interest in new leases may be reformed under the statute to reflect the creator's intent within the limits of the Rule."

Yowell v. Granite Operating Co. demonstrates that you should be clear whether an ORRI would be extended to any future lease, and specify the timeframe in which the future lease must come into existence in a manner which does not violate the limitations of the Rule. If the renewal and extension provision

is found to be in violation of the Rule, then it would theoretically be subject to reformation under the Texas Property Code §5.043. Unfortunately, we have no clear model of what an ORRI would look like, once reformed for having violated the Rule.

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M. Ryan Kirby is a founding Partner, J. Brian Davis is a Senior Attorney, and Gina Hong is a Law Clerk with Kirby, Mathews & Walrath, PLLC, a firm founded on the idea that oil and gas operators are best served by individuals that understand the needs of the industry, as well as fulfilling those needs in an efficient, cost-effective and timely manner, all the while establishing a relationship and a dialogue with the client. In addition to his legal practice, M. Ryan Kirby is also a frequent speaker at seminars for various Landmen's organizations; he also serves as an Adjunct Professor at South Texas College of Law, where he teaches the Texas Oil, Gas and Land Titles course. J. Brian Davis is an attorney licensed and practicing in Texas, New Mexico, and Colorado, as well as being Board Certified in Oil, Gas and Mineral Law by the Texas Board of Legal Specialization. Gina Hong is currently a 2L at South Texas College of Law and industrial manufacturing.

