

OG Energy Education Series

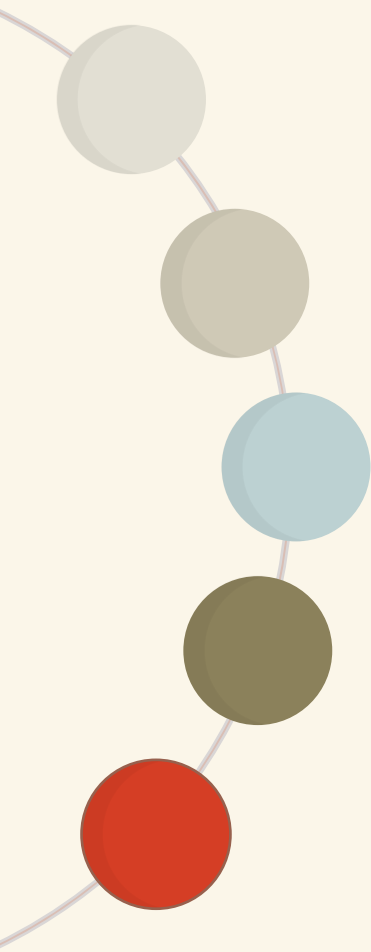
Mechanics of Washout Provisions



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Topics of Discussion

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- I. Background on non-operating interests
 - II. Lease washout transactions
 - III. Anti-washout clauses
 - IV. Privity of contract
 - V. Rule against perpetuities

I. Background on Non-Operating Interests

- ❖ Typically includes ORRI's, production payments, net profits interests, carried interests, etc.
 - Non-possessory
 - Termination of the lease = termination of these types of interests

II. Lease Washout Transactions

What is an **oil and gas lease washout transaction**?

- ❖ A method an operator uses to eliminate non-operating interests, by either releasing or allowing a current oil and gas lease to expire

Why would an operator do that?

- ❖ Sometimes, it makes financial sense.

Is the operator even allowed to do that?

- ❖ Yes (generally speaking).

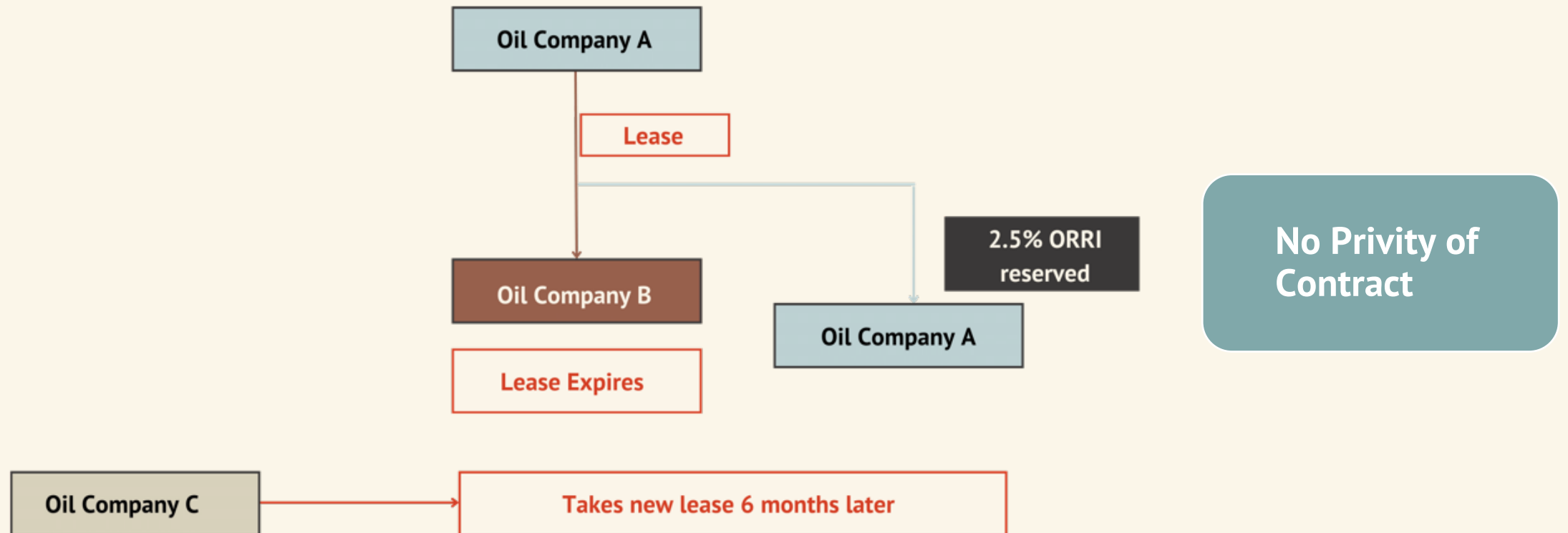
III. Anti-Washout Clause (a.k.a. Savings Clause)

- ❖ Since an ORRI is tied to the Lease, it can't survive termination, unless the instrument provides otherwise.
- ❖ Solution: **Anti-Washout Clause**
 - “Said interest is to apply to all amendments, extensions, renewals, or new leases taken on all or a part of the lease premises within one year after termination of the present lease.”

III. Anti-Washout Clause (Cont.)

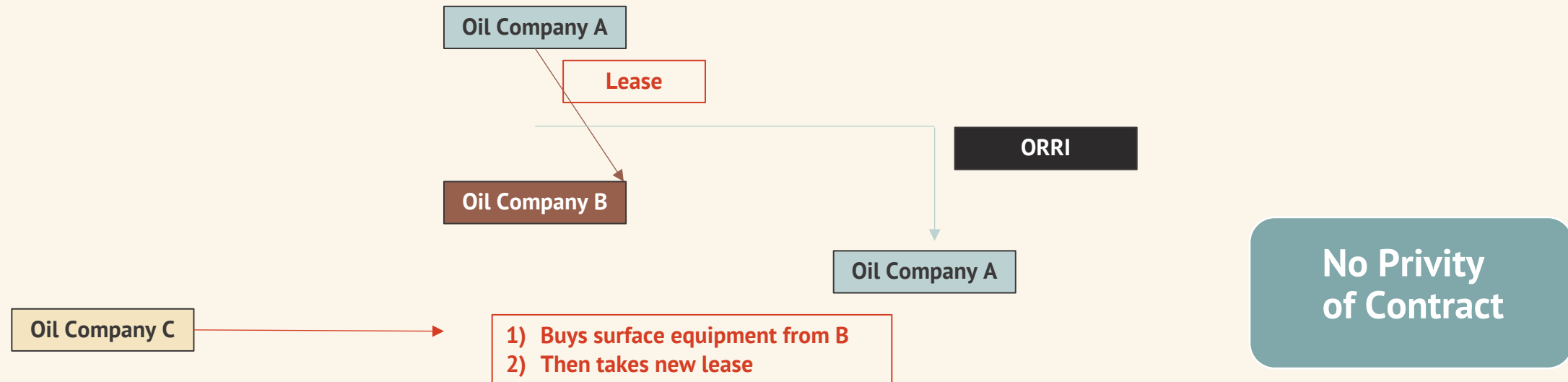
❖ Is a lessee under a new lease bound by the anti-washout clause? **It depends.**

1. Privity required. Example:



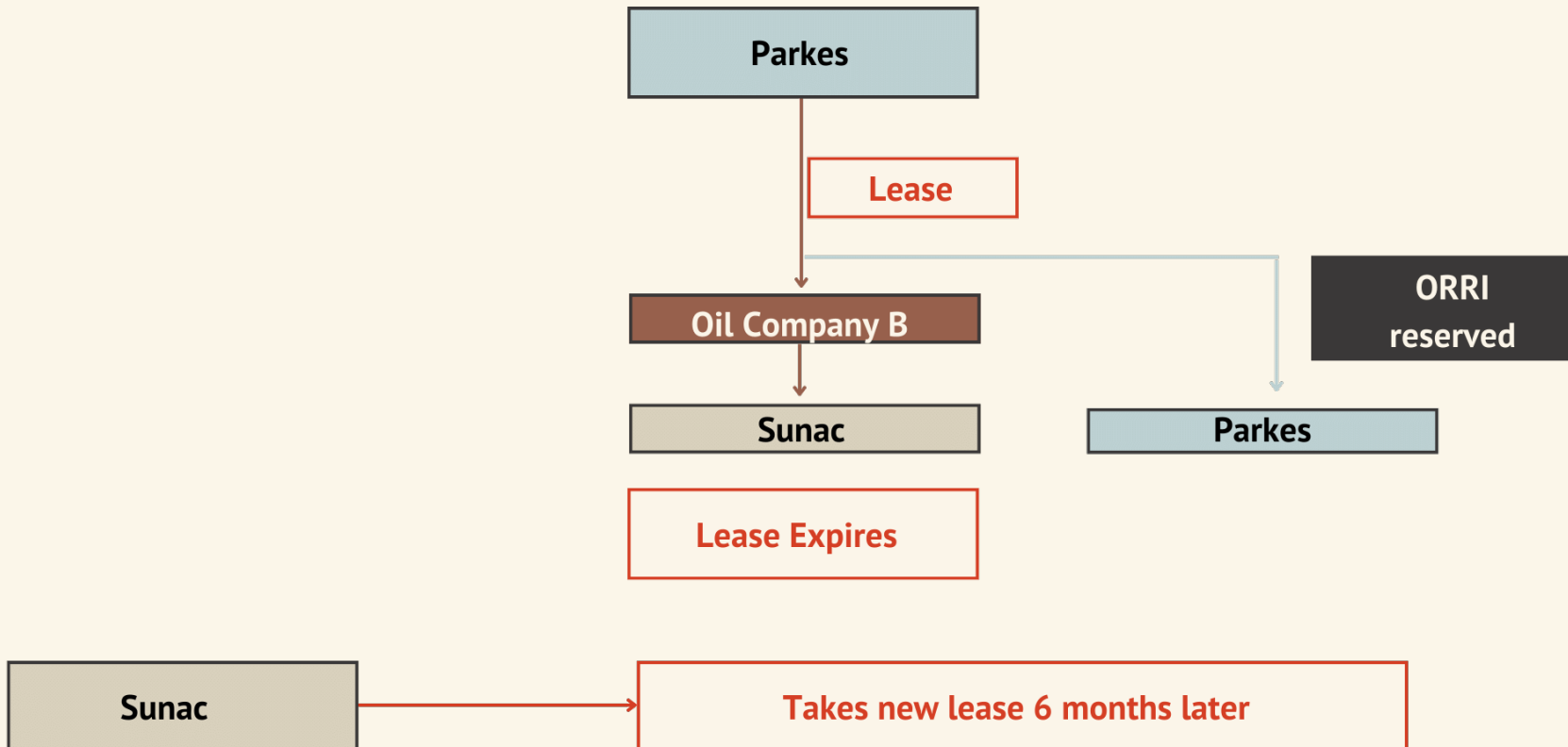
Privity Required (Cont.)

❖ McCormick V. Krueger, 593 S.W.2d 729 (Tex. App.—Houston [1st Dist.] 1979)



Anti-Washout Clause (Cont.)

- ❖ The situation fits squarely within the anti-washout clause.
Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798 (Tex. 1967)



An extension or renewal is NOT the same as a new lease

Anti-Washout Clauses (Cont.)

What happens if there is no surrender clause?

Same result.

- ❖ Exploration Co. v. Vega Oil & Gas Co.
- ❖ Facts: Anti-washout provision limited to “renewals and extensions. No “Surrender Clause.”

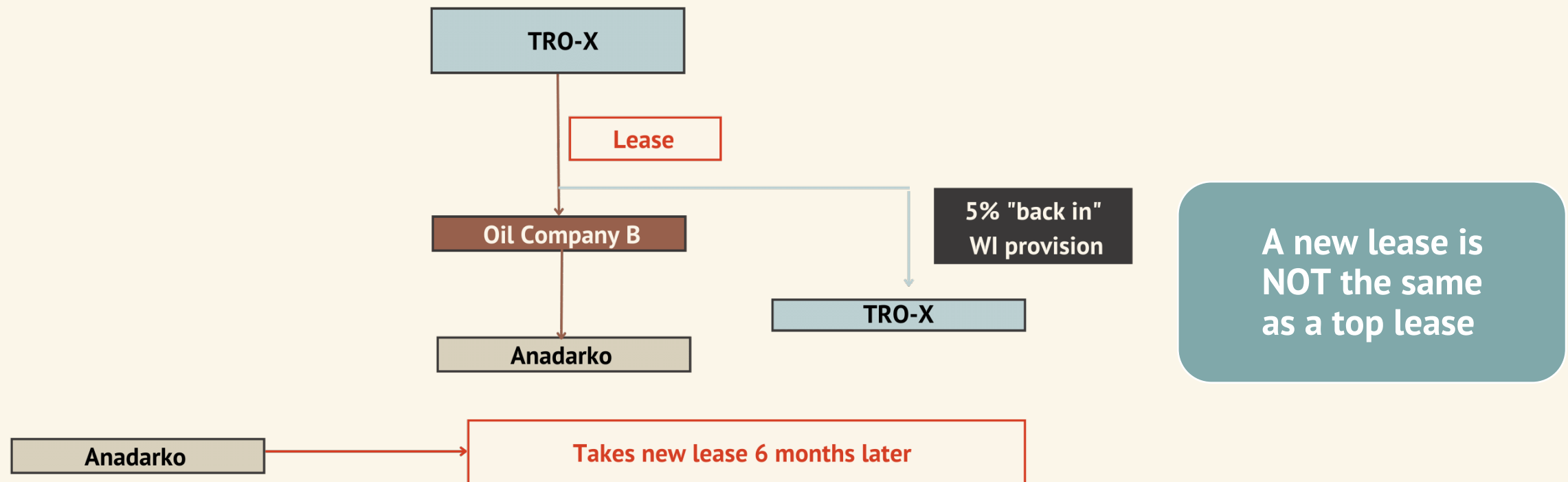
How could the ORRI owner create a fiduciary relationship?

Expressly state it.

- ❖ “Lessee owes overriding royalty owner a fiduciary duty to deal with the leased property in a manner that will protect the overriding royalty owner’s interest against any action or inaction by the lessee.”

Anti-Washout Clauses (Cont.)

❖ A recent 2018 example: TRO-X, L.P. v. Anadarko Petroleum Corp.



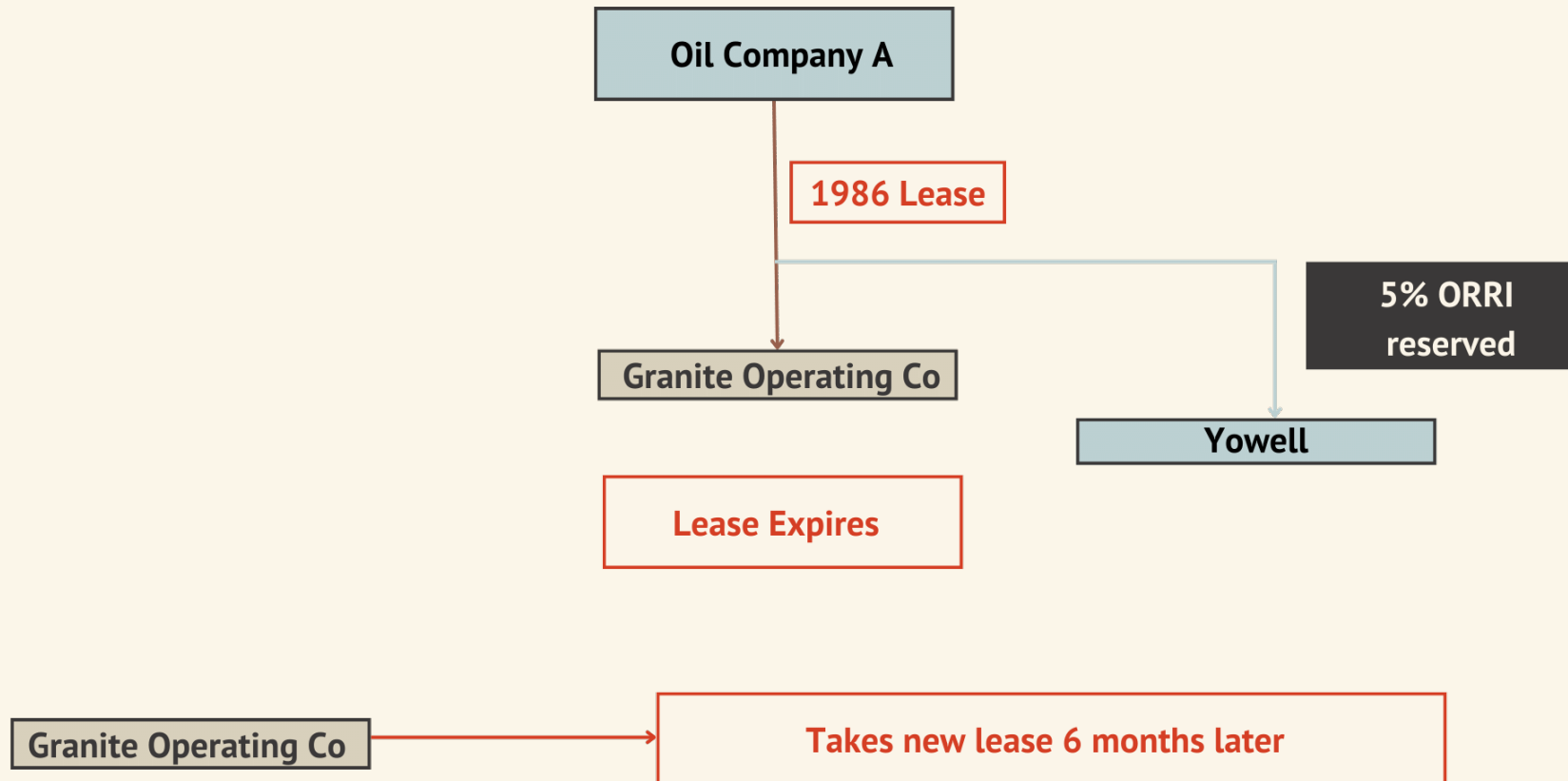
❖ **Anti-washout clause:** "shall extend to and be binding upon any renewal(s), extension(s), or top lease(s) taken within one (1) year of termination of the underlying interest."

V. Rule Against Perpetuities (RAP or the “Rule”)

- ❖ The anti-washout out clause must not violate the “Rule”
- ❖ **History:** English Common Law & Texas Constitution
- ❖ **Definition:** “No property 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.”

Rule Against Perpetuities (Cont.)

❖ Yowell v. Granite Operating Co.



Anti-washout clause:

Applied to an extension, renewal, or new lease

Texas Property Code Sec. 5.043

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- (a) Within the limits of the rule against perpetuities, a court shall reform or construe an interest in real or personal property that violates the rule to affect the ascertainable general intent of the creator of the interest. A court shall liberally construe and apply this provision to validate an interest to the fullest extent consistent with the creator's intent.
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- (b) The court may reform or construe an interest under Subsection (a) of this section according to the doctrine of cy pres by giving effect to the general intent and specific directives of the creator within the limits of the rule against perpetuities.
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- (c) If an instrument that violates the rule against perpetuities may be reformed or construed under this section, a court shall enforce the provisions of the instrument that do not violate the rule and shall reform or construe under this section a provision that violates or might violate the rule.
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- (d) This section applies to legal and equitable interests, including noncharitable gifts and trusts, conveyed by an inter vivos instrument or a will that takes effect on or after September 1, 1969, and this section applies to an appointment made on or after that date regardless of when the power was created.

Rule Against Perpetuities (Wait-and-See Jurisdictions)

- ❖ Texas: Cy pre reformation
- ❖ Majority of other states: “Wait-and-See” Approach
- ❖ Ohio Example:
 - Any interest in real or personal property that would violate the rule against perpetuities under division (A) of this section shall be reformed, within the limits of the rule, to approximate most closely the intention of the creator of the interest. In determining whether an interest would violate the rule and in reforming an interest, the period of perpetuities **shall be measured by actual rather than possible events.**
 - R.C. 2131.08(C)

Key Points to Remember:

❖ Draft anti-washout clause broadly.

- Example: This reservation (or assignment) shall apply to all amendments, modifications, replacements, renewals, extensions or new leases that the assignee, his successor or assigns may secure.

❖ Include perpetuities savings clause.

- Either limit the interest in the anti-washout clause to:
 - (i) to a firm period of no more than 21 years from the creation of the interest or
 - (ii) limit it to 21 years within some lives in being at the time of the conveyance.

RAP Savings Clause

- ❖ Any interest granted or reserved under this instrument that would violate the Rule Against Perpetuities shall terminate no later than twenty-one (21) years after the death of the last survivor of [named person(s) alive on the effective date of the instrument that could affect whether the interest vests].

Washout Transactions: Working Interests

- ❖ A "**working interest**" is the interest owned by the lessee of an oil and gas lease.
- ❖ The interest is referred to as a "working interest" because it grants the lessee the right to work on the leased property to search for, develop, and produce oil and gas on the property.

Working Interests (Cont.)

❖ Ridge Oil Co. v. Guinn Investments, Inc., 148 S.W.3d 143 (Tex. 2004).

Ridge Tract



**(Production from
1937 to 1997)**

Guinn Tract

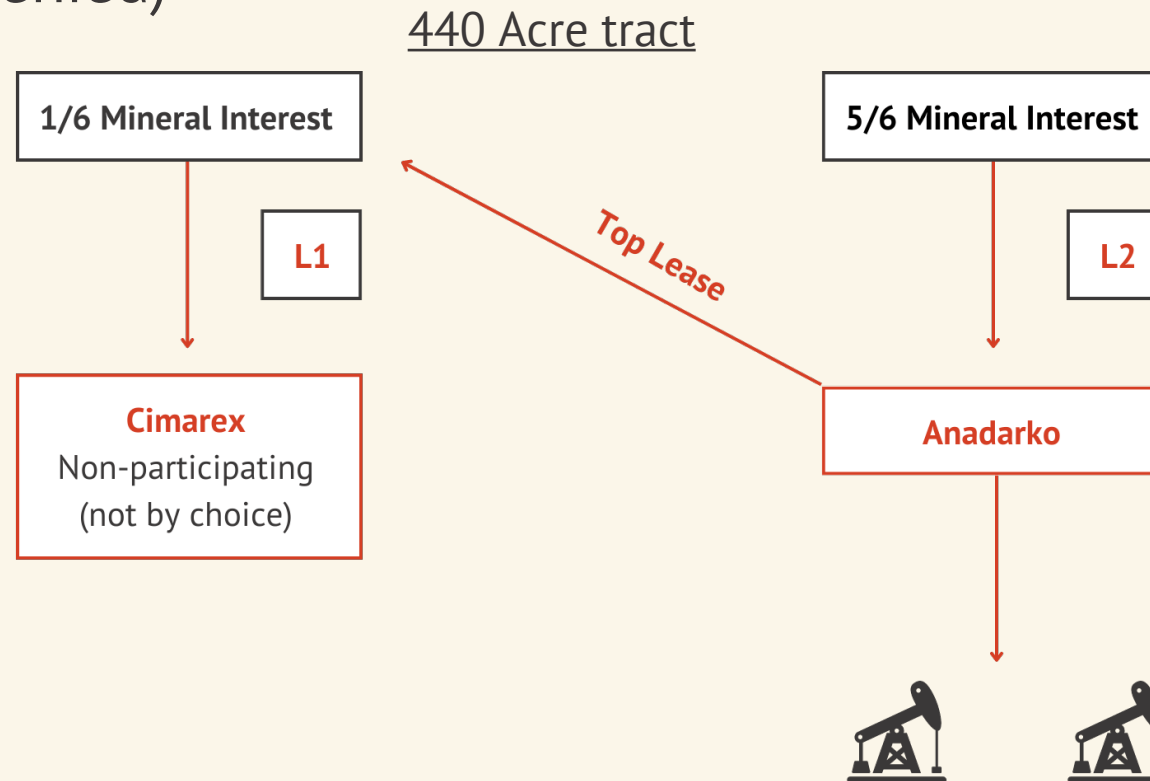


(Well P&A in 1950)

Ridge takes new lease in 1998

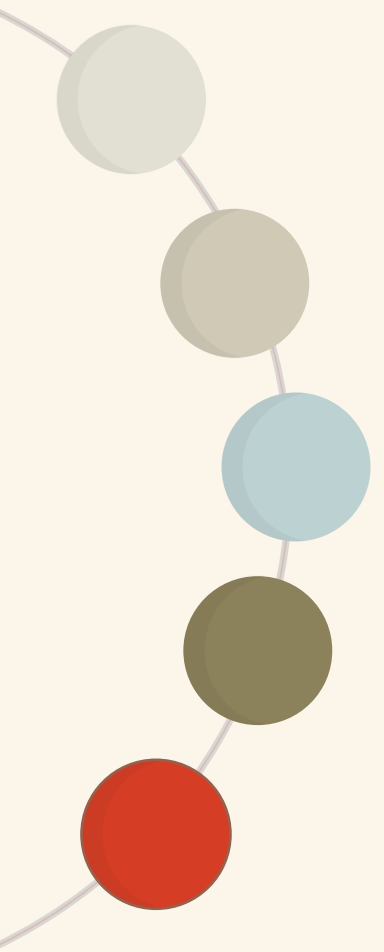
Working Interests (Cont.)

- ❖ *Cimarex Energy Co. v. Anadarko Petroleum Corp.*, 574 S.W.3d 73 (Tex. App.—El Paso 2019, pet. denied)



Cimarex Lease (L1): 5 years and "as long thereafter as oil or gas is produced from said land or from land with which said land is pooled."

Conclusion

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- I. Important to (i) review existing non-operating interests, and (ii) be aware of these issues in future transactions.
 - At risk of being washed-out?
 - Need to be compliant with RAP.