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**Turn Around, Don't Drown:  
A New Generation of Oil and Gas Lease  
"Washouts" in Texas and How to Avoid Them**

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# TURN AROUND, DON'T DROWN: A NEW GENERATION OF OIL AND GAS LEASE "WASHOUTS" IN TEXAS AND HOW TO AVOID THEM

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## I. Introduction

*Well, now, there is a tiny creature . . . with enormous problems. How he has survived throughout the ages is one of nature's big mysteries. His life is hazardous. Downright dangerous. Uh, would you like to try it?*

*Oh, no, I'd better not.*<sup>1</sup>

Like the noble squirrel in Disney's classic animated film, the life of a non-operating interest in an oil and gas lease can be fraught with peril. Lacking the clout and control of a lease operator with a majority working interest, overriding royalty owners' complaints about nonpayment are often a low priority and small fractional working interest owners often struggle to obtain payout accountings. But the most dreaded predator of all is the infamous washout.

At the risk of mixing metaphors, a lease washout transaction is a procedure used by lease operators to eliminate non-operating interests, much like a flood washing out a country road. For better or worse, washouts are not a rare occurrence in the oil and gas industry. Although they are most often associated with overriding royalty interests,<sup>2</sup> washouts can happen to any type of non-operating interest in an oil and gas lease, such as a back-in option,<sup>3</sup> net profits interest,<sup>4</sup> security interest,<sup>5</sup> or a non-operating working interest.<sup>6</sup>

This article will review Texas case history on the enforcement of washout transactions and the efficacy of anti-washout clauses, examine three new Texas cases that have expanded our jurisprudence regarding washouts, and explore ways for non-operating interest owners to protect themselves from washouts.

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<sup>1</sup> THE SWORD IN THE STONE (Walt Disney Productions 1963).

<sup>2</sup> See generally 2 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS §§ 2.4(B)(3), 16.5(A)(3)(b) (LexisNexis Matthew Bender, 2nd ed. 2021).

<sup>3</sup> See TRO-X, L.P. v. Anadarko Petroleum Corp., 548 S.W.3d 458, 548 (Tex. 2018).

<sup>4</sup> See Ultra Res., Inc. v. Hartman, 226 P.3d 889, 909 (Wyo. 2010).

<sup>5</sup> See Macquarie Bank Ltd. v. Knickel, 723 F.Supp. 2d 1161, 1168–69 (D.N.D. 2010).

<sup>6</sup> See Cimarex Energy Co. v. Anadarko Petroleum Corp., 574 S.W.3d 73, 95 (Tex. App.—El Paso 2019, pet. denied).

## II. Lease Washouts in General

In a broad sense, “[a] washout describes conduct by the lessee designed to extinguish the burden of a non[-]operating interest, such as an override, while still effectively preserving the lessee’s interest.”<sup>7</sup> More specifically, a washout is the “[e]limination of an overriding royalty or other share of the working interest by the surrender of a lease by a sublessee or assignee and subsequent reacquisition of a lease on the same land free of such interest.”<sup>8</sup>

The purpose of a washout transaction is to eliminate revenue burdens on the operating lessee’s working interest or annex competing non-operating working interests.<sup>9</sup> The operating lessee achieves this by taking advantage of existing contract terms, as opposed to directly acquiring the outstanding interest. Although washouts have historically referred to the intentional elimination of lease burdens in bad faith as evidenced by the operating lessee acquiring a new lease before termination of the original lease,<sup>10</sup> Texas case law has consistently treated the operating lessee’s intent as immaterial.<sup>11</sup> Note that the term “non-operating interest” is used herein to simply describe an interest in an oil and gas lease that cannot or does not drill and operate oil and gas wells.<sup>12</sup>

Broken down into its component parts, a washout transaction occurs when: (1) the operating lessee of an oil and gas lease releases its interest in the lease or allows it to terminate under its terms; (2) the release or termination causes another party’s non-operating interest to likewise terminate; and (3) the operating lessee acquires a new lease covering the mineral interest formerly covered or burdened by the now-terminated non-operating interest, free and clear of such interest.<sup>13</sup> However, these elements are not absolute requirements; washouts come in a variety of flavors. In some cases, the operating lessee acquired the underlying fee

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<sup>7</sup> Lawrence P. Terrell, *Overriding Royalties and like Interests—A Review of Nonoperating Lease Interests*, ROCKY MT. MIN. L. INST. 4-16, n.161 (1993).

<sup>8</sup> PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS MANUAL OF OIL AND GAS TERMS (16th ed. 2015).

<sup>9</sup> Terrell, *supra* note 7, at n.162 (“The lessee obviously has an economic incentive to eliminate such burdens, since they diminish his net share of production and profit.”).

<sup>10</sup> See *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 804 (Tex. 1967) (“Another situation in which some courts have protected the holder of the overriding royalty is called a ‘washout’ transaction, generally involving some bad faith on the part of the lessee. In this type of situation, the operator takes a new lease before the expiration of the old lease and then simply permits the old lease to expire.”).

<sup>11</sup> See *Ridge Oil Co. v. Guinn Invs., Inc.*, 148 S.W.3d 143, 154 (Tex. 2004); *Stroud Prod., L.L.C. v. Hosford*, 405 S.W.3d 794, 803–04 (Tex. App.—Houston [1st Dist.] 2013, pet. denied).

<sup>12</sup> More specifically, it is used to describe a leasehold interest that either: (1) by its nature, lacks the legal authority to operate, such as an overriding royalty, production payment, or security interest; or (2) bears the legal authority to operate, but cannot economically do so or otherwise elects not to do so for practical reasons. Cf. MARTIN & KRAMER, *supra* note 8 (defining the term “non[-]operating interest”).

<sup>13</sup> See 2 PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW § 420.2 (LexisNexis Matthew Bender 2021); M. C. Cottingham Miles & Paul J. Benavides, *Contracting for Clarity: Practical Solutions for Drafting Around the Current State of the Law Affecting Overriding Royalty Interests*, 46 TEX. TECH L. REV. 1043, 1045–50 (2014).

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