‘Washing Out’ an Overriding Royalty Interest: An Overview of *Oil Valley Petroleum v. Moore*

By Kraettli Q. Epperson

In the Oct. 3, 2023, Oklahoma Supreme Court case of *Oil Valley Petroleum v. Moore*, 2023 OK 90, the court considered the question of “whether a lessee’s release of a lease may extinguish another’s interests [*e.g.,* an overriding royalty interest] in the base oil and gas lease when a claim is made of continuing production holding the lease.”[1]

The answer given by the Oklahoma Supreme Court was that “an overriding royalty interest may be extinguished by an extinguishment of the working interest from which it was carved by a lessee’s surrender of the lease in substantial compliance with the lease, unless the surrender is the result of fraud or breach of a fiduciary relationship.”[2]

By way of background, the trial court considered competing motions for summary judgment between the plaintiff (Oil Valley) holding a “top lease,” seeking to quiet title to their “top lease,” and the defendant (Clay Moore) holding an overriding royalty interest (ORRI) and seeking to preserve it. The trial court ruled in favor of Mr. Moore, preserving his ORRI in the face of a recorded release of the underlying oil and gas lease by relying on the continuation of production in paying quantities. On appeal, the Oklahoma Court of Civil Appeals reversed the trial court ruling and ruled for the plaintiff, Oil Valley, extinguishing the ORRI. After granting certiorari, the Oklahoma Supreme Court ruled: “Opinion on the Court of Civil Appeals Vacated; Order of the District Court Reversed; and Cause Remanded for Additional Proceedings.” This matter was “remand[ed] [to the trial court] for additional proceedings consistent with this opinion.”[3]

This article focuses on the Supreme Court’s holding as to if and when an ORRI may be extinguished, aka “washed out.” What is considered herein is 1) how did the court get to this conclusion that an ORRI can be washed out and 2) which related questions remain unresolved.

RELEVANT TERMINOLOGY

To address the first question, we need to briefly explore what the Supreme Court said about the meaning of the relevant albeit basic terms in this case, such as “oil and gas lease,” “working interest,”

"overriding royalty interest," "surrender" of an oil and gas lease, "base oil and gas lease," "top lease," "paying quantities" and related phrases.

Oil and gas lease. An oil and gas lease "does not operate as a conveyance of oil and gas in situ but constitutes merely a right to search for and reduce to possession such of these substances as might be found ... it is really a grant in praesenti of oil and gas to be captured in the lands described during the term demised and for so long thereafter as these substances may be produced."[4]

Working interest. "Generally, the phrase 'working interest' 'unequivocally implies the right to "work" or do the things necessary to producing, the lease and helps distinguish such an interest from one which does not carry with it that right.' A working interest is one of those rights usually created as part of a cluster of rights granted to a lessee in an oil and gas lease."[5]

Overriding royalty interest. "An overriding royalty interest is often defined as: 'a certain percentage of the working interest which as between the lessee and the assignee is not charged with the cost of development or production.'"[6]

Primary term and habendum clause (secondary term). The Supreme Court said:

The phrases "primary term" and "habendum clause" have well-known meanings in our jurisprudence.[7]

One court has explained an incomplete but useful definition for a "primary term" as the period of time stated in the lease "during which the lease may be kept alive by a lessee by virtue of drilling operations or the payment of rentals, even though there is no production in paying quantities, ... [and] is also a period of time at the end of which the estate granted will terminate but which estate may be extended by some other provision, usually one for production."[8]

In *Hall v. Galmor*, 2018 OK 59, 427 P.3d 1052, we noted the habendum clause in an oil and gas lease defines the lease's primary term and usually extends the lease for a secondary term of indefinite duration as long as oil, gas, or other minerals are being produced. After the primary term, a lease is effective based upon a well capable of production in paying quantities such that the lease remains viable under the habendum clause, which defines the duration of the lease in relation to the production life of the well. Id. 2018 OK 59, ¶21, 427 P.3d at 1063.[9]

Surrender. "We have explained a surrender or release of a lease in substantial compliance with the terms of the lease will be given effect. We have also explained a lessee's interests in a lease may be extinguished with a surrender by delivery to a lessor or filing on the record in the proper county when allowed by the terms of the lease."[10]

Paying quantities. "Paying quantities means not only discovery but taking out oil or gas in pursuance of the covenants and purposes of the lease in such quantities as will pay a profit to the lessee over the operating expenses."[11]

Base lease and bottom lease. "The phrases 'base lease' or 'bottom lease' are often used to identify an earlier oil and gas lease which controls or defines oil and gas rights in subsequent conveyances involving the same leased premises."[12]

Top lease. "A 'top-lease' is a lease subject to a pre-existing lease that has not expired."[13]

MEANING OF 'WASHOUT'

As noted above, one of the basic questions considered by the court in the present case is: Can an existing ORRI be extinguished – or, in other words, "washed out" – and if so, under what circumstances?

In explaining the common use of this term, this court said:

The term "washout" may be used to refer to extinguishing a nonoperating interest, such as an overriding royalty, by another's surrender or release of a lease. However, the term is often used when

a party intentionally surrenders the lease and then reacquires the same lease free of the nonoperating interests which are “washed out” by the surrender. For example, one court has explained: “The intentional termination of a lease to destroy a nonoperating interest is a washout tactic. A washout is conduct by an operator designed to extinguish the overriding royalty interest while at the same time preserving the operator's interest.” One author has stated that in addition to overriding royalty interests, “washouts can happen to any type of non-operating interest in an oil and gas lease, such as a back-in option, net profits interest, security interest, or a non-operating working interest.”[14]

PROTECTING AGAINST WASHOUT OR EXTINGUISHMENT

This court, in this opinion, has supported the policy of expecting the holder of the leasehold or ORRI interest to protect itself against a washout:

For several decades, including a time prior to Moore obtaining his assignment, model operating agreements for those possessing an operating interest have often included provisions for abandonment and surrender of a lease as well as renewal or extension of a lease to prevent a washout. ... Similar language indicating the availability of contractual extinguishment protection is found in *Rees v. Briscoe*, 1957 OK 174, 315 P.2d 758. One party expected the opposing party to protect a reserved override when new leases were created, and the Court noted “it would have been easy to have added a few words to the effect that the reservation [of the override] should apply to renewals or extensions of the leases assigned.” *Id*. 315 P.2d at 761 (explanation added). Some courts have viewed a washout as not necessarily wrongful and prohibited by an oil and gas lease, but should be prohibited by express anti-washout provisions if desired by the parties.[15]

If the interest holder fails to protect itself by including such anti-washout language in its agreements, there are several other defenses to assert that would attempt to defeat the washout, as discussed below.

TYPICAL STEPS TO ACHIEVE A WASHOUT

Two typical methods used to achieve a washout include the lessee – who holds the lease (which supports the ORRI) – signing and, for constructive notice purposes, filing in the local county land records, an instrument that releases or surrenders the lease rights. This action restores the right of the lessor/mineral owner to either directly explore for and extract the oil and gas or indirectly do it through granting a new oil and gas lease. The second option involves the lessee establishing the absence of production in paying quantities (roughly meaning revenue fails to exceed expenses), thereby terminating the lease by its terms. In the present case, both methods were asserted.

As to the use of an affirmative release by the lessee, the Supreme Court stated:

The Athan lease [the lease from which the subject ORRI was carved] provides in part the following: “Lessee may at any time and from time to time surrender this lease as to any part or parts of the leased premises by delivering or mailing a release thereof to lessor, or by placing a release of record in the proper County.” We have explained a surrender or release of a lease in substantial compliance with the terms of the lease will be given effect. We have also explained a lessee's interests in a lease may be extinguished with a surrender by delivery to a lessor or filing on the record in the proper county when allowed by the terms of the lease.[16]

It should be noted that this court held, “The parties did not specifically seek an adjudication whether ‘execution of the release’ satisfied the lease language for a surrender. We need not make this first-instance adjudication in an appeal.”[17]

The second justification to extinguish the lease (lack of paying quantities) and the dependent ORRI arises if the lessee fails to complete a well during the primary term of the lease (varying in time from one to five years) and, thereafter, to produce continuously in paying quantities. Such termination could occur by the lessee surrendering or releasing the lease in writing or by the lessor or a new lessee completing a quiet title action to prove a lack of paying quantities. After such termination, a different

lessee could take a lease free from the prior ORRI. Sometimes, as occurred in this present case, another lessee, often waiting on the sidelines, takes a top lease, which would become effective only upon the termination of the base lease.

The determination as to whether production in paying quantities either never began or, after beginning, ceased (without being restored within a reasonable or stipulated period, such as under a 60-day cessation clause in the lease) is a fact-specific matter.

When the lease ends, so does the ORRI that was "carved" from it:

[A]n overriding royalty may be lost entirely by expiration of the primary lease since, absent fraud or breach of fiduciary relationship, the interest does not continue and attach to a subsequent lease secured, in good faith, by the lessee. ... *Neither does an overriding royalty survive cancellation, surrender, abandonment resulting from diminution of production beyond economic feasibility, nor total failure to secure production in paying quantities.*[18]

OTHER DEFENSES TO A WASHOUT

This court takes time to explain that the holder of an ORRI can assert other defenses when there is an attempt to extinguish an ORRI by a release, either with or without a top lease being in place. This court emphasizes that the defending party must first assert/plead and then prove, in court, the essential elements of the defenses. Such defenses could include equity, fraud (actual or constructive) and breach of fiduciary duty, and production in paying quantities.

Equity is Relevant

In order to extinguish the underlying base lease and, thereby, washout the related ORRI and consequently quiet the title, the claimant must prove such action is supported by equitable principles: "Oil Valley did not address elements to a claim in equity to cancel an oil and gas lease based upon all of the circumstances in the controversy."[19] And, "We agree that a trial court proceeding in equity must consider all circumstances when parties seek to cancel an oil and gas lease and adjudicate title."[20] And, "Oil Valley argues Moore has no claim in equity. Oil Valley is mistaken. We have reaffirmed for several decades a party possessing an overriding royalty may challenge a surrender or release when alleging in an equitable proceeding the release or surrender was a result of fraud or a breach of a fiduciary duty."[21]

Breach of Fiduciary Duty or Fraud Are Defenses

This court held, "An overriding royalty interest may be extinguished by an extinguishment of the working interest from which it was carved by lessee's surrender in substantial compliance with the lease, unless the surrender is the result of fraud or breach of a fiduciary relationship."[22] And, "We have reaffirmed for several decades a party possessing an overriding royalty may challenge a surrender or release when alleging in an equitable proceeding the release or surrender was a result of fraud or a breach of a fiduciary duty."[23]

A simple release of an ORRI is not typically deemed to automatically constitute constructive fraud, logically meaning it would not be considered actual fraud either:

In summary, our opinions spanning several decades in *XAE*, *De Mik*, *Thornburgh*, and *Kile* explain an overriding royalty interest being lost or extinguished when the lessee's working interest that was used to carve out the override was itself lost or extinguished. These opinions indicate an overriding royalty extinguished by extinguishing its related working interest is not within the traditional class of constructive frauds when these frauds are defined by the nature and subject of the transaction itself.[24]

Further, the Supreme Court said, "We explained in *Krug v. Helmerich & Payne, Inc.*, 2013 OK 104, 320 P.3d 1012, that our prior opinions could *not* support a general proposition that Oklahoma law

recognizes a fiduciary duty between lessors and lessees in an oil and gas lease. *Id*. 2013 OK 104, n. 7, 320 P.3d at 109."[25]

In another case, it was stated that there is not a fiduciary duty based solely on the existence of a lease: "In *Bunger v. Rogers*, 1941 OK 117, ¶ 5, 188 Okla. 620, 112 P.2d 361, 363, the plaintiff sought damages for underpayment of royalty. This Court stated that the producer's 'liability was purely a contractual one and in no sense fiduciary.'"[26] And, "In *Goodall*, 1997 OK 74 at ¶ 11, 944 P.2d at 295, this Court refused to find an operator owed a fiduciary duty to an overriding royalty interest owner based solely on the lease."[27]

Production in Paying Quantities Might Be a Defense

The court said, "Amicus curiae on certiorari correctly identifies the issues presented to us by the parties: Whether a lessee's release of a lease may extinguish another's interests in the base oil and gas lease when a claim is made of continuing production holding the lease, and whether this production can be used to show a party's 'unclean hands' or constructive fraud in obtaining the release."[28] However, a lease is not continued under the habendum clause "by mere production, but a commercially profitable production which is often referred to as 'production in paying quantities.'"[29]

"We have reaffirmed for several decades a party possessing an overriding royalty may challenge a surrender or release when alleging in an equitable proceeding the release or surrender was a result of fraud or a breach of a fiduciary duty."[30]

The court failed to state whether, in this instance, the release that was given by the lessee at a time the well was allegedly producing in paying quantities constituted fraud or breach of a fiduciary duty. This was because the facts presented by the defendant were insufficient to establish whether there were paying quantities.[31]

CONCLUSION

The court refused to affirm the decisions of the trial court or the Court of Civil Appeals but instead remanded it to the trial court for further proceedings following the guidance provided in this opinion.

The gist of the ruling was that the best way for a holder of an ORRI to protect their interest against being washed out is to include an anti-wash provision in their agreement or assignment with the lessee. In the absence of such an express protection, the holder can offer as defenses claims of equity, fraud and breach of fiduciary duty, and production in paying quantities.

Author's Note: Kraettli Q. Epperson was the author of an amicus brief in this case and supported the losing side on appeal, the defendant, Larry E. Moore; this matter has been "remand[ed] [to the trial court] for additional proceedings consistent with this opinion." Oil Valley*, para. 92.*

ABOUT THE AUTHOR

Kraettli Q. Epperson is of counsel with Nash Cohenour & Giessmann PC in Oklahoma City. He received his J.D. from the OCU School of Law in 1978 and focuses on mineral and surface title litigation and expert representation. Mr. Epperson chaired the OBA Title Examination Standards Committee from 1988 to 2020 and taught "Oklahoma Land Titles" at the OCU School of Law from 1982 to 2018. He edits and co-authors West/Epperson: Oklahoma Real Estate Forms.

ENDNOTES

[1] *Oil Valley*, para. 2.

[2] *Oil Valley*, para. 0.

[3] *Oil Valley*, para. 92.

[4] *Oil Valley*, para. 24: Fn 15: *Hinds v. Philips Petroleum Co.*, 1979 OK 22, 591 P.32d 697, 698; *see also Mohoma Oil Co. v. Ambassador Oil Corp.*, 1970 OK 161, 474 P.2d 950, 960 ("An oil and gas lease is a chattel real, an incorporal hereditament, and a profit a pendre, which grants only the exclusive right, subject to legislative control, to explore by drilling operations, to reduce to possession, and thus acquire title to the oil and gas which is personalty.").

[5] *Oil Valley*, para. 24; Fn. 14: *Colonial Royalties Co. v. Keener,* 1953 OK 385, 266 P.2d 467, 472. An owner of a working interest may have limited that "right to work" by an operating agreement. Howard R. Williams and Charles J. Meyers, *Manual of Oil and Gas Terms*, 472 (5th ed. 1981) (a “non-operating working interest" is "the working interest or fraction thereof in a tract the owner of which is without operating rights by reason of an operating agreement.”).

[6] *Oil Valley*, para. 22, Fn. 46: *XAE Corp. v. SMR Property Management Co*., 1998 OK 51, ¶23, 968 P.2d 1201, 1206 (quoting *Thornburgh v. Cole*, 1949 OK 167, 201 Okla. 609, 207 P.2d 1096, 1098); *see also Claude C. Arnold Non-Operated Royalty Interest Props., L.L.C. v. Cabot Oil & Gas Corp*., *supra* n. 32, at n. 2, 485 P.3d at 819 (citing *De Mik v. Cargill*, 1971 OK 61, 485 P.2d 229, 232); *Walden v. Potts*, 1944 OK 299, 194 Okla. 453, 152 P.2d 923 (syllabus by the court) (*paying quantities* means not only discovery but taking out oil or gas in pursuance of the covenants and purposes of the lease in such *quantities* as will pay a profit to the lessee over the operating expenses).

[7] *Oil Valley*, para. 42.

[8] *Oil Valley*, para. 43, Fn. 40: *Fox v. Thoreson*, 398 S.W.2d 88, 91 (Tex. 1966) (material omitted); *see also Winn v. Nilsen*, 1983 OK 91, 670 P.2d 588 (lease executed on Feb. 17, 1977, with a *primary term* of five years in a commencement-type lease, authorized operator's commencement of operations on Feb. 16, 1982); *Buckles v. Wil-Mc Oil Corp.*, 1978 OK 137, 585 P.2d 1360, 1362-63 (discussed *primary term*, a provision of a lease, and the applicable law that is a part of a contract when executed) Williams and Meyers, *Manual of Oil and Gas Terms*, *supra* n. 14, 570-71 (*primary term*) (relying on *Fox v. Thoreson*, *supra*).

[9] *Oil Valley*, para. 43, Fn. 41: *Hall v. Galmor*, 2018 OK 59, n. 59, 427 P.3d at 1063.

[10] *Oil Valley*, para. 78, Fn. 75: *McKee v. Grimm*, 1925 OK 425, 111 Okla. 24, 238 P. 835 (*surrender* of lease in substantial compliance with a provision in a lease will be given effect) (syllabus by the court). And Fn. 76: *Plains Petroleum Corp. v. Fine*, 1935 OK 825, 174 Okla. 570, 51 P.2d 284, 286 (oil and gas lease

provided, “Lessee may at any time *surrender* this lease by delivery or mailing a release thereof to the lessor, or by placing a release thereof on record in the proper county.”).

[11] *Oil Valley*, Fn. 46: *XAE Corp. v. SMR Property Management Co*., 1998 OK 51, ¶23, 968 P.2d 1201, 1206 (quoting *Thornburgh v. Cole*, 1949 OK 167, 201 Okla. 609, 207 P.2d 1096, 1098); *see also* *Claude C. Arnold Non-Operated Royalty Interest Props., L.L.C. v. Cabot Oil & Gas Corp*., *supra* n. 32, at n. 2, 485 P.3d at 819 (citing *De Mik v. Cargill*, 1971 OK 61, 485 P.2d 229, 232); *Walden v. Potts*, 1944 OK 299, 194 Okla. 453, 152 P.2d 923 (syllabus by the court) (*paying quantities* means not only discovery but taking out oil or gas in pursuance of the covenants and purposes of the lease in such *quantities* as will pay a profit to the lessee over the operating expenses).

[12] *Oil Valley*, para. 41, Fn.38: *Baytide Petroleum, Inc. v. Continental Resources*, 2010 OK 6, n.6, 231 P.3d 1144 (explaining a base lease); Williams and Meyers, *Manual of Oil and Gas Terms*, supra n. 14, at 70 (bottom lease is the existing lease covering a mineral interest upon which a second lease or top lease has been granted).

[13] *Oil Valley*, para. 13 Fn.8: *Voiles v. Santa Fe Minerals, Inc.,* 1996 OK 13, ¶11, 911 P.2d 1205, 1209 ("A top lease is where the lease taken is subject to a pre-existing lease that has not expired when the second lease was taken."); *French Energy, Inc. v. Alexander*, 1991 OK 106, n.15, 818 P.2d 1234, 1238 (same).

[14] *Oil Valley*, para. 57.

[15] *Oil Valley*, para. 58.

[16] *Oil Valley*, para. 78.

[17] *Oil Valley*, para. 79.

[18] *Oil Valley*, para. 64.

[19] *Oil Valley*, para. 6, *see also*: paras. 2, 59, 89, 90.

[20] *Oil Valley*, para. 2.

[21] *Oil Valley*, para. 55, *see also*: para. 64.

[22] *Oil Valley*, para. 7.

[23] *Oil Valley*, para. 55.

[24] *Oil Valley*, para. 65, *see also*: paras. 64, 69.

[25] *Oil Valley*, para. 67.

[26] *Howell v. Texaco Inc.* para. 26.

[27] *Howell v. Texaco Inc.* para. 27.

[28] *Oil Valley*, para. 2, *see also*: para. 3.

[29] *Oil Valley*, para. 48, *see also*: para. 49.

[30] *Oil Valley*, para. 55.

[31] *Oil Valley*, para. 89: “Exhibits presented during partial summary adjudication proceedings by Moore were insufficient to show the Ball #1-24 well was commercially profitable and producing in paying quantities. The parties disputed whether the well was producing in paying quantities. Whether the well was producing in paying quantities was a material fact for an element of Moore's equitable claim against Oil Valley based on the habendum clause.”

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