Top Leases and the Rule Against Perpetuities

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Top Leases and the Rule Against Perpetuities

The competition for oil and gas leases has resulted in an increase in the use of top leases to secure oil and gas leasehold estates. Top leases which are found to violate the Rule against Perpetuities could result in the loss of millions of dollars to the lessee.

The author examines top leasing in light of the Rule against Perpetuities and concludes that absent a savings clause, such leases violate the Rule. A savings clause is proposed which would save an otherwise invalid lease thereby circumventing the harsh application of the Rule.

I. INTRODUCTION

In the field of mineral development, a top lease is defined as, "[a] lease granted by a landowner during the existence of a recorded mineral lease which is to become effective if and when the existing lease expires or is terminated."[1] Basically, a top lease arises when a subsequent lease is acquired on mineral interests which are subject to a valid, existing prior lease.[2] The existing prior lease is referred to as the bottom lease.

Two types of top leases are generally recognized: a two-party top lease and a three-party top lease.[3] A two-party top lease involves the same parties in interest as in the bottom lease. The same lessor grants a second lease to the same lessee, covering the same interests as the bottom lease, but prior to the first lease's expiration or termination. The following is an example of this type of top lease.

> Mineral owner O leases his interest to X Oil Co. for a primary term of five years commencing August 1, 1973, and provides for a royalty of one-eighth of production. X Oil Co. maintains the lease by proper and timely

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1. H. WILLIAMS & C. MEYERS, MANUAL OF OIL AND GAS TERMS 777 (5th ed. 1981) [hereinafter cited as H. WILLAMS & C. MEYERS].

Frankfurt v. Snakard, 279 F.2d 436, 445 n.23 (10th Cir. 1960) provides a more lengthy definition of top leasing:

> In the oil and gas vernacular to toplease is to secure a lease on land covered by an existing lease to the end that the toplease will be effective after the expiration of the existing lease and the interest of one or more lessees thereby eliminated. Top leasing has the same invidious characteristics as claim jumping.

Id.

2. Brown, *Effect of Top Leases: Obstruction of Title and Related Considerations,* 30 BAYLOR L. REV. 213 (1978); Ernest, *Top Leasing — Legality v. Morality,* 26 ROCKY MTN. MIN. L. INST. 957 (1980) [hereinafter cited as Ernest].

3. Brown, *supra* note 2, at 213; Ernest, *supra* note 2, at 958.

payment or tender of delay rentals for each year in advance in accordance with the terms of the lease which is the customary "unless" form. The last delay rental is paid to cover the period commencing August 1, 1977. The lease will expire August 1, 1978, in the absence of production or operation. X Oil Co. considers O's property a valuable prospect, but its management is uncertain that operations can be commenced in time to prevent the expiration of the 1973 lease. In order to retain ownership of the working interest, X Oil Co. persuades O to execute a new lease for a primary term of five years effective May 1, 1978. X Oil Co. does not release the 1973 lease. The top lease from O to X contains a number of provisions that are significantly different from the corresponding ones in the 1973 lease, the most important of which is a royalty of three-sixteenths. X Oil Co. is finally able to begin operations in mid-July 1978, in accordance with the terms of both leases.[4]

At this point the question becomes, which lease terms control? The answer is obviously of paramount importance to both parties.

In a three-party top lease, the original lessor executes a subsequent lease in favor of a lessee not a party to the first lease.[5] The same lessor leases to two different lessees, one of which was not a party to the first or bottom lease. The three-party situation arises as follows:

Mineral owner O leases his interest to X Oil Co. for a primary term of five years to run from June 1, 1973. Then while the first lease to X is still in effect, the same mineral owner leases the same interest to Y Production Corp. for a primary term to run from June 1, 1975.[6]

Top leasing as a means of acquiring new oil and gas interests is becoming more common as unleased oil and gas prospects become increasingly scarce.[7] The difficulty posed by this situation is that unless care is exercised during drafting, such top leases are likely to be held in violation of the Rule against Perpetuities under California law.[8] If a top lease violates the Rule, then that lease will be void and the lessee will not acquire an oil and gas leasehold interest as intended.

At the time oil and gas leases are acquired, it is extremely difficult to ascertain the value of the leasehold estate. The market value of the leasehold estate as exploratory acreage may be nomi-

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4. Brown, *supra* note 2, at 214; Ernest, *supra* note 2, at 958.

5. Brown, *supra* note 2, at 213; Ernest, *supra* note 2, at 958.

6. Brown, *supra* note 2, at 213.

7. *See* Ernest, *supra* note 2, at 968-70.

8. Jones, *The Rule Against Perpetuities as it Affects California Oil and Gas Interests,* 7 U.C.L.A. L. REV. 261, 278 (1960).

Suppose an oil and gas lease which is to commence upon the termination of an existing lease with a "thereafter" clause. Since the "thereafter" clause creates the possibility that the existing lease will not terminate and the second lease commence within the permissible period, the second lease presumably would be void in California under the *Haggerty* case, and the prediction of one writer that a "subject to outstanding lease" recital would save the second lease seems unlikely to come true in this state if *Haggerty* remains the law.

Id.

nal or is questionable at best. Once the leasehold estate has been explored by drilling, in the event oil and gas is produced in paying quantities, the leasehold estate will be worth millions of dollars. Therefore, any challenge to the title of the lessee is more likely to occur after the increased value of the leasehold is recognized and becomes a reality. Any successful challenge to the leasehold at this point, which finds the lease invalid because it violates the Rule against Perpetuities, would result in substantial economic loss to the lessee. Because it is practically impossible for the lessee to cure this defect in title, the lessee would lose the lease entirely, consequently losing the potential economic benefit of production of millions of barrels of oil and gas during the lease period. For example, an oil and gas lease covering 1,280 acres in an exploratory area may realistically be acquired for aproximately ten to twenty dollars an acre, totaling \$12,800 — \$25,600.[9] Upon discovery of oil and gas in paying quantities, this lease may be worth hundreds of millions of dollars depending on the amount of oil and gas reserves discovered underlying the entire leasehold.[10] Consequently, in order to avoid loss of a potentially valuable lease, it is imperative to be certain that a top lease is valid before acquiring it.

The purpose of this article is to discuss the application of the Rule against Perpetuities to top leasing, and possible methods of drafting such leases to avoid the harsh consequences of violating the Rule. This article will also examine the application of the Rule to oil and gas leases in California, where the habendum clause[11] provides for a primary term[12] of a stated period of time,

9. Interview with Edward C. LeLouis, Attorney, in Bakersfield, California (Nov. 4, 1982).

10. Assuming a total lease of 1280 acres is productive, a 400 barrel per acre-foot recovery factor, 200 feet average thickness of producing interval, and a net price (after deducting costs of operation) of \$20 per barrel, the total oil produced from the lease would be worth \$2,048,000,000. ((400)(200)(1280)(\$20) = \$2,048,000,000). Interview with William D. Newsom, consulting petroleum engineer, in Bakersfield, California (Nov. 10, 1982).

These figures do not take into consideration the life of the field and a discount to present value.

11. "Habendum clause" is defined by H. WILLIAMS & C. MEYERS, *supra* note 1, at 332 as follows:

> The clause in a deed or lease setting forth the duration of the grantee's or lessee's interest in the premises. A typical habendum clause in an UNLESS LEASE (q.v.) provides as follows:
> "It is agreed that this lease shall remain in force for a term of ten years from date and as long thereafter as oil, or gas, of whatsoever nature or

and a secondary term[13] of "so long thereafter[14] as oil and gas is produced."

In rare instances, oil and gas leases may exist where the habendum clause only provides for a specified period of time, and does not provide for a secondary term of "so long thereafter as oil and gas is produced." The Rule will be inapplicable if this specified time period does not exceed the period permitted by the Rule. However, if the period is in excess of the time permitted by the Rule, the Rule may be controlling.

II. THE RULE AGAINST PERPETUITIES APPLIED TO TOP LEASING[15]

The Rule against Perpetuities was designed to prevent the crea-

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> kind, or either of is produced from said land or drilling operations are continued as hereinafter provided."

Id.

12. "Primary term" is defined by H. WILLIAMS & C. MEYERS, *supra* note 1, at 570-71 as follows:

> The period of time, typically five or ten years, during which a lease may be kept alive by a lessee even though there is no production in paying quantities by virtue of drilling operations on the leased land or the payment of rentals. After the expiration of the primary term, the lease usually can be kept alive only by production in paying quantities (q.v.) absent some savings clause in the lease, such as a shut-in gas well clause, drilling operations clause or continuous drilling operations clause (q.v.). . . .
> For purposes of the Mineral Leasing Act of 1920, the phrase "primary term" has been said to include the entire period in the life of the lease prior to the period of extension because of production.

Id.

13. "Secondary term" is defined by H. WILLIAMS & C. MEYERS, *supra* note 1, at 682, as follows:

> The period subsequent to the expiration of the primary term during which the lease or deed is continued in force by operation of the thereafter clause (q.v.) of the lease or deed.

Id.

14. "Thereafter clause" is defined by H. WILLIAMS & C. MEYERS, *supra* note 1, at 767-68, as follows:

> The lease clause providing for continued validity of the lessee's interest subsequent to the expiration of the primary term "so long as" a specified state of affairs continues, e.g., so long as there is production in paying quantities, or so long as drilling operations are prosecuted. The habendum clause of a contemporary lease provides in general as follows:
> "It is agreed that this lease shall remain in force for a term of ten years from date [the primary term] and as long thereafter as oil, or gas, of whatsoever nature or kind, or either of them is produced from said land or drilling operations are continued as hereinafter provided."

Id. [hereinafter cited as "so long thereafter"].

15. For further discussion of the Rule, see generally J. GRAY, THE RULE AGAINST PERPETUITIES (4th ed. 1942) [hereinafter cited as GRAY]; L. SIMES & A. SMITH, THE LAW OF FUTURE INTERESTS §§ 1201-1298 (2nd ed. 1956) [hereinafter cited as SIMES & SMITH]; 6 AMERICAN LAW OF PROPERTY § 24, at 3 (1952); Leach, *Perpetuities in a Nutshell,* 51 HARV. L. REV. 638 (1938) [hereinafter cited as Leach, *Perpetuities in a Nutshell*]; Leach, *Perpetuities: The Nutshell Revisited,* 78 HARV. L. REV. 973 (1965). For discussion of the Rule against Perpetuities with regard to oil and gas interests, see generally I. KUNTZ, LAW OF OIL & GAS §§ 17.1-17.4 (1962) [hereinafter cited as KUNTZ, OIL & GAS]; Jones, *The Rule Against Perpetuities as it*

tion of contingent future interests which may vest too remotely. The underlying policy of the Rule against Perpetuities is that society's best interests are served by promoting the alienability of property in commerce by preventing interference with the alienation of property beyond a certain period of time.[16] The Rule and its underlying policy are firmly entrenched in the common law. As stated by Gray, the Rule provides: "No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest."[17]

Most states have adopted a statutory form of the Rule. The California statute provides as follows:

> No interest in real or personal property shall be good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest and any period of gestation involved in the situation to which the limitation applies. The lives selected to govern the time of vesting must not be so numerous or so situated that evidence of their deaths is likely to be unreasonably difficult to obtain. It is intended by the enactment of this section to make effective in this State the American common-law rule against perpetuities.[18]

It is important to remember that the Rule against Perpetuities is not a rule invalidating interests which *last* too long, but rather, is directed at invalidating interests which *vest* too remotely.[19] This vesting requirement is met only when it is certain, at the time the instrument creating such interest takes effect, that the interest being created will vest within the period of the Rule.[20] That the interest created might vest is not sufficient; it must be

Affects California Oil and Gas Interests, 7 U.C.L.A. L. REV. 261 (1960) [hereinafter cited as JONES]; Kuntz, *The Rule Against Perpetuities and Mineral Interests,* 8 OKLA. L. REV. 183 (1955) [hereinafter cited as Kuntz, *The Rule Against Perpetuities*]; Simonton, *Oil and Gas Leases and the Rule Against Perpetuities,* 25 W. VA. L. Q. 30 (1917) [hereinafter cited as Simonton].

16. KUNTZ, OIL & GAS, *supra* note 15, § 17.1, at 388. This policy was enunciated in a case concerning oil and gas matters, Weber v. Texas Co., 83 F.2d 807 (5th Cir. 1936). The court in *Weber* stated:

> The rule against perpetuities springs from considerations of public policy. The underlying reason for and purpose of the rule is to avoid fettering real property with future interests dependent upon contingencies unduly remote which isolate the property and exclude it from commerce and development for long periods of time, thus working an indirect restraint upon alienation, which is regarded at common law as a public evil.

Id. at 808.

17. GRAY, *supra* note 15, § 201, at 191.

18. CAL. CIV. CODE § 715.2 (Deering 1971).

19. Leach, *Perpetuities in a Nutshell, supra* note 15, at 639. One author has suggested that it would have been more appropriate to have called the Rule against Perpetuities the "Rule against Remoteness." GRAY, *supra* note 15, at 4.

20. Leach, *Perpetuities in a Nutshell, supra* note 15, at 642.

certain that the interest created will vest, if at all, within the period of the Rule.[21] Simply stated, the Rule against Perpetuities is "the law limiting the time within which future interests can be created."[22]

The same rules that apply to grants and exceptions of other interests in land have been applied to determine the validity of grants and exceptions or reservations of separate interests in oil and gas.[23] The Rule against Perpetuities clearly applies to oil and gas leases, and such leases will be held void if they violate the Rule.[24]

The Rule against Perpetuities becomes an issue in top leasing situations in the following manner. A top lease will usually commence upon the expiration of the bottom lease, which contains a "so long thereafter"[25] term (secondary term)[26] in the habendum clause.[27] The "so long thereafter" term creates the possibility that the bottom lease will not timely terminate in order to allow the top lease to commence within the period of the Rule (this is so because under the "so long thereafter" term, production of oil and gas in paying quantities may go on indefinitely). When this occurs, the top lease is void in California under the Rule against Perpetuities.[28] Further, a "subject to outstanding lease" recital is not likely to save the top lease under California law.[29] A top lease

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21. *Id.*

22. GRAY, *supra* note 15, at 4. There appears to be no simple way to explain the Rule against Perpetuities; volumes have been written on the subject. *See supra* note 15.

23. 1A W. SUMMERS, OIL & GAS § 134 (1954).

24. *Id. See generally* Brown v. Terra Bella Irrigation Dist., 51 Cal. 2d 33, 330 P.2d 775 (1958) (action to quiet title to oil, gas, and mineral rights); Rousselot v. Spanier, 60 Cal. App. 3d 238, 131 Cal. Rptr. 438 (1976) (a deed which excepted and reserved oil and gas rights, creating a present vested possessory interest, was not a violation of Rule); Keville v. Hollister Co., 29 Cal. App. 3d 203, 105 Cal. Rptr. 238 (1972) (grantor's retained power to enter into and execute leases and agreements concerning minerals did not violate Rule); Victory Oil Co. v. Hancock Oil Co., 125 Cal. App. 2d 222, 270 P.2d 604 (1954) (grantee's interest in minerals was contingent and therefore void under Rule against Perpetuities); Dallapi v. Campbell, 45 Cal. App. 2d 541, 114 P.2d 646 (1941) (oil and gas lease which might vest beyond period of Rule against Perpetuities violated Rule).

See also KUNTZ, OIL & GAS, *supra* note 15, §§ 17.1-17.4, at 388-98; Jones, *supra* note 15; Kuntz, *The Rule Against Perpetuities*, *supra* note 15; SIMONTON, *supra* note 15.

25. *See supra* note 14.

26. *See supra* note 13.

27. *See supra* note 11.

28. Jones, *supra* note 15, at 278.

29. *Id.* Brown, *Effect of Top Leases; Obstruction of Title and Related Considerations*, 30 BAYLOR L. REV. 214, 227 (1978).

> [T]he argument has been advanced that execution of a top lease containing language which conditions its taking effect "subject to" the subsisting bottom lease will avoid clouding the title of the bottom lessee under an "unless" form lease instrument. On the other hand, it is argued that the

is subject to a bottom lease whether or not this is expressly stated in the top lease, since the bottom lease is prior in time (and recording) to the top lease.

There is ample authority to support the view that upon the execution of an oil and gas lease, the lessee takes a vested interest in the land for the purposes of the lease.[30] This vesting occurs because the right to explore is not inchoate, and is therefore vested from the time the lease is executed.[31] However, under an executed top lease (while the bottom lease is in effect) the top lessee has no right to explore or enter the leased premises until after the bottom lease has terminated. Since the vesting of the top lease is contingent upon the occurrence of "an uncertain future event" (the cessation of production in paying quantities), it is subject to the Rule against Perpetuities. Under the "so long thereafter"[32] provision of the habendum clause,[33] the top lease cannot vest until oil and gas production[34] or drilling operations have ceased, thereby terminating the bottom lease by its terms. The condition precedent may not occur within the period of the Rule, and therefore, the top lease may be declared void under a strict application of the Rule against Perpetuities since the rights in the top lessee will vest too remotely.[35] The Rule can be stated as follows: "[i]t is perfectly clear that, if a lease for years is granted to take effect

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> recital that a top lease is to take effect upon expiration of the bottom lease violates the Rule against Perpetuities. Considered theoretically, this latter assertion is correct because the effective date of the top lease is uncertain and may never occur.

Id. *Contra*, KUNTZ, OIL & GAS, *supra* note 15, § 17.2, at 391; Ernest, *supra* note 2.

30. W. SUMMERS, *supra* note 23, § 171, at 496. *See also* Callahan v. Martin, 3 Cal. 2d 110, 43 P.2d 788 (1935); Pimental v. Hall-Baker Co., 32 Cal. App. 2d 697, 90 P.2d 588 (1939); Jones v. Piers, 124 Cal. App. 444, 12 P.2d 646 (1932).

31. W. SUMMERS, *supra* note 23, § 171, at 497.

32. *See* H. WILLIAMS & C. MEYERS, *supra* note 1, at 767-68.

33. *See* H. WILLIAMS & C. MEYERS, *supra* note 11, at 332.

34. H. WILLIAMS & C. MEYERS, *supra* note 1, at 576-77. Without a further definition in the lease, "production" sufficient to keep a lease alive after the primary term has expired, is generally interpreted to mean production in paying quantities, *i.e.*, production in sufficient quantities to provide a return in excess of operating costs. *Id.*

35. To comply with the Rule, an interest has to become "vested" within the period of perpetuities. An interest is "vested" for purposes of the Rule when the following conditions exist:
a. any condition precedent attached to the interest is satisfied, and
b. the taker is ascertained, and
c. where the interest is included in a gift to a class, the exact amount or fraction to be taken is determined.

Id.; 6 AMERICAN LAW OF PROPERTY § 24.18, at 56 (1952).

on a condition precedent which may not occur within the period of the rule, it is bad."[36]

A determinable estate is created in the lessee where the habendum clause states that the lease term is for a certain period of years or so long thereafter as oil or gas is produced therefrom.[37] The interest remaining in the lessor is a possibility of reverter,[38] which is not subject to the Rule against Perpetuities because

36. SIMES & SMITH, *supra* note 15, § 1242, at 153. *See also* GRAY, *supra* note 15, at 353, where it is stated:

> This lease appears to be in a usual form for a reversionary lease, in which the term granted is to begin on the termination of the existing term . . . . He seems, however, not to consider the presence of an existing term as significant for the question of the validity of the future term; and his opinion indicates that he considers that the future term would be outside the scope of the Rule against Perpetuities, for the reason that it was presently vested, even if there were no term preceding it. This view, it is submitted, is incorrect. The future term, without any subsisting intermediate term, would not be a vested interest for the purposes of the Rule against Perpetuities. Such a term may be spoken of as a "vested interest" in some connections, but it is not vested in a strict sense for the purposes of the Rule.

Id.; 2 H. TIFFANY, REAL PROPERTY (3rd ed. 1939) [hereinafter cited as TIFFANY]; Isen v. Giant Food, Inc., 295 F.2d 136 (D.C. Cir. 1961) (interest which had to vest within a reasonable time was within period of Rule); Cities Service Oil Co. v. Sohio Petroleum Co., 345 F. Supp. 28 (W.D. Okla. 1972) (application of provision in reservation by assignor as to new leases would violate the Rule); Singer Co. v. Mahad, Inc., 213 Kan. 725, 518 P.2d 493 (1974) (lease agreements to take effect on completion of shopping center were not void in violation of the Rule as a reasonable time for performance was implied in the provisions); Montgomery Ward & Co., Inc. v. Crossroads Shopping Center, 620 P.2d 40 (Colo. 1980) (shopping center lease option requiring determination before 21 year period not void in violation of Rule). *But cf.* Wong v. Di Grazia, 60 Cal. 2d 525, 386 P.2d 817, 35 Cal. Rptr. 241 (1963) (ten-year lease to commence upon completion of building not void under Rule where all rights established by agreement arose within 21-year period); First & C Corp. v. Wencke, 253 Cal. App. 2d 719, 61 Cal. Rptr. 531 (1967) (contract provision giving vender a specified amount of office space in new building to be constructed and yearly option to renew from date thereof violated the Rule); Haggerty v. City of Oakland, 161 Cal. App. 2d 407, 326 P.2d 957 (1958) (lease to commence on completion of building was not vested and violated Rule). *Cf.* FLA. STAT. § 689.22 (1979) (lease to commence in the future is exempt from the Rule against Perpetuities but invalid unless the term commences within forty years from the date of execution of the lease).

37. Montana-Fresno Oil Co. v. Powell, 219 Cal. App. 2d 653, 666, 33 Cal. Rptr. 401, 409 (1963). The defendant contended in this case that the habendum clause in the original lease created a title in fee on condition subsequent rather than a determinable fee which would therefore have entitled defendant to a notice of default. The plaintiff claimed that the habendum clause created a determinable fee which would have caused defendant's interest to cease upon the first or a later period of total cessation of production and thus no notice was required. The court held:

> It is our holding that the habendum clause created an estate determinable upon a special limitation applicable both to the primary and the "thereafter" term and that the notice requirement contained in paragraph 21 relates to the covenants numbered 1 to 30 and does not operate to change the interest of the defendant to an estate on condition subsequent.

Id.

38. GRAY, *supra* note 15, §13, at 8.

such interest in the lessor is vested,[39] and the Rule is concerned only with those interests which are not vested. It is argued that because a reversionary interest in the lessor is alienable, the holder of such an interest may grant an oil and gas lease as a partial alienation of this reversion, thereby avoiding the application of the Rule against Perpetuities because it does not apply to reversionary interests.[40] However, in California, the issue is not what the lessor has to grant, but rather, when does the lessee's interest vest? One must be cognizant of the fact that a possibility of reverter is exempt from the Rule, but an executory interest to take effect upon the same contingency is not exempt from the Rule.[41] The lessee's interest under a top lease is an executory interest and, therefore, subject to the Rule against Perpetuities. Further, if that interest vests too remotely due to a condition precedent which may not occur within the period of the Rule, then the interest is void.

Top leases may be subject to problems of interpretation and validity for reasons other than those involving perpetuities violations. The grounds for attack on the top lease may be due to obstruction of a first lessee's title, cloud on title, or problems of substituted contract theories and novation issues. However, these issues are beyond the scope of this comment.[42]

A. *California's Treatment of Top Leases*

California has not specifically dealt with the issue of top leasing

39. *Id.* § 113.3, at 105-07. *See also* 6 AMERICAN LAW OF PROPERTY § 24.62, at 150.

40. Ernest, *supra* note 2, at 962; Kuntz, *The Rule Against Perpetuities, supra* note 15, at 186; Brown, *supra* note 2, at 227. *Contra* Jones, *supra* note 15, at 278.

41. 6 AMERICAN LAW OF PROPERTY § 24.62, at 151. The example is stated as follows:

> A, owner in fee simple, conveys "to the B Church in fee simple so long as the premises are used for church purposes, and when the premises cease to be so used then to C in fee simple." The gift to C is void under the Rule against Perpertuities. However, the B church is given only a fee simple determinable; and A has a possibility of reverter, unlimited in time, which is exempt from the Rule.

Id. The gift to C in this example is analogous to a top lease and the conveyance to the B Church is analogous to the bottom lease.

42. *See generally* Brown, *supra* note 2; *see also* Twyford v. Whitchurch, 132 F.2d 819 (10th Cir. 1942); Hamilton v. Empire Gas & Fuel Co., 297 F. 422 (8th Cir. 1924); Robinson v. Continental Oil Co., 255 F. Supp. 61 (D. Kan. 1966); Shell v. Goodroe, 197 S.W.2d 395 (Tex. 1946); Simmons v. McDaniel, 154 Okla. 168, 7 P.2d 419 (1932).

as a violation of its Rule against Perpetuities.[43] The situation is analagous to California's treatment of "on completion" leases which, under an application of traditional property concepts, were found to violate the Rule against Perpetuities.[44]

The case of *Haggerty v. City of Oakland*[45] was decided under these traditional property concepts. The case involved a lease for a ten year term which was to commence upon the completion of a building. The court held that since the commencement of the term was delayed until completion of the building, the lease was void because this condition precedent might not occur within the permissible period of the Rule.[46] The court emphatically stated that leases are subject to the Rule against Perpetuities[47] and further stated that "[i]f, at the time of the creation of the interest, there exists any possibility at all that the interest involved may not vest within the prescribed period, the rule has been violated, and the grant must fail."[48] The defendant in *Haggerty* argued that the lessee obtained a vested right upon the final adoption of the ordinance awarding the lease. Therefore, he argued, the Rule against Perpetuities did not apply. Although it is true that vested interests are not subject to the Rule, the court held that the interest created by the lease was not a vested interest since the tenancy would take effect upon the occurrence of an uncertain event—the completion of a building.[49] The *Haggerty* court stated that:

> There seems to be relatively few cases discussing this problem, but the recognized legal authorities in the field of future interests agree that such an interest is not vested, and that, if a lease for years is granted to take effect on a condition precedent which may not occur within the period of the rule, it violates the rule and must fail.[50]

The remaining question in *Haggerty* was whether or not, upon execution of the lease, any possibility existed, no matter how remote, that the estate might not vest within twenty-one years. The

43. *See supra* note 18 and accompanying text.

44. *See generally* Haggerty v. City of Oakland, 161 Cal. App. 2d 407, 326 P.2d 957 (1958). *Contra* Wong v. Di Grazia, 60 Cal. 2d 525, 386 P.2d 817, 35 Cal. Rptr. 241 (1963); Note, *Rule Against Perpetuities: Applicability to Commercial Leases,* 6 U.C.L.A. L. REV. 165 (1959). *See also* Prime v. Hyne, 260 Cal. App. 2d 397, 67 Cal. Rptr. 170 (1968).

45. 161 Cal. App. 2d 407, 326 P.2d 957 (1958).

46. *See supra* note 44. *Haggerty* has been severely criticized, but has not been overruled and leads one to the conclusion that under traditional property concepts "on completion" leases may still be found void due to perpetuity problems. *See infra* note 59 and accompanying text.

47. 161 Cal. App. 2d at 417, 326 P.2d at 964; Epstein v. Zahloute, 99 Cal. App. 2d 738, 22 P.2d 318 (1950); Dallapi v. Campbell, 45 Cal. App. 2d 541, 114 P.2d 646 (1941).

48. 161 Cal. App. 2d at 418, 326 P.2d at 964.

49. *Id.* at 419, 326 P.2d at 965.

50. *Id. See* SIMES & SMITH, *supra* note 15, § 1242, at 153-54; GRAY, *supra* note 15, at 353; TIFFANY, *supra* note 36, § 406, at 170-72.

court held that "[i]f the slightest possibility exists that the estate will not vest within the prescribed period, the rule has been violated."[51] The problem of delayed commencement of a lease is analagous to the uncertainty of the vesting of the top lessee's interest. Because it cannot be determined when oil and gas production will cease, thereby causing termination of the bottom lessee's interest under the "so long thereafter" term, the top lessee's interest may vest beyond the period of the Rule making the lease void.[52] The *Haggerty* court dismissed the defendant's argument that the use of the term "due diligence" meant a requirement of a reasonable time and any time longer than twenty-one years would be unreasonable as simple and unsound logic.[53]

The California court modified the *Haggerty* rule in the case of *Wong v. Di Grazia.*[54] The parties in *Wong* entered into a written agreement wherein the defendant agreed to lease to the plaintiff, for a period of ten years, a building to be constructed by the defendant. The major contention at trial was the validity of the agreement under the Rule against Perpetuities. The court held that a ten year lease, to commence upon the filing of a notice of completion of a building to be constructed on certain property, was not void under the Rule against Perpetuities where all rights established by the agreement arose within the twenty-one year period, and any breach of the agreement would be remedial within such period.[55] The court further stated that the nature of the transaction was such that the contemplated building was to be completed within a reasonable time, and that such reasonable

51. 161 Cal. App. 2d at 420, 326 P.2d at 965.

52. *See supra* note 8 and accompanying text.

53. 161 Cal. App. 2d at 420-21, 326 P.2d at 966.

> This argument is deceptively simple, and is unsound. The courts are not permitted to relax the rule against perpetuities. The people have spoken by adopting the constitutional provisions, and the Legislature has reaffirmed that position as late as 1951. The rule itself contains no exceptions, and the courts should not create them. The rule has developed over a long period of time. It is predicated on fundamental principles of public policy. Once an exception is created to the application of the rule, no matter how innocuous it may seem, no one can foretell where it may lead, or how it may be abused. . . .

Id. But cf. Isen v. Giant Food, Inc., 295 F.2d 136 (D.C. Cir. 1961), where the court held an agreement to "diligently pursue" a pending zoning application and subsequently execute a lease requiring the zoning to be obtained within a "reasonable time" to be within the period of the Rule.

54. 60 Cal. 2d 525, 386 P.2d 817, 35 Cal. Rptr. 241 (1963).

55. *Id.* at 527-28, 386 P.2d at 819, 35 Cal. Rptr. at 243.

time was less than twenty-one years, thereby causing the interest to either vest or fail within the statutory period.

The court in *Wong* rejected the plaintiff's argument that construction would not be completed within twenty-one years due to the use of such terms as "forthwith" and "continue expeditiously" in the language of the lease. The court found that the use of these terms imposed an obligation on the defendant to complete construction within a reasonable time. The court's reasoning was as follows:

> Courts and scholars almost unanimously agree that provisions which make vesting contingent upon performance within a reasonable time, or some equivalent phrase, do not violate the rule "if in light of the surrounding circumstances, as a matter of construction, a reasonable time is necessarily less than twenty-one years." . . . Many courts, in fact, presume that a "reasonable time" is less than the period of the rule. In any event, a reasonable time in the present transaction in the light of the circumstances must necessarily be a period far less than 21 years. We cannot accept that portion of *Haggerty v. City of Oakland* which expresses a contrary position and, to that extent, it is disapproved.[56]

Although the *Wong* court disapproved of the reasoning in *Haggerty,* it has not actually been overruled. In the 1967 case of *First & C Corporation v. Wencke*[57] the court followed *Haggerty* in finding that an option for a year to year lease of office space in a building yet to be constructed was within the Rule against Perpetuities.[58]

The distinction between *Wong* and the cases of *Haggerty* and *First & C Corporation* appears to be in the "forthwith" and "continue expeditiously" language of *Wong.* Applying this reasoning to top leases leads to the conclusion that *Wong* is inapplicable since terms such as "forthwith" and "continue expeditiously" have no bearing on the cessation of the production of oil and gas in paying quantities pursuant to the "so long thereafter" term. Because this cessation of production may not occur within a reasonable time (the time permitted by the Rule),[59] the exception set forth in the *Wong* case will not apply to save a top lease in California.

B. Treatment of Top Leases in Other Jurisdictions

The case law involving top leasing, as it relates to the Rule against Perpetuities, is limited but generally finds top leases to be

56. *Id.* at 536-37, 386 P.2d at 825-26, 35 Cal. Rptr. at 349-50.

57. 253 Cal. App. 2d 719, 61 Cal. Rptr. 531 (1967).

58. *Id.* at 725, 61 Cal. Rptr. at 536. "We are inclined to agree that the option for the year-to-year lease after construction is within the rule against perpetuities, as asserted by plaintiff." *Id.*

59. Obviously the bottom lessee could stop production and thereby terminate the lease, but it is unlikely a lessee would do so.

in violation of the Rule against Perpetuities. An overview of treatment of top leases in other jurisdictions reveals that few cases have directly addressed the issue. There are also cases which hold that arrangements similar to top leases are covered by the Rule.

In the case of *Melcher v. Camp,*[60] a five day option to acquire a lease including the same terms and conditions as the first lease, where the period of the first lease was for one year and "so long thereafter as oil and gas, or either of them is produced from said land by the lessee," was found to violate the Rule. The court held "that a contract for an ordinary oil and gas lease to vest in the future creates such an interest in real property as is sufficient to invoke the rule against perpetuities as a rule of property."[61] The court followed the rule that, as applied to interests in land, "[a]ny limitation or provision, the purpose or possible effect of which is to cause an estate to commence in the future, is invalid if, as a result thereof, an estate may commence more than twenty-one years after a life or lives in being."[62]

Melcher was followed by *Cities Service Oil Company v. Sohio Petroleum Company*[63] which involved an overriding royalty interest reservation. In *Cities Service* the assignor of an assignment of an oil and gas lease reserved an overriding royalty interest and provided that any new lease or leases covering the lands assigned acquired by the assignee or a third person for the assignee's benefit, was deemed to continue and preserve the assignor's reserved rights. The court reasoned that the assignee could have held the oil and gas lease by continued production (i.e., kept the lease alive by continuing to produce oil and gas in paying quantities) for an interminable number of years, and his assignee might not have been alive at the creation of the assignor's reservation; and more than twenty-one years after assignee's death, his assignee may have obtained a new lease which would allow assignor's reserved interest to vest.[64] The court held that "[t]his would be beyond and after the period of time of some life in being and twenty-one years after Plaintiff's [assignor's] reservation created

60. 435 P.2d 107 (Okla. 1967).
61. *Id.* at 114.
62. *Id.* (quoting Estate of McCray, 204 Cal. 399, 268 P. 649 (1928)).
63. 345 F. Supp. 28 (W.D. Okla. 1972).
64. *Id.* at 30.

in its [Plaintiff's] assignment to Boyle [assignee]."[65]

In cases such as *Melcher* and *Cities Service*, the future interests created are subject to conditions precedent which may not occur within the period of the Rule against Perpetuities, thereby preventing them from vesting within the period of the Rule. Top leases are interests taken subject to a condition precedent which may not occur within the period of the Rule (that is, termination of production in paying quantities). Following the reasoning of *Melcher* and *Cities Service*, these interests will be void as violations of the Rule.

Top leases were clearly stated to violate the Rule against Perpetuities in the case of *Stoltz, Wagner & Brown v. Duncan.*[66] One of the requirements for the commencement of the top leases, "to have and to hold . . . for a term of one (1) year . . . from and after the expiration of the existing oil and gas lease, whichever is the later,"[67] was found to violate the Rule against Perpetuities. The court's reasoning was as follows:

> The top leases were taken in June of 1975 when there were existing base leases, the primary terms of which would expire in August of 1975. Hence, the possibility existed in June, 1975 that a well could be commenced before the expiration of the existing base [bottom] leases, the same could be drilled to production and the ensuing life of production could possibly exceed the period permitted by the Rule. The second alternative provision in the top leases thus appears to violate the Rule unless the top leases are reformed under the foregoing statutory authority.[68]

The court in *Stoltz* found the top leases to be in violation of the Rule and, pursuant to its reformation power,[69] reformed the

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65. *Id.*

66. 417 F. Supp. 552 (W.D. Okla. 1976).

67. *Id.* at 556.

68. *Id.*

69. The Oklahoma court relied on three statutes, 60 OKLA. STAT. ANN. tit. 60, §§ 75, 76, 77 (West 1971). These three sections provide:

> Any interest in real or personal property that would violate the Rule Against Perpetuities shall be reformed, or construed within the limits of the Rule, to give effect to the general intent of the creator of that interest whenever that general intent can be ascertained. This provision shall be liberally construed and applied to validate such interest to the fullest extent consistent with such ascertained intent.

Id. at 75.

> To effectuate the provisions hereof, all courts of this state are, within their otherwise jurisdictional limits, hereby granted the power to reform or construe interests in real or personal property, as provided in Section 1 hereof, in accordance with the doctrine of cy pres.

Id. at 76.

> If an instrument violates the Rule Against Perpetuities, but can be reformed or construed in accordance with the provisions of this act, it shall not be declared totally invalid. Rather, the provisions thereof that do not offend the Rule shall be enforced, and only the provisions thereof that do violate, or might violate, the Rule shall be subject to reformation or construction under the doctrine of cy pres within the terms of this act.

Id. at 77.

leases to give effect to the "general intent" of the lessor. The court followed the doctrine of cy pres[70] which carries out the intention of the party as nearly as possible when it would be impossible or illegal to give full effect to the instrument involved.[71]

In *Francis v. Superior Oil Company,*[72] the term of commencement was subject to the condition precedent that the restrictions against drilling imposed by ordinances be lifted. Although drilling was allowed on nearby land, it was not allowed on plaintiff's land. However, plaintiff hoped that the restrictions would be lifted in the future so drilling would be permitted. The lease provided that the lessors:

> '[H]ave this day granted and leased and do hereby grant, lease, and let * * *' the premises; and further that the lease should remain in force for a term of five years from the date the lessee may legally and peacefully enter upon and drill on said leased premises, and so long thereafter as oil, gas, casinghead gas, casinghead gasoline, or any of them is or can be produced from the leased premises. . . .[73]

The court presumed that the parties executed the lease contemplating that the restrictions on drilling would be lifted within a reasonable time or the contract would terminate.[74] The court stated "[t]here is nothing contained in the instrument or the circumstances attendant its execution which indicates even remotely that they intended or purposed to create a right in perpetuity, or an objectionable restraint upon the alienation of property."[75] The lease was found valid.

The facts in *Francis* are distinguishable from the situation of a top lease subject to a "so long thereafter" term. In *Francis,* the court found that a time less than the limit of the Rule, was foreseeable from the circumstances by virtue of increased drilling in a nearby zone which would likely cause a removal of restrictions in the zone containing the lease. When a lease is subject to a "so long thereafter" term, a reasonable time limit is not foreseeable since it is quite possible that oil and gas will be produced long af-

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70. BLACK'S LAW DICTIONARY 349 (rev. 5th ed. 1979) defines cy pres as follows:
> As near as (possible). The rule of *cy-pres* is a rule for the construction of instruments in equity, by which the intention of the party is carried out *as near as may be*, when it would be impossible or illegal to give it literal effect.

Id.

71. Stoltz, Wagner & Brown v. Duncan, 417 F. Supp. 552, 557 (W.D. Okla. 1976).
72. 102 F.2d 732 (10th Cir. 1939).
73. *Id.* at 735.
74. *Id.*
75. *Id.*

ter the period of the Rule thereby preventing commencement of the top lease and making it void as a violation of the Rule.

III. DRAFTING TO AVOID THE RULE[76]

In order to avoid the harsh consequences of the Rule against Perpetuities and still make provision for top leases, the leases should be drafted with a savings clause.[77] Proper draftsmanship will prevent problems from arising under the Rule. The *Wong* court offered the following language to avoid application of the Rule:

> The parties could simply have provided that the lessee's term would commence on filing of the notice of completion, "but not later than twenty-one years from the date of this agreement." If more time were desired, the parties could specify, for example, "twenty-one years after the death of the survivor of X, Y, and Z," these being healthy infants living at the time of the agreement.[78]

One commentator has suggested the following savings clause:

> As to any provision in this agreement, the parties hereto do not intend that there shall be any violation of the Rule against Perpetuities or any related Rule. If any such violation should inadvertently occur, it is the wish of the parties hereto that the appropriate court shall reform such provision in such a way as to approximate most closely the intent of the parties hereto within the limits permissible under such Rule or related Rule.[79]

The author recommends the following savings clause which has been drafted specifically to avoid perpetuities problems with top leases.

> This lease shall become effective upon termination of the [describe the bottom lease] but no later than 21 years[80] from the date of execution of this lease. If this lease does not become effective within this 21 year period, this lease shall be void. Lessee shall have no obligation to perform under this lease until after this lease becomes effective. The effective date of this lease shall be the anniversary date of the lease for the measurement of all obligations of the Lessee under this lease.

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76. *See* Leach & Logan, *Perpetuities: A Standard Saving Clause to Avoid Violations of the Rule,* 74 HARV. L. REV. 1141 (1961) [hereinafter cited as Leach & Logan].

77. The author expresses no opinion as to the validity of the following proposed savings clause set forth in Leach & Logan. That clause states as follows: "I hereby incorporate by reference the Standard Perpetuities Savings Clause set forth in 74 Harvard Law Review 1141 (1961)." Leach & Logan, *supra* note 76, at 1150.

78. Wong v. Di Grazia, 60 Cal. 2d 525, 532 n.8, 386 P.2d 822, 827 n.8, 35 Cal. Rptr. 241, 246 n.8 (1963).

79. Reidy, *Perpetuities and Mineral Development,* 22 ROCKY MTN. MIN. L. INST. 15, at 43-44 (1976). The central problem is that the parties must resort to a court action to interpret the language of the document. This is often an expensive and time consuming prospect.

80. This period may be as long as 60 years if desired under CAL. CIV. CODE § 715.6 (Deering 1971) which states that: "No interest in real or personal property which must vest, if at all, not later than 60 years after the creation of the interest violates Section 715.2 of this code." *Id.*

In addition to a well drafted savings clause, the doctrine of cy pres[81] may aid in preventing a top lease from violating the Rule. However, in light of the recent growth of legal malpractice claims, an attorney should not rely exclusively on the cy pres doctrine to avoid a harsh application of the Rule against Perpetuities. In *Lucas v. Hamm,*[82] the California Supreme Court held that the Rule against Perpetuities is so esoteric that as a matter of law it cannot be negligence for an attorney to violate it. This decision has been strongly criticized,[83] and may be overruled the next time the issue is before the court. If the *Lucas* case is overruled, a savings clause will be necessary, not only to prevent the top lease from being invalidated, but also to prevent a possible malpractice claim against the attorney.[84]

IV. CONCLUSION

Top leasing is becoming more popular as a means of acquiring oil and gas rights. As a result of such popularity, it becomes increasingly important for top leases to be properly drafted in order to be valid under the Rule against Perpetuities. Other jurisdictions may provide ways to prevent top leases from being rendered invalid, but in California, it is clear that top leases will be in violation of the Rule unless an appropriate savings clause is included in drafting such leases. To be absolutely certain the lease is not held invalid under the Rule against Perpetuities, an appropriate

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81. CAL. CIV. CODE § 715.5 (Deering 1971) provides:

> No interest in real or personal property is either void or voidable as in violation of Section 715.2 of this code if and to the extent that it can be reformed or construed within the limits of that section to give effect to the general intent of the creator of the interest whenever that general intent can be ascertained. This section shall be liberally construed and applied to validate such interest to the fullest extent consistent with such ascertained intent.

Id.

82. 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), *cert. denied*, 368 U.S. 987 (1962).

83. J. DUKEMINIER & S. JOHANSON, FAMILY WEALTH TRANSACTIONS, 1002-03 (1978).

84. Florida has solved the problem of leases commencing in the future by statute. FLA. STAT. ANN. § 689.22 (West 1969) provides as follows:

> (a) The Rule against Perpetuities does not apply to:
> 5. Leases to commence in the future or upon the happening of a future event, but no such lease is valid unless the term thereof actually commences in possession within 40 years from the date of execution of the lease.

Id.

savings clause should be used in all jurisdictions when top leases are taken.

J. SUZANNE HILL