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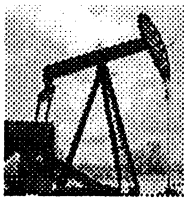

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I. FEATURED ARTICLE

EFFECTIVE TOP LEASING AND MYSTERIES OF THE HABENDUM CLAUSE

by

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I. INTRODUCTION

Top leasing is "claim jumping."[1] But that doesn't mean it is bad, unethical, or illegal. Instead, it is an accepted business practice in the oil and gas industry which the courts have sanctioned in various ways for almost a century. This practice known as "top leasing" has been used in Oklahoma for over 80 years. For example, in *Adcock v. Bennett*,[2] the court recites the following facts:

> There was an oil and gas lease on the allotment of Millie Pettit. She executed a top lease to another party. She and the top lessee joined in a suit to cancel the first lease upon the ground that the lessee had not complied with its terms. . . . The suit was filed February, 1917.[3]

The basic function of the top lease is to put the top lessee "next-in-line" in the event the existing lease terminates, or is ultimately held to have terminated. The goal is to tie-up the mineral interest owner's development rights before other competitors, including the existing lessee, have a chance to get a lease.

This article discusses how to most effectively accomplish the goal of being "next-in-line" when termination of the existing lease, under its habendum clause, is at best tentative. Predicting the status of a lease under the habendum clause in Oklahoma is more difficult

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[1]"Claim jumping" is defined as: "Filing of duplicate mining claims hoping that prior claim will be invalid." BLACK'S LAW DICTIONARY 225 (5th ed. 1979).

[2]235 P. 229 (Okla. 1925).

[3]*Id.* at 229-30.

because of Oklahoma's "capability" analysis and the use of equitable principles as opposed to a strict special limitation analysis. These provide the "mysteries" of the habendum clause the top lessee must solve to determine whether their interest will ever vest them with possession of the leased premises.

II. MYSTERIES OF THE HABENDUM CLAUSE AND $50/BARREL OIL

My oil and gas students often comment, recently at least, that the practice of oil and gas law must be thriving as oil approaches $50 per barrel. Certainly there has been an upswing in the sort of work one associates with increased development, such as drilling title opinions, the preparation or review of farmout agreements, and related development documents. However, I am quick to tell my students that the legal work often comes not because of the high price of oil, but rather because it tends to fluctuate wildly giving rise to the boom-bust cycles we have come to expect with the industry. The boom-bust cycle is especially important for the habendum clause because the industry has decided it would base the very life of its most basic contract, the oil and gas lease, largely on the price of oil and gas. As soon as courts decided to interpret "so long as oil or gas is *produced*" to mean produced "*in paying quantities*,"[4] the price of oil and gas loom large in the equation defining when the lessee no longer has a lease. Among the many oddities of the oil and gas lease is the realization that this price-sensitive aspect of the habendum clause continues to be a self-inflicted problem for the lessee.[5]

The important things to remember for our purposes is the reality that when prices are low, lessees often lose interest in their marginal properties and frequently abandon them without letting anyone know. In other situations, the intent is to retain the property, and operate it at a loss, in hopes for new discoveries or "better times" (translated: higher prices). Two things happen when prices rise: (1) demand increases for acreage to lease for exploration and development; and (2) existing oil and gas leases, if valid, become more valuable. One source of "new" development acreage is to find situations where existing leases have terminated. The top lease is merely a device to establish the "finder's" rights in the event their analysis of the existing lease proves correct, and it is determined the existing lease did indeed terminate. In the vast majority of situations the focus will be on the habendum clause because anything less than termination will not work for the top lessee. For example, a breach of covenant claim (e.g. to develop or market) will rarely result in a present cancellation of the lease. If the existing lessee is given time to comply with the court's order, the same price incentives that prompted the top lessee to act will also prompt the existing lessee to act to preserve their lease rights. Once this is done, the top lessee has lost.

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[4] *See generally* Stewart v. Amerada Hess Corp., 604 P.2d 854 (Okla. 1979).

[5] David E. Pierce, *Incorporating a Century of Oil and Gas Jurisprudence Into the "Modern" Oil and Gas Lease*, 33 WASHBURN L. J. 786, 806-08 (1994) (discussing the market-sensitive nature of the habendum clause and proposing a "covenant" approach to replace the current "special limitation" approach to defining the duration of the oil and gas lease).

Therefore, as potential top lessees evaluate their top leasing opportunities, they will need to evaluate the mysteries of the habendum clause to determine their chances of a successful challenge to an existing lease.

A. What Is Production "In Paying Quantities"?

This is perhaps the most basic issue under the oil and gas lease, at least an oil and gas lease covering lands in Oklahoma where actual production is not required to satisfy the habendum clause.[6] Because a lease can be maintained when "capable" of producing in paying quantities, even a non-producing lease will not terminate unless it is found to be incapable of producing *in paying quantities*.[7] When the cessation clause and shut-in royalty clause are viewed merely as "savings clauses," the paying quantities issue becomes the determinative issue in most cases. For example, in *Pack v. Santa Fe Minerals*,[8] the court holds a lessee need not concern themself, at least in this case,[9] with the terms of the cessation clause, or shut-in royalty clause, if the well was in fact capable of producing in paying quantities. The cessation clause, in *Pack*, was found to be triggered only when "*production* on the leased premises shall cease . . . ."[10] The court holds "production" for purposes of the cessation clause means the same as "production" under the habendum clause: a capability to produce in paying quantities. The parties in *Pack* stipulated the wells, at all times, were capable of producing in paying quantities so a *physical* cessation of production was not a *legal* "cessation" as defined by the cessation clause.[11] The court held the shut-in royalty clause was not triggered because the wells had not been shut-in for the required one-year period.[12]

If the terms of the habendum clause are in fact satisfied, there is no need to even consider the cessation and shut-in royalty clauses, unless they impose new, express provisions on the lessee.[13] By viewing them as mere "savings clauses" the court effectively

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[6]The Oklahoma courts have relied heavily on the writings of Professor Kuntz to assist them in analyzing the many cases addressing habendum clause and related issues. *See, e.g.*, 2 EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 26.6, at 344 (1989) ("In Oklahoma, the court has held that completion of a commercial gas well satisfies the habendum clause and that the lessee has a reasonable time within which to market the gas.") [hereinafter KUNTZ ON OIL AND GAS].

[7]Hoyt v. Continental Oil, 606 P.2d 560, 563 (Okla. 1980) ("there is a cessation of production if the habendum clause requires production in paying quantities and such requirement [paying quantities] is not met.").

[8]869 P.2d 323 (Okla. 1994).

[9]Although the cessation clauses and shut-in royalty clauses involved in *Pack* were in a form often encountered in oil and gas leases, the precise terms of any clause will, of course, govern the rights of the parties. It is possible to draft such clauses as an additional condition to continuation of the lease instead of a back-up savings clause in the event the habendum clause is not satisfied.

[10]*Id.* at 327.

[11]*Id.* at 325 (reciting the stipulated facts).

[12]*Id.* at 330.

[13]If the wells had been shut-in for the one-year period required by the shut-in royalty clause, a failure to pay the shut-in royalty, or otherwise comply with the clause,

holds they will not be triggered, nor will they *limit* the rights of the lessee under the habendum clause,[14] so long as the lessee is able to meet the terms of the habendum clause: a well that is capable of producing in paying quantities. Because the well need not actually produce to be capable of producing, the determinative issue becomes whether a well on the idle lease is capable of producing *in paying quantities*.

B. The Three Elements of the Paying Quantities Test

The Oklahoma "paying quantities" test consists of three elements: (1) identification of the current revenue and expenses associated with operation of the lease; (2) determination of an appropriate accounting period in which to compare revenue and expenses identified in item (1); and (3) the consideration of any "compelling equitable considerations" to justify this failure to produce in paying quantities. In Kansas the test consists of only items (1) and (2) with any equitable issues considered in the context of establishing the appropriate accounting period for making the comparison of revenue and expenses.[15] Although Texas has a step (3), it is defined by determining whether a prudent operator would continue to hold the lease even though revenue does not exceed costs during the accounting period.[16] Ascertaining whether a prudent operator would maintain a negative cash flow lease, for purposes other than speculation, would trigger many of the same sort of "equitable considerations" used in the Oklahoma analysis.

Step (1) of the analysis is merely a matter of applying Oklahoma law to define current revenue and current expenses.[17] These are primarily discovery problems to

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could give rise to new claims–depending upon the express terms of the shut-in clause. Also, the court notes the implied covenant to market may play a residual role when there is a voluntary decision not to market. In *Pack* the court discusses this in the context of the "temporary cessation doctrine" noting: "If the temporary cessation is reasonable, the lease will continue, and the burden of proving that the lessees failed to use reasonable diligence in the operation of the well squarely rests with the lessors." *Id.* at 331. This also seems to recognize that the temporary cessation "doctrine" can co-exist with a lease containing a cessation of production "clause" which purports to apply to a cessation "from any cause." *Id.* at 327. In Oklahoma this apparent inconsistency is resolved by limiting the cessation of production clause to situations where the cessation is "permanent" (i.e. *not capable* of producing in paying quantities) as opposed to "temporary" (capable, but not in fact being produced).

[14]The assumption is these clauses are included to expand, not limit, the terms of the habendum clause.

[15]The equitable issues would be limited to those matters that would go into defining the period of time a prudent operator would need to compare revenue and expenses in order to determine whether the lease was, in fact, producing in paying quantities. *See generally*, 1 DAVID E. PIERCE, KANSAS OIL AND GAS HANDBOOK § 9.24 (1989).

[16]Clifton v. Koontz, 325 S.W.2d 684 (Tex. 1959).

[17]For example, in *Stewart v. Amerada Hess Corp.*, 604 P.2d 854, 857-58 (Okla. 1979), the court discusses the "lifting expenses" that can be considered, including depreciation of equipment used in lifting operations. This analysis has been refined by subsequent cases, such as *Hininger v. Kaiser*, 738 P.2d 137, 140-41 (Okla. 1987), where the court holds overriding royalties are not "lifting costs" and flat-rate administrative costs under

ascertain the facts regarding revenue and expenses. This can sometimes be a daunting task, particularly when the lessee purports to have no records. Step (2) requires analysis of a less precise set of facts. Each party will select a time frame that maximizes their position. The challenge for the court will be to select a time frame that best reflects the factual situation regarding the lease itself in the context of all the surrounding circumstances that could impact a lessee's decision to continue to operate, or abandon, the lease. Although step (2) is less defined than step (1), courts have been able to apply this two-step analysis in a fairly predictable manner and therefore a potential top lessee can make informed predictions whether an existing lease has, in fact, terminated. However, step (3) presents a problem for the top lessee's ability to predict termination.

C. Step (3): *Smith v. Marshall Oil Corporation*

The uncertainty (mystery), and therefore "risk" to the prospective top lessee, associated with step (3) of the paying quantities analysis, was recently highlighted by the Oklahoma Supreme Court in *Smith v. Marshall Oil Corporation*, 85 P.3d 830 (Okla. 2004). Applying the three-step analysis, it appears the oil and gas leases were obtained by Smith in 1987 and 1988, production was obtained in paying quantities, extending the leases into their secondary terms for several years. Production dwindled with expenses exceeding revenue for the years 1996, 1997, and 1998. Production ceased in 1998[18] and was not regained until April 1999 when Marshall Oil, a top lessee, reworked the wells on the leased land. There was no dispute concerning the items to be included as current revenue and current expenses.[19] Steps (1) and (2) resulted in revenue of $9,495.77 and expenses of $52,355.00. Although the court does not address how step (2), the accounting period, was determined, the court apparently looked back to the first year production revenue failed to keep pace with production expenses: 1996. The accounting period ended with the date Marshall Oil regained production from the property.

Was Smith short-changed on the step (2) accounting period? It would seem that in picking an accounting period to provide a prudent operator with the information they need to decide whether to abandon the lease, it should include some of the "good" times with the "bad." What would the balance sheet have looked like if the accounting period ran from 1988 to 1998? Perhaps a reasonable accounting period would have been three years before the three years of negative cash flow: 1993, 1994, and 1995 in addition to the losing years of 1996, 1997, and 1998. This provides a more objective basis for a prudent operator's

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an operating agreement are not "lifting costs."

[18]"Smith quit using electricity in January 1998." *Smith*, 85 P.3d at 835.

[19]The court observes:

> Smith failed to produce any evidence to support his assertion that the wells were at all times capable of producing in paying quantities, other than his personal belief to that effect. The record establishes that Smith's lifting expenses, which by his own admission understate his actual costs due to insufficient record-keeping, far exceed any return, when the wells actually were producing.

Smith, 85 P.3d at 835.

future market expectations. The accounting period will always be one of the intangibles in the equation that can change the result.[20]

However, the major intangible element of the analysis is step (3). Even with a clear-cut negative cash flow situation applying steps (1) and (2), the court in *Smith* seems to go out of its way to evaluate "EQUITABLE CONSIDERATIONS"[21] to see if there is any way to avoid terminating Smith's oil and gas leases. The court first notes the interrelationship of step (2) and step (3) stating:

> We first conclude that the period employed by the trial court in the instant case, to measure the Stacy and Paige wells' profitability, was sufficient under all the facts and circumstances for a fair and reasonable determination.[22]

However, the court then suggests the accounting period should be measured by "the period of cessation of production and of failure to produce in paying quantities . . . ."[23] This cannot be correct, in the context of a proper accounting period, since it would mean that cessation and period of negative cash flow would define the accounting period instead of the period of time a prudent operator would look at production data to consider whether to keep or abandon the lease.

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[20]Consider the approach followed in Kansas, where whatever equitable considerations the court plans to apply must be encompassed by step (2) of the Kansas two-step analysis:

> [I]t is generally accepted that profitability on an oil and gas lease should be determined over a relatively long period of time in order to expose the operation to the leveling influences of time. The arbitrary use of a short period of time while a well is down for a workover is obviously untenable. On the other hand, the use of an unreasonably long period would entail using past glories of flush production to determine a lease's present condition, which would give a distorted result not reflective of the current status of the lease. The better rule precludes the use of a rigid fixed term for determination of profitability and uses a reasonable time depending upon the circumstances of each case, taking into consideration sufficient time to reflect the current production status of the lease and thus to "provide the information which a prudent operator would take into account in whether to continue or to abandon the operation."

Texaco, Inc. v. Fox, 618 P.2d 844, 848 (Kan. 1980) (quoting KUNTZ ON OIL AND GAS LAW § 26.7(u), at 368-69). In *Texaco* the trial court used a 13-year period but then proceeded to require profitable production for *each year* of the 13-year period. The Supreme Court reverses rejecting the year-by-year profitability requirement, but also rejects a single comparison for the 13-year period as being an unreasonably long period to compare revenue and expenses. *Id.* at 847-48.

[21]This is the heading the court uses in its opinion. 85 P.3d at 834.

[22]85 P.3d at 834.

[23]*Id.*

The second category of "equitable considerations" includes a wide range of lease- and *lessee*-specific information relevant to ascertain whether the court should spare the lease from termination. The analysis is highly fact-specific and conducted on a case-by-case basis.[24] As the court observes: "Indeed, we have held that 'compelling equitable considerations' may save a lease from termination even with unprofitable well operations."[25] The court's survey of possible "compelling equitable considerations" includes: (1) whether the period of cessation or negative cash flow from the lease was "reasonable"; (2) whether the cessation was voluntary;[26] (3) an impending event that may result in higher prices, such as passage of the Natural Gas Policy Act; (4) problems in gaining access to a pipeline to transport production; (5) attempts to resolve conflicts with partners.

The court concludes:

> Smith offered no compelling equitable concerns to justify this. Instead, Smith testified he deliberately ceased production, hoping oil and gas prices would rise. However, he had no factual support for this, and testified it was his mere "hope."[27]

Smith testified he had "decided to wait until they [oil prices] rose to $30.00 a barrel."[28] Notably, the court responds stating: "Fluctuating market prices do not rise to the level of an equitable consideration, or an excuse for Smith's failure to produce in paying quantities."[29]

The "equitable considerations" analysis is perhaps best illustrated by the court's holding in *Barby v. Singer*.[30] The accounting period [step (2)] for considering revenue and lifting costs [step (1)], was held to run from February 1978 to the date suit was filed, April 18, 1979.[31] If the actual revenue received during this time period was used, it would result in a negative cash flow under steps (1) and (2). However, in the process of applying step (3) the court evaluates whether the prospect of Congress passing the Natural Gas Policy Act of 1978, resulting in higher gas prices, would be an "equitable consideration" a prudent operator would have factored in to retain the losing lease. Evidence was offered to establish that a prudent operator would factor this in as a basis for retaining the losing lease–for legitimate purposes instead of merely for speculation.[32] Although this alone would seem to be an adequate basis for refusing termination of the lease, the court concludes noting:

> The Natural Gas Policy Act was adopted by Congress, effective as of December 1, 1978. Appellees filed an application to qualify the Barby 1-12 as a "stripper" well, resulting in a price increase for the gas produced,

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[24] *Id.*

[25] *Id.*

[26] The court was particularly unimpressed with Smith's testimony that "he turned the wells on when he wanted to, and turned them off when he wanted to." *Id.*

[27] *Id.* at 835.

[28] *Id.* at 836.

[29] *Id.*

[30] 648 P.2d 14 (Okla. 1982).

[31] *Id.* at 16.

[32] *Id.* at 17.

> retroactive to December 1, 1978, The trial court held that the retroactive price increase was properly to be taken into consideration in determining the well's profitability. We agree. . . . The fact the production income was received retroactively does not convert it into something other than what it is, production income. . . .
>
> The undisputed evidence before the trial court shows that if the increase in the price of natural gas is applied retroactively to the production income from the well, the well produced a profit each month during the test period. Having so determined, it is unnecessary to consider other specifications of error set forth in the briefs.[33]

It would seem that even if the NGPA did not provide for the retroactive price adjustment, the prospect of future higher gas prices for this stripper well would alone be an "equitable consideration." Under the facts, a prudent operator during the selected accounting period would not plug their well, and abandon their lease, until they knew the impact of a bill (which seemed to everyone to have a good chance of passing) which would provide gas price incentives to keep wells, like the Barby 1-12, profitable to operate.

The underlying basis for the "equitable consideration" analysis in Oklahoma is Okla. Stat. Tit. 23, § 2 which provides:

> Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful or fraudulent breach of duty.[34]

Although the full factual and legal contours of this provision have not been literally applied, the Oklahoma Supreme Court has consistently relied on this section to avoid applying any sort of "fee simple determinable" or "special limitation" analysis to the habendum clause, or other clauses, of the oil and gas lease.[35]

III. EFFECTIVE TOP LEASING

Top leasing in Oklahoma became more predictable following the Supreme Court's decision in *Voiles v. Santa Fe Minerals, Inc.*[36] where the court addresses the slander of title, tortious interference with contract, and champerty and maintenance issues.[37] Previous cases have addressed the obstruction and rule against perpetuities issues. All of these issues can be managed through careful transaction structuring and drafting. After

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[33] *Id.* at 18.

[34] OKLA. STAT. tit. 23, § 2 (1987).

[35] *E.g.*, Pack v. Santa Fe Minerals, 869 P.2d 323, 326-27 (Okla. 1994).

[36] 911 P.2d 1205 (Okla. 1996).

[37] *See generally*, Marichiel Lewis, Note, *Oil and Gas: Top Leasing After Voiles v. Santa Fe Minerals–Unethical Claim-Jumping or Prudent Business Practice?* 57 OKLA. L. REV. 127 (1999).

examining the common issues associated with top leasing, we can more effectively determine whether the focus should be on a present right to a future lease of the minerals after they revert to the mineral owner, or on a present right to the mineral owner's possibility of reverter under an existing oil and gas lease.

A. Do the Terms of the Top Lease Attack the Validity of the Existing Lease?

Many of the problems associated with top leasing can be avoided if the top lease makes it clear it is not an assertion regarding the validity of the existing lease. Although the top lease may be the prelude to a law suit concerning the validity of the existing lease, the top lease document should be drafted as a title document, not a litigation document. As a title document it should clearly indicate its focus is on whatever residuary mineral interest may exist in property during the life of the top lease. This is the essence of a top lease: "[A]n oil and gas lease to take effect only if the pre-existing lease should expire or be terminated."[38] Contrast this situation with a second lease covering the same property that is not contingent on the invalidity of the existing lease. Although this is sometimes referred to as a "top lease,"[39] it does not fit the *Voiles* definition of a lease to take effect "only if the pre-existing lease should expire or be terminated."[40] The mere existence of a top lease, that takes effect only when an existing lease terminates, will not trigger liability for obstruction, slander of title, tortious interference, or champerty and maintenance.

1. Obstruction

In *Simons v. McDaniel*[41] the existing lease, held by Simons, had a primary term that would expire on February 20, 1927.[42] On October 25, 1926 the adult heirs to the original lessor entered into a second lease, with McDaniel, that was recorded January 11, 1927 and had an "effective date" of March 27, 1927.[43] Simons began preparing a well location on the leased land on January 15, 1927 and a rotary rig was completed on the lease on February 8, 1927. Apparently Simons became aware of the recorded McDaniel leases and filed suit on February 15, 1927 "to eliminate the McDaniel leases as a cloud on their title and to quiet title of their lease, and in the meantime to authorize and direct plaintiff [Simons] to cease drilling operations on the lease."[44]

Although the leases to McDaniel would not begin until after the primary term of the

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[38] *Id.* at 1207.

[39] *E.g.*, Simons v. McDaniel, 7 P.2d 419, 420 (Okla. 1932) ("The acts of the Van Meter heirs, in executing and delivering 'top leases,' was an election to declare the first lease at an end.").

[40] *Voiles*, 911 P.2d at 1207.

[41] 7 P.2d 419 (Okla. 1932).

[42] There was a dispute over whether it would run five years from the date of the lease (February 20, 1922) or five years from the date it was executed (March 11, 1922). *Simons*, 7P.2d at 419-20.

[43] The guardian for the minor heirs had entered into a similar lease on November 16, 1926 to go into effect March 27, 1927; this lease was recorded on January 5, 1927. *Id.* at 420.

[44] *Id.*

Simons lease had expired, they did not account for extension of the Simons lease, into the secondary term, through operations and subsequent production. Therefore, the McDaniel leases were in essence an assertion the Simons lease, regardless of the situation, was no longer valid as of March 27, 1927. The court comments on this situation, as follows:

> These acts obstructed the exercise of the rights of the original lessees under the terms of their lease. Their title was clouded. Had they produced oil or gas as a result of commenced development, ownership thereof would have been in litigation and the value of production impounded, so that a real obstacle was imposed by lessors upon the right of lessee plaintiffs.[45]

The court in *Jennings v. Elliott*[46] refused to enjoin the mineral owners from executing "a 'Top' lease" because "the second lessee does not acquire the right to explore, develop for, and produce oil from the premises as against the prior lessee until the prior lease had terminated."[47] The court notes: "If plaintiffs should execute such a lease it would in no way interfere with defendants in whatever rights they may eventually be adjudged to have under the lease they claim to be still in force."[48]

To avoid obstruction, the top lease should not address or otherwise comment upon the continuing validity of the existing lease. Instead, the terms of the existing lease should be respected by making the top lease effective only upon termination of the existing lease– or to lease a right that is not covered by the existing lease, such as the mineral owner's possibility of reverter.[49]

2. Slander of Title

To establish a slander of title claim the complaining party must establish:

> "(1) the uttering and publishing of the slanderous words; (2) that they were false; (3) that they were malicious; (4) that [the plaintiff] sustained special damage thereby; and (5) that [the plaintiff] possessed an estate or interest in the property slandered."[50]

In *Voiles* the top lessee, Hugoton, argued because its interest was clearly contingent on the

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[45] *Id.*

[46] 97 P.2d 67 (Okla. 1939).

[47] *Id.* at 71.

[48] *Id.*

[49] In *Voiles* the court notes: "The top lease states that it vests in the top lessee the mineral owner's reversionary interest under the base lease." *Voiles*, 911 P.2d at 1209. However, it also makes clear: "No party has argued that the top lease grants, or was intended to grant, a reversionary interest independent of the adjudication of the base leases in this proceeding." *Id.* Presumably the court is focusing on the lessor's possibility of reverter in the leased land which was a present interest it held even while the existing lease was in effect.

[50] *Voiles*, 911 P.2d at 1209 (quoting James Energy Co. v. HCG Energy Corp., 847 P.2d 333, 340 (Okla. 1992)).

termination of Santa Fe's existing lease, no slander of title took place.[51] Apparently Hugoton was asserting there had been no "uttering and publishing" of any "slanderous words." However, the court instead bases its decision on whether the actions of Hugoton were "malicious."[52] As the court notes: "This malice [for slander of title] is not ill will or hatred, but a lack of good faith and want of probable cause."[53]

Finding the underlying theories relied upon by Hugoton were based upon a favorable trial court judgment against Santa Fe in a similar suit, the court concludes Hugoton's actions were taken in good faith. Therefore, the malice element could not be satisfied for a slander of title claim. However, this leaves open the issue whether the top lease, by itself, is a potentially slanderous publication. If the top lease is carefully drafted not to express any view on the validity of the existing lease, it would not appear to be any sort of "slanderous words."

3. Tortious Interference with Contract

To establish a tortious interference claim the complaining party must establish:

> "1. That he or she has a business or contractual right that was interfered with. 2. That the interference was malicious and wrongful, and that such interference was neither justified, privileged nor excusable. 3. That damage was proximately sustained as a result of the complained-of interference."[54]

Quoting from a prior case, the court notes: "'A cause of action for wrongful interference with contract can arise only when one who is not a party to a contract interferes with that contract by convincing one of the contracting parties to breach its terms.'"[55] The court holds there is no tortioius interference because Hugoton was acting as the agent for a party to the contract.[56] The facts indicate:

> In 1989 Oklahoma Hugoton Corporation (Hugoton) approached the lessors of the Santa Fe leases, or their successors, and paid each for what is know as a top lease, an oil and gas lease to take effect only if the pre-existing lease should expire or be terminated. In the process Hugoton obtained from each lessor his or her authority to take the necessary steps to bring suit, in the name of the lessor, but at the expense of Hugoton, to judicially terminate the earlier leases, called base leases.[57]

The agency analysis the court adopts would seem to be among the weakest bases for

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[51] *Id.*

[52] *Id.*

[53] *Id.* at 1209-10.

[54] *Voiles*, 911 P.2d at 1210, n.6 (quoting Mac Adjustment, Inc. v. Property Loss Research Bureau, 595 P.2d 427, 428 (Okla. 1979)).

[55] *Voiles*, 911 P.2d at 1210 (quoting Ray v. Nat. Bank & Trust Co., 894 P.2d 1056, 1060 (Okla. 1994)).

[56] *Id.* at 1210-11.

[57] *Id.* at 1207-08.

avoiding a tortious interference claim. After all, it was Hugoton the initiated the contact. As the court observes:

> In short, they [the lessors] wanted more money. Hugoton appeared on the scene and told them that they might be entitled to more.[58]

It would appear that most tortious interference claims can be legitimately avoided once the top lease is viewed as a property interest held by the top lessee and, in any event, would not rise to the level of a "malicious and wrongful" act.

4. Champerty and Maintenance

"Champerty" is defined as: "an officious intermeddling in a suit by a stranger, by maintaining or assisting either party with money or otherwise to prosecute or defend it, and dividing the proceeds obtained in the suit between the party and the stranger."[59] "Maintenance" is "'an officious intermeddling in a suit which in no way belongs to the intermeddler, by maintaining or assisting either party to the action, with money or otherwise, to prosecute or defend it.'"[60] As with the slander and tortious interference claims, the court focuses on the theory relied upon by Hugoton to attack Santa Fe's existing leases instead of analyzing whether the elements of a champerty or maintenance claim could be established under the facts.[61] Instead of focusing on the act of top leasing, the court focuses on the validity of the theory put forth by Hugoton.

Hugoton's front-line argument against the champerty and maintenance claims was that it has its own interest in the outcome of the litigation–as a property owner who will benefit from a holding that Santa Fe's lease terminated. It is not a "stranger" to the suit, but rather a very interested party to the suit.[62] Although the court in *Voiles* chose not to base its decision on this argument, its prior decision in *Mitchell v. Amerada Hess Corp.*[63] suggests champerty and maintenance will not pose a problem for the careful top lessee. It would appear that under the authority of *Mitchell*, a top lease would provide the top lessee with an adequate interest in the subject matter of the lawsuit to avoid a champerty or maintenance claim.

B. Drafting Options and Issues

1. Defining the Lessor's Property Interest

The two potential drafting approaches focus on different aspects of the lessor's mineral interest ownership. After the mineral interest owner enters into an oil and gas

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[58] *Id.* at 1211.

[59] *Id.*

[60] *Id.* "Champerty is maintenance with compensation derived from the proceeds of the suit." *Id.*

[61] *Id.* at 1212 ("We agree with the trial court that in this case Hugoton served an important interest of the mineral owners in having their first impression case heard in a court of law.").

[62] *Id.* at 1212.

[63] 638 P.2d 441 (Okla. 1981).

lease, its property interest is in the nature of a mineral interest that is subject to a *profit a prendre* in the oil and gas lessee.[64] However, an issue in Oklahoma is whether the lessee has: (1) a defeasible *profit a prendre* in the oil and gas, with the lessor having a possibility of reverter in the *profit a prendre*; or (2) a *profit a prendre* in the oil and gas subject to a condition subsequent with the lessor having a right of re-entry for condition broken (power of termination). The court in *Danne v. Texaco Exploration and Production Inc.*,[65] suggests the future interest is more in the nature of a power of termination or right of re-entry during the secondary term.[66] This was done in an effort to explain the "equitable considerations" an Oklahoma court must address before terminating a lease under the habendum clause.[67] The problem arises with the differing rules Oklahoma applies regarding the ability to convey a power of termination or right of re-entry. However, it appears these differences are of only historical significance and have been eliminated by statutes that make all of these future interests freely alienable.[68]

2. Seek to Obtain Lessor's Present Possibility of Reverter/Power of Termination Rights?

If the prospective top lessee acquires the lessor's possibility of reverter or power of termination, the grantee will receive an interest that in no way clouds the interest of the existing lessee. The rights associated with the interest would vest immediately,[69] thereby avoiding any rule against perpetuities issues.[70] Also, there will be no risk the lessor will try and extend the existing lease or grant a new lease, since they would no longer have those rights in the mineral interest.[71] From the lessor's perspective, the existence of a lease

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[64]Rich v. Doneghey, 177 Pac. 86 (Okla. 1918); KUNTZ ON OIL AND GAS LAW § 23.23, at 262-65.

[65]863 P.2d 210, 213-14 (Okla. App. 1984).

[66]*Id.* at 213 ("Oklahoma does not, however, take the view that habendum clauses are special limitations; rather, Oklahoma views the habendum clause as an estate on condition subsequent creating only a right of entry in the grantor.").

[67]*Id.* at 214-15.

[68]*See* Ludwig v. William K. Warren Foundation, 809 P.2d 660, 662 (Okla. 1991) (discussing the common law rules and the changes made by statute).

[69]Although actual "possession" under the interest conceptually may never vest, the interest in the minerals under the possibility of reverter or power of termination vests "in interest" at the moment of the conveyance.

[70]*See* Siniard v. Davis, 678 P.2d 1197, 1200 (Okla. App. 1984) (dicta); Stoltz, Wagner & Brown v. Duncan, 417 F. Supp. 552, 556-58 (W.D. Okla. 1976).

[71]Sometimes the existing lessee will try and address the lessor's top leasing activities by providing, in the oil and gas lease:

> If Lessor, during the primary term of this Lease, receives a bona fide offer which Lessor is willing to accept from any party offering to purchase from Lessor a lease covering any or all of the substances covered by this Lease and covering all or a portion of the land described herein, with the lease becoming effective upon expiration of this Lease, Lessor agrees to notify Lessee in writing of said offer immediately, including in the notice the name and address of the offeror, the price offered and all other pertinent

would not be a breach of warranty since all they are purporting to convey is their future interest.[72]

However, the practice has not been to convey the possibility of reverter/power of termination. One problem is the difficulty in conceptualizing the transaction and whether the interest can be "leased" as opposed to conveyed. Conveying the interest would vest the oil and gas developer with all the residual rights in the property and provide them with all the minerals upon termination of the existing lease. It would also need to be made clear that no rights to production revenue or surface management were being conveyed as part of the interest. Because of these problems, and the lack of any experience with the practice in Oklahoma, a transfer of the possibility of reverter/power of termination is not recommended.

3. Seek to Obtain a Lease on Lessor's Rights Following a Reversion?

The typical approach to top leasing creates a future interest in the lessor's mineral interest in the event the existing lease terminates, triggering the possibility of reverter/power of termination, with the lessor regaining possession of the mineral interest, which is then burdened by the new top lease. As a future interest that will not vest in interest until and unless the existing lease terminates, it can violate the rule against

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> terms and conditions of the offer. Lessee, for a period of 15 days after receipt of the notice, shall have the prior and preferred right and option to purchase the lease or part thereof or interest therein, covered by the offer at the price and according to the terms and conditions specified in the offer. All offers made to and including the last day of the primary term of this Lease shall be subject to the terms and conditions of this paragraph. Should Lessee elect to purchase the lease pursuant to the terms hereof, it shall so notify Lessor in writing by mail or telegram prior to expiration of said 15 day period. Lessee shall promptly thereafter furnish Lessor the new lease for execution on behalf of Lessor along with Lessee's sight draft payable to Lessor in payment of the specified amount as consideration for the new lease, such draft being subject only to approval of title according to the terms thereof. Upon receipt thereof, Lessor shall promptly execute said lease and return same along with the endorsed draft to Lessee, a representative or through Lessor's bank for payment.

This is a form of lease that has been used in Alabama. Note that the preferential right is limited only to top leases sought during the primary term.

[72]When representing the lessor in a top leasing transaction, any warranty provisions in the lease form should be appropriately altered to account for the existing lease burdening the property. *See* Siniard v. Davis, 678 P.2d 1197, 1199-1200 (Okla. App. 1984) ("Appellants [lessors] argue that the proper construction to be placed on a general warranty of title clause in a top lease is that the lessor warrants he owns the minerals and has the authority to convey right of entry, exploration, production and possession subject only to the right, if any, of a prior unreleased lease of record. We believe that if Appellants desired this result they could have easily inserted in the top lease the above stated language or could have stricken the warranty clause in said top lease . . . .").

perpetuities if it is not certain to vest, or not vest, within a measuring life or lives, plus 21 years from the date the interest is created.[73] Although Oklahoma has useful reformation statutes to address conveyances that run afoul of the rule,[74] the problem should always be addressed to ensure the rule is not triggered in the first instance.

The perpetuities problem is easily addressed by placing an outside limit on the time in which the existing lease can terminate, causing the top lease to vest in interest. For example, the top leases involved in the *Voiles* case provided:

> The top leases also states that if the possession does not vest then the reversionary interest and top lease granted would terminate "within ten (10) years from the date of this Agreement."[75]

As noted previously, the top lease should also make it clear that it is not a statement regarding the validity of the existing lease, but merely an advance lease by the mineral interest owner of their potential reversionary rights in the minerals. This should avoid issues concerning obstruction, slander of title, tortious interference, and breach of warranty by the lessor to its existing lessee. The top lessee's contingent interest in a future lease on the minerals should avoid issues concerning champerty and maintenance. It would appear these matters could be addressed in a more express manner. Consider the following recital information:

> Mineral owner ["Bob"] entered into an oil and gas lease with Acme Oil Company ["Acme"] on [date] covering [describe existing lease, the "Existing Lease"]. Pursuant to the terms of the Existing Lease, Bob is the present owner of certain reversionary rights in the event the Existing Lease terminates. Bob, through this Top Lease, is conveying to Claim Jumper Oil Company ["CJ"] leasehold rights that will take effect only in the event the Existing Lease terminates and the mineral interest in the Leased Land is reunited with Bob free of Acme's Existing Lease rights. Until and unless Acme's Existing Lease terminates, CJ will have no present right in the Leased Land possessed by Acme under its Existing Lease. CJ's rights in the Leased Land are contingent future rights that will vest CJ with possession only after Acme's Existing Lease rights have terminated, if that should occur while CJ's contingent future interest is still in effect.

To ensure the lessor/mineral interest owner does not extend the existing lease, or otherwise take action that may defeat termination of the existing lease, a special warranty may be included tailored to the top lease situation. This could also be the context in which the

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[73] *See* Stoltz, Wagner & Brown v. Duncan, 417 F. Supp. 552, 556-58 (W.D. Okla. 1976) (applying the rule against perpetuities, and the Oklahoma reformation statutes, to a top lease). Oklahoma has a constitutional basis for its rule against perpetuities. OKLA. CONST. art. 2, § 32 ("Perpetuities and monopolies are contrary to the genius of a free government, and shall never be allowed, nor shall the law of primogeniture or entitlements ever be in force in this State.").

[74] OKLA. STAT. tit. 60, §§ 75 & 77.

[75] Voiles v. Santa Fe Minerals, Inc., 911 P.2d 1205, 1209 (Okla. 1996).

lessor's agreement to participate in clearing title of a terminated existing lease is addressed. This would seem to be a more accurate way to portray the relationship of the top lessee and top lessor in litigation. It could also incorporate agency provisions which the court relied heavily upon in *Voiles*. For example, consider the following:

SPECIAL WARRANTY/REMEDIES: Bob warrants to CJ that Bob currently possesses 100% of the reversionary interest in the Existing Lease covering the oil and gas mineral interest in the Leased Land. Bob warrants that upon termination of the Existing Lease, he will own 100% of the mineral interest in fee simple absolute in the Leased Land, subject only to the following encumbrances: [list]. Bob warrants to CJ that Bob will not do anything that impairs or diminishes the rights Bob has conveyed to CJ under this Top Lease. In the event CJ concludes the Existing Lease has terminated, causing this Top Lease to take effect, CJ will notify Bob of the event. If CJ deems it necessary to pursue any course of action to clear title to its Top Lease rights, Bob hereby appoints CJ as its agent to take whatever action CJ deems necessary under the circumstances, including judicial action, to establish marketable title in CJ under the Top Lease. Bob agrees to cooperate fully with CJ in its efforts to establish marketable title following a termination of the Existing Lease.

This provision would be followed by the other title provisions typically contained in the oil and gas lease, such as a proportionate reduction clause. The mineral owner, Bob, may also want the Top Lease to address costs of litigation and indemnification of Bob regarding any litigation that may be pursued on Bob's behalf.

IV. CONCLUSION

Since 1917 the top lease has been actively used in Oklahoma. Like other options on property in the business world, the top lease has proven to be a useful business tool. In most cases the top lease will be the classic future interest, a springing executory interest, that will vest in interest and possession only when, and if, an existing lease terminates. Conceptually there should be no problem with a lessor burdening its future reversionary interest with a future lease that will take effect in the event the existing lease terminates. The challenge is trying to draft the interest in a manner that: avoids clouding title to the existing lease; effectively creates a right to a lease on the mineral interest if it should become available in the future; and provides the administrative guidance to prevent the top lessor from evading the rights granted while establishing the machinery to clear title once the top lessee concludes the existing lease has, in fact, terminated.