Top Leasing in Arkansas & Other States -- Selected Problems from Theory to Reality

W. Eric West
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Mr. West is a partner in McDavid, Noblin & West, a law firm in Jackson, Miss. He received his B.B.A. and his J.D. degrees from the University of Mississippi. He is admitted to practice in Arkansas and Mississippi. He has been actively involved in both the Mississippi and Arkansas Bar Association Natural Resource Law Sections, served as President of the Mississippi Oil & Gas Lawyers Association and is active in the Rocky Mountain Mineral Law Foundation and the Mid-Continent Oil & Gas Association.

McDavid, Noblin & West
Suite 1000
Security Centre North
200 South Lamar Street
Jackson, Mississippi 39201
TOP LEASES IN ARKANSAS AND OTHER STATES - SELECTED PROBLEMS FROM THEORY TO REALITY

A Presentation To The 1992 Arkansas Natural Resources Law Institute

By

W. Eric West

McDavid, Noblin & West
Suite 1000
Security Centre North
200 South Lamar Street
Jackson, Mississippi 39201
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INTRODUCTION

The purpose of this paper is not an exhaustive treatment of the subject of top leases, rather, it is intended to identify certain problem areas which traditionally arise and point out new problems, discuss significant cases, and provide advice which may help avoid or deal with the problems which are discussed. Problems that may arise in connection with top leasing of mineral estates which are discussed, from legal theory to practical reality, include whether a novation was intended in a two-party top lease situation, the issue of clouding of title and or equitable obstruction, and their three cousins contractual interference, intentional breach of contract and slander of title, and
trespass in three-party top lease situations. The problem areas associated with the rule against perpetuities and with extending the bottom lease (cutting off top leases) by pooling, production, or other operations are also discussed. Since most of these issues have not been directly addressed by the Arkansas Supreme Court and pertinent Federal Courts, cases and statutes from other jurisdictions have been included for both their precedential value and to identify the different possibilities from the legal theories involved to the factual reality of the situation.

I. WHAT IS A TOP LEASE?

A. DEFINITION

While most people in the oil business know what a top lease is (or think they do) the following discussion regarding the establishment of a solid definition for top leases will show otherwise. The mental process of formulating a definition for top leases will point out the basis for many of the problems surrounding them both factually and legally. To understand the many and varied ways that top lease problems can arise, both factually and legally, it is essential to address the different aspects which go into formulating a valid definition.

The term "top lease" has been defined in a number of ways. Probably the best and clearest definition of a top lease is an oil and gas lease covering a mineral estate that is currently under a valid, existing oil and gas lease.1

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1 Kemp, Top Leasing for Oil and Gas: The Legal Perspective, 59 Den. L. J. 641 (1982).
Conversely, a "bottom lease" has been defined as an existing lease covering a mineral interest upon which a second lease or a top lease has been granted.²

Another definition of a top lease has been given as follows:

A ‘top lease’ is one taken by a lessee from a lessor who has previously given a lease on the same interest to another, which previous lease had not expired at the time the top lease was taken.³

Note that this definition fails to recognize that the lessor in a top lease is not necessarily one and the same person as the lessor in the original or bottom lease. A lease executed by a successor in interest to the original lessor, if executed while the bottom lease was still in force and effect, would also constitute a top lease. It also fails to recognize that the lessee in a top lease is not necessarily a different person or entity from the lessee in the bottom lease. Another definition which has been given for a top lease emphasizes the fact that the lessee in a top lease may be either the present lessee under the bottom lease or some third party:

A ‘top lease’ is a lease that is acquired by either a third-party or the present lessee during the term of a valid and effective lease for the purpose of having a new lease at the termination of the present lease.⁴

This definition also points out the basic reason why the current lessee or a third party would acquire a top lease - to put in place a lease which will be effective upon the

⁴ Bledsoe, Conveyancing of Oil and Gas Interests, 32nd Oil & Gas Inst. 83, 95 (Matthew Bender 1981).
termination of the current lease. Whether a particular top lease achieves this goal will be discussed later in more detail.

Other definitions of top leases attempt to define the nature of the legal interest created by the top lease. The description of a top lease as "a partial alienation of a possibility of reverter" refers to the fact that an oil and gas lease is, in many producing jurisdictions and arguably in Arkansas, \(^5\) considered the grant of a determinable fee (a real property interest). The interest remaining in the lessor after the grant of an oil and gas lease would therefore be a possibility of reverter. When a top lease is granted it operates as a partial alienation (sale) of that possibility of reverter. \(^6\)

B. HISTORY

The practice of top leasing has been a controversial subject in the oil and gas industry for many years. The legal issues surrounding top leasing have been the subject of reported cases for more than fifty years. The controversy regarding top leasing has concerned not only its legality, but also its morality. In 1960, a federal circuit court went so far as to state that "top leasing has the same invidious characteristics as claim jumping." \(^7\) This analogy appears appropriate in certain circumstances when viewed in connection with some of the situations which follow.

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\(^6\) Brown, Effect of Top Leases: Obstruction of Title and Related Considerations, 30 Baylor L. Rev. 213, 239-240 (1978).

\(^7\) Frankfort Oil Co. v. Snakard, 279 F.2d 436, 445 n. 23 (10th Cir. 1960), cert. denied, 364 U.S. 920 (1960).
C. VALIDITY OF TOP LEASES IN ARKANSAS

While Arkansas has not expressly adopted the validity of top leases several of its neighboring states have. In Barnett v. Getty Oil Company\(^8\) the Mississippi Supreme Court, in recognizing the validity of a top lease, stated that a top lease may be considered a present grant of a future interest. The Court implied by its holding that a top lease is a valid and subsisting oil and gas lease and that a Mineral Right and Royalty Transfer, which was by its terms subject to valid and subsisting oil and gas leases, was subject to the top lease, despite the fact that the primary term of the top lease was not to commence until a date in the future. Miss. Code Ann. § 89-1-1 would appear to further support the validity of top leases (as a present grant of a future interest or a partial alienation of a possibility of reverter) in providing that "any interest in or claim to land may be conveyed...by writing signed and delivered".\(^9\) The Supreme Court of Louisiana expressly acknowledged the validity of top leases\(^10\), subject to certain limitations. In Mitchell v. Mesa Petroleum Company\(^11\), the Texas Supreme Court stated, "if properly executed the second lease, normally called a "top lease," is a valid and effective lease."\(^12\) Oklahoma has also recognized the validity of top leases.\(^13\)

\(^8\) Barnett v. Getty Oil Company, 266 So.2d 581 (Miss. 1972).
\(^12\) Id. at 513.
Arkansas' statute is similar to that of Mississippi, which as stated above, does seem to accept the validity of top leases (being a present grant of a future interest). Ark. Statute Ann. § 18-12-102(a) (1987) states that "[a]ll lands, tenements, and hereditaments may be aliened and possession thereof transferred by deed without livery of seizin." In the Arkansas case Smith v. Smith\(^{14}\) a deed containing the provision that it did not take "effect until the grantor's death" was interpreted as being a present grant of a future interest. This case would support the validity of top leases in that what is presently being granted is the future right to drill for oil, gas and other minerals.

While Arkansas has not expressly stated that a top lease is valid or defined it as a real property interest, several Arkansas oil and gas cases impliedly acknowledge the validity of top leases.\(^{15}\)

In Enstar Corporation the primary issue was whether Enstar's lease should be cancelled because of its violation of an implied covenant to develop the leasehold for the production of oil and gas. Crystal Oil had acquired a lease (top lease) on land that included Enstar's leasehold estate thus making its lease a top lease. The Court without mentioning the top lease issue held that the top lease was valid.

A second case, Perry v. Nicor Exploration, involves a top lessee suing to cancel oil and gas leases due to the failure to produce in paying quantities during the secondary term. The Court did not address or mention the top lease issue, but apparently assumed

\(^{14}\) Smith v. Smith, 235 S.W.2d 886 (Ark. 1951); see also Lindsey v. Christian, 257 S.W.2d 935 (Ark. 1953); Davis v. Davis, 243 S.W.2d 739 (Ark. 1951); Grimmett v. Estate of Beasley, 777 S.W.2d 588 (Ark. App. 1989).

\(^{15}\) Enstar Corp. v. Crystal Oil Co., 740 S.W.2d 630 (Ark. 1987); Perry v. Nicor Exploration, 738 S.W.2d 414 (Ark. 1987); Goldsmith v. Diamond Shamrock Corp., 767 F.2d 411 (8th Cir. 1985); Saulsberry, 252 S.W.2d at 835, 836.
their validity even though it denied the cancellation of the bottom lease because production in paying quantities was calculated on a unit basis.

**Goldsmith v. Diamond Shamrock Corp.** was a case before the United States Court of Appeals for the Eighth Circuit which was appealed from the United States District Court for the Western District of Arkansas. The Goldsmiths brought suit against Diamond Shamrock for payment of a signing bonus on a top lease. Diamond Shamrock argued that the instrument was an option to lease. The case was appealed on procedural grounds and neither oil and gas law nor the validity of top leases was discussed.

In **Saulsberry v. Siegel**. the issue was whether a bottom lease terminated upon cessation of production or by reason of a breach of an implied covenant. The lessees of a 1951 top lease sought to have a 1922 bottom lease cancelled. The Court refused to cancel the 1922 bottom lease and instead cancelled the 1951 top lease as a cloud on the bottom lease. The Court did not discuss the validity of top leases and did not even classify the leases involved as top or bottom leases.

These cases seem to support the proposition that Arkansas recognizes the theory and/or reality of top leases. One assumes that if top leases were invalid in Arkansas then one of these Courts would have stated so in its opinion.

**D. THE SITUATION TODAY**

Top leasing continues to be a controversial subject today because of the complex legal issues surrounding top leasing situations and because some in the oil and gas industry continue to view top leasing as immoral. This is no surprise. Because, as will
be seen in certain situations, the act of top leasing is the equivalent of busting lease blocks (claim jumping). The legitimate use of top leases has gained wider acceptance and top leasing increased significantly in the 1970s and 1980s. Several factors have contributed to the increased use of top leases. In some instances in the 1970s and 1980s the use of top leases became almost a competitive necessity in acquiring a lease block in certain highly competitive areas. Companies, as a result of the deeper depth of prospects, have also found it necessary to top lease their own leases in order to provide sufficient time to conduct their operations.

The existence of top leases can either accelerate or impede development of the lands under lease. Where the prospect-originating bottom lessee has been top leased by a third-party, it may accelerate development of the prospect in order to maintain its leases. However in today's environment where numerous prospects compete for limited exploration capital, the bottom lessee may not wish to conduct operations when faced with a "claim jumping" top lessee and may forego development of the prospect altogether and search for greener pastures.

As evidence that the practice of top leasing has gained wider acceptance, large independent drilling companies and major oil companies now engage in the practice of top leasing while prior to the 1970s and 1980s most top leases were acquired individually by speculators.
II. CATEGORIES OF TOP LEASES

The process of categorizing types of top leases, like trying to define top leases, helps to understand the factual and legal situations in which they arise. Top leases may be categorized by either the number of parties involved or the time at which they are executed. Each category gives rise to its own unique set of problems.

A. PARTIES

As alluded to above, top leases are primarily described as either two-party top leases or three-party top leases. The four Arkansas cases which impliedly acknowledge the validity of top leases all involve three-party top leases.

1. TWO-PARTY TOP LEASES

A two-party top lease is a top lease acquired by the same lessee as in the bottom lease (only one lessee is involved). It is essentially a new lease taken by the same lessee covering the same interest. A lessee may acquire a top lease on its own bottom lease for the same reasons it would seek an extension or renewal of its original lease - to gain additional time to conduct operations or because of a suspicion that a top lease is about to be granted to a third-party.

A problem that may arise in the two-party top lease situation is that the top lease may be a substituted contract for, or a novation of, the bottom lease. This issue is of particular importance where the top lease and the bottom lease contain different royalty
or operating provisions. The question of whether the top lease in a two-party top lease situation amounts to a substituted contract or a novation and how to avoid this problem are discussed later in this paper. Disputes in two-party top lease situations typically involve only the lessor and lessee. However, overriding royalty interest owners under the bottom lease may become involved if anti-washout provisions exist. These potential problems are also discussed in more detail later in this paper.

2. THREE-PARTY TOP LEASES

The more common type of top lease is the three-party top lease. A three-party top lease is a top lease where the top lessee is not the same party as the bottom lessee. As noted earlier, the top lessee may acquire a third-party top lease purely for speculative purposes, although in some instances in the 1970s and 1980s, the third-party top lease became almost a competitive necessity in certain highly competitive areas if you wanted to put a prospect together.

The three-party top lease situation raises numerous legal issues and involves disputes among the lessor, the bottom lessee and the top lessee. A number of these issues are addressed below. A three-party top lease may give rise to claims of contractual interference, obstruction, clouding of title or even intentional breach of contract. Issues of trespass and the rule against perpetuities may also arise. Attention to careful drafting and the use of informed common sense may help avoid these problems. However because of the antagonistic and competitive nature of assembling,
drilling and developing a prospect it is wise to protect your position on the front end and not wait to be top leased.

B. **TIME EXECUTED**

Top leases may also be categorized by the time at which they were executed - during the primary term of the bottom lease or after its primary term (during the secondary term). In most instances, the bottom lease is still within its primary term when a top lease is executed as the top lessee (in a three-party top lease situation) anticipates that the bottom lease will expire at the end of its primary term, or the bottom lessee (in a two-party top lease situation) wants to extend and maintain its leasehold position. The **Goldsmith** case is a situation where the bottom lease was in its primary term when the top lease was executed. However, a lease covering lands currently burdened by a lease in its secondary term is also considered a top lease. A top lease may be acquired during the secondary term in the mistaken belief that the bottom lease has expired, or in anticipation of some action by the top lessee to cancel or otherwise circumvent the bottom lease. The **Enstar**, **Perry** and **Saulsberry** cases are just such situations where the bottom leases were being held by production or operations and the top lessees sought to have them cancelled respectively for failure to reasonably develop, failure to achieve production in paying quantities and for cessation of production. When there are multiple top leases on the same interest or where there is an underlying dispute between the lessor and bottom lessee, when the top lease is executed will be seen to be important.
III. SELECTED TOPICS

A. NOVATION OR SUBSTITUTED CONTRACT

Novation, simply defined, is the substitution of a new obligation for the original one.\textsuperscript{16} This problem is necessarily limited to the two-party top lease situation since novation requires a new agreement which supersedes a prior agreement between the same parties. Various courts have taken different approaches when determining whether a top lease is a novation of a bottom lease.

If the theory of novation or substituted contract is applied in a two-party top lease situation, it follows that the bottom lease will be discharged.\textsuperscript{17} Under Professor Corbin's view, whenever two contracts exist which encompass the same subject matter as between the same parties and the second contract fails to set forth whether the first contract has been discharged, the later agreement between the parties should prevail to the extent of any inconsistencies.\textsuperscript{18} This view of Professor Corbin was applied in Texas, in the context of drilling contracts, in the case of Chastain v. Cooper & Reed.\textsuperscript{19} Although the principles of novation have been applied to oil and gas leases, application of the concept has been subject to criticism.\textsuperscript{20} In most states (Louisiana being an

\textsuperscript{16} Ernest, \textit{supra} note 2, at 966.

\textsuperscript{17} Brown, \textit{supra} note 6, at 235.

\textsuperscript{18} \textit{Id}.

\textsuperscript{19} Chastain v. Cooper & Reed, 152 Tex. 322, 257 S.W.2d 422 (1953).

\textsuperscript{20} Brown, \textit{supra} note 6, at 235.
exception) an oil and gas lease is considered a grant of real property rights, even though a combination of both contract and real property rights is involved. 21 One lease or the other must grant the present right to explore for oil and gas. It is therefore difficult to conceptualize harmonizing two separate leases into one grant. Furthermore, because the portion of an oil lease granting the right to explore and produce minerals is primarily a grant of real property rights, it has been argued that contractual concepts should not be applied at all. The underlying theory of the argument that the concept of novation should not be applied in two-party top lease situations appears to be that the parties do not intend the original lease to be relinquished or reconveyed to the lessor. Rather, it is argued that it is more reasonable to treat the top lease as merely a protective measure which will insure the continued right to explore for oil and gas.22

This author is not aware of an Arkansas case dealing with novation in top leases. Because Arkansas arguably categorizes leases as real property rights,23 there should be no reason that other states’ cases should not be accepted in theory and be examined to help determine the possible holding in Arkansas.

In a recent case the Louisiana Supreme Court considered the subject of novation in Bares v. Stone Oil Corp.24 The lessors in Bares claimed that the four new leases they executed were intended to novate and extinguish four old leases. Revising the lower

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22 Brown, supra note 6, at 236, 237.

23 Wright, supra note 5.

court's grant of partial summary judgment in favor of the lessors, the court of appeals held that whether the new leases were intended as top leases or to terminate the old leases was not a proper matter for summary judgment as it raised genuine issues of material fact.

As the question of novation will not be decided as a matter of law in Louisiana, Placid Oil Co. v. Taylor\(^{25}\) continues to control. In Placid Oil the Court looked to various code articles which state that novation of a contract is not to be presumed. In order for a novation to be effectuated, such an intent must be clear from the terms of the latter agreement. The Court also noted that the facts and circumstances which surround the contract's execution are important to consider in controversies concerning novation. After applying these principles the Court determined that there had in fact been a novation.

In Placid Oil, the Court of Appeals emphasized the fact that the second lease was silent as to the first lease. Additionally, the Court noted that the lessor had acquired additional fractional mineral interests in the property after the original lease had been executed. As the lease was now more valuable it follows that the lessor would exact a higher royalty. Lastly, a letter agreement attached to the lease stated that the later lease contained all the terms and conditions agreed upon. Therefore the Court of Appeals came to the conclusion that the parties did intend that the second lease work as a novation.

In Louisiana, then, the courts have been willing to look at both the express terms of the agreement and the circumstances surrounding the execution of the lease. This could be a problem for oil companies as most juries, regardless of the facts, will not hesitate to answer questions to their disadvantage.

In the case of Obelgoner v. Obelgoner, the question of whether a new lease to a prior lessee constituted a substituted contract was impliedly addressed by a Texas court. In Obelgoner, the lessors executed an initial lease for a ten year primary term. Approximately three years prior to the expiration of the initial lease, the successors in interest to the lessors executed another lease to the same lessee for a primary term of ten years from the "effective date" of the second lease. Subsequently, the lessors executed a third lease, this time to a third-party, providing for a primary term of five years beginning exactly ten years after the execution of the second lease. The lessee in the first two leases brought suit to remove the third lease as a cloud upon his title, alleging that the primary term of his second lease did not begin until the expiration of his first lease, and therefore his second lease had not expired. The Texas Court of Civil Appeals disagreed, holding that the primary term of the second lease began to run upon the execution of said lease. Although the Court did not specifically state that the second lease was a novation or substituted contract for the first lease, this is implied in that the primary term of the second lease was held to begin immediately upon its execution. The Court pointed to the fact that the granting clause in the second lease was a present grant which contained no reference to the first lease or any collateral agreements between the

parties. Thus the Court concluded that the second lease was effective from its execution date, and that the third lease (the third-party top lease) became effective upon the expiration of the primary term of the second lease.

Arkansas' general theory on novation was addressed in the case *Orr v. Bergemann*²⁷. In this case the Arkansas Supreme Court stated that it is essential to a novation that there be a mutual agreement by which the new is substituted for the old. A novation is the substitution by mutual agreement of the parties of a new obligation for an existing one.²⁸ In order for there to be a novation the old obligation must be released and the new obligation substituted in its place.²⁹ It can be argued that failure or refusal to release the bottom lease in accord with statutes requiring same proves that no novation was intended. Ark. Code Ann. § 15-73-203 (1987) requires that an oil, gas or mineral lessee cancel of record his expired or terminated leases and if he fails to do so the lessor can cause the margin of the lease to reflect that it terminated. Other states have similar statutes that require leases be cancelled of record.³⁰ A general legal maxim is the presumption that parties will conduct themselves in accordance with the law. Therefore a presumption should be that the lessee or lessor would follow the law (statute) and release (cancel) the bottom lease if the new lease was intended to be a novation.


One problem with the novation or substituted contract theory lies in the fact that in jurisdictions following the "in place" ownership theory, an oil and gas lease is a conveyance of the title to minerals in place. This type of conveyance can bind its parties, as well as their heirs and assigns, indefinitely and in perpetuity. This a contract can not do.\(^{31}\) The decision in *Placid Oil*, however, is somewhat justifiable as Louisiana treats oil and gas leases as contracts.\(^{32}\)

In summary, several approaches can be taken in the analysis of two-party top leases as to whether the top lease constitutes a novation or substituted contract. In Louisiana, as seen above, the courts will look to the instrument as well as the facts surrounding the transaction to determine the intention of the parties. It appears that Texas, on the other hand, will look primarily to the four comers of the instrument. As seen by implication in *Obelgoner*, a top lease which does not refer to the bottom lease, and which is drafted as a present grant, would probably be deemed a novation as to any inconsistent terms. Another approach taken by some commentators and, in this author's view, the one that makes common sense, is that an oil lease is primarily a real estate transaction, not a contract, and that the contractual theory of novation should not be applicable.

Because of the uncertainties in the interpretation of two-party top leases it is suggested that great care should be taken in drafting so that the intention of the parties with regard to the bottom lease is clearly expressed. The novation problem becomes

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\(^{31}\) Brown, *supra* note 6, at 236.

particularly important where the prior lease is held by production or where the operator will be drilling at or near the end of the primary term of the first lease. It should be obvious that if the top lease provides that it is not a novation of the bottom lease then the matter is settled and novation does not apply. If the top lease is made "subject to" the bottom lease and the date of the primary term is changed to start at the end of the primary term of the bottom lease, it is not legally as clear but should be factually as obvious that no novation is intended. Through careful drafting, ambiguities such as those discussed above may be avoided.

B. LEGAL THEORIES THAT MAY INVALIDATE A TOP LEASE OR GIVE RISE TO A CAUSE OF ACTION BY A BOTTOM LESSEE

There are a number of legal theories and/or factual realities which may lead to several causes of action, often related, which may result in a top lessee being liable for injunctive relief, actual damages and in proper circumstances punitive damages. Legal theories which may result in top lessee liability are clouding of title, the equitable doctrine of obstruction, slander of title, tortious contractual interference, and trespass. A review of these causes of action (legal theories) will reveal that many have common legal elements and the facts which lead to their existence are often similar and/or related. Another interesting point is that several of these theories may apply equally to the lessor if he engages in similar conduct in conjunction with the granting of a top lease. The doctrine of the rule against perpetuities is an additional legal theory which may invalidate a top lease and is discussed below. While several of these legal theories have not heretofore been discussed in traditional oil and gas law cases, they are valid general
legal theories and should, under the proper circumstances, be applicable.

1. **CLOUD ON TITLE AND/OR EQUITABLE OBSTRUCTION**

While it may be short sighted and it may kill the prospect, often, when the primary term of a lease is about to expire, the lessor may look to another willing lessee in order to "protect" his interest. Often this need to "protect" is initiated by a speculator contacting the lessor if he thinks the bottom lessee will drill the prospect but not in time to maintain the bottom lease. This "protection" is often accomplished by executing another oil and gas lease which would go into effect immediately upon termination of the first lease. However, the lease must be carefully worded so as to grant a use only after the expiration of the present use. By granting a lease on an interest covered by an existing lease, it has been successfully argued that the lessor/top lessees have clouded the title of the first lessee. One commentator advises that any top lease should expressly state that it is taken "subject to" the rights of the prior lessee as expressed in the terms of any valid and subsisting bottom lease which is of record and in existence at the time of the top lease's execution.\(^\text{33}\) In other words it is critical that the top lease be taken subject to the rights of the prior lessee to avoid an obvious action for clouding of title, and possibly slander of title or obstruction. However, the inclusion of the "subject to" language will not in and of itself protect a top lessee if the facts subsequent to the taking of the top lease are sufficient to invoke any of the other theories including tortious contractual interference or, if the lessor is involved, intentional breach of contract.

\(^{33}\) Kemp, *supra* note 1, at 647.
In the area of oil and gas leases, the doctrine of obstruction is related to but different from clouding of title. If the granting of a top lease is combined with other acts of either the lessor or the top lessee which appear to repudiate the bottom lease, the rights of the bottom lessee may become obstructed. Some acts which when combined with the granting of the top lease are a repudiation of the bottom lease are: filing of a lawsuit, preventing access to the property, correspondence stating that the bottom lease has terminated, obtaining a temporary restraining order and appearing before an administrative agency to challenge a unit or well. The equitable doctrine of obstruction prevents the lessor or top lessee from obstructing the operations required of the lessee under the bottom lease and subsequently claiming that the lease has terminated or otherwise come to an end due to the lessee's failure to comply with the terms of the lease. However, these obstructions must be the cause of the lessee's failure to comply with the lease terms, whether by nonproduction or otherwise, before the doctrine will apply. Obstruction should have the practical result of perpetuating the bottom lease throughout the period of obstruction.

Obstruction requires a clear and unequivocal repudiation of the lease. However, this requirement could possibly be met by the mere granting of a naked top lease (a top lease that does not contain language showing that it is subordinate to the

34 Id. at 659.

35 Haddock v. McClendon, 266 S.W.2d 74 (Ark. 1954); Berry v. Tidewater Associated Oil Co., 188 F.2d 820 (5th Cir. 1951).

36 Ernest, supra note 2, at 963.
lease currently in effect) since such a lease purports to be immediately effective.\textsuperscript{37} It should be noted however that if the original lessee is without knowledge of the top lease and the top lease is not recorded until after expiration of the original lease, the top lease alone should not constitute an obstruction.\textsuperscript{38} In addition to actual or constructive notice of the top lease, the bottom lessee must prove that he suspended operations as a result thereof.\textsuperscript{39} Unlike slander of title, malice is not an essential element of obstruction.\textsuperscript{40} The remedy for obstruction is typically to clear the title of the competing top lease and, if production is involved, damages for wrongfully extracted minerals may be recovered.\textsuperscript{41}

Although the execution of a naked top lease alone may constitute obstruction, claims of obstruction generally arise where a top lease has been executed and the lessor or top lessee engages in other actions in repudiation of the bottom lease.\textsuperscript{42} Professor Kuntz states that for the claim of obstruction to arise the lessor must be engaged in a course of conduct which includes not only a total repudiation of the lease, but some form of physical interference which could be a lawsuit.\textsuperscript{43}

\textsuperscript{37} Kemp, \textit{supra} note 1, at 659.


\textsuperscript{40} Kidd v. Hoggett, 331 S.W.2d 515 (Tex. Civ. App. 1959), \textit{writ re'd n.r.e.}

\textsuperscript{41} Brown, \textit{supra} note 6, at 217.

\textsuperscript{42} Kemp, \textit{supra} note 1, at 659.

\textsuperscript{43} Kuntz, \textit{supra} note 38, at 425, n.18.
In the Arkansas case of Haddock v. McClendon, the lessors notified the lessees in writing that the lease had terminated a few days after the end of the primary term but while the lessor was attempting to drill a well. This notification was followed by the lessees filing suit asking title to be quieted in them. The Court declined to terminate the lease stating "appellants had a right, as we have mentioned, to wait until practically the last day to begin drilling, and cannot therefore be penalized for lack of diligence on that account, and since they were stopped by appellees on March 4 (the date of the letter to lessee), the question of diligence thereafter never arose." The Haddock case can be used as persuasive authority that Arkansas courts have accepted the common sense argument that actions by a lessor, or top lessee, which tend to repudiate the bottom lessee’s title constitute obstruction and would excuse the bottom lessee from performance until a reasonable time after the obstruction is removed.

In a Texas case, Shell Oil Co. v. Goodroe, the lessor executed a top lease and also sent a letter to the bottom lessee’s assignee repudiating the bottom lease and demanding release thereof. These actions relieved the assignee, just as in Haddock, of its duty to operate the well until settlement of the controversy.

It should be noted that like Haddock and Goodroe the Fifth Circuit, in Berry v. Tide Water Associated Oil Co., interpreting Mississippi law, in a footnote stated that

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44 See note 35.


46 See note 35.
the plaintiff had executed what is in effect a top lease, thus forbidding operations by the defendants (bottom lessees).

When obstruction occurs, the lessee is excused from performance until the obstruction is removed. Once the obstruction is removed, the period of time in which the lessee may then establish production (to extend the lease beyond its primary term) becomes an issue. There are two lines of thought on this question. The lessee's extension may be for the period of time that was remaining on his lease when the obstruction occurred\(^{47}\), or the extension may be for a period of time, reasonable under the circumstances, in which to proceed with drilling.\(^{48}\)

Generally, there will be no finding of obstruction if the top lease recognizes the existence of the bottom lease and both the lessor and top lessee refrain from asserting rights superior to those of the bottom lessee or hindering the bottom lessee's actions to extend his lease. Again, it must be emphasized that the top lease must acknowledge the validity of the bottom lease. This not only operates as notice to the parties but also helps to avoid misunderstandings between the parties. When a bottom lessee has been top leased he should be alert for signs to support a claim of obstruction and consider seeking a court order excusing performance until the title is resolved. Such a court order would protect him in advance from claims that his lease had terminated pursuant to its terms for failure to produce. It would be helpful to know in advance whether a particular jurisdiction will remedy obstruction with a reasonable time to fulfill lease


requirements or merely suspend lease requirements during the period of obstruction. Based on the Arkansas Supreme Court’s application of good faith and diligence tests in Haddock the argument can be made that Arkansas will merely suspend the lease requirement during the period of obstruction and allow a reasonable time thereafter to begin operations.

The top lessee’s lease may also be extended in the situation where he is dispossessed by the lessor’s dispute with the bottom lessee. Until the dispute is resolved, the top lease should be extended. The mineral owner in Massey, a Texas case, had executed a top lease before seeking a declaratory judgment that bottom leases had expired. Subsequent settlement agreements between the mineral owner and bottom lessee purporting to permit the bottom lessee to resume production under his old leases could not defeat the valid top lease which was prior in time to the settlement agreements. The Court held that the top lease was extended until the dispute with the bottom lessee was resolved.

2. SLANDER OF TITLE

The doctrine of obstruction can be carried one step further by the doctrine of slander of title. While the term "slander of title" is highly criticized the term is well recognized. The term is used to describe intentional words or conduct which tend to bring into question the right or title of another to property. This requirement of

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intentional words or conduct differentiates slander of title from cloud on title which does not require intentional conduct. In fact an action for slander of title will not lie if the statement or conduct was made in good faith.\textsuperscript{51}

For an action based on slander of title there must be a showing of actual malice.\textsuperscript{52} An obstruction can be so willful that it brings rise to a slander action.\textsuperscript{53} It is obvious that the more egregious the actions of the lessor or top lessee the greater the possibility for the Court to find that slander of title has occurred. In a slander of title claim the bottom lessee can obtain not only time to remedy the obstruction but also damages.\textsuperscript{54}

Generally the elements of slander of title are: (1) a publication, (2) that the publication was false, (3) actual malice and (4) damage to the opposing party.\textsuperscript{55} A showing of good faith or a reasonable basis for the obstruction will usually defeat a claim of slander of title.

This author is aware of no Arkansas oil and gas or top lease cases involving the doctrine of slander of title.

\begin{itemize}
\item \textsuperscript{51} \textit{Id.} at § 544.
\item \textsuperscript{52} Elliott v. Elliott, 482 S.W.2d 123, 128 (Ark. 1972).
\item \textsuperscript{54} \textit{Id.}
\item \textsuperscript{55} See Hicks v. Early, 357 S.W.2d 647 (Ark. 1962).
\end{itemize}

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3. **TORTIOUS INTERFERENCE WITH CONTRACT**

In legal theory and factual proof the doctrine of tortious interference with a contract can be similar to the doctrine of obstruction and to slander of title.

Because the bottom lease is a contract the bottom lessee may bring an action for interference with his contractual rights if a top lessee, with notice of the bottom lease, begins to drill or conduct other operations on the land or otherwise interferes with the bottom lease without first verifying that the bottom lease has expired. Therefore, the top lessee must be certain that his lease recognizes any outstanding leases or option agreements. He must further verify that the term of the bottom lease has in fact expired prior to beginning drilling or other operations or from otherwise interfering with the bottom lease. In short, a top lessee cannot interfere with or cause a breach of the bottom lease without suffering the consequences.

Louisiana does not recognize a cause of action for tortious interference with a contract except in certain limited employment circumstances. Mississippi, Alabama, Texas and Oklahoma recognize the cause of action for tortious interference with a contract, but have not decided any top leasing cases based on this theory. It is possible that punitive damages would be recoverable for this action in tort.

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56 Kemp, *supra* note 1, at 659.


Arkansas, while recognizing the cause of action, has yet to decide any top leasing cases. *Mid-South Beverages, Inc. v. Forrest City Grocery Co., Inc.*[^59] is a recent Arkansas case discussing the theory of tortious interference with a contract. In this case the Arkansas Supreme Court listed the elements for the tort of interference. For there to be a claim for interference with a contract there must be a showing that: (1) there was the existence of a valid contractual relationship or business expectancy; (2) knowledge of the relationship or expectancy by the interferer; (3) intentional interference inducing or causing a breach or termination of the relationship or expectancy and (4) damage to the party whose relationship or expectancy has been disrupted.

In applying *Mid-South* to a top lease situation, one should realize that (1) the bottom lease would be the valid contractual relationship; (2) the fact that the bottom lease was recorded should be sufficient knowledge of the relationship; (3) the execution of the top lease if coupled with other acts like obstruction would be the interference causing a breach and (4) the damages could be the value of any lease that the bottom lessee lost or the cost of delaying operating or the cost to establish its lease or possibly the amount of production lost to drainage during the period, etc. It is apparent that factually the elements of a claim for tortious interference with a contract are often present when there has been an obstruction or slander of title by the lessee of a top lease.

When the lessor becomes involved in the act, it takes on a character much like that of obstruction and can result in intentional breach of contract. The complaint must

[^59]: *Mid-South Beverages, Inc. v. Forrest City Grocery, 778 S.W.2d 218 (Ark. 1989).*
be couched in terms of intentional breach of contract because the state of Arkansas does not presently recognize a cause of action for tortious breach of contract. The Arkansas Supreme Court has stated that presently the tort of bad faith for breach of contract only applies to insurance contracts. Traditionally the recovery of punitive damages for breach of contract is only allowed in limited situations (where a "special relationship" exists between the parties), one being breach of a fiduciary duty. To support a punitive damages claim, a willful or malicious act must exist in conjunction with the contract. It would be interesting, given the legal status of oil and gas lessees to lessors (it is, this author would argue, a special relationship), to see if an Arkansas court would allow a claim for tortious breach of contract against a lessor who has maliciously obstructed a bottom lessee. It is clear that regardless of the legal action used, neither the lessor nor the top lessee has the right to infringe on the contractual rights of the bottom lessee, and should suffer the consequences if they do.

If the bottom lessee's contractual rights are violated by the top lessee in cooperation with the lessor there is the possible remedy of specific performance. A Mississippi case dealing with the specific performance of a real estate contract and intentional breach of same is interesting and may be susceptible to application to top lease situations. In Hamilton the Court found that the plaintiff was ready, willing and able to perform his real estate contract and the Court therefore specifically enforced the


61 Brill, Punitive Damages in Arkansas, Arkansas Law Notes (1990).

contract and determined that a subsequent sales contract was null and void. The Court also allowed for the recovery of attorneys' fees. In Mississippi attorneys' fees are only recoverable if punitive damages are justified. If the logic in the Hamilton case is applied, to the top lease scenario, then if the top lessee and/or lessor violate the bottom lessee's rights in a malicious manner the top lease might be cancelled by the Court. In addition, the top lessee and lessor might also be liable to the bottom lessee for the consequences including attorneys fees and punitive damages.

4. TRESPASS

The application of the doctrine of trespass in a top lease situation is very limited in scope. Trespass does not apply to co-tenancy situations. Factually it will be unusual and difficult in the top lease scenario for trespass to apply. Generally, trespass will apply only when there is one tract and one lease on the lands or unit in question. Stated differently, as long as the operator has a legal right (owns a lease or minerals in the unit) to be on the lands or unit trespass does not exist.

Trespass is an intrusion which invades a possessor's protected interest in exclusive possession. When it can be shown that the top lessee had actual or constructive notice of a valid prior interest, the court may find the top lessee to be a trespasser if he conducts exploration or drilling operations after expiration of the primary term of the bottom lease and if he has no other right to be on the unit in question. This situation generally arises when the bottom lease has been extended into a secondary term by

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pooling, drilling or production of which the top lessee is unaware. Once found to be a trespasser, he would be held liable for damages and any other relief that may be appropriate.64 A central issue for courts, when determining damages as the result of a trespass, is whether the party was a "willful" or an "innocent" trespasser.

In the Arkansas case Fife v. Thompson,65 Fife claimed that Thompson, the operator, was a willful trespasser and therefore Fife was not obligated to reimburse Thompson for any portion of the costs of drilling the well. Thompson had drilled a well unaware that Fife's 1/8 mineral interest was unleased. The Court, in accordance with prior Arkansas cases, found that Thompson, the operator, was not a willful trespasser but was tantamount to a co-tenant and was therefore granted a lien against Fife, even though no forced pooling was involved, for her portion of the cost of drilling.

In Killam v. Texas Oil & Gas Corp.,66 the Court cited Ward v. Spadra Coal Co. for the proposition that the proper measure of damages for good faith trespass was the value of the minerals in the ground. In computing this amount the Court discussed the two different methods for measuring the damages, the royalty measure and the working interest measure. The Killam Court used the royalty method and awarded the party the amount that could have been obtained had they leased the mineral rights rather than the

64 Kemp, supra note 1, at 651, 660.
65 Fife v. Thompson, 708 S.W.2d 611 (Ark. 1986).
66 Killam v. Texas Oil and Gas Corp., 798 S.W.2d 419 (Ark. 1990).
profit that could have been obtained had the party drilled the well themselves (working interest measure).\textsuperscript{67}

Arkansas has no cases dealing with the bottom lessee as a trespasser. The general law as to the extraction of minerals can be examined to ascertain the remedies available to the bottom lessee. The Arkansas cases involving the wrongful removal of hard minerals are useful in determining remedies.\textsuperscript{68} In these cases good faith or the lack thereof can affect the amount of damages. If the trespass was in bad faith the amount of recovery is the amount of minerals taken. The measure of damages for good faith trespass is the value of the minerals produced less the expense of production.\textsuperscript{69}

In determining whether the trespass is innocent or willful, the court will look to the trespasser's sincerity and good faith expressions of his intentions.\textsuperscript{70} In Swiss Oil Corp. v. Hupp,\textsuperscript{71} a case before the Kentucky Supreme Court, the top lessee was found to be an innocent trespasser since he had acted on the advice of counsel and there was doubt surrounding the bottom lessee's claim to the leasehold. The Court stated that:

\begin{quote}
The conditions and behavior are usually such that the court can determine whether the trespass was perpetuated in a spirit of wrongdoing, without knowledge that it was wrong, or whether it was done under a bona fide mistake, or as where the circumstances were calculated to induce or justify
\end{quote}

\begin{itemize}
\item \textsuperscript{67} Id. at 423, see also Wright, supra note 5 at 236.
\item \textsuperscript{68} Wright, supra note 5 at 235.
\item \textsuperscript{69} Id. at 238 citing Young v. Ethyl Corp., 581 F.2d 715 (8th Cir. 1978); National Lead Co.v. Magnet Barium Corp., 231 F.Supp. 208, 213 (W. D. Ark. 1964).
\item \textsuperscript{70} Jackson & Weissbrod, supra note 53, at 12-12.
\item \textsuperscript{71} Swiss Oil Corp. v. Hupp, 69 S.W.2d 1037 (Ky. 1934).
\end{itemize}
that reasonably prudent man, acting with a proper sense of the rights of others, to go in and continue along the way.\textsuperscript{72}

In the case of a willful trespasser, the violating party is responsible for gross revenue (the gross value of all oil or gas produced by the trespasser). On the other hand, an innocent trespasser is only accountable for net profits. The net profits will be calculated by subtracting the reasonable production costs from the value of the oil or gas at the well.\textsuperscript{73} The innocent trespasser, therefore, is allowed to recover proper costs and production expenses but is not allowed to profit from his offense. Reasonable costs and expenses of production should include the cost of drilling the well, and have also been held to include water flooding expenses, overpayment of royalties, ad valorem taxes, the cost of drilling a dry well, and operating expenses subsequent to the filing of the lawsuit.\textsuperscript{74} However, income taxes, legal fees, and the value of improvements to the leasehold property have been held not to be reasonable expenses.\textsuperscript{75}

The bottom lessee might also be found in trespass if he fails to relinquish his leasehold at its expiration. The Mississippi Supreme Court, in \textit{Lone Star Producing Co. v. Walker}\textsuperscript{76}, addressed the issue of the bottom lessee as the trespasser. Here, the top lessee was allowed to recover damages from the bottom lessee since there was no valid bottom lease. The bottom lessee's lease had been extended into its secondary term by

\textsuperscript{72} Id. at 1041.

\textsuperscript{73} Id. at 1044.

\textsuperscript{74} Jackson and Weissbrod, \textit{supra} note 53, at 12-13.

\textsuperscript{75} Id.

\textsuperscript{76} Lone Star Producing Co. v. Walker, 257 So.2d 496 (Miss. 1971).
production. A top lease was executed during a cessation of production during the secondary term. The bottom lessee failed to resume production within the sixty day period allowed under the lease; however the bottom lessee continued in possession after the lease had terminated claiming the continuous reworking provision of the lease was being complied with. In addition to clearing the cloud on his title, the top lessee recovered damages in the amount of the value of production from the time the bottom lessee completed reworking operations less reasonable production costs. The Court did not discuss the willful/innocent trespasser distinction, but merely affirmed the chancellor’s ruling on damages.

For a top lessee to avoid a charge of trespass, it may be necessary for him to obtain an affidavit from the lessor (assuming he is not involved) stating that the bottom lease has terminated or rely in good faith on a title opinion or like instrument. A release from the bottom lessee would be more effective, but generally much more difficult to obtain.

5. RULE AGAINST PERPETUITIES

The common law of England was responsible for creating the rule against perpetuities, which is still recognized in many jurisdictions today. The Rule was promulgated to prevent the creation of remote future interests in land that might never vest. At common law, the rule against perpetuities provides that "no interest within its scope is good unless it must vest, if at all, not later than 21 years after some life or lives

77 Id. at 501.
in being at the creation of the interest to which is added the period of gestation, if gestation exists." 78

The primary term of a top lease typically commences upon the expiration of the bottom lease. If the bottom lease contains a habendum clause which keeps the lease alive for a secondary term "so long thereafter" as oil or gas is produced or operations are conducted (which virtually all oil, gas and mineral leases do contain), it is conceivable that the bottom lease could be maintained indefinitely. There is therefore no assurance that the bottom lease would expire within the time period provided by the Rule, and likewise there is no assurance that the top lease will be effective (its primary term will commence) within the perpetuities period.

It has been argued that the scenario outlined above constitutes a violation of the rule against perpetuities. This argument is based on the premise that the interest of the top lessee does not vest (which is the key factor in determining whether the Rule is violated) until the primary term of the top lease commences and the top lessee has the right to explore for oil and gas. It is thus stated that "the vesting of the top lease is contingent upon the occurrence of 'an uncertain future event'." 79

Obviously if a lessor purported to grant a top lease which was to vest (as opposed to becoming effective) upon the expiration of the bottom lease, the top lease would violate the Rule. 80 However, it is suggested that the following analysis should be

80 Ernest, supra note 2, at 961.
applied to a top lease which purports to be a present grant, but which is subject to the bottom lease (the primary term will not commence until the expiration of the bottom lease). Upon the execution of an oil and gas lease with a "so long thereafter" habendum clause, the lessee acquires a determinable estate. The interest remaining in the lessor is a possibility of reverter, which is a vested interest and is therefore not subject to the rule against perpetuities.\footnote{Arkansas as well as several other states have statutes providing that any interest in land is alienable\footnote{including future interests. Therefore, if the top lease is viewed as a partial alienation of the lessor’s possibility of reverter, this is merely the conveyance of a vested interest, which is not subject to the Rule.\footnote{It is this author’s view that the above is the proper analysis of top leases and that the rule against perpetuities should not apply to top leases.}} Arkansas as well as several other states have statutes providing that any interest in land is alienable\footnote{including future interests. Therefore, if the top lease is viewed as a partial alienation of the lessor’s possibility of reverter, this is merely the conveyance of a vested interest, which is not subject to the Rule.\footnote{It is this author’s view that the above is the proper analysis of top leases and that the rule against perpetuities should not apply to top leases.}} including future interests. Therefore, if the top lease is viewed as a partial alienation of the lessor’s possibility of reverter, this is merely the conveyance of a vested interest, which is not subject to the Rule.\footnote{It is this author’s view that the above is the proper analysis of top leases and that the rule against perpetuities should not apply to top leases.}}

As previously noted, the Mississippi case of Barnett v. Getty Oil Co., implies that a top lease is a present grant of a future interest.\footnote{It is therefore arguable that Mississippi would not apply the Rule to top leases. Since Arkansas’s statute providing that an interest in land is alienable is similar to the Mississippi statute the argument can be made that Arkansas would also not apply the rule against perpetuities to top leases.}}

In any event, a jurisdiction applying the Rule may not automatically void the interest purported to be created, but may reform the instrument under the doctrine of

\footnote{Hill, supra note 79 at 780, 781.}


\footnote{Ernest, supra note 2, at 962; Brown, supra note 6, at 227.}

\footnote{Barnett v. Getty Oil Company, 266 So.2d 581 (Miss. 1972).}

\footnote{Hill, supra note 79 at 780, 781.}


\footnote{Ernest, supra note 2, at 962; Brown, supra note 6, at 227.}

\footnote{Barnett v. Getty Oil Company, 266 So.2d 581 (Miss. 1972).}
cy pres, or apply the "wait and see" approach.\textsuperscript{85} Mississippi adopted the "wait and see" approach in \textit{Phelps v. Shropshire}.\textsuperscript{86} under which the interest is valid if the contingency actually happens during the perpetuities period. The rule against perpetuities has not been applied in Mississippi in a top lease situation. This author is aware of no cases indicating that Arkansas has adopted the "wait and see" approach. In \textit{Stoltz, Wagner and Brown}\textsuperscript{87} the United States District Court for the Western District of Oklahoma, in applying Oklahoma law reformed a top lease by cy pres power to prevent the top lease from being a violation of the rule against perpetuities. The top lease was to take effect after the expiration of the existing lease. If the existing lease was held by production this would put the top lease in violation of the rule against perpetuities. The intent of the top lessee was applied and reformation of the top lease was allowed. Arkansas has a statute allowing the cy pres power to reform charitable trusts, however this author is not aware of any other statutory cy pres power in Arkansas.

One precaution against the perpetuities problem which could be used in drafting a top lease would be to include a "savings clause", which states the latest point at which the primary term of the top lease will begin. However, the best approach to the perpetuities problem is to draft the top lease as a present grant which vests immediately,


\textsuperscript{86} \textit{Phelps v. Shropshire}, 183 So.2d 158 (Miss. 1966).

\textsuperscript{87} See note 3.
subject to the existing lease. Where the interest vests immediately, but enjoyment or utilization is postponed, this should present no perpetuities problem\(^{88}\).

C. **EFFECT OF POOLING, PRODUCTION, OR OPERATIONS ON TOP LEASES**

Essential to a basic understanding of the effect of pooling, production or operations on top leases is the basic principle, that the terms and provisions of the bottom lease control. The outcome of most top lease/bottom lease conflicts is dictated by the language contained in the bottom lease. The most commonly litigated issues are the effect bottom lease provisions concerning pooling (voluntary or compulsory), production or well operations have on the top lease. The following sections discuss the effect of pooling, production and well operations on the top lease.

1. **POOLING**

Pooling questions involve the application of basic oil and gas law principles as modified by the concepts of voluntary pooling (under the lease) or statutory or compulsory pooling (by appropriate governmental agency). The effect of pooling on top leases and correspondingly on bottom leases is such that it creates numerous interesting questions few of which have specific case or statutory authority on point.

Acts of pooling either under the lease (voluntary) or by the appropriate oil and

\(^{88}\) Ernest, *supra* note 2, at 961.
gas regulatory body (compulsory by -- Corporation Commission-Okla., Railroad Commission-Texas, Oil and Gas Commission-Arkansas, Oil and Gas Board-Mississippi and Alabama, Conservation Commission- La.,) will often continue the bottom lease. The relationship between the parties and the relative equities will also be seen to be important in the cases discussed below. Further, in instances of statutory (regulatory) pooling the force majeure provision of the lease may apply to extend all leases in the drilling (probably production also) unit. In certain instances, the application of constitutional law impacts the terms of the lease and/or the pertinent regulatory statutes and will protect the bottom lease. Arkansas authority (case law and statutory) discussed below can lead to the conclusion, when viewed in conjunction with similar law from other jurisdictions, that pooling will extend the bottom lease. In short, if the option of production or operations on the leased premises is not practicable or possible, there may be another avenue available to the bottom lessee to protect his position. That is a bottom lessee may choose (or be forced) to pool his interest, which in appropriate circumstances, should perpetuate his lease position. The cases set out below when viewed together indicate a willingness by courts to give the bottom lessee some protection from assaults by top lessees and lessors. These cases seem to indicate that a bottom lessee is entitled to the court’s protection when it operates within the bounds of the lease provisions or those rights afforded it under statutory pooling. The only authority to the contrary is the widely criticized, and in this author’s view, patently erroneous, Envirogas case set out below.
The New York courts were faced with a top lease/bottom lease pooling problem in Envirogas v. Consolidated Gas Supply Corp.\textsuperscript{89} There, pursuant to the terms of the bottom lease, the bottom lessee prepared a plan of pooling, then drilled the required wells on other acreage pursuant to the plan within the period of the bottom leases. The top lessee objected, claiming that the unit designation was a sham, was not made in good faith, and was solely for the purpose of extending the bottom lease. The top lessee sought a declaratory judgment that the unitization was invalid and a preliminary injunction restraining further drilling by the bottom lessee. The trial court granted the bottom lessee's motion to dismiss on the basis that the top lessee had no standing to challenge the bottom lessee's pooling and that the top lessee is not the beneficiary of the implied covenant to pool in good faith. The appellate court, however, reinstated the complaint holding that the top lessee was suing to protect its own alleged present possessory leasehold estate. While the court noted that the duty to pool in good faith runs primarily to the land owners, it appears to allow the top lessee to enforce this duty by claiming that the bottom lease is no longer valid and existing. The appellate court affirmed the denial of a preliminary injunction against the bottom lessee, holding that the bottom lessee had at least facially complied with the pooling clause of the lease, and that the top lessee had not demonstrated the likelihood of success on the merits.

The apparent (erroneous) establishment of the bottom lessees duty to pool in good faith toward the top lessees is still being forged. It appears from the Envirogas cases and their successors that the New York Appellate Court is ignoring the law from other jurisdictions including the common sense approach developed by the Courts in the cases discussed below, as well as the apparent law and the facts of the case before it, to allow the top lessee to win. This author tried to find out the real story behind these cases, but has had no success in doing so. Therefore, the comments in this paper are limited to the reported decisions which have been criticized by authors in addition to this author. If the result of these New York decisions is to establish a right on behalf of the top lessee to block a bottom lessee from pooling and drilling near the end of the primary term to develop its leases, then it is contrary to the law in Arkansas and other states. Hopefully, if this is actually what the New York Court intended, this ruling will not extend to other states.

Even a cursory examination of the Envirogas decisions reveals that the New York Court completely ignored numerous pertinent legal and factual matters which other states’ courts have thought important. The New York Court ignores the fact that there is no relationship, contractual or otherwise, between the bottom lessee and the top lessee, that the bottom lessee is free to pool under the terms and conditions of its bottom lease, that the top lessee and bottom lessee are in fact in a competitive and antagonistic


91 Kramer and Martin, Pooling and Unitization § 8.06 (3rd Ed. 1991).
position (i.e. there is no fiduciary, trustee or any other special relationship), that almost all (I assume New York's does) oil and gas regulatory statutes provide that production, operations, etc. on a unit are deemed production, operations, etc. from each and every lease and tract in the unit and that most states, including Arkansas, Mississippi and others, hold that the bottom lessee can wait until near the end of the primary term to commence operations under the lease (which should include the act of pooling). It is submitted that the courts of Arkansas, Mississippi, Oklahoma, Louisiana and others as seen from the following cases would not ignore the above matters and would not follow the New York Court's erroneous position.

Kuykendall v. Helmerich & Payne, Inc.\(^{92}\) is an interesting Oklahoma case concerning what extends leases beyond their primary term in so far as pooling and/or unitization is involved. In this case the operator made a diligent attempt to acquire an order allowing it to drill on the unit which effort resulted in preliminary approval to drill a unit well not on the lessor's lands. However, the order was signed one day after the end of primary term of the lease. The trial court found that the pendency of the spacing proceeding coupled with the commencement and diligent drilling of a prospective unit well triggered the force majeure clause of the lease, because the operator was prohibited by statute from drilling a well on the plaintiff's land and that the force majeure clause contemplated the situation and excused compliance for the period of the statutory prohibition. The appellate court reversed the trial court stating that such a holding would allow the lessee to maintain leases in force and effect after the primary terms

simply by filing an application to drill. The appeals court rejected the lessee’s arguments relating to the force majeure clause and pooling. The Oklahoma Supreme Court reversed the appellate court and reinstated the trial court’s decision. After a lengthy discussion of the Oklahoma conservation statutes and their effect, the Oklahoma Supreme Court held that the combination of the commence clause in the lease and the statutory provisions for formation of spacing units have the legal effect of continuing a lease where drilling is commenced to a common source of supply named in a pending drilling and spacing application if the well so commenced is completed as a producing well. The commentator in the *Oil and Gas Reporter* states that both the diligence used in seeking a spacing order and the fact that the lessee was also the operator should be irrelevant. He further states that the results reached by the court should be the same, that is, the lease should be extended, as to any lease within a proposed unit the primary term of which expires while a spacing application is pending and while the unit well is being drilled. It is obvious how the *Kuykendall* case holding could be applied in a top lease situation.

It is submitted that this holding, its logic and application of the pooling statutes is correct and will be seen again in several other cases which follow. This holding and the others using similar logic are based on a central idea that if the bottom lessee is attempting to pool the lease either under its terms or in accordance with the applicable statutes and rules to get a well drilled then the lease will be extended. It is therefore possible that, the filing of an application for a permit to drill will extend any lease
ultimately included in the unit. Furthermore, as discussed under the obstruction
doctrine, if a lessor or top lessee tries to delay a pending application or otherwise
interferes with the bottom lessee these should be additional reasons for a similar holding.
A top lessee's appearance before a regulatory agency, regardless of whether he has
standing, could likewise be construed as contractual interference. If the appearance is
merely a delaying tactic so that the lease will expire then there is tortious interference
with the bottom lease.

In Gorenflo v. Texaco, a lease clause authorized lessees to declare a unit when
declaration of such unit would be necessary or advisable to properly develop and operate
the property so as to promote conservation, avoid waste and unnecessary wells, or to
comply with spacing orders. The lessees formed a unit and began conducting operations
when the primary lease terms were about to expire. The well was spudded after
expiration of the primary term. The lessor sought cancellation of the lease alleging, inter
alia, that the pooling clause did not authorize declaration of a unit for purposes of an
exploratory well, that the declaration was made in bad faith merely to extend the lease,
and that operations on the unit were insufficient. The Court held that the formation of
the unit for the purposes of an exploratory well was authorized by the lease form. The
fact that the pooling arrangement also helped retain the leases did not affect this finding
nor did it point to bad faith or arbitrariness on the part of the lessee. The Court further

held that the lessee's operations on the unit prior to the expiration of the primary term (making inspections of drill pipe and placing portions of the drilling rig on the well site) were sufficient operations to extend the lease. From this decision it should be obvious that Louisiana would not follow the Envirogas cases.

Mississippi has also addressed the issue of pooling just prior to the expiration of the primary term, in the context of a challenge of an oil and gas board order creating a unit, and indicated that it is a valid exercise of the lessee's rights.\textsuperscript{94} Also, forced pooling pursuant to Miss. Code Ann. § 53-3-7 and subsequent drilling within the unit will continue leases on all lands within the unit.\textsuperscript{95} This rule is followed even as to lessors who refused to agree to the pooling.\textsuperscript{96} The Tri M case involved a top lessee who argued that the bottom lease had expired for failure to obtain production or conduct operations on the leased premises during the primary term of the bottom lease. In this case Getty Oil Company, which owned the bottom lease, refused to sign the operating agreement and participate in drilling costs. Getty refused to sign the operating agreement because the unit was force-pooled as a gas unit and if the well was completed as an oil well the unit would be down sized excluding Getty's acreage. Getty did not want to advance costs for drilling, take the risk of a dry hole, then be precluded from receiving any production if the operation was successful as an oil well.

\textsuperscript{94} State Oil and Gas Board v. Crane, 271 So.2d 84 (Miss. 1972).

\textsuperscript{95} Tri M Petroleum Co. v. Getty Oil Co., 792 F.2d 558 (5th Cir. 1986); see also Superior Oil Co. v. Beery, 63 So. 2d 115 (Miss. 1953), \textit{sugg. of error overruled}, 64 So.2d 357 (Miss. 1953).

\textsuperscript{96} Humble Oil & Refining Co. v. Hutchins, 64 So. 2d 733 (Miss. 1953), \textit{sugg. of error overruled in part}, 65 So.2d 824 (Miss. 1953).
The Fifth Circuit Court of Appeals, applying Mississippi law, and citing in particular Superior Oil Co. v. Beery, held that involuntary pooling altered the lessee's rights and obligations and would extend the bottom lease by production or operations within the unit. The Court in Tri M noted that it is well established in Alabama and Louisiana that drilling anywhere in the involuntarily-pooled unit constitutes drilling on all property in the unit. Arkansas statutes likewise provide for forced pooling, and provide that all operations on any part of a drilling unit shall be deemed operations on all lands in the unit. Ark. Code Ann. § 15-72-305 (b) (Supp. 1991) states:

(b) All operations, including, but not limited to, the commencement, drilling, or operation of a well upon any portion of a drilling unit for which an integration order has been entered shall be deemed for all purposes the conduct of operations upon each separately owned tract and interest in the drilling unit by the several owners thereof. The portion of the production allocated to the owner of each tract or interest included in a drilling unit formed by an integration order shall, when produced, be considered for all purposes as if it had been produced from the tract or interest by a well drilled thereon.

Pooling and operations within the primary term anywhere in the unit should therefore extend any bottom lease which is in the unit in these states.

The rationale for such a holding under the Arkansas and Mississippi statutes and other similar states is based partially on the takings provision of constitutional law. In Superior Oil Co. v. Beery, the Mississippi Supreme Court held that forced pooling must extend the primary terms of all leases in the unit to protect the constitutional rights of

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97 Everett v. Phillips Petroleum Co., 51 So.2d 87 (La. 1950); Matthews v. Goodrich Oil Co., 471 So.2d 938 (La. App. 2nd Cir. 1985), writ denied, 475 So.2d 1105 (La. 1985); Sheffield v. Exxon Corp., 424 So.2d 1297 (Ala. 1982).

all lessees in the unit, because a well can be drilled only on one tract covered by a lease in the unit. Thus, although the right to drill is taken from the force pooled lessees, their leases are nonetheless extended by the forced pooling. Likewise, the Court held that the constitutional rights of mineral owners in the unit are also protected. Although the mineral owner no longer has the right to have a well drilled on his tract, he is given the right to receive the same portion of production from the unit well he would have been entitled to if a well had been drilled on his tract. Interestingly, the lease in the case did not have a pooling or force majeure clause and would have otherwise terminated but for the statutory pooling.

It should be noted that in Tri M, there were operations in the pooled unit prior to the expiration of the lease involved. Superior Oil Co. v. Beery, however, indicates that involuntary pooling alone (without operations) would extend the lease of a third party lessee. There is some question as to whether pooling alone, absent other circumstances, would serve to hold a lease of the operator. Because of the similarity between the Mississippi statutes regulating pooling and those of Arkansas, the arguments in Superior and Tri M should be persuasive.

At least one Texas court has held in a top lease situation that improper pooling will not extend the primary term of a lease under its habendum clause.99 This case is not however, what it appears on first review. This case turned on the particular provisions in the bottom lease and the ultimate outcome of the case appears to be that the top lessee was denied any relief. The lessee in Hunt Oil pooled and unitized a 92

acre tract covered by his lease into two 160 acre production units. The lease in question authorized pooling into units not to exceed 40 acres for oil, unless larger units were "prescribed" by regulatory authorities. The Court held that the field rules in effect "prescribed" 80 acre units, but "permitted" 160 acre units in certain circumstances. Because the lease allowed pooling in excess of 40 acres only where "prescribed" by regulatory authorities, the Court held that the lease had not been validly pooled by attempting to include it in a 160 acre unit. The lease was held terminated since there had been no production from the leased premises or lands validly pooled with said premises. What really appears to have happened was that the top lessee was denied an accounting for past production and effectively removed from the unit. In states like Arkansas, Mississippi and Alabama where unit size is set by the regulatory agency the bottom lessor, Hunt, would have prevailed even under this lease form.

Vogel v. Tenneco Oil Co.\textsuperscript{100}, is in accord with Hunt Oil in relying on the explicit language contained in the lease pooling provision in determining whether a lease is validly pooled. In Vogel, a 50 acre tract in Oklahoma was included in a 320 acre unit at the unilateral request of the lessee, Tenneco. The pooling provision in the lease provided in part that "unitized tracts may not exceed ... 160 acres for gas ... except when any governmental authority prescribes or permits a larger unit." The lessor argued that the exception portion of the pooling provision applied only where a larger unit was unavoidably compelled by governmental order, or where both the lessor and lessee requested a larger unit. The Court held that the language of the pooling clause clearly

\textsuperscript{100} Vogel v. Tenneco Oil Company, 465 F.2d 563 (D.C. Cir. 1972).
allowed any unit permitted by governmental authority. The Court noted, in rejecting the lessor’s arguments, that if the parties had intended the result sought by the lessor, they would not have included the words "or permits" in the provision. The Court noted that the lessor’s interpretation could only be followed if those two important words were ignored or were read out of the provision.

In Gordon v. Crown Central Petroleum Company, an Arkansas case, the pooling provision in question allowed for gas units not exceeding 660 acres. The provision contained no exception for larger units prescribed or permitted by the appropriate authority. However, the lease contained a governmental regulations or force majeure clause which provided that the lease was subject to all governmental regulations. The lease in question was force integrated into a 727 acre unit upon motion of a third party. The lessor sought cancellation of the lease for breach of the pooling clause. The Court held that the force majeure clause expressly prevented cancellation of the lease for violation of a lease term caused by compliance with a state law or regulation. The Court cited Bibler Bros. Timber Corp. v. Tojac Minerals in holding that forced pooling was not an exercise of the lease’s pooling provision but was compulsory and not voluntary.

Under Gordon, it can be argued that no lease containing a similar force majeure provision should be cancelled for violation of the pooling provision when a governmental


rule or order is involved, regardless of who requests the unit because size of the unit and who has right to operate are established by the Commission.

Arkansas might go further based on the holdings in Gordon v. Crown Central Petroleum, Tojac and Perry relating to its statutes. An interesting and persuasive argument can be made that based on the above cases (Arkansas, Mississippi and Oklahoma), any lease provision that conflicts with the statutes, rules and regulations of the pertinent regulatory agency will not be enforced against the bottom lessee.

To the extent possible from reading the preceeding cases and statutes a number of generalizations can be drawn. Generalizations are always dangerous from a legal perspective because cases turn on facts and law not generalizations. However with that caveat one can generalize that the courts will tend to favor bottom lessees when they have tried to develop the lands in question in accord with pertinent lease provisions and/or regulatory agency statutes, rules and regulations. Whether courts have viewed the top lessees’ or lessors’ conduct in these cases as claim jumping is not discernible. However, except for the Envirogas decision, the courts have not looked with favor upon the lessor’s or top lessees’ arguments. It is important to note that the top lessee’s rights are always subject to the rights of the bottom lessee as set out in the latter’s lease. Thus, if the bottom lease contains an express provision allowing pooling, and the lands are in fact pooled prior to the expiration of the bottom lease, the top lease will not be able to take effect. This result would be the same if the original lease contained provisions for extension or renewal and such an extension was exercised prior to the expiration of the
primary term. When the original lease contains no provision giving the bottom lessee a right to obtain an extension, an extension obtained after the execution and recording of a top lease will be subject to the rights of the top lessee.\textsuperscript{103} The bottom lessee might also want to include a right of first refusal in his lease to give him the option of matching a prospective top lessee's offer.

2. \textbf{OPERATIONS AND/OR PRODUCTION}

Operations and/or production are obvious ways that a bottom lessee has of extending his lease. This extension is made possible by complying with the terms of the lease through its habendum clause. Temporary cessation of production will not terminate a lease held under production\textsuperscript{104} and most lease forms specify the number of days allowed in which to resume. The issues of extending the lease by production, shutting in a well or otherwise, were discussed in detail in an excellent presentation and paper by Mr. Thomas A. Daily, Esq. before the 1991 Arkansas Natural Resources Law Institute.\textsuperscript{105} This paper will not attempt to address the same matters but will briefly address their application to top leases.

In the Arkansas case of \textit{Perry v. Nicor Exploration}, the top lessee sued to cancel leases for lack of production in paying quantities during the secondary term. The top lessee argued that in making the determination as to whether the wells were producing

\textsuperscript{103} Rorex v. Karcher, 224 P. 696 (Okla. 1923), \textit{rehearing denied} (1924).

\textsuperscript{104} Saulsberry, 252 S.W.2d at 836.

\textsuperscript{105} Daily, \textit{And For So Long Thereafter ... "Paying Quantities", "Shutting-In" And Other Legal Problems Of The Secondary Term}, Arkansas Natural Resources Law Institute (1991).
in paying quantities the leases should be examined individually. The Court, in its opinion
noted that all the leases in question contained a pooling clause that allowed the acreage
to be pooled to form a unit. It went on to further state that the purpose of pooling is
to get production from the whole area. Because of pooling, paying production was
calculated on a unit basis and thus each individual lessee's performance was not an issue.
Cancellation was therefore denied.

In discussing the holding of this case, this author recommends that you read the
comments to the case contained in the Oil and Gas Reporter which critically question the
Court's rationale and its holding. The commentator contends that the unit basis was
contrary to the policy underlying the Garcia v. King standard. He further stated that this
holding does nothing to redress the problem created by low "fixed price" gas purchase
contracts. The commentator continued by stating that the Court's rationale is not
compelling because pooling is unrelated to the marketing of gas. The result of this case
would be to "limit lease cancellation for lack of production in paying quantities to
unprofitable leases situated in unprofitable units." 106

and Paying Quantities" likewise criticizes the Perry v. Nicor decision for some of the
same reasons stated above but adds additional "equitable" reasons. The criticisms above,
while understandable, do not represent the Court's opinion nor those of this writer. In
addition to the reasons stated by the Court in Perry v. Nicor there are additional reasons
(equitable) which may have been a factor in the decision which were not discussed. One

106 97 Oil and Gas Reporter, 499.
interesting observation about the decision is that the top lessee, who took none of the risks of drilling, would receive a windfall simply because he could spot a perceived legal question and take advantage of the situation. One might ask if the constitutional precepts of Superior Oil Co. v. Beery would apply to Perry if the bottom lessee was not in a position to protect itself because the Oil and Gas Commission had decided who would be the operator of the well.\textsuperscript{107}

In the Saulsberry v. Siegel case a top lessee sought to cancel a bottom lease executed in 1922 on the grounds of cessation of production. The well in question was shut down for a period of four years after the derrick was destroyed by fire. The Court found that since the derrick was rebuilt and production continued, and the lessors did not complain for twenty-one years, cessation was temporary. In its ruling, the Court sustained the 1922 lease and cancelled the 1951 lease. Even where a portion of the land subject to an "unless" lease is assigned to a third party, a producing well brought in by the original lessee on his retained portion of land, if within the primary term, will extend the entire lease.\textsuperscript{108} This is of course now subject to Arkansas' statutory pugh clause.\textsuperscript{109}

Where the lease requires reworking operations within so many days, additional drilling or resumption of production may not be necessary within that time. In Jardell


\textsuperscript{108} See note 102; Berry v. Tide Water Associated Oil Co., 188 F.2d 820 (5th Cir. 1951).

v. Hillin Oil Co., repairs, site clean up, and pressure tubing testing constituted sufficient reworking operations within the meaning of the lease in light of the problems involved in obtaining approval from the working interest owners in a unit.

It is apparent that operations, production and pooling, whether voluntary or compulsory, have an effect on the top lease situation. It should be remembered that generally the terms of the bottom lease will control the effect of operations and/or production and whether they extend the bottom lease. The question of the effect of pooling on top leases, while generally favorable to bottom lessees, is somewhat difficult to categorize and has not been decided with certainty in Arkansas. Careful attention to the form of the lease and the terms contained therein by both the bottom lessee and potential top lessees is encouraged and recommended. A more explicit pooling provision and/or force majeure provision would help to clarify the situation as to pooling.

D. MISCELLANEOUS

Another matter of concern is that of anti-washout clauses. An anti-washout or extension and renewal clause is a provision which prevents the assignor of an overriding royalty interest, or an assignee who takes subject to a reserved overriding royalty interest, from acquiring a new lease and wiping out the previously assigned or reserved overriding royalty. The clause will typically state that the overriding royalty interest will burden any extension, renewal, or new lease on the same lands executed within a stated time period. When a bottom lessee and his assignees are bound by an anti-washout clause, will they

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bind a subsequent top lessee? This question was addressed in Avatar v. Chevron.111

Avatar leased from the mineral owners and assigned overriding royalty interests to two individuals, Moyers and Jenkins. The overriding royalty assignments contained anti-washout clauses. Avatar then assigned all of its right, title, and interest in the lease to Gulf. This assignment was made "subject to the terms and provisions contained in" the assignment of overriding royalty interests to Moyers and Jenkins. The mineral owners subsequently entered into a top lease with Murexco in the last month of the Avatar lease's primary term, at which time no operations had begun. Gulf agreed with Murexco to let the Avatar lease expire so that the Murexco lease would become effective. When the Avatar lease expired, Murexco assigned its lease to Gulf. Moyers and Jenkins claimed that the Murexco lease, now held by Gulf, was subject to their overriding royalty interests, under two theories. The first alleged that Gulf had a duty, under the terms of the assignment from Avatar to Gulf, to reassign the lease to Avatar before it expired. Moyers and Jenkins claimed to be third party beneficiaries of this clause in the assignment. However, the Court held that Gulf never became obligated to reassign the lease, and thus it was irrelevant whether the overriding royalty interest owners were third party beneficiaries.

The stronger claim of the overriding royalty interest owners was that since the assignment from Avatar to Gulf was "subject to the terms and provisions contained in"

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the assignment of overriding royalty, Gulf became subject to the anti-washout provision in the assignment of overriding royalty. Since the Murexco lease was in effect an extension or renewal of the Avatar lease, Moyers and Jenkins argued that the Murexco lease was subject to their overriding royalties. The Court rejected this argument by holding that the "subject to" language in the Avatar/Gulf assignment did nothing more than put Gulf on notice of an existing lease burden. Thus, if the Avatar/Gulf assignment had been clearer as to the applicability of the anti-washout provision to extensions or renewals acquired by Gulf, it is conceivable that the provision would have been applied with regard to the top lease.

*Avatar* is analogous to a two-party top lease situation because Gulf acquired the Murexco top lease. Anti-washout problems typically arise where the bottom lessee assigns his lease, reserving an overriding royalty interest, and the assignee acquires a top lease from the mineral owner and allows the bottom lease to expire. If the anti-washout provision is contained in the assignment (rather than in a separate conveyance of overriding royalty as in *Avatar*) there should be a stronger argument that the provision is applicable to a top lease. Under a theory of constructive trust, a top lease acquired by the assignee may be held subject to overriding royalties which burdened the bottom lease, even if the assignment which contained the reservation of overriding royalty did not contain an anti-washout provision. However, there generally must be some form of
confidential or fiduciary relationship between the assignor and assignee in order for this theory to apply.\footnote{112}

IV. CONCLUSION

As discussed, problem areas of top leases include the potential for novation or substituted contract, cloud on title, equitable obstruction, contractual interference, intentional breach of contract, slander of title, trespass, and violations of the rule against perpetuities. Furthermore, the actions of pooling, production, or other operations may well have an effect upon top lease arrangements.

In order to avoid problems and potential litigation the prudent purchaser will take certain precautions in drafting a top lease. In addition to those set out earlier in this paper, the following suggestions to consider were gathered from the referenced articles by J. Clayton Johnson\footnote{113} and J. Hovey Kemp\footnote{114}.

1. The top lease must be made "subject to" any right which may exist in the current lessee to avoid obstruction of the present lessee's title.

2. The habendum clause should contain a term of years to begin the day after the bottom lease is to expire.

\footnote{112}{Johnson, \textit{The Top Lease - No Longer a Stranger in the Lease Block}, Thirty-Fourth Annual Institute on Oil and Gas Law and Taxation 201, 218-223 (1983).}

\footnote{113}{\textit{Id.} at 227-28.}

\footnote{114}{Kemp, \textit{supra} note 1, at 660-62.
(3) The top lease should contain a provision that makes it effective immediately (although the primary term will not begin until some point in the future).

(4) The top lease should be recorded as soon as possible.

(5) Upon acquiring the lease, a portion of the bonus must be paid to the mineral owner. There are numerous ways to structure the remaining consideration upon termination of the bottom lease.

(6) A top lessee in Louisiana should be aware that the term of his top lease may be limited, by statute, to ten years from the date that the top lease is entered into. Additionally, he should be sure that there is language included that makes the top lease applicable to mineral rights that the lessor may obtain in the future.

(7) If a present lessee decides to top-lease his own current lease, the document needs to be specific as to whether the new lease is subject to the present lease and any rights of the lessee to maintain the present lease. In other words, whether or not a novation is intended should be specified.

(8) If a lessee assigns his interest to a sublessee, reserving an overriding royalty, the assignment should contain language which makes it applicable to extensions, renewals, and any new leases, in order to avoid a top lease "washout".

In summary, as the top lessee, it is important to make sure that the top lease is made subject to the bottom lease. Also, there must be a provision in the top lease that
causes it to vest immediately. From the bottom lessee’s point of view, it is of paramount importance to either draft against the possibility of a top lease, or at least put other parties on notice of the bottom lease. Always keep alert for problems.

More fundamentally, documents for either party must be certain, clear, and specific in expressing the intent of the parties. If the documents are drafted with clarity and specificity, the top lease can be an effective tool in the oil and gas industry. A good landman with good land owner contacts can prevent possible litigation.

W. ERIC WEST

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