MEMORANDUM

LEGISLATIVE CORRECTIONS TO THE RULE AGAINST PERPETUITIES

Summary

This memorandum addresses the need for a legislative correction to the Rule Against Perpetuities (RAP) in North Carolina. Despite the General Assembly's attempt to abolish the common law RAP and install a statutory replacement, North Carolina courts continue to apply the common law RAP to future interests excluded from the statutory regime. In effect, there are *two* RAPs in North Carolina today. Future interests created pursuant to commercial transactions have suffered the most under current law. For example, rights of first refusal (ROFR) in leases are treated less favorably than other future interests that more adversely affect marketability. The current landscape is untenable and produces results that undermine the purpose of the RAP. A legislative correction is necessary to remedy these issues and restore the benefits of the statutory reform.

Legislative Background

North Carolina's Uniform Statutory Rule Against Perpetuities (USRAP, § 41-15 through § 41-27) reformed the preexisting common law RAP in 1995. The General Assembly intended the new statutory framework to replace the common law RAP altogether. Under USRAP a nonvested property interest is valid if it (i) satisfies the common law RAP (must be certain to vest or terminate within 21 years of the death of someone who was alive when the interest was created) or (ii) actually vests or terminates within 90 years of creation (a wait-and-see approach). All nonvested interests arising from nondonative transfers, including commercial transactions, are exempted from USRAP unless otherwise specified in the statute. § 41-22 states that Article 2 supersedes the common law RAP.

Passed in conjunction with USRAP, Article 3 of Chapter 41 tailors specific durational limits for certain types of interests, including options and preemptive interests like a ROFR. § 41-29 affords a 30-year wait-and-see period only if the option or interest is *in gross*, meaning that the holder of the option or interest does not have any possessory interest in the land subject to the option or interest. Article 3 does not have a supersession clause.

Judicial History

The present jurisprudence can be traced to two Court of Appeals cases. *New Bar P'ship v. Martin*[1] and *Khwaja v. Khan*[2] each used the common law RAP to invalidate a tenant's ROFR. The ROFRs were exercisable for the life of the lease but not otherwise limited in time. Although the initial term was less than 21 years, the ROFRs were void because the exercise was not tied to a life in being and renewal options could extend the life of the lease beyond 21 years.

[1] 221 N.C. App. 302 (2012).
[2] 239 N.C. App. 87 (2015).

The real-world consequences for commercial leases were substantial, but the outcomes of the cases were simply a function of one key holding: that the supersession clause in § 41-22 does not abolish the common law RAP. The court read "supersede" to mean "modify" rather than "abolish," relegating USRAP exemptions back into the world of the common law RAP. To make matters worse, the court added further restrictions to the commercial context in its application of the common law RAP. In both cases the court rejected the precedent that future interests created in commercial transactions non-violative of the RAP's underlying policy are not subject to it. This was a departure from Supreme Court precedent that demands evaluation of the extent to which such interests affect alienability or marketability.[3]

After *New Bar* and *Khwaja*, the common law RAP applies in full force to those interests excluded from USRAP, including ROFRs in leases and other future interests arising out of nondonative transfers. The courts have resuscitated the common law RAP and applied it without regard to whether invalidating the interest would serve the purpose of the RAP. Not only have the courts neutralized the General Assembly's statutory reform, but they have made the common law doctrine even stronger in commercial transactions.

The Problem

Despite the statutory overhaul and legislative history to the contrary, the courts have continued to apply the common law RAP. The first problem with this result is that *New Bar* and *Khwaja* undermine the original goal of USRAP. The statutory reform was intended to be *the* Rule Against Perpetuities in North Carolina. Chapter 41 was designed to be a comprehensive replacement of the common law RAP, with any future interest excluded by statute having no time limit on vesting. Two of the primary benefits of a statutory RAP are (1) certainty for practitioners and transacting parties and (2) relieving judges of the difficult task of evaluating whether a future interest runs counter to public policy. The Court of Appeals has nullified those benefits by treating USRAP as a mere modification of the common law RAP. Almost 10 years have passed since *New Bar*—the General Assembly can no longer afford to wait for the Supreme Court to clean up the mess.

The second problem is that the current jurisprudence is incompatible with the policy rationale of the RAP. This is most evident when comparing ROFRs in leases to options in gross. Options in gross discourage investment and reduce marketability because the property owner has little incentive to invest in the property given that the optionee may exercise the option and reap the benefit. On the other hand, ROFRs in leases do not discourage investment by the property owner because any subsequent sale of the property will be at the fair market value. That options in gross are treated more favorably under current law than ROFRs in leases demonstrates that the reason for the common law RAP's existence is no longer being served.

The third problem is that courts could take *New Bar* and *Khwaja* a step further. Courts could compound the chaos by extending the reasoning in those cases to the interests in § 41-29 for which the General Assembly prescribed a specific wait-and-see period. That issue was not presented in *New Bar* and *Khwaja* because preemptive interests held by lessees are not in gross. Although Article 3 was enacted alongside Article 2, only the latter has a supersession clause. In

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[3] *Rich v. Carolina Constr. Corp.*, 355 N.C. 190 (2002).

the absence of such a clause it would be a small step to hold that the common law RAP applies to § 41-29 interests. The 30-year period could be interpreted as merely lowering the ceiling on the common law RAP for options in gross and preemptive interests in gross. Such a holding would amplify the adverse impact on commercial transactions by extending the common law RAP's reach to a new class of future interests.

<u>Legislative Recommendations</u>

1. Clarify that USRAP abolishes the common law RAP.

The most needed legislative action is to make clear that the common law RAP is abolished in its entirety, including for any interest excluded from USRAP. The *New Bar*/*Khwaja* holding that the supersession clause in § 41-22 left part of the common law RAP intact would be directly overturned. This clarification is the most effective way to restore the original goal of USRAP by enshrining one RAP for North Carolina. Statutory law would be the one-stop shop for practitioners when dealing with time limits on future interests. The open question of whether the common law RAP applies to the interests in § 41-29 would be rendered moot. Having *some* limit on when future interests created in commercial transactions must vest is reasonable. However, that limit should be clearly outlined in Chapter 41 so that parties can transact with certainty and courts do not change the rule or muddy the waters periodically. A statutory limit is preferable to the current common law RAP analysis, which does not even consider whether the interest violates the RAP's underlying policy. Without the common law RAP, the existing headaches with future interests in commercial transactions would be eliminated. The common law RAP is as impractical and unnecessary now as it was in 1995 when the General Assembly tried to discard it.

2. Make special provision for commercial transactions and/or ROFRs in leases.

The General Assembly could continue to exempt nondonative transfers from USRAP or tailor unique rules fit for the commercial world. For the former approach, a new provision could read that any future interest arising out of a nondonative transfer not listed in § 41-18(1) is exempt from any RAP, whether statutory or common law. Whatever durational limits the General Assembly selects, it should consider that the traditional RAP is ill-suited to the commercial context in which the "life in being + 21 years" framework makes little sense. Sophisticated parties are better equipped to understand the implications of future interests and contract accordingly. Courts have already recognized that future interests created pursuant to commercial transactions are less likely to implicate the RAP's policy rationale. As noted by the Supreme Court and the concurrence in *Khwaja*, the common law RAP "is a wholly inappropriate instrument of social policy to use as a control over such arrangements."[4] These interests should be afforded more permissive durational limits.

If the common law RAP is left intact, a change to the treatment of ROFRs in leases is imperative. Our recommendation would be to tailor a time period specific to ROFRs in leases. One option is to exempt ROFRs in leases from the common law RAP but subject them to the default USRAP period. A shorter wait-and-see period could also be applied like the one in § 41-29, though

[4] *Khwaja*, 239 N.C. App. at 93 (quoting *Rich*, 355 N.C. at 194). Before *New Bar* and *Khwaja*, most courts deployed a flexible, lenient approach towards the application of the RAP to future interests created in commercial transactions.

30 years is too low of a limit in the commercial context for the reasons listed above. An alternative approach would be to allow any ROFR that must vest or terminate within the lease term and any renewals. If the General Assembly exempted all commercial transactions from any RAP, most ROFRs in leases would be covered under that exemption.

Additional Resources

Ronald C. Link & Kimberly A. Licata, *Perpetuities Reform in North Carolina: The Uniform Statutory Rule Against Perpetuities, Nondonative Transfers, and Honorary Trusts*, 74 N.C. L. Rev. 1783 (1996).

John V. Orth, *Recent Developments in North Carolina Property Law: Where's the Supreme Court of North Carolina?* 95 N.C. L. Rev. 1561 (2017).

Statutory References

Article 2

§ 41-15. Statutory rule against perpetuities.

(a) Except as otherwise provided in G.S. 41-23, a nonvested property interest is invalid unless:

(1) When the interest is created, it is certain to vest or terminate no later than 21 years after the death of an individual then alive; or

(2) The interest either vests or terminates within 90 years after its creation.

§ 41-18. Exclusions from statutory rule against perpetuities.

G.S. 41-15 does not apply to:

(1) A nonvested property interest or a power of appointment arising out of a nondonative transfer, except a nonvested property interest or a power of appointment arising out of:

a. A premarital or postmarital agreement;

b. A separation or divorce settlement;

c. A spouse's election;

d. A similar arrangement arising out of a prospective, existing, or previous marital relationship between the parties;

e. A contract to make or not to revoke a will or trust;

f. A contract to exercise or not to exercise a power of appointment;

g. A transfer in satisfaction of a duty of support; or

h. A reciprocal transfer;

§ 41-22. Supersession.

This Article supersedes the rule of the common law known as the rule against perpetuities. (1995, c. 190, s. 1.)

Article 3

§ 41-28. Definitions.

As used in this Article:

(1) "Nonvested easement in gross" means a nonvested easement which is not created to benefit or which does not benefit the possessor of any tract of land in his or her use of it as the possessor.

(2) "Option in gross with respect to an interest in land" means an option in which the holder of the option does not own any leasehold or other interest in the land which is the subject of the option.

(3) "Preemptive right in the nature of a right of first refusal in gross with respect to an interest in land" means a preemptive right in which the holder of the preemptive right does not own any leasehold or other interest in the land which is the subject of the preemptive right. (1995, c. 525, s. 1.)

§ 41-29. Options in gross, etc.

An option in gross with respect to an interest in land or a preemptive right in the nature of a right of first refusal in gross with respect to an interest in land becomes invalid if it is not actually exercised within 30 years after its creation. For purposes of this section, the term "interest in land" does not include arrangements relating solely to an interest in oil, gas, or minerals. (1995, c. 525, s. 1.)