

Analyzing the Eastern Oil and Gas Lease

Russell L. Schetroma

Steptoe & Johnson PLLC

russell.schetroma@steptoe-johnson.com

Goals

- Focus on why analysis of an Eastern oil and gas lease is *different* from analyzing leases in other basins
- Consider the evolving definition of the legal nature of a Eastern oil and gas lease
- Review essential issues to confirm in reviewing an Eastern oil and gas lease
- Consider the major terms of common leases and what to watch for and what to note

Why Eastern Leases are Different

- **Eastern leases fall into two major categories**
 - Leases brought to the East from elsewhere
 - **Indigenous Eastern products that have evolved from ancient Eastern forms in the absence of a complete modern jurisprudence or sense of evolving technology**
- **We need to note any unusual and uncommon term of any lease**
- **We need to avoid *assuming* the meaning of common mid-con lease terms**

BUT—we're in the USA so the law is the same, right?

- **Wrong**
- **As a part of property law, oil and gas law is largely a creature of state definition**
- **Many eastern states continue to have a much stronger tie to ancient English common law than states to the West**
- **All US states other than LA are “common law” states but some Eastern states are much more “English common law” on property issues**

Why?

- **Many Eastern states have long, pre-revolution history**
 - Virginia /West Virginia – 1606 Maryland – John Cabot 1498 | English 1634
 - Delaware – Cabot 1489 | Originally claimed as part of Virginia – named for an early governor of Va, Thomas West, the 3rd Baron De La Warr
 - New York – 1636
 - BUT, for our purposes, who cares!
 - Pa – 1682
- **Not a lot of title searched to patent !**

A Couple of Examples--Pa

- Pa
 - Only appellate case on AAPL JOA found the preferential right to purchase clause to be enforceable because it did not offend
 - The *Statute Quia Emptores of 1290*
 - Is an APPORTIONMENT state in which royalties payable on post lease divided tracts must be shared across all tracts, not just the tract on which production is achieved

A Couple of Examples--WV

- A grant or reservation of a “1/16 royalty” may be construed to be
 - A grant or reservation of a
 - **½ MINERAL INTEREST**
- How?
 - Lord Coke (1552-1634) – “For what is the land but the profit thereof”

And then, there is Ohio

- **Ohio—different history**
- **Northwest Territories**
 - Originally French 1622
 - Ceded to England 1763—Treaty of Paris
 - Included in BRITISH Province of Quebec-1774
 - Captured – George Rogers Clark-1779
 - Claimed as Illinois County by Virginia
- **Ceded to US by Va to get some states (Md!) to ratify the Constitution in 1784**
- **A REALLY different place**
 - **First Land R² State (among other things!)**

What are Eastern Oil and Gas Leases?

- **Frankly, we don't know for sure**
- **2 major theories**
 - A “mere mining lease”
 - **Earliest leases were for term of years and close to conventional leases**
 - A conveyance in fee simple determinable of the oil and gas with related rights to explore and produce
 - **Arises from the “so long thereafter” secondary term**

Various Eastern “Lease” Definitions

- **an incorporeal hereditament in fee made defeasible and alienable by contract**
- **a chattel real or an estate for years**
- **a license at will**
- **a license coupled with a conditional grant**
- **a right to possession that is not an “estate in land” but that vests as an “estate in land” upon discovery of oil / gas**
- **a conveyance of the oil and gas in place in fee simple determinable**

BUT---

- **Recent Pa intermediate appellate court says, an oil and gas lease does create a conveyance of the oil and gas in place in fee simple determinable BUT that conveyance is *inchoate* until production is achieved**
 - **Mere mining lease until production?**
 - **What is it before production?**
 - **OED: “just begun so not fully formed or developed; rudimentary”**

Common Parts of a Lease

- **Major Parts of a common Eastern lease that we will discuss**
 - **Masthead**
 - **The Leasing Clause**
 - **The Description**
 - **The Term Clause**
 - **Extender Clauses**
 - **The Royalty Clause**
 - **Royalty Payment Clause**
 - **The Pooling Clause**
 - **The Unitization Clause**

Common Parts of a Lease

- **The Surrender/Release Clause**
- **Anti-Top Lease Clauses (options)**
- **Arbitration Clauses**
- **Anti-Covenant Clauses**
- **Mother Hubbard**
- **Pugh**
- **Lesser Interest**
- **“Free” Gas**
- **Addenda**

The Masthead

- **The Masthead commonly includes**
 - Identification of lessors and lessee and relationship of lessors
 - Date of lease
 - Intended type of document
 - **Watch for the title---not always controlling**
 - Oil and gas lease
 - Lease
 - Hydrocarbon Conveyance
 - » **Really *is* a conveyance and probably in fee simple absolute and not fee determinable**

Masthead

- **Key review issues**
 - **Lessor names must exactly match the names of the owners of the oil and gas at the time the lease is given**
 - **Watch for and note “effective dates”**
 - **May be problematic in states in which an absolute, immediate conveyance is intended**
 - **“springing” conveyance/gap in chain of title issues**
 - **Watch for straw party language**

The Leasing Clause

- **SHOULD** say it grants “*exclusive*”
 - Right to explore
 - Right to drill
 - Right to produce
 - Right to transport from the lease
 - **NOTE:** Many new Eastern leases give Lessee right to transfer alien gas *thru* the lease
 - Problematic--What happens when lease ends
 - Should (at least) say will survive end of lease
 - » May not be enforceable, however

Leasing Clause

- **Best if includes express right to seismic (should be noted if it does)**
 - Also if it includes explore “by geophysical means”
- **Watch for any substances other than oil and natural (native) gas**
 - Coalbed methane **MUST** be noted with a comment that CBM is owned by coal owner in some states (Pa) and not oil and gas owner if coal is severed
 - Note any other substances and conference whether additional comment necessary

Leasing Clause

- **Watch for storage rights**
 - IF lease is of severed oil and gas estate must consider ownership of open pores
 - Look for customized storage language
 - **Buyout of unproduced native reserve**
 - **Specific compensation for storage**
 - **If not present—must consider potential difficulties if reliance is placed on storage to continue lease**
 - Storage clause does not hold lease w/o a shut-in clause when production ceases

Description

- Usually by adjoinders
- Usually has tax ID number current at time of lease
- Watch for counties with fixed “Parcel ID” numbers
- SHOULD have reference to deed book and page of full description
- MUST plot to be certain title covers all of lease—lease is the puzzle into which tracts fit-- In East: \neq land²
 - Watch for changes in assessment numbers
 - County system changes
 - Outsale changes—post lease outsales still included in the lease---APPORTIONMENT in PA!
 - Watch for and report depth limitations

Description

- **The “Mother Hubbard” clause**
 - **Lease includes**
 - **All land of lessor adjacent to the leasehold**
 - **Some types of land of lessor adjacent to or in vicinity of the leasehold**
 - **Some now claim all land of lessor in the County**
 - **Etc.**
 - **Generally—adds land not specifically described to the lease**
 - **Probably enforceable for small collateral tracts and increasingly problematic as amount grows!**

Term Clause

- **Traditional two tiered term generally recognized**
 - **Primary term**
 - Period in which lease may be held **WITHOUT** production
 - **HUGE Eastern issue on “perpetual” primaries**
 - **Secondary term**
 - Period in which lease can only be held **WITH** production
 - **Primary term supported by “RENT” (delay rental = rental for delay in production)**
 - **Secondary term supported by ROYALTIES**

Term Clause

- **Traditional secondary term language**
 - “. . . and so long thereafter as oil and gas or either of them is produced in paying quantities.”
 - **Watch for and note ANY alternative or conjunctive triggers for continuing secondary term**
 - Many modern leases are simply too broad and may not be effective “produced in paying quantities *or lessee thinks it may be . . .*”

BUT NOTE: Unique PA Term Approach

- **Minority View**
- **Once Lessee has \$ in the ground, great deference is given to Lessee on development issues**
- **Paying quantities / breaks in production will be interpreted in favor of lessee so long as lessee is acting in “good faith”**
- **“Subjective” rather than “Reasonably Prudent Operator” approach**

The Unless / Or Lease Issue

- **This lease shall end one year from the date hereof unless on or before that date Lessee shall pay to Lessor the sum of \$1.00 per acre per year as delay rental for the privilege of continuing this lease for an additional four years**
- **Lessee agrees to commence a well on the leased premises within one year of the date hereof or to thereafter pay to the Lessor as rental the sum of \$1.00 per acre per year as delay rental**

Consequence of Or/Unless

- An “unless” lease **ENDS** by its terms at end of the term set before the “unless” clause if no well is drilled
- An “or” lease only gives the lessor the right to sue for the stated rental if not made
- In some states neither an “or” or an “unless” clause can continue a lease beyond the full primary term through the payment of rentals

Royalty Clause

- **A royalty is (classically) a fractional share of production**
- **Early leases gave actual oil at the well head as royalty**
 - Some expressly required the lessor to provide his/her own barrels
- **Lessor/Lessee may each sell/use their own portion of the production**
- **Difficult with gas**
- **“Share of proceeds” form now dominant**

Royalty Clause

- **Problem with market value formula**
 - Which market ??????
- **What about post production cost deductions**
 - Eastern states radically different
 - Pa: adopts Federal net back method and permits
 - WV: *Estate of Tawney*—very difficult to support, high risk of punitive damages if wrong
 - *Perhaps* a “first marketable product” state ala Colorado
 - Ohio: ok with clear language and no overreach

The Lesser Interest Clause

- **If lessee learns that lessor owns less than all of the oil and gas, rents, royalties and other payments to lessor will be reduced proportionately to lessor's actual interest.**
- **Some Eastern trial level language potentially limiting use if there is a deferral of initial bonus payment to permit title—if payment is made, landowners can argue that title issues waived**

Extender Clauses

- **Pending Operations**
 - If operations toward a producing well are in progress at the end of the primary term, the primary term will continue for so long as those operations are reasonably pursued—probably will be generally accepted subject to good faith
 - **Usually extends PRIMARY term**
 - Can be written to extend SECONDARY term to cover periods of non-production due to maintenance efforts

Extender Clauses

- **Dry Hole**
 - If a dry hole is drilled near the end of the primary term, the primary term is extended for a reasonable time if the Lessee commences the drilling of a replacement well (extends PRIMARY Term)
 - Some (few) also contain a clause that make this clause work for a reasonable period after the end of production from all producing wells on the leasehold

Extender Clauses

- **Delay in marketing**
 - Well capable of production drilled
 - No pipe OR no market for gas
 - *Initial* paying production cannot be achieved
 - *Usually* has a fixed maximum term
 - Extends the PRIMARY Term
- **No clear authority supporting**
- **OFTEN shut-in is asserted in place of DIM clause**
 - Result imcertaon

Shut-In Clause

- Initial paying production attained
- Market closed to gas OR maintenance required
- *Usually* indefinite term in return for shut-in royalty (sometimes called rental)
- *Some* require offset against future royalty
- Usually extends the **SECONDARY** Term
 - Can be (and often is) argued to also work as a marketing delay extender too
 - No certain answer yet

Extender Clauses

- **Renewal Options**
 - **Extend primary term**
 - **Usually for a fixed term**
 - **Usually for a repeat of the initial delay rental**
 - **WATCH for and NOTE “the above rental” in “paid up” leases that don’t state the initial delay rental!**
 - **Really mean the entire, undifferentiated, bonus / rental paid on taking the lease ?**

Extender Clauses

- ***Force Majeure***
 - A rapidly evolving clause
 - Traditionally only major uncontrollable items such as war, storms, strikes, etc.
 - Most now have *some* governmental regulation language
 - Governmental language evolving as the result of the NY drilling ban and the Pa Delaware River Basin Commission virtual ban on Marcellus activity
 - Some are beginning to include economic triggers
 - Traditionally indefinite / some maximum terms now being seen

Option (Anti-Top Lease Clauses)

- “If within 12 months after the expiration of the term of this lease Lessor desires to enter into an oil and gas lease upon all or part of the demised premises, Lessee shall have the first option to take that lease. . . .”
- Really an anti-Top Lease clause
- Potentially extends the SECONDARY term (unlike most extension clauses)
- If badly written can be asserted as a RFR on any 3rd party offers *during* lease!

Pooling and Unitization

- **Both rose out of the conservation movement**
- **Conservation in the sense of assuring the greatest possible recovery of resource over time rather than the fastest possible recovery in the shortest time**
- **Technically not the same**
- **So often used together that they are treated by most companies and courts as synonyms**
- **So confused that the correct classical definitions are becoming lost**

Pooling and Unitization

- **Pooling**---the assembly of sufficient acreage from different leases to comply with pre-existing governmental well spacing regulations to drill one well
 - Pa /WV do not have spacing SO technically cannot have “pooling”;
 - Ohio has spacing so OH can have “pooling”
- **Unitization**---creation of a plan to coordinate the development of all acreage in a reservoir in accord with conservation principles

Pooling / Unitization

- **MOST Eastern leases use the combined form**
- **Some leases treat properly and separately**
- **Need to note what is permitted and**
 - **Maximum size of pool/unit**
 - **Some reference non-existent governmental limits**
 - **Any standards/formalities required to exercise**
 - **Can it be “redone” and are there any limits on redo’s**
 - **Need to be wary of any unusual language**

Eastern Voluntary Pooling / Unitization

- **Little law**
- **No announced requirement for contiguity, geological basis, etc. etc.**
- **Best projection: reasonable exercise in good faith to assure long term development will be supported by Eastern courts**
 - **Most likely in Pa, more strict in WV and Ohio**

Common Conservation in US

- **State imposes spacing rules for various producing formations—no well can be drilled more near another well than X feet**
- **Producers must, therefore, have a way to voluntarily pool all or parts of various leases to meet the spacing requirements**
- **States can “integrate” interests if parties cannot agree**
- **The ONLY spacing in Pa is under the Coal-Gas Coordination Act -1,000’ over mineable coal**

Compare East With Texas

- **Texas has**
 - **Highly regulated spacing system**
 - **Very limited use of its statutory “pooling”/integration statute**
 - **AND**
 - **State (Railroad Commission) can set oil production limits to avoid glut on market**
- **Pa, WV, Ohio do not give the state the last power**

PUGH Clauses

- **“Pugh” clauses**
 - State that if the lessee develops/pools/unitizes less than all of a lease, the part developed/pooled/unitized will continue BUT the part not developed/ pooled/unitized will terminate
- **Rare in older Eastern leases**
- **Becoming More Common**
- **Being VERY BADLY WRITTEN IN LANDOWNER ADDENDA—BE CAREFUL**

Pennsylvania Statutory Conservation

- Pa is **PURE RULE OF CAPTURE**
- **EXCEPT**
 - **Formations at and below the Onondaga (c. 3,800)**
 - Conservation law permits forced integration of interests
 - Only used 15 times in history
 - Should apply to Utica but state is trying to avoid
 - **Dormant Oil and Gas Interest Act of 2006**
 - Really not a “dormant mineral” act

WV Statutory Conservation

- **No statewide spacing**
- **3 Statutory Integration Acts**
 - **Shallow Wells—really only used to protect coal**
 - **Deep Wells—similar to Pa (Onondaga and down)**
 - **Coal Bed Methane**

Ohio Statutory Conservation

- **Statewide Spacing**
- **Mature statutory interest integration proceedings**
- **BUT**
 - **Limited number permitted per year per company**
 - **Limited hearing slots available**

Surrender / Release / Dormant

- **Most leases have a clause permitting the lessee to terminate all or part of the lease**
- **Another pair of terms that are losing their independent meaning**
- **Some “land owner rights” legislation requires filing of surrenders/terminations**
- **Ohio has complex dormant mineral act that can terminate unused mineral estates**

Right to Cure

- **MOST violations of a lease give rise to a claim for damages rather than a termination of the lease**
 - **Covenant/Condition Distinction**
- **More recent leases have a clause that avoids any default unless the lessor tells the lessee in writing in advance and lessee does not correct the problem**
 - **Usually strictly enforced, however**

Arbitration Clauses

- **A growing MINORITY of leases have arbitration clauses**
- **A minority of the minority have adequate arbitration clauses**
- **Successfully enforced in the East**
 - **Even tripartite arbitration requiring UNANIMOUS vote to decide!**

The “Free” Gas Clause

- **Sometimes interpreted as a reservation of gas by the lessor**
- **Usually viewed as a GREAT annoyance by non-Eastern operators**
- **Many modern leases have a buy-out clause in place of or along with the “free” gas clause**
 - **Many companies are concerned about permitting landowners to connect to Marcellus wells given the pressures, nature of the gas, *etc.***

Addenda

- **Usually a landowner product**
- **Growing and growing and growing**
- **Not uncommon to have 40-50 pages**
- **Often not recorded**
 - **Watch for unrecorded addenda to recorded leases**
 - **Watch for incomplete memos of lease if addenda to original have undisclosed extenders**

Addenda (continued)

- **Must read for exploration and operational right limitations (subsurface use only, *etc.*)**
- **Watch for depth limitations and badly drawn Pugh clauses**

Conclusions

- **Special care must be taken in reviewing Eastern leases**
 - Text appears “normal” but will be interpreted by courts with little modern jurisprudence to guide them
 - Core jurisprudence of many Eastern states is different from the more “American” state of the common law at the time mid-content and western states established

Conclusions

- **Far more care must be taken to get decisions from company legal departments on how company wants to interpret “standard” language in new jurisdictions rather than relying upon generally recognized understandings**
- **Novel language, interpretations, *etc.* should be avoided until state specific case law and case law trajectories are established!**

Conclusions (continued)

Y'all Be Careful Out there ! ! !

Analyzing the Eastern Oil and Gas Lease

Russell L. Schetroma

Steptoe & Johnson PLLC

russell.schetroma@steptoe-johnson.com