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Hite v. Falcon Partners: A Model Rule for Marcellus and Utica Shale States Precluding the Use of Delay Rental Payments to Extend the Primary Term in an Oil and Gas Lease

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Hite v. Falcon Partners: A Model Rule for Marcellus and Utica Shale States Precluding the Use of Delay Rental Payments to Extend the Primary Term in an Oil and Gas Lease

Aaron Richardson*

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I. INTRODUCTION

The rule handed down by the Pennsylvania Superior Court in Hite v. Falcon Partners,¹ that payment of delay rental alone under an oil and gas lease cannot extend the length of the lease beyond the primary term,

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should be adopted throughout the Appalachian region. New technological advances in drilling techniques have made vast amounts of natural gas trapped in the Marcellus and Utica shale beds reachable in this area. The prospect of reaching the gas in these formations has led some commenters to refer to the United States as the “Saudi Arabia of natural gas.”

The relatively recent development of leasing of mineral rights in states overtop of these formations has resulted in widely varying precedent and laws regarding oil and gas leases. This Note will focus on the law of four states: New York, Pennsylvania, Ohio, and West Virginia. The Background section of this note will give a description of the developments in these states that have rejuvenated the relevance of the interpretation of oil and gas leases in this region and explain why this is an important area of the law today. This section will also reveal the state of the laws regarding delay rental payments. States in this group are organized according to their treatment of the issue at hand. First, New York presents the strongest precedent upholding the extension of an oil and gas lease through delay rental payments. Ohio law provides that a lease terminates at the end of the primary term when no well is producing, even if delay rentals continue. West Virginia represents a state that is yet to definitively dispose of the issue. The Background will conclude with a brief review of the nature of the habendum clause of a lease, which is typically the relevant part of a lease regarding this issue.

The next section, the Statement of the Case, will include a synopsis of the facts that led to Falcon. Although the court’s reasoning will be more extensively examined in the Analysis section, the Statement of the Case will briefly provide the bases of the court’s decision.

2. Id. at 948.
3. The Utica and Marcellus shale beds cover much of the same area. For simplicity, I will refer to these states as the Marcellus States.
6. Unlike many areas of law in the United States, the law of oil and gas leases was not based on centuries-old precedent derived from English law. Martin refers to the way in which oil and gas law was established as “largely home-grown, state-by-state, rather than imported.” Patrick H. Martin, Unbundling the Executive Right: A Guide to Interpretation of the Power to Lease and Develop Oil and Gas Interests, 37 NAT. RESOURCES.J. 311, 312-315 (1997).
7. Ball v. Ball, 244 N.Y.S. 300, 304 (1930).
8. See infra Part II.B.(2).
9. See infra Part II.B.(3).
The Analysis will be broken down into five main arguments in support of a uniform law regarding delay rental provisions in leases in this area. First, this section will demonstrate the importance of the development of a uniform law in this region. The next part of the Analysis shows why the very nature of the property right transferred in an oil and gas lease disfavors the extension of the term by delay rental payments. The third part will deal with the policy reasons for refusing to allow delay rentals to extend a lease beyond its primary term. These include recognition in each of these states of an implied or express covenant of development in oil and gas leases and public policy concerns with finding the most profitable use for property. Finally, this policy argument will conclude with an analysis of the alternatives available to the oil and gas lessee and why these alternatives further prove that Falcon presents the best model law concerning delay rental.

II. BACKGROUND

A. The Surfacing of the Marcellus Shale

The Marcellus shale formation, which runs beneath New York, Pennsylvania, Ohio, West Virginia, and even parts of Maryland, Virginia, Kentucky, and Tennessee, is not a new discovery. However, recent technological advances have made this vast source of natural gas accessible. These advances have made it feasible to use a technique known as hydraulic fracturing to drill deep down into the Marcellus shale formation. As a result, oil and gas companies have flocked to these states, ready to invest billions of dollars in purchasing oil and gas

10. George A. Bibikos & Jeffrey C. King, A Primer on Oil and Gas Law in the Marcellus Shale States, 4 TEX. J. OIL GAS & ENERGY L. 155, 156 n.2 (2008-2009). Only small parts of Maryland, Virginia, Kentucky, and Tennessee overlay the Marcellus Shale. Id. Accordingly, these states will not be given great attention as their oil and gas laws are not likely to be greatly affected.

11. Id. at 156.

12. Hydraulic fracturing is a drilling technique that is used to extract “oil, natural gas, geothermal energy, and even water” from below the earth’s surface. Hydraulic Fracturing Background Information, U.S. ENV’L PROT. AGENCY (Oct. 31, 2011), http://water.epa.gov/type/groundwater/uie/class2/hydraulicfracturing/wells_hydrowhat.cfm. The drilling method involves drilling down hundreds to thousands of feet below the surface, at which point the drilling proceeds horizontally below the surface. Id. Chemicals and water are pumped into the well at high pressure, causing the shale to break, or fracture. Id. Next, a “propping agent” is used to prevent the fractures from closing up and allowing the now-free resources to flow out of the earth. Id. The pressure from the formation then causes the water and chemicals used to create the fractures to flow back out of the well, at which point they are disposed of. Id.

13. Bibikos & King, supra note 10, at 156.
rights and tapping into this huge resource. Many uninformed property owners signed leases just before the boom at low prices and are now looking for ways out of seemingly unfair leases. Gas companies are doing everything in their power to preserve these “lowball” leases. Consequently, these property owners are turning to the courts for answers.

B. Differing Perspectives: How Have These States Disposed of the Issue of Delay Rental?

The states in question have all faced the issue of delay rentals, but they have not all come to the same conclusion.

1. Extension of the Primary Term in an “Or” Lease: New York

New York has the least-developed oil and gas law among the states relevant in the Marcellus discussion. Researchers examining New York’s oil and gas laws in anticipation of the Marcellus boom have referred to the state as essentially “a blank slate as to all significant oil and gas lease issues.” It is also the only state whose case law explicitly allows for the payment of delay rental to extend a lease for as long as


16. Id.

17. See id. Rubinkam describes the plight of the Beinlichs, a Pennsylvania couple who sold the oil and gas rights to their 117-acre parcel to a gas company for two dollars per acre. Id. Five years later, near the expiration of the lease term, neighbors are receiving up to $7500 per acre as a signing bonus. Id. The Beinlichs are now suing in federal court to challenge whether their leases should continue. Id. See also Casey Junkins, Mineral Owners Sue Chesapeake: Claim Company can’t Renew Leases for $5 per Acre, THE INTELLIGENCER/WHEELING NEWS REGISTER (May 16, 2011), http://theintelligencer.net/page/content.detail/id/555132/Mineral-Owners-Sue-Chesapeake.html?nav=5233 (describing a class-action lawsuit filed by West Virginia landowners, challenging the gas company’s claim that payment of delay rental extends the lease beyond the five year primary term).

18. “Delay rental” is a fee paid to the lessor of property under an oil and gas lease for the delay in production during drilling and development. BALLENTINE’S LAW DICTIONARY (3d ed. 2010).

19. The issue of delay rentals is barely addressed in New York statutory law. See New York General Obligations Law § 5-333(2) (McKinney 2005), which provides merely a timeline for payment of the first delay rental after a new lease is signed.


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such rental is paid. In Ball v. Ball, the court enforced a lease with a one-year primary term based on the lessee’s payment of delay rental for seven years. The court limited its ruling to leases which contain the “or” habendum clause construction. With new attention being given to oil and gas rights in New York, this issue is likely to arise (and soon, since litigation concerning old leases has already began).

2. Established Law: Delay Rental Provisions in Ohio

For over a century, the law in Ohio has been that delay rental has been inadequate to extend a lease beyond a primary term. The Ohio Supreme Court has based its reasoning on the idea that the time period set out in the habendum clause sets the term of the lease, and without production at the expiration of this term, the lease terminates. The rule in Ohio is similar to the law in states with much more developed oil and gas law, such as Texas, which has the most experience with oil and gas leases of any state examined, and New Mexico.

22. 244 N.Y.S. 300.
23. Id. at 303-04. The habendum clause of the lease in Ball authorized a lease “for the purpose of mining and operating for oil and gas for the term of one year, and as much longer as the rent for failure to commence operations is paid.” Id. at 302. The court construed this clause as an “or” clause (discussed infra Part II.C.), and states that “failure to develop does not authorize termination.” Id. at 304.
24. Id. at 304. See infra Part II.C. for an analysis of the difference between “or” and “unless” delay rental provisions.
26. See Brown v. Fowler, 65 Ohio St. 507, 522 (1902) (holding that a lease that states that the lease expires if no well is drilled in two years, unless delay rental payments of one-dollar per acre are made in advance cannot extend a lease for as long as such payments are made, but expires when no well is drilled at the end of the two year term).
27. Id. at 521.
28. See A. W. Walker, Jr., The Nature of the Property Interests Created by an Oil and Gas Lease in Texas, 8 TEX. L. REV. 483, 513 (1930) (claiming that Texas law provides that a lease cannot continue “after the expiration of the fixed term by the payment of delay rentals” even though a literal reading would imply the lease could be continued in this way forever).
29. Pennsylvania was actually home to the very first oil well, drilled in Crawford County in 1859. Hite v. Falcon Partners, 13 A.3d 942, 946 (Pa. Super. 2011).
30. Humphreys v. Fletcher, 204 P. 70, 70 (N.M. 1922). In Humphreys, the lease provided for a two year term and stated that it would expire after one year if no well was drilled, unless delay rental was paid. Id. The payment of delay rental would extend the time for drilling for twelve more months, and this lease explicitly stated that further payments “should further defer the drilling for like periods.” Id. Even with this express provision allowing extension beyond the primary term, the New Mexico Supreme Court ruled that the term of the lease supersedes the rental period. Id. In this case, the term of the lease was two years, regardless of whether the rental period could be extended.
3. Drilling for Answers: West Virginia’s Need for a Rule

West Virginia has updated its oil and gas statutory law regarding delay rental fairly recently.\textsuperscript{31} In applying this statute, the West Virginia Supreme Court has agreed that the legal presumption of abandonment of a well is not created when delay rental has been paid,\textsuperscript{32} as long as this payment is agreed to by the lessor and lessee and designed to keep the lease in effect or extend its term.\textsuperscript{33} In \textit{Howell v. Appalachian Energy Inc.},\textsuperscript{34} the West Virginia Supreme Court upheld a ruling that wells and equipment had been abandoned when no royalties or rentals were paid to the lessors over an eight-year span.\textsuperscript{35} The question is yet to be decided\textsuperscript{36} as to whether consistent payment of delay rental beyond the term of the lease will extend a lease when the language of the lease can be read to allow for such an extension.\textsuperscript{37} Litigation is already arising which will give West Virginia courts a chance to answer this question.\textsuperscript{38}

Another important aspect of the analysis in West Virginia is the state’s recognition of a no-term oil and gas lease.\textsuperscript{39} In \textit{Wilson v. Reserve Oil Co. v. South Penn Oil Co.}, 34 S.E. 923, 925-26 (W. Va. 1899). The Court refused to allow delay rental to extend a lease, stating a lessee who enters an oil and gas lease with no intent to develop the property should not be allowed to pay delay rental and later profit to the detriment of the lessor. Id. The Court was not kind to the lessees, going so far as to say that the option to explore or not “evidences a plain intention on their part not to explore for oil and gas” and amounting such activity to fraud and “a blind to deceive the lessor.” Id.

According to the code, the terms of the lease must show that the delay rental is “designed to keep an oil or gas lease in effect or extend its term” in order for such payment to extend the lease. W. VA. CODE § 36-4-91. In \textit{Falcon}, the term of the lease was for “(1) year . . . or as long as lessee shall continue to pay lessors two ($2.00) dollars per acre as delayed rentals.” 13 A.3d 942, 944 (Pa. Super. 2011). The question is yet to be determined in West Virginia as to whether such language is “designed to keep an oil or gas lease in effect or extend its term.”

At least one class-action lawsuit is already pending in U.S. District Court for the Northern District of West Virginia. \textit{Junkins}, supra note 17. This case involves six property owners who entered into leases in 2006 for five-dollars per acre. Id. These leases provided for a five-year primary term, which ended in early 2011. Id. The gas company now claims they can keep these leases in effect by paying the delay rental payments. Id. With gas companies now paying in excess of $5,000 per acre and 156 such leases owned by one gas company in one region of West Virginia, this case is likely to be the first of many concerning this and similar lease issues. Id.

\begin{enumerate}
\item See \textit{W. VA. CODE \S 36-4-9a} (West 2013) (stating that payment of delay rental in the absence of production for twenty-four months overcomes the rebuttable presumption that a lease has been abandoned).
\item Other instances preventing the creation of such a presumption include a lease for storage purposes, interference by the owner of the gas or oil or his lessee, or inability to market the gas or oil. \textit{Id.}
\item 519 S.E.2d at 431.
\item Id. at 432.
\item This issue has been decided in West Virginia, but not as applied by the statute. Eclipse Oil Co. v. South Penn Oil Co., 34 S.E. 923, 925-26 (W. Va. 1899). The Court refused to allow delay rental to extend a lease, stating a lessee who enters an oil and gas lease with no intent to develop the property should not be allowed to pay delay rental and later profit to the detriment of the lessor. \textit{Id.} The Court was not kind to the lessees, going so far as to say that the option to explore or not “evidences a plain intention on their part not to explore for oil and gas” and amounting such activity to fraud and “a blind to deceive the lessor.” \textit{Id.}
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\item \textit{Wilson v. Reserve Gas Co.}, 88 S.E. 1075, 1077 (W. Va. 1916).
\end{enumerate}
the court upheld a lease that provided for a quarterly rental absent drilling and that permitted “said gas company during the term for which payments are made to drill or not to drill as it may elect.”

Six years later, the West Virginia Supreme Court went even further, stating that a lease with a term for ten years “and as much longer as the rental for delay in operating is paid” also constituted a no-term lease.

West Virginia courts will therefore have to determine whether delay rental provisions in controverted leases fall under the statute as intended to keep the lease in effect, whether they should be regarded as no-term leases, or whether to follow the precedent of rulings like *Falcon* that the tendering of delay rental does not extend the primary term of a lease.

C. The Nature of the Habendum Clause in an Oil and Gas Lease: “Or” vs. “Unless” Clauses

There is no standard form for a habendum clause in leases. Although they differ greatly, some constructions have become fairly common. The primary term in a habendum clause sets out the length of time that the lessee has to put the property into production. The secondary term is usually contingent on the lessee producing oil and gas during the primary term, and extends the period of time of the lease, often for as long as gas or oil is produced in paying quantities.

Delay rental provisions in a habendum clause commonly come in one of two forms, the “or” form or the “unless” form. Although the difference in phraseology is small, the legal significance is great. The “or” clause refers to a lease in which the lessee has a certain amount of time to commence drilling or pay delay rental in lieu thereof. The “or” clause is a condition subsequent, meaning that when the lessee fails to

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40. 88 S.E. 1075.
41. Id. at 1076.
42. Todd v. Mfr.’s Light & Heat Co., 110 S.E. 446, 446 (W. Va. 1922). The habendum clause continued: “This lease shall become null and void and all the rights thereunder shall cease and determine unless one well shall be completed on the said premises within three months from the date hereof, or unless the lessees shall pay at the rate of fifty and no dollars ($50) quarterly in advance for each additional three months such completion is delayed from the time above mentioned for the completion of said well until one well is completed.” Id. at 447.
43. A habendum clause is the portion of the lease that sets out how long the lease endures.  BLACK’S LAW DICTIONARY (9th ed. 2009).
45. Id. at 532-33.
47. Id.
48. Id. at 536.
produce or pay delay rentals, the lessor may terminate the lease or waive
his right to terminate it. The “unless” clause provides that a non-
producing lease will automatically terminate at the end of the specified
time unless the lessee pays delay rental.

III. STATEMENT OF THE CASE

Hite v. Falcon Partners arose from a group of similar leases
erentered into by landowners and a gas company on either December 18,
2002, or October 30, 2003. The habendum clause of each lease
provided as follows:

3. Term. Lessee has the right to enter upon the property to drill for oil
and gas at any time within one (1) year from the date hereof and as
long thereafter as oil or gas or either of them is produced from the
Property, or as operations continue for the production of oil or gas, or
as lessee shall continue to pay lessors two ($2.00) dollars per acre
as delayed rentals, or until all oil and gas has been removed from the
Property, whichever shall last occur.

No action was ever commenced for the drilling on the plaintiffs’
properties. However, the delay rental was paid each year. In
December 2008, after five years without any development by Falcon, the
plaintiffs sent notice that the leases were terminated and filed the
action. Falcon believed, and argued in the case, that the provision in
the contract allowed them to extend the lease into perpetuity simply by
paying the delay rentals.

The court refused Falcon’s arguments, holding that these leases
expired automatically when the property was not in production of oil or
gas at the end of the one-year primary term. By so ruling, the court
eliminated the possibility that a lease containing a primary term and a
secondary term could be extended beyond the primary term with
payment of the delay rentals alone. In its concise explanation for the

49. Id. at 536-37.
50. Id. at 520-21.
52. Id. at 944.
53. Id. (emphasis added to the delay rental provision).
54. Id.
55. Id.
56. Id.
57. Id.
58. Id. at 948.
59. Id. at 947-48. The court acknowledges that a lease may be read to create a perpetual term
when such an intention “is expressed in clear and unequivocal terms.” Id. However, it then
ruling, the Court stated:

To find as Falcon urges, that it may pay delay rental indefinitely, thereby denying Plaintiffs the opportunity to reap the financial benefits of actual production, would be contrary to the decisions of our Courts, at odds with the presumed intention of the parties in executing the leases in the first place, and in stark contrast to the clear opinion of the courts of Pennsylvania that the obligation to pay delay rentals is intended to “spur the lessee toward development.”\(^{60}\)

Additionally, the nature of the property right granted by an oil and gas lease discredited the argument that delay rental alone would extend the lease.\(^{61}\) Each of these bases for the decision in *Falcon* will be developed and further analyzed below.\(^{62}\)

**IV. ANALYSIS**

The Pennsylvania Superior Court has presented the most appropriate standard when it comes to the payment of delay rentals. While it acknowledges that a perpetual lease is possible, it shuts down another way for lessees to extend a lease with just the mere payment of delay rental beyond the primary term.\(^{63}\)

**A. The Need for a Uniform Law**

The four states comprising the bulk of the Marcellus Shale formation, New York, Pennsylvania, Ohio, and West Virginia are in need of a uniform law governing the ability of delay rentals to extend a lease beyond the primary term.\(^{64}\) In order to demonstrate the need for a uniform law, we will use a hypothetical lease based on true facts, to examine the vastly differing impact a lease may have in these similarly-

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\(^{9}\) See *supra* Part IV.

\(^{60}\) *Falcon*, 13 A.3d at 949. *Falcon* reiterates the rule that a lessee cannot postpone development indefinitely, even in the case of a no-term lease, showing consistency to the principle that a lease cannot be held perpetually by the lessee without development. *Id.*

\(^{61}\) *Id.* at 949. Falcon contended that payment of delay rental created a vested property right. *Id.* Under oil and gas law, the oil and gas lease conveys an inchoate title to these minerals which is only perfected when the property is put into production. *Id.*

\(^{62}\) See *infra* Part IV.

\(^{63}\) *Id.*  at 948. It necessarily follows that in any lease containing a primary and secondary term, delay rentals alone will not extend the lease beyond the initial primary term. *Id.*

\(^{64}\) See *supra* Part II.B. for more details regarding the conflicting laws of these states.
situated states. 65

1. The Terms and Habendum Clause

Our hypothetical lease covers a 1,000-acre farm. 66 The lease is for a term of five years, beginning January 1, 1967, and for as long thereafter as the leased premises are operated in the search for or production of oil or gas, or as long as the lessee pays delay rentals in the amount of one dollar per acre annually, whichever shall last occur. 67 As further consideration, the lessor is to receive a 1/8 (12.5%) royalty on all gas or oil produced from the property. The lessee has the option to cancel this contract by paying one dollar at any time to the lessor. Using these delay rental terms, we will examine the effect that such a lease will have on the lessor in Ohio and Pennsylvania, 68 West Virginia, and New York.

2. Rags to Riches: Our Farmer Becomes a Millionaire in Ohio or Pennsylvania

Applying the rule that the payment of delay rental alone is not enough to extend an oil and gas lease beyond the primary term, the farmer may cancel the lease and refuse to accept any further delay rental payments. 69 Free to enter into a new oil and gas lease, our farmer will discover that his property is quite valuable. Using fairly modest numbers by today's standards, we will assume our farmer negotiates a new five-year lease for $5,000 per acre as a signing bonus plus eighteen percent royalties on all oil or gas produced from the property. 70 Months after signing this lease, our farmer will receive a $5 million bonus check; money the farmer retains regardless of whether drilling commences

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65. This portion of the analysis is based on an actual lease executed in 1967.
66. The actual lease covers 960 acres. For math purposes, we have rounded this number up to 1,000 acres.
67. The gas company has been faithfully making the yearly installments.
68. Due to the similarity in the laws of Ohio and Pennsylvania, they will be grouped together using the Rule laid down in Falcon.
69. It is important to note the form of the habendum clause used in this example. The “or” clause is used, rather than the “unless” clause. As previously stated, the “or” clause gives the lessor the opportunity to cancel the lease, while leases with an “unless” clause terminate automatically if the condition is not met. If the habendum clause here had been an “unless” clause, the farmer would be free to lease the premises because technically the lease terminated by its own terms. See supra Part II.C.
70. See Junkins, supra note 17 (claiming that signing bonuses in West Virginia’s Northern Panhandle are as high as $5,000 per acre).
within the term of the agreement. If drilling does commence and is successful, he will reap the further benefits of receiving nearly one-fifth of the income from a producing well.

3. State of Uncertainty: West Virginia

Under West Virginia law, if the terms of the lease providing for the delay rental can be defined as “designed to keep an oil or gas lease in effect or extend its term,” there is no way for the farmer to cancel the lease. Neither the statute nor the case law provides guidance for how to determine whether a clause is designed to keep the lease in effect. The lease in question uses a common form, similar to the “or” form used in Falcon, which states that the lease continues “so long as the leased premises are operated in the search for or production of oil and gas, or as long as the lessee pays delay rentals.” Using the literal meaning of the words, it appears that payment of delay rentals could extend the lease indefinitely. It seems highly unlikely that legislators in West Virginia intended to create the possibility of a perpetual lease with no production requirements, so it will be interesting to see how the law develops in this state.

4. A Fracking Waste: The Disincentive to Drill in New York

New York’s authorization of a lease which can be extended through the mere payment of delay rentals has devastating effects on our farmer. Rather than entering a new lease for a multi-million dollar profit, the farmer is forced to accept annual $1,000 rental checks for so long as the lessee so chooses, even into perpetuity. Although New York is hesitant to allow gas companies to use fracking within the state, its law on this issue greatly benefits these companies. Gas companies can use the “or” form in drafting leases to ensure that a lease will continue forever at

71. See Elisabeth N. Radow, Homeowners and Gas Drilling Leases: Boon or Bust?, 83-DEC N.Y. St. B.J. 10, 16 (Nov./Dec. 2011) (describing the process by which lessors are commonly compensated upon signing an oil and gas lease).
72. W. VA. CODE § 36-4-9a (West 2013).
73. Supra Part IV.A.(1).
74. Hydraulic fracturing in New York has been the subject of great debate. In 2009, lawmakers passed legislation permanently banning fracking, but Governor David A. Paterson vetoed the bill, instead placing a temporary ban on fracking until more research could be done. Danny Hakim & Nicholas Confessore, Cuomo Moving to End a Freeze on Gas Drilling, N.Y. TIMES, July 1, 2011, at A1. Earlier this year, Governor Andrew M. Cuomo announced his support for lifting the ban and allowing drilling to commence. Id.
little cost to the company and at a great cost to the individual lessors.\textsuperscript{75} Based on the above example alone, there is clearly a need for a uniform delay rental law in states dealing with oil and gas leases. Aside from the difficulty of having to know the differing rules in each state, gas companies entering into leases are faced with the uncertainty of ambiguous and undeveloped laws. Sometimes, their leases will terminate automatically when no gas is produced at the end of the primary term, regardless of whether further delay rentals are paid to the lessor.\textsuperscript{76} In another case, payment of delay rental in the absence of cancellation by the lessor might extend their rights under the contract.\textsuperscript{77} In still other situations, continued rental payments by the gas company even when no well is drilled at the primary term will keep the lease in full force.\textsuperscript{78} These differing outcomes will require oil and gas companies to not only know the varying laws of the state, but also to pay scrupulous attention to court decisions and make certain that they abide by each state’s ever-changing laws.

B. The Nature of the Property Right Transferred in an Oil and Gas Lease

Oil and gas leases are unusual in that they are not technically leases at all. In some jurisdictions, these “leases” actually transfer a property right in the oil and gas from the lessor to the lessee in fee simple determinable.\textsuperscript{79} The lease then functions as a way to sever the estate of the surface from that of the minerals below.\textsuperscript{80} The lessor retains possession of the surface estate in fee simple, while the lessee takes title to the oil and gas in fee simple determinable.\textsuperscript{81} This interest is a vested interest, meaning it does not violate the rule against perpetuities.\textsuperscript{82} However, this vested interest is subject to divestment if a stated event

\textsuperscript{75} Over the course of our hypothetical, the gas company will have paid the farmer $44,000 in delay rental. The company could hold onto the 1,000 acres for 5,000 years until they will have paid the $5 million to the farmer that he would likely receive in a new lease.

\textsuperscript{76} See supra Part III.B.(2).

\textsuperscript{77} See supra Part III.B.(3).

\textsuperscript{78} See supra Part III.B.(1).


\textsuperscript{80} Id.

\textsuperscript{81} Snyder Brothers, 676 A.2d at 1230.
occurs. The interest retained by the lessor is known as a possibility of reverter, because at the occurrence of the stated event, title reverts back to the lessor. More simply, the lessor retains full ownership rights to the surface of his property, while the gas company owns all the oil and gas. If a certain event occurs as set out in the lease, the owner of the surface automatically reacquires title to the minerals without any further action. This is the view in the majority of states.

For a practical example of how this interest works, let’s take another look at our hypothetical lease from the example above. The relevant portion of the habendum clause specifies that the lease shall endure for “as long thereafter as the leased premises are operated in the search for or production of oil or gas, or as long as the lessee pays delay rentals in the amount of one ($1.00) dollar per acre annually, whichever shall last occur.” In jurisdictions recognizing an oil and gas lease as a fee simple determinable, the stated event which would divest the interest of the lessees is the cessation of production or the cessation of rental payments. Therefore, as soon as rental payments stop in the primary term or the production or search for gas stops during the secondary term, the lease terminates automatically without any action necessary by either party.

The question necessarily arises as one examines this fee simple determinable classification of the interest transferred in an oil and gas lease as to whether the outcome in Falcon was correct. If a lessee acquires vested property rights in fee simple determinable, and the contract expressly states that the interest will continue as long as delay rentals are paid, should not payment of annual delay rentals prevent title from reverting back to the lessor? At least one jurisdiction, Texas, applying this law has come up with an interesting, albeit faulty, solution—that the purpose of an oil and gas lease (to explore for, develop, and produce gas or oil) constitutes a special limitation on the estate.

Classification of a limiting clause as a special limitation means

83. Id.
84. Id.
85. Bibikos & King, supra note 10, at 172. For more information about the states that classify an oil and gas interest as a fee simple determinable, see id. at 159, n. 15.
86. See supra Part IV.A.(1).
87. Supra Part IV.A.(1)
88. Walker, supra note 28, at 494 (restating the rule announced in Stephens County v. Mid-Kansas Oil and Gas Co., 254 S.W. 290 (Tex. 1923) and Waggoner Estate v. Sigler Oil Co., 19 S.W.2d 27 (Tex. Sup. Ct. 1929); see also McCullough Oil, Inc. v. Rezek, 346 S.E.2d 788, 797 (W. Va. 1986) (holding that the “thereafter” provision in a habendum clause constitutes a special limitation).
that the estate automatically terminates at the occurrence of a specific event. In other words, the interest transferred is a fee simple determinable, but the purpose of the lease becomes one of the stated events that will terminate the lease. The significance of this classification is that in the event that the lessee is not engaged in exploration, development, or production after the primary term, the title to the property automatically reverts to the lessor, even if delay rentals are paid.

The court in *Falcon* refused this analysis. In the case of the lease in *Falcon*, the fee would divest when the last of the following occurred: ceasing production of gas or oil, discontinuing the two dollar per acre rentals, or removing all of the oil and gas from the property. Under a literal reading of that clause, it would appear that the fee simple determinable would not divest if the delay rentals are paid, even after the end of the primary term. The *Falcon* court found that the property right transferred to the lessee under an oil and gas lease is not a fee simple determinable, but rather an inchoate right, that becomes vested when the property is brought into production. Failure to bring the property into production meant that the property right never vested. Under Texas law, the court’s decision would be the same, but based instead on a violation of a special limitation—the purpose to explore for, develop, or produce oil and gas.

At least one researcher has criticized the Texas Supreme Court’s reasoning in *Stephens County v. Mid-Kansas Oil and Gas Co.* Texas’s approach of classifying the purpose of an oil and gas lease as “oil and gas exploration, development and production” is flawed. Texas law recognizes that there is an implied covenant to develop a leased property with reasonable diligence. This creates inconsistency among the duties of a lessee. As a result of these conflicting policies, “there is no duty on the lessee to develop the premises at all, but there is a duty on the lessee to develop the premises with reasonable diligence.”

89. Walker, supra note 28, at 484.
90. Id. at 485.
92. Id.
93. Id. at 949.
94. Id.
95. Walker, supra note 28, at 484.
96. Id. at 493.
97. 254 S.W. 290, 292 (Tex. 1923).
98. Texas Pacific Coal & Oil Co. v. Barker, 6 S.W.2d 1031, 1035 (Tex. 1998).
100. Id.
when a lessee does nothing after the execution of the lease, the lease will be forfeited as a violation of the special limitation. However, if the lessee begins working on the premises, but violates his duty to develop the premises with reasonable diligence, he will be liable for money damages to the lessor. Clearly, there is a need for a bright line rule eliminating the legal fiction that the purpose of the lease imposes a special limitation on a lessee’s rights.

New York presents a possible solution to the classification of the purpose of an oil and gas lease as a special limitation. In Ball v. Ball, New York rejected the idea that the purpose of the lease imposes a limitation upon the lessee. Instead, the court held that the obligations to explore and produce oil and gas are mere covenants. Further, the court states that a breach of an implied covenant in New York does not permit the lessor to terminate the lease. Accordingly, New York precedent supports a finding that a lessee can hold on to a lease indefinitely, for both no-term leases and term leases using the “or” form, simply by paying delay rentals.

New York law, therefore, stands on the ground that the obligations to explore and develop a lease are covenants, and the breach of these covenants does not allow for forfeiture. Damages alone serve as the remedy for a breach of the covenants. Unfortunately for a lessor, stipulated rental payments are the contractual equivalent of damages for a breach of these covenants. So long as these rentals are paid, the lessee has no remedy in law or equity. Perhaps even more discouraging is that

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101. Id.
102. Id.
103. See id. at 503 (arguing that the Texas Supreme Court should reverse its decision that the purpose of the oil and gas lease is for exploration, development and production). Walker suggests that the most appropriate solution is for the court to explain that the purpose of an oil and gas lease is actually “to secure a reasonably diligent development of the property for oil and gas.” Id. For the reasons to be stated below, I believe the approach taken in Falcon of classifying the property interest obtained by a lessee in an oil and gas lease as inchoate is the more rational approach.
104. See Ball v. Ball, 244 N.Y.S. 300, 304 (1930).
105. Id.
106. Id.
107. Id.
108. Id. at 303. The court went on to distinguish this lease as a “wild cat” lease. Id. It defines such a lease as different from one where “proven territory exists,” referring to the uncertainty of drilling operations in states such as New York. Id.
109. See id. (stating that the lease in question for “one year and as much longer as the rent for failure to commence operations is paid” contains no definite term and is valid so long as rent is paid).
110. See id. at 304. Although the lease in question used an unusual “and” form, the court classifies this type of clause as an “or” lease. Id.
111. Id.
failure to pay rentals appears to be grounds only for a suit to recover unpaid rentals.\footnote{112}

The Pennsylvania Superior Court has presented us with yet another method of analyzing the property right transferred in an oil and gas lease. The court in \textit{Falcon} rejected the idea that a vested right under a fee simple determinable is created when an oil and gas lease is executed.\footnote{113} Instead, the Superior Court states that the initial title conveyed in an oil and gas lease is for the purpose of exploration only.\footnote{114} Execution of the oil and gas lease creates an inchoate title, which vests only when the property is brought into production.\footnote{115} Only at this point is a fee simple determinable created.\footnote{116}

States seeking a legal basis for deciding that oil and gas leases may not be extended beyond the primary term by mere payment of delay rentals, even when the lease can be interpreted to allow such extension, should follow the lead of the Pennsylvania Superior Court in \textit{Falcon}. The idea that no title vests in an oil and gas lease until gas or oil is found is not a revolutionary concept.\footnote{117} Classification of this interest as an inchoate title, which, upon discovery of oil and gas in paying quantities, perfects into a fee simple determinable, preserves the lessee’s property interest in the premises while not obliging the lessee to take any affirmative action. If the lessee conducts no exploratory drilling within the specified time and pays no delay rental, his title in the oil and gas never vests. If he does pay delay rental throughout the primary term, but does not find gas or oil in producing quantities, the lease expires at the end of the primary term because no fee simple determinable was ever perfected. If the lessee continues to pay delay rental after the term of the lease expires, he is paying for a right he does not possess.

\footnotesize{
\begin{itemize}
  \item\footnote{112} See id. (stating that a breach of the covenant to develop does not allow for termination).
  \item\footnote{113} Hite v. Falcon Partners, 13 A.3d 942, 945 (Pa. Super. 2011).
  \item\footnote{114} Id.
  \item\footnote{115} Id.
  \item\footnote{116} Id.
  \item\footnote{117} Some of the oldest oil and gas precedent in Pennsylvania establishes that title to oil and gas is inchoate until gas or oil is discovered: A vested title cannot ordinarily be lost by abandonment in a less time than that fixed by the statute of limitations, unless there is satisfactory proof of an intention to abandon. An oil lease stands on quite different ground. The title is inchoate, and for purposes of exploration only, until oil is found. If it is not found, no estate vests in the lessee, and his title, whatever it is, ends when the unsuccessful search is abandoned. If oil is found, then the right to produce becomes a vested right, and the lessee will be protected in exercising it in accordance with the terms and conditions of his contract. Venture Oil Co. v. Fretts, 25 A. 732, 735 (Pa. 1893).}

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C. Uniform Adoption of the Rule in Falcon: Policy Allows No Alternative

Although the property right transferred in an oil and gas lease is actually a conveyance of the estate in fee simple determinable, or in some states, a fee simple determinable whose interest vests upon production of gas or oil, there are strong public policy considerations which prevent delay rentals from extending a primary term. Some of the strongest policy arguments underlie the reasoning behind the development of implied covenants. Policy considerations also arise from the economic advantages of maximizing development of oil and gas in the United States.

1. Implied Covenants

Oil and gas leases commonly contain several unstated obligations, or covenants.118 Usually these involve getting the land to produce gas or oil, making the land as productive as possible, and preventing drainage of oil or gas under one property resulting from pumping of gas or oil from nearby properties.119 These covenants are used in this argument mainly as evidence of the general policy surrounding the rights of lessors of oil or gas interests.

a. What is the Implied Covenant to Develop in Oil and Gas Leases?120

In Falcon, the court acknowledged that in the development of Pennsylvania law there arose an obligation on the lessee to immediately develop the property after the signing of a lease.121 It went on to state that “the obligation to pay delay rentals is intended to ‘spur the lessee toward development.'”122 This philosophy, which is not unique to Pennsylvania, is most commonly referred to as the implied covenant of development, the implied covenant to test, or the implied covenant of

119. Id.
120. It is important to note that the implied covenant to develop the property does not arise until the property is found to be productive. Id. at 320. It is not being contended that the failure of a lessee to drill during the primary term of a lease is a breach of the implied covenant of development.
122. Id. at 948 (quoting Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759, 789 (W.D. Pa. 2004)).
The implied covenant of development is recognized in some form by courts in most states.124

b. The Effect of Delay Rental Provisions on the Implied Covenant to Develop

In order to get around the implied covenant to develop, oil and gas companies began executing leases that contained provisions relieving them of the obligation to drill immediately by paying delay rental.125 Commonly, lease terms were used which would give the lessee a certain period of time during the primary term of the lease to drill without paying rentals to the lessor.126 If the lessee was unable to drill during that time, he could pay the delay rental and extend the time to drill for another year and each subsequent year that the rental was paid.127 Courts recognized and accepted the use of delay rental provisions, allowing lessees to forego drilling as long as the rentals are paid.128 However, the court in Lake v. Ohio Fuel Gas Co.129 emphasized that delay rental payments were created to prevent a lessor from suing for the violation of the implied covenant to develop during the primary term only.130

c. Purposes Served by the Implied Covenants

Implied covenants in oil and gas leases traditionally serve three main purposes: fill in the gaps in incomplete contracts, promote fairness and equity, and serve public policy.131 As this covenant applies to the

123. Hall, supra note 118, at 319-20. Some jurisdictions refer to this covenant as the “implied covenant of reasonable development” or the implied covenant “to conduct exploratory drilling.” Id. at 314-15. Often these different covenants have slightly different meanings in different jurisdictions. For consistency, we will refer to this covenant as the implied covenant of development. By using this term, we mean to refer not only to the obligation of the lessee to drill a test well or otherwise attempt to find gas or oil on the leased premises, but also on the obligation of the lessee to make the land profitable by developing its oil and gas interests.
124. See, e.g., Steelsmith v. Gartlan, 29 S.E. 978, 981 (W. Va. 1898) (holding that allowing a lessor to hold onto a lease indefinitely without an obligation to develop the land while others are clamoring at the opportunity is “unconscionable, and contrary to both right and justice”); see also Mills v. Hartz, 94 P. 142, 143 (Kan. 1908) (stating that a lessee has a duty to develop and explore the property within a reasonable time).
126. Hall, supra note 118, at 319.
127. Id. at 319-20.
128. Lake, 207 N.E.2d at 664.
129. 207 N.E.2d 659.
130. Id.
131. Mills v. Hartz, 94 P. 142, 143 (Kan. 1908). Hall suggests that the public policy reasoning
extension of a lease’s primary term without any development, royalty payments, or production, the covenant’s ability to promote fairness and equity and serve public policy are most relevant here. In this section, we will examine the notions of fairness and equity behind the implied covenants. The public policies underlying the covenants are examined in Section IV.C.(1)(d), below.

It is impossible for an oil and gas lease to account for all possible scenarios regarding a leased property. Gas drilling is highly speculative and uncertain. At the time the lease is executed, neither party can know the true value of the minerals, if any, that may be produced from the premises. Oil and gas leases rarely state in explicit terms that the intentions of the parties (such as to remove, as quickly and profitably as possible, the minerals under the leased estate) constitute limitations on the lease. Instead, the lease will often set out specific grounds for which the lease may be canceled and grounds for such cancelation. However, when a lessor enters into a gas lease, his sole purpose is to make that land profitable. While delay rental might be considered by some to be profit, it is the royalty payments to be received from the sale of the oil and gas that serve as the true consideration for leases. Accordingly, “principles of fairness dictate that the lessee be obliged to make diligent efforts to ensure that the lessor receives the benefit of his bargain.”

d. The Policies behind the Implied Covenant to Develop

Landowners whose properties are tied up in unproductive leases have an interest in having their leases canceled in order to achieve more profitable ones. In Sauder v. Mid-Continent Petroleum Co., the U.S. Supreme Court stated that the object of an oil and gas lease is to

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133. Id.
134. Walker, supra note 28, at 500-01.
135. Id. at 501.
136. Hall, supra note 118, at 316.
137. Id.
138. Id. (citing Jacobs v. CNG Transmission Corp., 772 A.2d 445, 454 (Pa. 2001)).
140. 292 U.S. 272.
obtain a profit for both the lessor and lessee. In cases where delay rental would permit an indefinite lease, the lessee would be tying up the land for his own profit to the exclusion of the lessor by waiting until a time arose when it would be more profitable for him to develop the land. This tying up of the land against the rights of the lessor is referred to as speculation.

“In no event is the lease to be used by the lessee for speculation.” This policy grows even stronger when there is a high demand for the gas or oil under the land. In Steelsmith v. Gartlan, the court opines that allowing a lessor to hold onto a lease indefinitely without developing the land while others are clamoring at the opportunity is “unconscionable, and contrary to both right and justice.” Clamoring is an appropriate verb to describe the way in which gas companies, such as Chesapeake, Exxon, Consol, and Marquette, are doing business, exhibiting a “gold rush mentality” in the Marcellus states.

With royalty payments being the main consideration for the lessor and profitable production of oil and gas serving that function for the lessee, the very nature of the oil and gas lease shows a joint expectation that the property will be developed by the lessee. This arrangement is advantageous to the lessor because it allows him an opportunity to make his land profitable at no financial risk. Due to the impracticability of determining the value of oil and gas on a leasehold estate before drilling, the royalty-based consideration also benefits the lessee by ensuring they do not overpay for a lease that yields no producing wells. In other words, if the lessee wants to make a profit, he will develop the leasehold, and if the lessee makes a profit, then the lessor makes a profit as well.

Different states use different standards for determining when a lessee has violated an implied covenant of development. The most

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141. Id.
142. Conine, supra, note 132, at 677.
143. Id. at 678.
145. 29 S.E. at 981.
146. Id.
147. Bibikos & King, supra note 10, at 156.
148. Conine, supra note 132, at 678.
149. Id.
150. Id. While in the case of traditional vertical wells drilling a producing well was more of a gamble, when it comes to the Marcellus “[g]eologists know just where to find the gas-rich shale” taking the guesswork out of drilling and eliminating dry holes. George Hohmann, Marcellus Shale Gas Boom Mirrors Gold Rush, CHARLESTON DAILY MAIL (Nov. 25, 2011), http://www.dailymail.com/Business/201111240048?page=2&build=cache.
151. See Bibikos & King, supra note 10, at 161 (acknowledging that most states imply the
common standard of conduct for a lessee is the prudent operator standard. 152 The prudent operator standard is an objective standard requiring that the lessee act as a reasonable operator would act in similar circumstances to protect the interests of both the lessor and lessee. 153 This standard is the equivalent of a reasonable person standard in tort law. 154 All of the Marcellus Shale states have acknowledged or adopted some form of the prudent operator standard when analyzing whether there has been a breach of an implied covenant. 155 This indicates that each of these states has acknowledged that the purpose of an oil and gas lease is to make the land profitable for both the lessor and the lessee.

e. Balancing Equity’s Distaste for Forfeiture

Opponents to the rule laid out in Falcon are likely to argue that courts of equity generally disfavor forfeiture of a contract. 156 Indeed, this is a policy echoed by courts, even as concerning certain issues in oil and gas leases. 157 However, some courts find that oil and gas leases are an exception to the rule. 158 Instead, these courts hold that leases are supposed to be construed “most strongly against the lessee.” 159 Falcon does not address the issue of forfeiture because of its holding that the lessor never obtained a vested fee simple determinable interest in the estate by the end of the term specified. 160

In West Virginia, which views the conveyance as a transfer of a determinable fee simple title, the law is that the lease “terminates, expires, or lapses” rather than being forfeited at the end of the primary term due to the nature of the reverter. 161 Both of these theories provide strong reasons why prohibiting delay rentals from extending the primary term of the lease does not violate the policy of courts of equity against forfeiture of contracts. Instead, these theories state that no forfeiture

152. Id.
153. Id. at 161-62.
154. Conine, supra note 132, at 679-80.
155. For a thorough review of the prudent operator standard, see Bibikos & King, supra note 10, at 161-63.
156. See Parish Fork Oil Co. v. Bridgewater Gas Co., 51 W. Va. 583, 658 (1902); “In general, equity abhors a forfeiture.” Id.
157. See, e.g., Thurner v. Kaufman, 699 P.2d 435, 438 (1985) (stating that forfeiture will not be enforced where “a less drastic remedy will satisfy the demands of justice”).
159. Id. at 914.
remedy is necessary in a court of equity, but, rather, that the expiration or termination of the lease occurs on its own. No action by the court is necessary except to enforce the terms of the lease itself.

2. The Economic Incentive: Fracking Our Way Out of a Recession

It is no secret that the U.S. economy is in bad shape. Poverty is booming and the unemployment rate has skyrocketed. Large government stimulus packages may have slowed the bleeding, but development and job creation is the key to healing the broken economy. Although the development of the Marcellus Shale is still in its early phases, the beneficial impact on the economies of the affected states has been astronomical. It is no surprise that these drilling operations make a huge impact on local economies. Each gas well costs about $7 million dollars to construct. According to Hohmann, Chesapeake Energy Corp., the biggest player in Marcellus Shale, plans to drill 252 wells in West Virginia in the next year alone. At $7 million dollars per well, this amounts to over $1.7 billion invested in the state just in 2012. With over 100,000 wells expected to be drilled in the upcoming years and decades in Pennsylvania, the state is likely to see an investment of over $700 billion. What these huge investments mean is that jobs will be created in these states. In fact, each new well will create eleven to thirteen full-time jobs. Additionally, some studies


163. The U.S. Government invested hundreds of billions of dollars in tax cuts and job creation under the American Recovery and Reinvestment Plan. David J. Lynch, Economists Agree: Stimulus Created 3 Million Jobs, USA TODAY (Aug. 30, 2010, 5:12 PM), http://www.usatoday.com/money/economy/2010-08-30-stimulus30_CV_N.htm. The huge investment seems to have been fairly successful at preventing another massive depression. Id. Between 2.5 million and 3.6 million jobs were created and the unemployment rate dropped back to below double digits as of late 2010. Id.

164. See Cecilia Vega, Sarah Netter, & Maggy Patrick, Boom Town: What Brings Thousands of Jobs to One Ohio Town, ABC NEWS (Oct. 18, 2011), http://abcnews.go.com/US/boom-town-ohio-town-sees-thousands-jobs/story?id=14761821#.Ts_ufKwV7c (a story about an Ohio town with an unemployment rate at fifteen percent which expects to get over 10,000 new jobs created paying up to $77,000 per year over the next three years due to Marcellus Shale Drilling).

165. Hohmann, supra note 150.

166. Id.

167. Eliza Griswold, Situation Normal All Fracked Up, N.Y. TIMES, Nov. 20, 2011, at MM44.

have shown that the average number of jobs of different types required to get a well operating exceeds four hundred.\footnote{169}{Id.}

The numbers referred to above address the value of putting a lease into production. These numbers do not account for the investments made in purchasing leases. Due to the fluctuation and uncertainty of bonus payments and royalty calculations,\footnote{170}{Current offers can range anywhere from a few hundred dollars per acre and twelve percent royalties to over $5,000 per acre and twenty percent royalties. Elwin Green, \textit{Marcellus Shale Could be a Boon or Bane for Land Owners}, PITTSBURGH POST-GAZETTE (Feb. 28, 2012, 10:11 PM), http://www.post-gazette.com/stories/business/news/marcellus-shale-could-be-a-boon-or-bane-for-land-owners-235675.} it is impossible to know just how much is being invested in the Marcellus Shale. What these early numbers do indicate, however, is that every unproductive lease that is held by the lessee without production harms not only the lessor, but the state and local economies as well. It seems the only person that is not harmed financially is the lessee, who holds on to a lease at minimal expense and enjoys the privilege of waiting for either a technological discovery or a higher price, which would make the asset more valuable.

This economic incentive has a long-standing basis in oil and gas law. Even a century ago, it was recognized that there is a public as well as a private interest in bringing leased lands into production.\footnote{171}{Parish Fork Oil Co. v. Bridgewater Gas Co., 51 W. Va. 583, 658 (1902).} The West Virginia Supreme Court stated that forfeiture for delay in drilling under oil and gas lease is “essential to private and public interest in relation to the use and alienation of property.”\footnote{172}{Id.} This public interest is even more compelling today, as the drilling of a well into the Marcellus Shale is a multi-million dollar investment, which creates jobs and injects millions into the state and local economies.


Oil and gas leases containing delay rental provisions are slowly becoming outdated. Modern leases have revealed an increase in the use of the “paid-up” lease.\footnote{173}{This “modern” trend has been growing since at least 1985. \textit{See, e.g.}, John S. Lowe, \textit{Negotiating Oil and Gas Leases for the Lessee}, 1-SPG NAT. RESOURCES & ENV’T 6, 56 (1985) (identifying the use of “paid-up” leases as a growing trend by oil companies).} In a “paid-up” lease, the gas company pays the delay rental provisions in a lump-sum payment shortly after the execution of the lease.\footnote{174}{Kirk B. Burkley, \textit{Navigating Oil and Gas Lease Issues}, 30-JUN AM. BANKR. INST. J. 18, 18 (2011).} This lump-sum payment usually takes the
form of a combination of the bonus that lessors often receive for granting a lease and the delay rental. The “paid-up” lease has gained momentum because it prevents the possibility that a gas company could lose its rights for failure to make a delay rental payment during the primary term. The “paid-up” lease essentially removes the obligation of the lessee to drill an exploratory well during the primary term or to pay delay rental in the absence of such drilling, but leaves intact the extension of the lease by production.

The increasing popularity of the “paid-up” lease among oil and gas companies has practical significance to the argument that delay rental provisions should allow a lease to extend beyond the primary term. Most importantly, by switching to the “paid-up” lease, these companies are acknowledging that the purpose of the delay rental provision is to compensate the lessor for the delay in drilling during the primary term only. By the very nature of the “paid-up” lease, the delay rentals for the entire primary term are lumped together and reflect consideration paid for the privilege of not drilling during the primary term.

In turn, oil and gas companies who have switched from the old delay rental payments to the “paid-up” lease would not have been willing to give up the right to continue a lease beyond the primary term by paying delay rentals. If this had been the intent, then the new “paid-up” leases would not limit the power of the bonus payment to considerate for the delay during the primary term alone. Instead, the terms of theses leases would allow them to continue indefinitely with the payment of subsequent rentals. The rational assumption that arises from the actions of oil and gas companies in switching to “paid-up” leases is that they never intended that delay rental would hold a non-producing lease property indefinitely.

D. Alternatives Available to the Lessee to Prevent Expiration of a Lease

Oil and gas companies certainly would prefer to hold onto a leased property forever without drilling, in the hopes that someday new discoveries or technologies would make development of the property feasible and profitable. They certainly would be opposed to an explicit

175. Hall, supra note 118, at n. 61.
176. Lowe, supra note 173, at 56.
177. For an example of a “paid-up” lease, see Nancy Saint-Paul, Paid-up Oil and Gas Lease, 5 Summers Oil and Gas § 59:6 (3d ed. 2011).
178. See generally id.
uniform law that would unconditionally limit the length of an oil and gas lease to the primary term unless the production requirements are satisfied. However, these profit-driven motives are not justified when these companies have the tools and expertise necessary to prevent ambiguity in leases and ensure their opportunity to remove minerals from the premises beyond the initial term of the lease without violating the rights of the lessors. Specifically, oil and gas companies can negotiate for lease terms that give them the option of renewing the lease at the end of the primary term, ensure that the primary term provides them enough time to bring the premises into production, or simply bring the property into production.

1. Renewal Clauses

It is easy to imagine why an oil and gas company would want to enter into a lease even if the company believes it would be impossible to drill on the property within the primary term. For the most part, these reasons center on competition. In an area where several companies are leasing acreage at skyrocketing prices in a limited drilling area, such as the Appalachian region, each company is not only seeking to maximize their own acreage, but also to prevent competitors from gaining access to the valuable mineral deposits. In order to maximize their own opportunities, it may be feasible for these companies to lease property without any intention to drill. Regardless of what a company’s motives may be, the use of an option to renew clause, or renewal option, provides a method the company can use to tie up property that they are uncertain they can bring to production in the first term.179

An option to renew clause has been recognized by the Supreme Court in Oklahoma.180 In Silk v. Phillips Petroleum Co.,181 the court was asked to determine whether the signature of a lessor on an “option to renew clause” was procured by fraud.182 The clause gave the lessee the option of renewing the lease at the end of the primary term by paying the same bonus to the lessor that was paid at the execution of the lease.183 Without specifically addressing the validity of the option to renew clause, the court found that it was not procured by fraud and

179. See generally 49 AM. JUR. 2D LANDLORD AND TENANT § 141 (2012). This explanation focuses on landlord and tenant law. In fact, there is not much law regarding the use of renewal option provisions in oil and gas leases.


181. 760 P.2d 174.

182. Id. at 177.

183. Id.
upheld the lessee’s exercise of the option.184

In commercial and real estate law, there are abundant sources of law validating the use of renewal provisions.185 It is important to acknowledge that oil and gas law is a distinct area of law, so much so that academics are reluctant to classify renewal provisions in oil and gas leases with other types of renewal provisions.186 Although renewal clauses in oil and gas leases are not as established as in other areas of law, courts have generally accepted the use of these provisions.187 In fact, renewal clauses are now so common that standard renewal forms can easily be found on legal databases.188 Based on the acceptance of these provisions in other states and areas of law, it is likely that New York, Pennsylvania, Ohio, and West Virginia will uphold the use of renewal provisions.189

Renewal provisions in oil and gas leases can be used by oil and gas companies to retain their interests in oil and gas leases beyond the initial term. Using this tool, companies that are willing to pay lessors bonuses multiple times190 can maximize their production in shale gas formations.

184. Id. at 181.

185. See, e.g., Daniel E. Feld, Validity and Enforceability of Provision for Renewal of Lease at Rental to be Fixed by Subsequent Agreement of Parties, 58 A.L.R.3d 500 (1974). This article presents just one aspect of renewal clauses addressed in the American Law Reports. A simple search of the A.L.R. with keywords “renewal clause” or “renewal provision” reveals dozens of articles dealing with specific aspects of renewal clauses.

186. See Jay M. Zitter, Sufficiency of Provision of Lease to Effect Second or Perpetual Right of Renewal, 29 A.L.R.4th 172, n. 2 (1984) (stating that oil and gas leases are of a “distinctive type” and refusing to include them in an analysis of renewal provisions).

187. See Silk v. Phillips Petroleum Co., 760 P.2d 174, 181 (Okla. 1988) (finding that separate consideration is not necessary when an option is incorporated into the lease agreement); APC Operating P’ship v. Mackey, 841 F.2d 1031, 1033 (10th Cir. 1988) (holding that tender of consideration for renewal by mail was sufficient though not explicitly authorized by lease).


189. Courts in each of these states have dealt with renewal provisions in other areas of the law and generally approved their use. See Thaw v. Gaffney, 83 S.E. 983, 984 (W. Va. 1914) (finding that provisions allowing perpetual oil and gas leases based on production justify the perpetual renewal of a lease for real property); Kern v. Clear Creek Oil Co., 778 N.E.2d 115, 120 (Ohio Ct. App. 2002) (approving of Ahmed v. Scott, 418 N.E.2d 406 (Ohio App. 1979), which terminated a real property lease when lessee failed to timely exercise the option to renew); Hite v. Falcon Partners, 13 A.3d 942, 946 (Pa. Super. 2011) (identifying the option to renew as a predecessor to the modern habendum clause); American Power Indus., Ltd. v. Rebel Realty Corp., 53 N.Y.S.2d 99, 100 (N.Y. App. Div. 1988) (enforcing an option to renew in a commercial lease even though lessee was two months late in notifying lessor of his exercise of the option).

190. It is important to note that courts are reluctant to enforce renewal of leases more than once. See, e.g., Howard v. Schildberg Const. Co., Inc., 528 N.W.2d 550, 555 (Iowa 1995) (holding that a renewal provision “is satisfied by one renewal, unless further renewals are expressly provided for”).
Therefore, oil and gas companies that would argue that payment of delay rental should extend their leases beyond the primary term can achieve virtually the same result by drafting clear leases that allow for a renewal. This would preserve the right of the lessee to delay developing property for some period of time, while at the same time ensuring that the lessor is fairly compensated for any excessive delays. However, if renewal provisions become contrary to public policy, these provisions could become subject to the same scrutiny that perpetual delay rental provisions now receive.

2. How Long Should the Primary Term Last?

In examining oil and gas leases, it quickly becomes apparent that the length of the primary term varies widely. In *Falcon*, the primary term was for one year. In the hypothetical lease discussed above, the primary term was five years. It is not uncommon for the primary term of a lease to endure for ten or even twenty-five years. This variation brings to mind two important questions. First, why would an oil and gas company agree to a lease term of five, ten, or twenty-five years if it was possible to have a one year lease term and then have merely an option to extend the lease by paying delay rental payments? This question necessarily leads one to wonder how long a primary term should last. These issues are addressed in turn below.

The inconsistency of primary terms of leases entered into by oil and gas companies reflects an acknowledgement by these companies that a lease expires when the production requirements have not been satisfied at the end of the primary term. It would not make sense for a gas company to agree to a primary term of ten years, during which they would be required to pay delay rental, when the same result could be accomplished by executing a one-year lease. If production was not accomplished during the first year, the company could continue to pay delay rental and bind the lessor to the lease as long as the company saw fit. The existence of longer primary terms clearly shows the intent of both lessors and lessees that the term of the lease cannot be extended absent a prior agreement or production.

One solution available to oil and gas companies regarding this issue

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191. *See generally supra* Section IV.C.
193. *Supra* Section IV.A.
is to base their decisions on how long to make a primary term on the realistic likelihood that they can get the land into production by the end of that term. While the original consideration required to execute a longer lease will be greater, so will the benefit to both parties. Obviously, ensuring that they have adequate time to drill a producing well will reduce the risk of forfeiting leased property due to the expiration of the term. Additionally, the longer duration will reduce the probability that the oil and gas company will have to pay the lessor multiple times for renewal of the lease.

3. Fulfilling the Object of the Lease: Production in Paying Quantities

It is customary for the habendum clause of an oil and gas lease to provide language that extends the lease for the primary term and “as long thereafter as oil or gas or either of them is produced from the Property.” If every leased property was brought into production by the end of the primary term, the question of whether delay rental could be used to extend the lease would become moot. While a world in which every gas lease resulted in production may be a fairy tale, production requirements make this aspiration more of a reality in Marcellus Shale states. In today’s era of hydraulic fracturing, there are many ways in which lessees can satisfy the production requirements, or at least prolong the expiration of the lease. Chief among these methods of producing are commencement clauses, pooling provisions, and continuous operations clauses.

In some instances, satisfaction of a commencement clause will allow a lessee to continue operations after the primary term of a lease expires without production. The commencement clause, which can vary greatly, basically provides that if a lessee commences drilling operations within the primary term of the lease, the lease will be extended so long as drilling continues. In some jurisdictions, merely

196. *Falcon*, 13 A.3d at 944.


199. See generally id.

200. Id. at 296.

bringing in materials to begin the drilling process will be enough to satisfy the commencement clause, but others require that the drilling operations reflect a showing of good faith development by the lessee.\textsuperscript{202} Regardless of whether actual drilling is required for commencement, carefully drafted leases can afford lessees more time to complete wells under a lease.

Another option available for the lessee is the use of a pooling clause. A pooling clause is part of a lease that allows the lessee to combine the acreage of a certain lease with others without the lessor’s consent.\textsuperscript{203} Often, these pooled units are required to be approved by a governmental entity before the drilling may begin.\textsuperscript{204} Pooling provisions are especially important in shale drilling due to the huge range of acreage that can be reached from a single horizontal drilling site.\textsuperscript{205} This tool can be particularly useful to oil and gas companies because production of oil or gas from any portion of the lands pooled together is considered production from each of the parcels involved in the unit.\textsuperscript{206} Cleverly created units can allow oil and gas companies to maximize production on their pooling units while ensuring that landowners entitled to royalties reap the benefits of production.\textsuperscript{207}

\textsuperscript{202} Compare Santa Fe Drilling Co., Inc. v. Moore, No. 82 X 15, 1983 WL 2278, at *3 (Ohio Ct. App. 1983) (holding that lessee that had paid delay rental and conferred with lessor about drilling sites could continue operations after the expiration of the primary term although drilling had not begun) and Todd v. Mfrs.’ Light & Heat Co., 110 S.E. 446, 447 (W. Va. 1922) (holding that drilling which commenced three months before the expiration of the ten year primary term satisfied the commencement clause extending the lease) and Henderson v. Ferrell, 38 A. 1018, 1019 (Pa. 1898) (upholding a jury determination that lessee who entered the property on the last day of the primary term and drove a stake into the ground to mark well site and lumber delivery mark had commenced drilling operations in good faith) with Gisinger v. Hart, 184 N.E.2d 240, 241 (Ohio Ct. App. 1961) (rejecting the argument of the lessee under a ten year primary term lease who commenced drilling operations four days before the expiration of the term) and Street v. Masterson, 277 S.W. 407, 407-08 (Tex. Civ. App. 1925) (holding that employees of lessee who drilled eighteen to twenty feet using a rig used to drill water wells with the intent to hold the lease until “hell freezes over,” did not commence drilling operations in good faith).

\textsuperscript{203} Kramer, supra note 198, at 286.

\textsuperscript{204} Id. at 288.

\textsuperscript{205} Id. at 291. Due to the horizontal nature of hydraulic fracturing, one vertical well location can result in a well that travels through several tracks. Id. Each of these tracts of land contributes to the production. Id.

\textsuperscript{206} Id. at 293. Courts are often reluctant to enforce pooled units when the unit is created shortly before the expiration of the primary term of leases involved. Id. Understandably, skepticism arises when it appears that a unit has been created simply to hold leases which are about to expire. Id.

\textsuperscript{207} It is important to note that many states limit the size of a pooling unit to 640 acres plus a ten percent drainage area. See, e.g., W. VA. CODE § 22C-9-8 (West 2013); N.Y. ENVTL. CONSERV. LAW § 23-0501 (McKinney 2008); TEX. NAT. RES. CODE ANN. § 32.202 (West 2013).
An operations clause is very similar to a commencement clause, but it can be an even broader way for a lessee to preserve its interest in an oil and gas lease.208 Kramer acknowledges that the “‘immature’ oil and gas jurisprudence” of the Midwest states that make up the shale gas plays makes it unclear how these states will interpret operations clauses.209 However, as long as the clauses are specific about what “operations” are required to keep a lease in effect and the lessee moves forward with the operations in good faith, the lease should be extended as long as the operations continue.210 In this way, a lease may be kept alive even if development of a property is only in the planning or preparation phases.211

Used alone or in conjunction, the commencement clause, pooling clause, and operations clause provide just three examples of alternatives available to oil and gas lessees which help ensure that the lessee can reap the fruits of the lease without violating the interests of the lessor. These provisions help to avoid the confounded reasoning by lessees that delay rental provisions should be construed to perpetuate leases. Carefully crafted leases that are unambiguous and well-explained to lessors should help to clarify the responsibilities of oil and gas companies and the expectations of landowners.

V. CONCLUSION

Driving through the hills of southeastern Ohio, it is clear that there is something important going on. In the local gas stations and convenience stores there is a buzz about economic development and jobs. County roads that are usually empty are packed with trucks with Texas license plates, tanker trucks, and tractor-trailers hauling drilling equipment. At night, the usual quiet darkness is interrupted by the bright lights of drilling rigs off in the distance and the unusual rumblings of machinery. This is the landscape in the areas overlying the Marcellus and Utica shale. Amid all of the excitement and urgency in accessing the valuable resources below the earth, important legal issues have arisen. To landowners tied up in decades-old leases, none of these issues are more important than whether they will be fairly compensated for their mineral rights.

208. See Kramer, supra note 198, at 301 (explaining that in some cases, operations that take place off of the leased premises which are intended to help get the leased premises producing can satisfy the operations clause).
209. Id.
210. Id. at 302-03.
211. Id. at 302.
While each Marcellus state has some idea of how it will handle issues related to delay rental, it is in the interests of both lessors and lessees for these states to come up with a definite, explicit, and well-reasoned conclusion. Principles of fairness, reflected through public policy and precedent led to the decision in *Hite v. Falcon Partners* that oil and gas companies will not be allowed to profit from speculation and lack of development of mineral rights to the detriment of the owner of the surface. The very nature of the property right transferred in an oil and gas lease aligns with the policy reasoning and provides further evidence that the *Falcon* court came to the right conclusion. The availability of alternative lease provisions and the proliferation of the “paid-up” lease serve only to strengthen the argument. Delay rental provisions are intended to compensate lessors for the right to postpone drilling during the primary term, and at the expiration of that term, further payment of delay rentals will not extend an oil and gas lease.