

## SUPERIOR COURT INTERPRETS OIL AND GAS LEASE IN FAVOR OF LANDOWNERS

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With the recent increase in activity in the oil and gas industry in Pennsylvania, disputes between developers and landowners over the interpretation of oil and gas leases are inevitable. In its most recent opinion on the subject, the Pennsylvania Superior Court held that landowners properly terminated leases where the developer had not commenced drilling by the end of the primary term of the lease. In so holding, the Court concluded that continued delay rental payments after expiration of the primary term did not extend the term of the lease.

In *Hite v. Falcon Partners, et al.*, 2011 WL 9632 (January 4, 2011), the landowners had entered leases with a developer in December 2002 and October 2003. The leases contained the following provision, which identified a primary term and also incorporated a traditional habendum clause (providing that lease term continues “so long thereafter” as oil or gas is produced) and a delay rental clause:

3. Term. Lessee has the right to enter upon the Property to drill for oil and gas at any time withinone [sic] (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.

Drilling never commenced on the property; instead, the developer (and its assignees) continued to pay delay rentals to the landowners for a period of five years. After obtaining offers from other developers and complying with the right of renewal clauses in

the leases, the landowners declared that the leases were terminated.

The Court first reviewed the history of oil and gas lease interpretation in Pennsylvania stretching back to the 19th century. In reviewing this history, the Court concluded that delay rental provisions “have a well-settled meaning” — that is, to provide something to the landowner in lieu of royalties from production. The Court further found that these clauses “typically” are concerned with the primary term of the lease only, and it reviewed all of the reasons why such clauses typically are restricted to a lease’s primary term. Historically, the delay rentals clause was developed not only to provide some compensation to the landowner, but also to limit the period in which drilling may be delayed. If delay rentals could be used to extend a lease indefinitely, the lease essentially would be a “no term” lease and may unreasonably restrict the landowner’s ability to use or transfer the land.

Based on this history, the Court concluded, “[t]o 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.’”

Although the Court based its decision on a long line of cases interpreting oil and gas leases, the clause at issue in this case was not a typical clause. The standard oil and gas lease has been modified many times over the years, but most modern leases include habendum and delay rental clauses that are separate and apart

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from the clause which defines the primary term of the lease. In this case, all these clauses were combined into one “term” clause. As a result of this structure, the lease could have been interpreted in a different manner. In particular, the Court could have found that, because the delay rental clause was included in the same clause that defined the primary term, the parties intended for the delay rentals to extend the primary term.

Interestingly, the Court stated that the unusual lease language compelled its decision: “Specifically, the language pertaining to the one year primary term and the delay rental due on an annual basis, used in conjunction, is not typical, and, as we will explain, require us to affirm the lower court’s summary judgment in Plaintiffs’ favor.” To the contrary, however, the Court’s decision appears to be based not on the specific language of the lease, but on the historical interpretation of oil and gas leases generally. Even if the Court focused on the specific language at issue, it would have been very reluctant to issue a ruling that would allow a developer to extend the primary term indefinitely, at least absent the clear intent of the parties.

This decision suggests that the courts may focus less on the specific language of a particular lease and more on the principles underlying the development of modern oil and gas leases. While this may provide more consistency for landowners and the oil and gas

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industry, it may make it more difficult to deviate from standard lease constructions unless the parties’ intentions are spelled out clearly in the lease. ♦

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