

MEMORANDUM

TO: Jim Goldstein
FROM: Jane Welsh
DATE: April 7, 2009
RE: The Need For State Regulation of Oil And Gas Lease Transactions

New York State's existing policy regarding the regulation of gas and oil lease transactions can most succinctly be summarized in two words: **BUYER BEWARE**. The only protection available at this time to the landowner is a completely ineffective state requirement that gives the landowner a three-day period in which to cancel or rescind the lease after it is executed. The reason that this protection is ineffective is that frequently the only signature on the lease is the landowner's signature. Dennis Holbrook, Nornew's counsel, has told me that their policy is to NOT execute leases but rather to deliver the check for the initial payment under the lease. Their position is that delivery of the check constitutes performance and thus the landowner is bound to the lease by virtue of accepting the payment. The obvious difficulty, then, is how to measure the three-day period. I have spoken to Michael Danaher, who specializes in consumer protection issues in the Binghamton office of the State Attorney General, about this problem. He assures me that the Attorney General is aware of this issue but, to date, nothing has changed.

The relationship of the parties to a gas lease is very much the opposite of the traditional balance of power. In a typical commercial or residential lease, the owner/landlord is usually the party in the stronger bargaining position. The tenant/lessee is expected to sign a lease and deliver it to the landlord, together with payment of a security deposit and the first month's rent. The landlord/owner then decides whether to accept the tenant/lessee's offer and either executes the lease and delivers it to the tenant/lessee or not. The lease agreement becomes a binding obligation of the parties **only** upon full execution and delivery. This is also true for other contracts, including, for instance, a contract for the sale and purchase of real property. Indeed, every first year law student learns this basic rule of contract law.

The gas lease transaction, on the other hand, involves a rather unique situation where the tenant/lessee, not the landowner/lessor, has the stronger bargaining position. New York State law regulates residential leasing transactions and protects the weaker party. Likewise, New York State law regulates mortgage and other financial transactions

involving real property, again recognizing the unequal bargaining power of the parties by legislating protection for the weaker party. New York State regulates numerous types on consumer transactions involving goods and services, again by explicitly acknowledging the State's public policy role in protecting individuals against companies with power and resources. Why wouldn't these same considerations apply in the context of a gas lease transaction? Why, to date, does New York State offer only advice and a little education to the landowner. Indeed, the State is remiss in not regulating these transactions, particularly since these leases create long-term encumbrances on real property and the drilling and other activities permitted by the leases have environmental consequences that will affect not only the one landowner signing the lease but entire communities of landowners. It is callous in the extreme to tell the landowner to hire a lawyer. For one, lawyers are expensive and payment is beyond the means of most of the landowners. For another, the companies often make it very difficult for the landowners' attorneys by either refusing to negotiate or by failing to provide a company attorney with whom to negotiate. Finally, most local attorneys have little experience with gas lease and drilling issues.

Having made the argument that aspects of these transactions can and should be regulated by New York State, here are some specific suggestions. (As an aside, many of the protections described below, such as insurance, indemnity and mandatory water testing, should be also extended to any landowner who is compulsorily integrated into a spacing unit):

- Require the companies to sign the lease and deliver a fully-executed original to the landowner before the lease will be deemed effective, enforceable and legally-binding on the parties. Measure the three-day rescission from the date of actual delivery of the fully-executed document to the landowner. Increase the three-day period to five business days in order to allow adequate time for the landowner to obtain advice and act. At the very least, these requirements would render the existing law meaningful.
- New York State licenses real estate brokers and mortgage brokers. Landmen act as agents for the companies' in connection with agreements affecting real property and are compensated on a commission basis. Landmen, like real estate and mortgage brokers should be subject to licensing requirements and be governed by a strict code of conduct, which if violated, would result in the loss of the landman's license and the imposition of penalties on the company under certain circumstances.

Current landman practices and tactics are so questionable that they could be the subject of an entirely separate memorandum.

- Many of the printed leases contain provisions permitting the company to unilaterally extend the primary term of the lease. Such provisions should not be enforceable. The written agreement of both parties should be required to extend the primary term.
- Many of the printed leases contain provisions that automatically extend the lease if drilling activity is commenced during the primary term. First, the words “commencement of drilling activity” or similar phrases in a gas lease should be given a specific statutory meaning, since the lease either continues or ends after the primary term depending upon one’s interpretation of this language. Furthermore, once drilling activity commences, such activity should be required to be continuous or a well should be required to be completed within a specified time frame. This position is consistent with common law principles that frown upon alienation of property.
- Many of the printed leases contain provisions that extend the lease with respect to the ENTIRE property covered by the lease if drilling activity has commenced on another owner’s property and a part of the land covered by the lease is included in a spacing unit in which drilling activity has commenced. These provisions should not be enforceable.
- State law should require the company to obtain liability insurance meeting minimum standards and amounts (these need to be established) and the landowner and the holder of any mortgage covering the property should named as an additional insured party.
- The company should be required to indemnify the landowner against any claims for property damage, environmental contamination, death or injury arising out of its activities on or under the property.
- Any printed form of lease used by the company should contain bold large typeface language at the top of the first page warning the landowner that this is an important legal document that will affect the rights of the landowner and encouraging review by an attorney. Obscure provisions in the printed document should also be required to be explained in plain English.

- The company should be required to conduct water testing and provide a copy of the written report to the landowner as a condition to the effectiveness of the lease.
- Default and remedy provisions similar to those found in virtually all commercial leases in New York State should be incorporated into every gas lease.
- Any representations of the landowner in the printed lease containing a warranty of title should be deemed void. The company should satisfy itself as to title.
- The company should not be permitted to assign the lease without the written consent of the landowner or at least without providing evidence to the landowner that the successor is no less well-capitalized and creditworthy and reputable than the assigning company. In addition, the assignor should not be released from liability on such assignment. This is typical and customary in any commercial lease transaction.

In short, a gas lease transaction is a commercial lease transaction. The legal concepts and protections that are commonly found in any commercial lease negotiated between experienced and sophisticated parties should be contained in a gas lease. The only reason they are not is that the parties to a gas lease are woefully mismatched in terms of negotiating power, experience, sophistication and financial clout. This is precisely why it is incumbent upon New York State to step in to level the playing field (as it has in many other instances involving consumer protection) to do what the parties to such a transaction either cannot or will not willingly do.

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