

**Oil and Gas Law Colloquium
2009 Case Law and Legislative
Update**

**By Joel R. Burcat
Saul Ewing LLP**

**I. IMPLIED COVENANT TO DEVELOP
AND PRODUCE OIL OR NATURAL GAS.**

- ***Jacobs v. CNG Transm. Corp.*, 565 Pa. 228, 772 A.2d 445 (2001) (State *Jacobs*).**
- 1999: The Third Circuit petitioned the Pa. Supreme Court for certification of Questions of Law which the court granted.
- May 29, 2001, the Supreme Court answered the certified questions.

QUESTIONS CERTIFIED:

1. Whether a finding that the contract between the parties is ambiguous is a prerequisite to applying the doctrine of severability set forth in Heilwood Fuel Co. v. Manor Real Estate Co. (Pa. 1961).
2. Whether Pennsylvania jurisprudence recognizes an implied covenant to develop and produce oil or natural gas that imposes upon the lessee the obligation to attempt to produce oil and gas from the leased property.

SUPREME COURT'S RESPONSES:

1. "Absent express language that a contract is entire, a court may look to the contract as a whole, including the character of the consideration, to determine the intent of the parties as to severability and may also consider the circumstances surrounding the execution of the contract, the conduct of the parties, and any other factor pertinent to ascertaining the parties' intent. The court need not make a specific predicate finding of ambiguity before undertaking the inquiry-- indeed if the contract were crystal clear as to the parties' intent, severability likely would not be a contested issue." 772 A.2d at 452.

2. "An implied covenant to develop the underground resources appropriately exists where the only compensation to the landowner contemplated in the lease is royalty payments resulting from the extraction of that underground resource. Where, however, the parties have expressly agreed that the landowner shall be compensated if the lessee does not actively extract the resource, then the lessee has no implied obligation to engage in extraction activities. They, so long as the lessee continues to pay the landowner for the opportunity to develop and produce oil or gas, the lessee need not actually drill wells. At the point where the compensation ceases due to the expiration of the term of the lease, or pursuant [to] the terms of the lease itself, the lessee then has an affirmative obligation either to develop and produce the oil or gas or terminate the landowner's contractual obligations." 772 A.2d at 455.

- **Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759 (W.D. Pa. 2004) ("Federal Jacobs") (Judge David S. Cercone).**
- Plaintiffs were seeking (1) an accounting of natural gas extracted, withdrawn, or produced; 2) a finding that the oil and gas lease has terminated; and 3) a declaration quieting title to the oil and gas interests underlying the property.
- **Court pointed out that plaintiffs contended that the production and storage provisions of the lease were contractually severable and that the defendant had failed to comply with an implied covenant to develop the property for production.**

- Court explained the different provisions of modern oil and gas leases:
- **GRANTING CLAUSE:** Initially conveys to the lessee the right to drill for and produce oil and gas from the property and the right to use various portions of the property for storage of gas, with the right to use the surface of the property in any manner necessary to effectuate either or both purposes.

- **HABENDUM CLAUSE:** Used to fix the ultimate duration of an oil and gas lease. In effect that the interest conveyed by the lease shall continue for a prescribed term of years (e.g. 5 or 10) and as long as one or more particular minerals are produced in paying quantities or some other specified activity continues.

- **DELAY RENTAL CLAUSE:** 1) Eliminates the ability to attack the lease as an executory contract; 2) relieves the lessee of the immediate obligation to develop the property and provides the lessee with an option to delay production until a convenient time during the primary term.

- **SURRENDER PROVISION:** Describes when and how the lessee gives up his rights to the lease.

Important facts:

- Court noted that no oil or gas wells have ever been drilled on the property;
- no one ever sought a drilling permit for the property;
- property was never pooled or unitized;
- defendant ceased its drilling business many years earlier; and
- Defendant had not drilled any wells in over 15 years and no longer owns any drilling rigs or equipment.

- Court holds that “it is appropriate to construe any Court ambiguity in such instruments in favor of the lessor.” 332 F.Supp. 3d at 772. (Presumably because it was the lessee who drafted the lease.)

- **SEVERABILITY ISSUE:** The lease did not contain any express provision indicating whether the lease was to be construed as an entire agreement or severable. 332 F.Supp. 3d at 776.
- **Ultimately, the court held that lease was intended to be entire and not severable.** *Id.* at 779.

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- The court found that “an implied duty to develop the property for production arose at the conclusion of the primary term and defendant’s long-term failure to comply with that duty has resulted in the expiration or surrender of all production rights not encompassed in and retained by defendant’s storage of gas.” *Id.*
- The provisions of the lease do not provide defendant with the option merely to elect to store non-native gas and through that activity alone indefinitely retain the production rights not affected by the storage. *Id.* at 787.

- **ABANDONMENT:** The court also found that assuming that the production rights did not expire at the end of the term of the lease, defendant had abandoned those rights “under the controlling principles of equity.” *Id.* at 792.

Penneco Pipeline Corp. v. Dominion Transmission, Inc., 2007 U.S. Dist. LEXIS 46621 (W.D. Pa. May 21, 2007) (Chief Judge Donetta Ambrose on a report and recommendation of Magistrate Lisa Pupo Lenihan).

- Dozens of leases were at issue. Plaintiffs were the lessors who were landowners encumbered by the leases. Plaintiffs sought a declaration that the oil and gas production rights in all of the leases had terminated; that the rights expired automatically that payments for delay rentals were inadequate to retain production rights; and, that they had abandoned their production rights. *Id.* at *11.
- Basically, plaintiffs tried to make this case a Federal *Jacobs* case and relied almost exclusively on the language in that decision. *Id.*

- The Magistrate analyzed the leases and found that the terms of the habendum clauses all provided that the term of any lease would be extended indefinitely so long as the properties are used for either production of oil and gas or for the storage of gas.

• **1. Severability:** Applying the severability standard enunciated in *State Jacobs*, the court held that the production and storage rights are not severable. The habendum clauses extend the term of the leases indefinitely so long as the land is used to produce *or* store gas.

• **2. Implied Covenant to Produce Oil or Gas:** The court applied *State Jacobs* to find that the leases created no implied covenant of to develop or produce oil or gas.

• **3. Abandonment:** Plaintiffs also argued that Defendants had intentionally abandoned their rights to produce oil and gas. The court found that the evidence showed that Defendants had not abandoned their rights.

II. VALIDITY OF VARIOUS OIL AND GAS LEASE PROVISIONS

***Power Gas Marketing & Transmission, Inc. v. Cabot Oil & Gas Corp.*, 948 A.2d 807 (Pa. Super. Ct. 2008).**

- The court held that the Joint Operating Agreement's preferential purchase rights provision was not subject to the rule against perpetuities. *Id.* at 818.

• ***Kropa v. Cabot Oil & Gas Corp.*, 609 F. Supp.2d 372 (M.D. Pa. 2009).**

- Defendant paid a bonus of \$25 per acre, covering 51 acres, amounting to \$1,275. Plaintiff claimed the defendant told him, it would "never pay any more than \$25 per acre so he better take the \$25 per acre."
- After learning that others received more money, plaintiff sued seeking to void the contract claiming fraudulent inducement and a declaration that the royalty provision, which pays 1/8th less expenses, violates Pennsylvania law.

- The court refused to dismiss that portion of the claim dealing with the statement that plaintiff would never be offered more than \$25, since that part of the claim was not covered by an integration clause. 609 F. Supp.2d at 378.
- The court did dismiss that part of the claim that there was fraud regarding the statements having to do with the amount of royalty, since that was covered by an integration clause. *Id.*

- As to royalty, the court held that “a plain reading of 58 P.S. § 33 guarantees one-eighth royalty and does not provide for the subtraction of any costs.” *Id.* at 379.
- Disagrees with the holding of the Pa. Court of Common Pleas in *Kilmer*.

- ***Stone v. Elexco Land Servs., Inc.*, 2009 U.S. Dist. LEXIS 45897 (M.D. Pa. June 1, 2009)**
- One of a number of cases dealing with questions of whether Lessee may deduct costs from 1/8th royalty.
- Defendants argued that reduction of costs is standard in the industry and the court noted that the question would turn on how “royalty” should be interpreted.

• The court declined to dismiss the case because two schools of thought exist as to what the term “royalty” means, *id.* at *12, and because the court would be required to look to materials outside of the pleadings to determine “industry practice,” which the court could not do at the motion to dismiss stage of the litigation, *id.* at *13.

• ***Kilmer v. Elexco Land Servs., Inc.*, No. 63 MAP 2009 (Pa.) (argued on Sept. 16, 2009).**

• Similar factual background to *Stone v. Elexco Land Servs., Inc.* Supreme Court took the case under its extraordinary jurisdiction from the Court of Common Pleas of Susquehanna County.

• **The Supreme Court is reviewing the question of: “Whether 58 P.S. § 33 precludes parties from contracting that post-production costs be factored into the determination of the amount of royalty payable under an oil or natural gas lease.”**

• ***T. W. Phillips Gas and Oil Co. v. Jedlicka*, No. 1918 WDA 2007 (Pa. Super Ct. 2008).**

• Defendants asserted that the lease has terminated because of the habendum clause that requires that the lease is valid so long as “oil or gas is produced in paying quantities.”

• The Court of Common Pleas of Indiana County evaluated the “in paying quantities” provision of the habendum clause pursuant to *Young v. Forest Oil Co.*, 45 A.2d 121 (Pa, 1899). That case established a “subjective test,” i.e. guided by the circumstances and construing the phrase “in paying quantities”, “with reference to the operator, and by his judgment exercised in good faith.” Slip op. at 4.

• The Court of Common Pleas rejected the defendants requested application of an “objective test” based on *Reese Entcs., Inc. v. Lawson*, 553 P.2d 885 (Kan. 1976), in which the court computes the production receipts, minus royalty, minus expenses including marketing, labor, trucking, repair, taxes, fees and other expenses.

• The Superior Court affirmed, noting that although *Young* is over a century old it is still the law as established by the Supreme Court. Slip op. at 8-9.

• ***T. W. Phillips Gas and Oil Co. v. Jedlicka*, No. 604 WAL 2008, 2009 WL 2342457 (Pa., July 29, 2009).**

• The Supreme Court granted the petition for allowance of appeal from the Superior Court.

• The issue accepted on appeal is: **“Did the Superior Court misapply the decision of this Court in *Young v. Forest Oil Co.*, 45 A. 121 (Pa. 1899), by holding that Pennsylvania employs a purely subjective test to determine whether an oil or gas lease has produced ‘in paying quantities.’”**

III. PREEMPTION OF LOCAL ORDINANCES

- **Range Res. – Appalachia, LLC v. Salem Twp., 964 A.2d 869 (Pa. 2009).**
- The court held that the Ordinance was an attempt by the Township to enact a comprehensive regulatory scheme relative to oil and gas development in the Township. *Id.* at 875. As the ordinance focused not on zoning or development, but on regulating oil and gas, its objectives conflict with the Act's objectives. *Id.* at 877.

- **Huntley & Huntley, Inc. v. Borough Council of the Borough of Oakmont, 964 A.2d 855, 864 (Pa. 2009).**
- The Court held that the "feature" of oil and gas well operations provision pertains to the technical aspects of well functioning and matters ancillary thereto (such as registration, bonding, and well site restoration), rather than the well's location.
- The court held that the ordinance serves different purposes from those in the Act, and that its overall restriction on oil and gas wells in R-1 district was not preempted.
- Next, the Court considered whether the Commonwealth Court mistakenly superimposed the MPC's definition of "mineral" upon the relevant portion of the zoning ordinance. Because the ordinance did not define the term mineral, the Supreme Court found that the Commonwealth Court's reliance on that definition to be appropriate. Moreover, the Supreme Court noted that it would be unwise to defer automatically to a local governing body regarding a term that is expressly defined in the MPC and used in a zoning ordinance, as that approach would invite litigation by fostering uncertainty as to zoning terms. *Id.* at 868.

- **Arbor Res. LLC v. Nockamixon Twp., 2009 Pa. Commw. LEXIS 208 (Pa. Commw. Ct. May 21, 2009)**
- The court held that the ordinances do not contain operational provisions. Rather, the ordinances identified zoning districts within the Township where oil and gas drilling was a permitted use. *Id.* at *22.

**IV. RIGHTS OF OIL AND GAS
LESSEES ON LANDS OWNED BY
THE COMMONWEALTH**

- **Belden & Blake Corp. v. Dep't of Conservation & Nat. Res., 969 A.2d 528 (Pa. 2009)**

- The Supreme Court affirmed Commonwealth Court, noting that DCNR may not "unilaterally impose additional conditions on Belden & Blake's exercise of its right to enter" the parcels. *Id.* at 532. Although it recognized that DCNR has a duty to maintain and preserve state parks, the court reiterated that it is the surface owner's burden to challenge the subsurface owner's reasonable exercise of its rights, not the reverse. *Id.* The court noted that a subsurface owner's rights cannot be diminished because the surface comes to be owned by the government, and the government must be held to the same standard as any other surface owner. *Id.* at 532-33.

- The court concluded that although DCNR may *seek* additional conditions because of its duty to protect state parks, it does not have the authority to *impose* additional conditions unilaterally without compensation under the Eminent Domain Code. *Id.* at 533.

LEGISLATION

SB 297:

- Amends the Oil and Gas Act. Provides for well reporting requirements regarding the amount of production. Provides for the Marcellus Shale formation. **Provides that the department shall make the reports available on its publicly accessible Internet website.**
- 15 sponsors

HB 1489:

- Amends the Taxation and Fiscal Affairs Code. **Imposes a tax on the extraction of natural gas.** Provides for natural gas severance registration certificate, for duties of the Department of Revenue, for tax assessments and tax liens. Imposes penalties. Provides for service of process, for rulemaking, for cooperation with other governments and for bonds. Makes an appropriation.
- This bill passed the house in May.

HB 977:

- Amends the Oil and Gas Conservation Act. Provides for definitions and for applicability. Provides that any oil or gas well that penetrates the Marcellus Shale horizon and the Onondaga horizon shall be subject to the requirements of this act that pertain to the unitization of lands for well spacing and the protection of correlative rights. Prohibits a well operator from horizontal drilling through any lands where an oil or gas lease does not exist between a landowner and operator.
- 30+ sponsors

- **HB 1205:**
- Amending Oil and Gas Act, to provide additional protections of water supplies.
- 20+ sponsors.

- **HB 934:**
- An Act amending the Oil and Gas Act, providing for secured meters; and further providing for well reporting requirements.
- 20+ sponsors

- **SB 298, HB 1394, HB 894**
- These amendments would allow for gas and oil development on “Clean and Green” land (farmland), with minimal roll-back tax consequences.

• **HB 1155:**
• An Act providing for duties of oil and gas well operators, additional notice of operations and surface use and compensation agreement, entry without surface use and compensation agreement, restriction on issuance of permits for wells, attorney fees and costs and for emergency situations.
• 20 sponsors.

• **HB 532:**
• Amends criminal code to make it a crime to talk on the phone while pumping gas.
• 9 sponsors.

QUESTIONS?
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