Leases, Language, and Litigation:
A Ten-Year Retrospective on the Evolution of Leasing in Appalachia

Kelly O'Bryan da Mota,[1] Christopher W. Rogers, and Kenneth J. Witzel[2]

INTRODUCTION

Historically, Pennsylvania, West Virginia, and Ohio have all experienced periodic episodes of heightened oil and gas activity, each of which has sparked litigation and presented courts with new questions about matters such as oil and gas ownership, leasing, and production. The emergence of the Marcellus and Utica as viable sources of oil and gas production in the middle and late 2000s brought with it leasing and development at levels unprecedented in both volume and value. It has also given rise to a host of new legal questions, many arising from new technologies required to produce oil and gas from shale formations and oil and gas lease language and provisions never before seen. In short, the Marcellus and Utica brought with them an infusion of money, fighting, and unanswered questions—the perfect formula for litigation.

OVERVIEW

The purpose of this presentation and this paper is to summarize the key cases in Pennsylvania, West Virginia, and Ohio issued over the past ten years (2009-2019) that have impacted oil and gas leasing as part of a retrospective on the lessons learned in obtaining leases, handling lease disputes, and changes and revisions that could be made to lease language. Rather than simply listing the cases chronologically, each case has been placed into one of the following categories: (1) negotiation and lease acquisition; (2) lease busting and continuous operations; and (3) royalty payments and pooling. They represent a distillation of the common areas of dispute

[1] Kelly is the founder and President of Cimmaron Land, Inc. with offices located in Bridgeville, Pennsylvania.

[2] Chris and Ken are attorneys in the Pittsburgh office of Frost Brown Todd LLC. They would like to thank Samantha Crawford, Project Assistant, for her valuable assistance in preparing these materials.

primarily at issue in the forty or so cases we will cover. Some cases obviously fit into more than one category, but for purposes of keeping things simple, each case gets only one classification.

<u>TABLE OF CASES</u>

Lastly, the disclaimers.[3]

[3] These materials represent the authors' opinions and should not be taken or used as a conclusive legal analysis. The significance of any case to a particular set of circumstances requires a separate analysis and will be greatly affected by variations in facts and nuances that simply cannot be covered in this presentation and paper. Further, these materials do not constitute a definitive and/or comprehensive list of every case that impacted leasing and/or that dealt with oil and gas between 2009 and 2019. Instead, this paper and presentation is a survey of the cases from the past ten years that, in the authors' opinions, were the most significant for purposes of the language and provisions of oil and gas leases. We hope you find it a useful and informative resource.

I. NEGOTIATION AND LEASE ACQUISITION

A. <u>Pennsylvania</u>

1. *Butler v. Charles Powers Estate*, 620 Pa. 1, 65 A.3d 885 (Pa. 2013)

The initial step of determining *who* owns the oil and gas you want to lease seems easy enough, but for new companies operating in the Commonwealth of Pennsylvania, title to oil and gas always had to account for the *Dunham* rule. The *Dunham* rule holds that there is a rebuttable presumption that an exception and reservation of "minerals" does not include the oil and gas. *See Dunham & Shortt v. Kirkpatrick*, 101 Pa. 36 (Pa. 1882). Such an exception and reservation is presumed to be limited to metallic substances unless otherwise specified/evidenced. The continued validity of the *Dunham* rule—and countless determinations of title based upon it—was targeted in *Butler*, where the plaintiff argued that ownership of the shale minerals containing gas includes ownership of the gas itself. This is similar to the concept of ownership of coal-bed methane and coal from *United States Steel Corporation. v. Hoge,* 503 Pa. 140, 468 A.2d 1380 (1983). However, because the deed at issue in *Butler* involved a reservation of minerals—not of "oil and gas"[4]—this interpretation was contingent upon overturning the validity of the *Dunham* rule. *See Butler*, 620 Pa. 1, 17, 65 A.3d 885, 895. Choosing not to upend well over a century of title and jurisprudence reliant upon *Dunham*, the Pennsylvania Supreme Court confirmed the continued efficacy of the rebuttable presumption that "minerals" does not include oil and gas (the Dunham rule). *Butler* confirmed that *Dunham* remains the law of Pennsylvania. *Butler*, 620 Pa. 1, 19–20, 65 A.3d 885, 896 ("The *Dunham* progeny has been unwavering in its clarity that, absent the terms 'oil' or 'natural gas' being included within a reservation for mineral rights within a

[4] The specific reservation was "one-half the minerals and Petroleum Oils ... together with all ... appurtenances, ... issues and profits thereof...." *Butler*, 620 Pa. 1, 17, 65 A.3d 885, 894.

private deed, oil or natural gas simply are not encompassed within the reservation without clear and convincing parol evidence produced by the proponent of the reservation to the contrary").

2. *Anadarko Petroleum Corp. v. Commonwealth*, No. 58 C.D. 2018 (Pa. Cmmw. Ct. Mar. 15, 2019)

Pennsylvania's Attorney General initiated the proceedings in *Anadarko Petroleum* by filing a complaint in the Bradford County Court of Common Pleas in December 2015.[5] In May 2016, the Attorney General filed a Second Amended Complaint that raised claims against Chesapeake Energy Corp., Anadarko Petroleum Corp., and various entities related to each of them (Chesapeake Energy Corp. and its related entities are collectively referred to as "Chesapeake," and Anadarko Petroleum Corp. and its related entities are collectively referred to as "Anadarko"). As explained by the Commonwealth Court, the Second Amended Complaint alleged that Chesapeake and Anadarko "agreed to split the portion of 'northeast Pennsylvania within the Marcellus Shale gas play' between them, so that [they] would each effectively have exclusive areas in which to seek mineral rights leases, without the fear that the other would tender competing offers to private landowners who were prospective lessors."[6] With that general backdrop, the Second Amended Complaint advanced six claims:

> **Count I –** alleged that Chesapeake violated the UTPCPL by taking "inflated deductions for post-production costs" from royalty payments, and by "engaging in deceptive and misleading practices in connection with [their] lease obligations with those landowners."
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> **Counts II and VI –** alleged that Chesapeake (Count II) and Anadarko (Count VI) violated the UTPCPL "by misrepresenting the applicability of deductions and the meaning of the Market Enhancement Clause," causing the landowners to believe that they were signing leases free of deductions.

[5] *See Commonwealth of Pennsylvania v. Chesapeake Energy Corp.*, No. 2015IR0069 (Bradford Cty. Dec. 15, 2017) [hereinafter, the "Trial Court Opinion"], at 2.

[6] *Anadarko Petroleum*, 2019 WL 1211892, at *1.

> **Count III –** alleged that Chesapeake and Anadarko violated the UTPCPL by participating "in a joint commercial venture aimed at allocating exclusive areas of operation within geographic areas of mutual interest to one or the other of them," which had "the effect of denying Pennsylvania landowners the benefit, inherent in a freely competitive marketplace, of the exercise of individual choice in the acquisition of oil and gas leases, and depriving those landowners of their freedom to meaningfully choose otherwise available market options." Count III further claimed that in "engaging in" the joint venture, the defendants "acted in restraint of trade or commerce in the oil and gas lease acquisition market by fixing, controlling, and/or maintaining at artificial and non-competitive levels, the acreage signing bonus and the royalties to be paid to Pennsylvania landowners."
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> **Count IV –** alleged that Chesapeake and Anadarko, as "Joint Venture Defendants," violated the UTPCPL "by unfairly and deceptively misrepresenting the presence or absence of competition for the acquisition of oil and gas leases, and by representing to" landowners that acreage signing bonuses and royalties they had been offered were "competitive and fair."
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> **Count V –** alleged that Chesapeake and Anadarko violated "the Pennsylvania antitrust common law prohibiting restraint of trade by engaging in an unfair and deceptive joint marketing venture, viz., allocating to each other the option to acquire interests in oil and gas leases already secured by one or the other of them within a particular allocated territory."[7]

Chesapeake and Anadarko filed preliminary objections to the Second Amended Complaint. The trial court issued an 82-page opinion in which it reached two pertinent conclusions. First, the UTPCPL authorizes the Attorney General to bring legal actions against oil and gas operators for "allegedly engaging in unfair acts or practices in connection with the purchase of oil and gas leases from private landowners[.]"[8] In reaching this conclusion, the trial court rejected the defendants' argument that purchasing oil and gas leases from Pennsylvania landowners did not constitute "trade" or "commerce" under the UTPCPL because those terms only apply to "sellers," and Chesapeake and Anadarko were the "buyers" with respect to the leases at issue. Second, the trial court held that common law antitrust violations, such as those averred in Counts III and IV of the

[7] Trial Court Opinion, at 4-6.

[8] *See id.* at 16-33; *see also Anadarko Petroleum*, 2019 WL 1211892, at *2 (discussing the Trial Court Opinion).

Second Amended Complaint, could give rise to actionable claims by the Attorney General under the UTPCPL.[9]

The trial court certified the two issues discussed above for immediate appeal to the Commonwealth Court.[10] Chesapeake and Anadarko promptly petitioned the Commonwealth Court for permission to take an immediate appeal. The Commonwealth Court granted the petitions and framed the issues to be considered, as follows: (1) whether a cause of action may be brought under the [UTPCPL] for alleged wrongful conduct by lessees in oil and gas lease transactions; and (2) whether a cause of action may be brought under the [UTPCPL] for alleged antitrust violations.[11]

The Commonwealth Court majority found that appellants' leasing activities fell within the UTPCPL's definition or "trade" and "commerce."[12] The Commonwealth Court majority also found that the second clause of the definition of "trade" and "commerce" was not intended to be limited in scope by its first clause.[13] In other words, the court divided the definition into two clauses, like so:

> [T]he advertising, offering for sale, sale or distribution of any services and any property, tangible or intangible, real, personal or mixed, and any other article, commodity, or thing of value wherever situate // and includes any trade or commerce directly or indirectly affecting the people of this Commonwealth.

[9] *See* Trial Court Opinion, at 47-50; *see also Anadarko Petroleum*, 2019 WL 1211892, at *2 (discussing the Trial Court Opinion).

[10] Trial Court Opinion, at 73-75. The appeal was properly taken to the Commonwealth Court, as the proceedings were brought by the Pennsylvania Attorney General. *See* 42 Pa. C.S.A. § 762(a)(1).

[11] *Anadarko Petroleum*, 2019 WL 1211892, at *2.

[12] *Id.* at **4-5.

[13] *Id.* at *4.

It then found that the second clause should be read independently from the first clause.[14] Thus, the majority held that "trade" and "commerce" under the UTPCPL was broad enough to include "any trade or commerce directly or indirectly affecting the people of this Commonwealth[,]" without limitation.[15] Next, although the terms "trade" and "commerce" are expressly defined in the UTPCPL, the majority consulted definitions of "trade" and "commerce" contained in Merriam-Webster's Dictionary.[16] Noting that those definitions include both "buying" and "selling[,]" the court held that Anadarko's and Chesapeake's leasing activities were within the definition of "trade" and "commerce" under the UTPCPL and that the trial court "properly overruled Appellants' demurrers that their behavior in securing these leases was not actionable under the UTPCPL."[17]

In terms of impact on leasing, the significance of *Anadarko Petroleum* and the Pennsylvania Attorney General's ongoing lawsuit should not be underestimated. Under *Anadarko Petroleum*, any misrepresentations or misleading statements to landowners during lease negotiations have the potential to lead to future UTPCPL claims.[18] This is significant because two of the Counts *not* addressed in *Anadarko Petroleum* (Counts II and VI) do not depend on the

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[14] *Id.* at **4-5.

[15] *Id.*

[16] *Anadarko Petroleum*, 2019 WL 1211892, at *4.

[17] *Id.* at **5-6. The Commonwealth Court did not address whether Count I of the Second Amended Complaint, which alleges that Chesapeake violated certain lease obligations to lessors after they entered into leases, as the claim was beyond the scope of the issues being considered on appeal.

[18] Although not directly addressed in *Anadarko Petroleum*, the Second Amended Complaint includes two leasing-related UTPCPL counts, Counts II and VI, that are not based on alleged antitrust violations. They allege that Chesapeake and Anadarko each "misrepresented the applicability of deductions and the meaning of the Market Enhancement Clause" in their leases, causing landowners to believe they were signing leases free of deductions for post-production costs.Trial Court Opinion, at 4-6 (summarizing Counts II and VI of the Second Amended Complaint).

existence of alleged antitrust activity between two or more operators,[19] but are instead founded on a single operator's alleged misrepresentations to landowners during lease negotiations. Additionally, claims under the UTPCPL are not subject to the same rules and defenses as traditional breach of contract claims. For example, when a landowner alleges that a landman made representations to them concerning the terms of their lease that are inconsistent with the lease's actual terms, the lessee is often able to rely on the parol evidence rule to prevent evidence of pre-execution representations from being considered by the court.[20] But the parol evidence rule will not provide a defense to a UTPCPL claim, and the landowner's testimony could form the basis for a viable UTPCPL claim.

Although *Anadarko Petroleum* is ongoing and the Pennsylvania Supreme Court could still change it – Chesapeake and Anadarko have filed Petitions for Allowance of Appeal with the Supreme Court of Pennsylvania, which are currently pending – *Anadarko Petroleum* is currently the law of the land.[21]

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[19] For further discussion on antitrust matters relating to oil and gas leasing activities, *see* Matthew C. Blickensderfer, Kenneth J. Witzel, Michael D. Brewster, Jeffrey P. Kramer, *What Do You Mean We Can't Do That? Antitrust Law Implications for Upstream Joint Development Arrangements*, 39 Energy & Min. L. Inst. Chapter 8.

[20] *See, e.g.*, *Yocca v. Pittsburgh Steelers Sports, Inc.*, 854 A.2d 425, 436–37 (Pa. 2004) ("Once a writing is determined to be the parties' entire contract, the parol evidence rule applies and evidence of any previous oral or written negotiations or agreements involving the same subject matter as the contract is almost always inadmissible to explain or vary the terms of the contract."); *Willison v. Consolidation Coal Co.*, 637 A.2d 979, 982 (Pa. 1994) ("It is well established that the intent of the parties to a written contract is to be regarded as being embodied in the writing itself, and when the words are clear and unambiguous the intent is to be discovered only from the express language of the agreement."). While fraud in the execution creates an exception to the parol evidence rule, fraud in the inducement – *e.g.*, evidence that a landman made a false representation that induced the landowner to enter into a lease – does not. *See Yocca*, 854 A.2d at 437 n.26.

[21] For additional background and analysis of *Anadarko Petroleum*, *see* Kenneth J. Witzel & Christopher W. Rogers, *Beware the Ides of March – Pennsylvania's Commonwealth Court Allows Attorney General to Pursue Claims relating to Oil and Gas Leasing Activities under the Unfair Trade Practices and Consumer Protection Law*, which has been accepted for publication in The Energy Law Advisor, and can be found at https://www.frostbrowntodd.com/resources-PA-Court-Allows-AG-Pursue-Oil-gas-activity-claims.html.

3. *Shedden v. Anadarko E. & P. Co., L.P.*, 635 Pa. 381, 136 A.3d 485 (2016)

In *Shedden v. Anadarko E. & P. Co., L.P.*, 136 A.3d 485 (Pa. 2016), the Sheddens leased 62 acres of land through an oil and gas lease that contained a covenant of warranty (i.e. a general warranty). *Id*. at 487. The Sheddens were later informed that they only owned 31 acres of oil and gas underlying his land, and were paid a bonus based upon 31 acres instead of 62.[22] *Id.* Two year later, the Sheddens successfully quieted title to the outstanding 31 acres, but subsequently refused to accept Anadarko's extension payment on the ground, which reflected their full ownership. *Id*. The Sheddens brought a declaratory judgment action seeking a declaration that the lease only covered 31 acres, which the trial court decided in favor of Anadarko on summary judgment. *Id.* at 488. On appeal, the Superior Court of Pennsylvania affirmed the trial court's order in favor of Anadarko. *Id.* at 488-89. On appeal from the Superior Court, the Supreme Court of Pennsylvania affirmed, describing estoppel by deed as follows:

> the doctrine of estoppel by deed precludes one who conveys an interest in land that he does not own, but subsequently acquires the title thereto, from denying the validity of the first conveyance.
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> While the doctrine of estoppel by deed is rooted in equity, its considerations are broader:
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> The principle is that when a person has entered into a solemn engagement by deed, he or she will not be permitted to deny any matter that he or she has asserted therein for a deed is a solemn act to any part of which the law gives effect as the deliberate admission of the maker; to him or her it stands for truth, and in every situation in which he or she may be placed with respect to it, it is true as to him or her. Estoppel by deed promotes the judicious policy of making certain formal documents final and conclusive evidence of their contents.

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[22] "Anadarko sent Appellants a Lease Purchase Report and an Order of Payment reflecting a bonus payment of $80 per acre on 62 acres, totaling $4,960. Prior to tendering the bonus payment, however, Anadarko's land agent discovered the Baxters' 1894 reservation of one-half of the oil and gas rights to the Property, and informed Appellants that Anadarko would pay a bonus on only 31 of the 62 acres. Thereafter, Anadarko sent Appellants a revised Order for Payment, describing the subject Property as "a tract of land containing 62.00 gross acres, 31.00 net acres," and indicating that, as consideration for the agreement, Anadarko would pay Appellants a total of $2,480. Order for Payment (R.R. at 19a). Appellants did not sign the revised Order for Payment, but subsequently accepted Anadarko's payment of $2,480." *Shedden*, 635 Pa. 381, 385–86, 136 A.3d 485, 487 (2016)

Shedden 136 A.3d at 492. Applying this principle, the *Shedden* court held:

> [a]ppellants conveyed, through a lease, the oil and gas rights to the Property, expressly warranting their full title to all the oil and gas therein. After discovering that they owned less than all of the oil and gas rights to the Property, Appellants filed a motion to quiet title to the one-half interest in the oil and gas rights to the Property, ultimately perfecting their title to all of the oil and gas rights to the Property. Under the doctrine of estoppel by deed, Appellants may not deny the validity of their initial conveyance to Anadarko of all of the oil and gas rights to the Property.

Id. at 493.

Shedden highlights the effect that general warranty of title, proportionate reduction, option to extend primary term, and order of payment language can have on the validity of a lease and payment obligations even where there is a partial title failure and a subsequent acquisition of that by the lessor.

4. ***Humberston v. Chevron U.S.A., Inc.*, 2013 PA Super 238, 75 A.3d 504 (2013)**

Does relatively standard leasing clause language include the right for a lessee to construct an 11-acre freshwater impoundment for use in wells on the property? In *Humberston*, the Pennsylvania Superior Court reviewed this very question.

Briefly, the plaintiffs owned 133 acres in Fayette County, Pennsylvania and in 2006 leased it to Keeton Group, LLC, who assigned its interest in the lease to Chief Exploration & Development LLC, who then assigned it to the defendant, Chevron. *Humberston* 75 A.3d 504, 506. The lease contained, in part, the following leasing clause:

> *LEASING CLAUSE:* Lessor hereby leases exclusively to Lessee all the oil, gas and coal bed methane and their constituents, whether hydrocarbon or non-hydrocarbon, underlying the land herein leased, **together with such exclusive rights as may be necessary or convenient for Lessee, at its election, to explore for, develop, produce, measure, and market production from the Leasehold, and from adjoining lands, using methods and techniques which are not restricted to current technology,** including the right to

> conduct geophysical and other exploration tests; to drill, maintain, operate, cease to operate, plug, abandon, and remove wells; to use or install roads, electric power and telephone facilities, and to construct pipelines with appurtenant facilities, including data acquisition, compression and collection facilities **for use in the production and transportation of products from the Leasehold and from neighboring lands across the leasehold,** and such right shall survive the term of this agreement for so long thereafter as operations are continued, to use oil, gas, and non-domestic water sources, free of cost, to store gas of any kind underground, regardless of the source thereof, including the injection of gas therein and removing same therefrom, to protect stored gas, to operate, maintain, repair, and remove material and equipment.

Id. at 507 (emphasis in original). The lease also included a unitization provision. *Id*. On July 17, 2010, Chief entered into a separate surface damage agreement with the plaintiffs whereby Chief paid $10,000 for any and all surface damages which may result from the location from operations performed by Chief, etc. within the initial impacted area, which was described as being no more than seven acres. *Id.* at 508. In January of 2011, Chief sought a surface lease for a freshwater impoundment on the property, but no agreement was entered into. *Id.* Subsequently, Chevron, via its contractor, Keystone, constructed a freshwater impoundment on an 11-acre area of the property without any separate agreement. *Id.* at 506. The impoundment serviced the wells located on the property and other wells within the unit (the Humberston Unit). Plaintiffs filed suit to quiet title and for trespass, claiming in essence, that Chevron had no right to construct an impoundment. *Id.* at 506-07. Chevron filed preliminary objections arguing that the complaint did not set forth a claim because the lease expressly allowed Chevron to utilize the surface as necessary for its operations. *Id.* at 508.

The trial court agreed with Chevron and Keystone and dismissed the complaint. *Id.* On appeal, the Superior Court affirmed, agreeing with the trial court that the language of the lease (quoted above) and Pennsylvania law "allow for the use of the surface area of the property as is reasonably necessary or convenient to develop the natural gas under the Humberstons' property and that of property constituting the Humberston Unit." *Humberston* 75 A.3d 504, 512. The court rejected the plaintiffs' argument that the surface damage agreement excluded the ability for a freshwater impoundment because it did not incorporate the lease. Likewise, it rejected the argument that the unexecuted surface agreement barred it since that was for an impoundment to service wells outside the Humberston Unit. *Id*. at 512-13. Lastly, the court rejected the argument that hydraulic fracturing, and the high volume of water required for it, was not contemplated at the time of the lease in 2006, pointing out the technique had been around for quite a while and the lease language expressly provided that it was not limited to current technology. *Id.* at 513.

Humberston once again confirms the importance of lease language versus a broad belief or understanding as to what is permitted. And while constructing an 11-acre freshwater impoundment purely under the surface rights granted in the lease may represent the outer limit of surface rights, it serves as a reminder that companies should be aware that they may already have the rights they seek to obtain through a separate surface use agreement, etc.

B. West Virginia

1. *Barber v. Magnum Land Servs., LLC,* CIVIL ACTION NO. 1:13CV78 (N.D.W. Va. Oct. 14, 2014)

In 2007 and 2008, Magnum Land Services, LLC acquired leases covering approximately 8,000 acres. Per its agreement with Belmont Resources the company then assigned those leases to Belmont Resources in 2010, who later that same year, sold its interest to Enerplus Resources, realizing a gross profit of about $1666 per acre. After signing leases with Magnum, several of the landowners got word that landowners in surrounding counties were signing leases with much higher bonus payments. In their discussions amongst one another, the landowners learned that in their sales pitches, the landmen had advised them that oil & gas companies could still collect gas under non-leased acreage by drilling wells on neighboring properties.

The lessors brought suit, alleging that the leases were unconscionable and that they were fraudulently induced to sign them to their detriment as a result of inaccurate representations made to them by the landmen. On July 3, 2014, the lessors moved for summary judgment, and the United States District Court for the Northern District of West Virginia dismissed the claim of fraud in the inducement, stating that the lessors were not justified in relying on the landmen's blatant misrepresentation of the law. *Barber v. Magnum Land Servs.,* LLC, CIVIL ACTION NO. 1:13CV78 (N.D.W. Va. Oct. 14, 2014). The court went on to state that "It is unreasonable to believe that the law would permit gas companies to drill into anyone's land and take that person's gas without his or her permission. Even if one did believe that the law permits such conduct, it is even more unreasonable to believe that gas companies would spend money on leases unnecessarily. Finally, no reasonable person would accept such a representation as true and sign the lease without first looking into the validity of the statement or consulting someone knowledgeable in the oil & gas field." *Id.* Furthermore, the court held that the leases were not unconscionable because 1/8 royalty payments are standard within the oil and gas industry and no *per se* inequity results just because a company's profits do not bear a certain proportional relationship to its purchase costs. *Id.*

Although the court dismissed the claims, in its discussion regarding whether the leases were unconscionable, it noted that during the time in question, Magnum was the only company offering to lease the plaintiffs' mineral rights, and that regardless of the statements made, the lessors only had the options to refuse to lease or to lease and accept the bonus payment offered. The outcome may have been different had other companies been leasing in the area and offering higher bonus payments at the same time. Landmen should take care not to make fraudulent statements when negotiating oil & gas leases.

2. *Cunningham Energy LLC v. Ridgetop Capital II, LP,* Civil Action No. 5:13-CV-78 (BAILEY) (N.D.W. Va. Jan. 9, 2015)

In *Cunningham*, the parties entered into leases on June 22, 2011 and August 1, 2011, whereby Cunningham Energy paid Ridgetop Capital in accordance with provisions providing for a delay rental of $400 per net mineral acre per year. *Cunningham Energy LLC v. Ridgetop Capital II, LP*, Civil Action No. 5:13-CV-78 (BAILEY) (N.D.W. Va. Jan. 9, 2015). Additionally, they contained provisions in which Cunningham committed to drill two horizontal Marcellus Shale wells within 24 months of the effective date of the lease. If it appeared that gas was present in commercial quantities, Cunningham agreed to drill two additional horizontal wells within 12 months of the completion of the initial wells. The leases also provided that "If at any time within 30 days of the expiration of the Lease's primary term…Lessor should receive a bona fide, acceptable offer to grant an additional lease ('Top Lease') for all or part of the subject premises, Lessor shall grant Lessee the option of meeting the terms and conditions of said offer… Any Top Lease granted by Lessor in violation of this provision shall be null and void." Because units typically encompass approximately 640 acres of land, and the subject land only contained 191 acres, it was intended by both parties, but not memorialized within the leases, that Cunningham would acquire additional acreage to create an appropriately sized unit. However, Cunningham was unable to secure additional acreage and approached Ridgetop to request an extension of time or rescission of its commitment. Ridgetop denied the request, and Cunningham began to prepare to drill the tracts. On March 26, 2013, it hired an engineering firm to prepare its well permit applications and submitted its first application on June 14, 2013. On June 16, 2014, the application was returned by the West Virginia Department of Environmental Protection because it was missing its required performance bond. On July 1, 2013, Ridgetop sent Cunningham a notice of forfeiture indicating that one of the leases was cancelled due to Cunningham's failure to satisfy its commitment. On July 19, 2012, Ridgetop executed a top lease, leasing the tracts to JB Exploration I, LLC. Ridgetop did not inform Cunningham of the top lease or offer the company the option of meeting the terms and conditions of JB Exploration's offer. Ridgetop and JB Exploration agreed to terminate the top lease, but then on September 20, 2013, they executed a second top lease. Again, Ridgetop did not inform Cunningham of the top lease or extend the company a first right of refusal.

Cunningham brought suit on June 24, 2013, seeking a declaratory judgment that the leases between Cunningham and Ridgetop were valid and in effect. The court ordered that the leases remain valid, held that the plaintiff breached the drilling commitment, and declared Ridgetop's top lease with JB Exploration to be invalid. *Id.* Ridgetop filed a counterclaim, alleging that Cunningham (i) committed fraud and (ii) made false representations by stating that the oil and gas covered by the subject leases would be diligently developed and that two horizontal Marcellus Shale wells would be drilled within the first 24 months of the leases and an additional two wells on each lease would be completed within 12 months after the completion of the first wells. *Id.* Specifically, as it related to the fraud claim, Ridgetop claimed that Cunningham failed to fulfill its promise to drill the wells and failed to research the land surrounding the leased premises to determine if it was available to be leased. However, the court stated that failing to properly plan does not amount to fraud and that the record did not support that Cunningham knew at the time of the execution of the leases that it would not be able to drill the wells. *Id.* Regarding the claim of negligent misrepresentation, Ridgetop claimed that Cunningham should have known that it would not have been able to drill the requisite wells on the leased premises. However, the court noted that a plaintiff "cannot maintain an action in tort for an alleged breach of a contractual duty" absent a special relationship between the parties. Ridgetop failed to prove that Cunningham had a special relationship which created a duty grounded in tort and the court therefore granted Cunningham's request for summary judgment. *Id.*

If a landman or other company representative makes a material statement to a landowner which he or she knows to be untrue, or should have known to be untrue, and the landowner relies upon it, the company may be liable for fraudulent misrepresentation.

3. *EQT Prod. Co. v. Crowder*, No. 17-0968 (W. Va. Jun. 5, 2019)

At the time of the lease in question in *Crowder*, back in 1901, the lessors, Crowder and Wentz, owned a fee simple interest in a 351-acre tract. *EQT Prod. Co. v. Crowder*, No. 17-0968 (W. Va. Jun. 5, 2019). Several years later, they then sold the surface, but reserved the minerals under the tract. The surface was then partitioned into several smaller parcels. About 8 years ago, the mineral owners signed an amendment, allowing pooling & unitization, and EQT drilled wells on some of the surface tracts, that were originally a part of the 351 acres, that would extract gas from the 3,232-acre unit.

The plaintiffs, who were the owners of the above-referenced surface tracts, brought suit, claiming trespass, and arguing that EQT only had the right to extract gas from the mineral estate beneath their surface lands. The case eventually made it to the Supreme Court of West Virginia, who held that "A mineral owner or lessee has an implied right to use the surface of a tract in any way reasonable and necessary to the development of minerals underlying the tract. *Id.* However, a mineral owner or lessee does not have the right to use the surface to benefit mining or drilling operations on other lands, in the absence of an express agreement with the surface owner permitting those operations." *Id.*

An express agreement with the surface owner is needed in order to conduct surface operations on a tract when the operations will lead to the development of minerals other than only those underlying the surface tract.

C. <u>Ohio</u>

1. *Dundics v. Eric Petroleum Corp.*, 155 Ohio St.3d 192, 2018-Ohio-3826, 120 N.E.3d 758 (2018) and R.C. 4735.01(I)(h) and 4735.023

On September 25, 2018, the Supreme Court of Ohio issued its decision in *Dundics v. Eric Petroleum Corp*¸ Slip Opinion No. 2018-Ohio-3826, holding, in essence, that the activities of oil and gas land agents negotiating and acquiring oil and gas leases constitute the activities of real estate brokers, which require a real estate brokers license pursuant to Chapter 4735 of the Ohio Revised Code. In that case, the Plaintiff (Thomas Dundics and his company, IBIS Land Group, Ltd.) in 2010 had entered into an agreement with Eric Petroleum Corp. ("Eric") to acquire oil and gas leases for Eric in exchange for compensation. *Dundics* at ¶ 2. When Eric did not pay as to certain leases, the Plaintiff brought a lawsuit against Eric to enforce the agreement and force payment. *Id*. Eric defended, arguing that Dundics could not bring a cause of action to recover payment because he was not a licensed real estate broker, and R.C. 4735.21 expressly precluded such an action for compensation unless the individual was licensed. *Id*., ¶ 3. The argument centered on whether oil and gas leasing was intended to be included in the statute's expansive definition of "real estate" for defining the activities of a real estate broker. *Id*., ¶¶ 8-10. The trial court held that it did and dismissed Plaintiff's lawsuit and the appeals court (the Seventh District Court of Appeals) agreed with the trial court's decision. *Id*., ¶¶ 4-5. The Ohio Supreme Court likewise agreed. In short, the *Dundics* Court observed that although the statute contains specific exceptions, it was not ambiguous and there was no express exception for oil and gas leasing. *Id.*, ¶ 11-12. As such, oil and gas leases were included in the definition of "real estate" and the activities of land agents negotiating those leases were the activities of real estate brokers. The Court was not persuaded that oil and gas leases are not real property, in light of R.C. 5301.09 (recording statute recognizing leases as real estate), nor the history of landmen working in Ohio. *Dundics* at ¶¶ 13-14. Although not referenced in *Dundics*, engaging in real estate broker activities without a license is a first-degree misdeameanor. *See* R.C. 4735.99.

Only a few months after the *Dundics* decision was handed down, Governor Kasich signed into law an amendment to the real estate broker statute that carved out oil and gas land professionals from the definition of oil and gas leasing activities from the definition of "real estate broker" etc. *See* R.C. 4735.01(I)(h). Importantly, however, the carve out is specifically limited to leasing and right-of-way activities; individuals involved in the purchase and sale of fee minerals are still considered real estate brokers and therefore must comply with the statute. *See id*. Further, oil and gas land professionals must still register annually with the superintendent of real estate and pay an annual fee. R.C. 4735.23.

Although *Dundics* did not have the detrimental effect many feared, it sent a shockwave through the oil and gas industry and functioned as a wake-up call. To be certain, other states, including Pennsylvania, have statutes very similar to Ohio's real estate broker's statute, which could result in a decision similar to *Dundics*. *See* 63 Pa. Stat. Ann. § 455.101 *et seq*. (West).

2. ***Alford v. Collins-McGregor Operating Co.*, 152 Ohio St.3d 303, 2018-Ohio-8, 95 N.E.3d 382 (2018)**

On January 3, 2018, in a 6-1 decision in the case of *Alford v. Collins-McGregor*, Slip Opinion No. 2018-Ohio-8, the Ohio Supreme Court answered a resounding **NO** to the question of whether Ohio recognizes a separate implied covenant to explore further. That is, when a lessee/operator is reasonably producing a shallow formation (e.g. the Gordon Sandstone formation) on a lease with no specific provisions regarding number of wells or formations to be produced, Ohio **does not** imply a further requirement on the lessee/operator to explore deeper formations (e.g. the Utica Shale).

Alford involved a 1980 lease that contained no specific provisions regarding the number of wells, the formations to be produced, and contained no express disclaimer of implied covenants. *Alford*, ¶¶ 4, 14. One well was drilled in 1981 into the Gordon Sand formation—a shallow formation. *Alford*, ¶ 5. That well had been productive from inception to present. No additional wells were drilled, nor was any exploration done into the deep formations such as the Utica or Marcellus Shale. *Id.* The Landowners (the lessors of the 1981 lease), seeing activity in the Utica Shale on nearby property, sued, claiming Collins-McGregor Operating Company (the lessee of the 1981 lease) breached the implied covenant of further exploration because it failed to explore deeper formations. *Alford*, ¶¶ 5, 6. As a remedy, the Landowners sought termination of the lease as to these deep formations to allow them to lease (a "partial horizontal forfeiture" of the lease). *Alford*, ¶ 6. Collins-McGregor moved to dismiss the complaint and the trial court agreed, holding that the lease was valid per its plain terms. *Alford*, ¶ 8. The Fourth District Court of Appeals agreed, holding that Ohio law does not recognize partial horizontal forfeiture as an available form of relief. *Id.*

In affirming the Fourth District Court of Appeals, the Supreme Court of Ohio held that whether a lessee/operator must explore additional formations is subsumed by the implied covenant of reasonable development, which Ohio has long recognized. *Alford*, ¶¶ 17, 23. Because this implied covenant better accounts for the overall circumstances, the interests of both the lessor and lessee, and overall profitability of development, there is simply no need to recognize a separate implied covenant of further exploration. *Alford*, ¶¶ 22, 23.

This decision serves as critical confirmation of the basic premise upon which millions of acres of deep leasehold rights have been acquired in eastern Ohio: that a well producing from a shallow formation generally holds the entire lease as to all depths. However, before a producer takes solace in the *Alford* decision, a thorough review of the terms of the lease at issue must be undertaken, as this case, like all cases dealing with lease interpretation, turn on the specific words used in the lease.

Alford could very well have been included in the Lease Busting and Continuous Operations category, but it has been included here because the outcome was dependent upon the language of the lease itself. It drives home the point that courts generally try their hardest to give effect to the words included in the agreement/lease. The issue in *Alford* could have been avoided through inclusion of a simple sentence specifying that the lease was not severable and production in paying quantities from any formation holds the as to all formations.

3. *Corban v. Chesapeake Exploration, L.L.C.*, 149 Ohio St.3d 512, 76 N.E.3d 1089 (2016)

No discussion of lease-impacting cases in Ohio can be undertaken without discussing the Ohio Dormant Mineral Act (the "DMA"). And since September 15, 2016, no discussion of the Ohio DMA can be undertaken without discussing *Corban v. Chesapeake Exploration, L.L.C.*, Slip Opinion No. 2016-Ohio-5796, 2016 WL 4887428 (Ohio). Through that case, the Supreme Court of Ohio has affected a tectonic shift in mineral ownership in Ohio.

First, a very brief review of the Ohio Marketable Title Act ("MTA") and the DMA.[23] The MTA, R.C. 5301.47-5301.56, operates to remove old claims or interests on land. In particular, it

[23] The Ohio Supreme Court decided 13 other cases on the basis of *Corban*. However, a discussion of all of these cases and the changes *Corban* has and will cause is well beyond the scope of this topic. A simple Google search will lead the reader to articles and blogs to fill this void.

defines "'marketable record title' as a 'title of record, as indicated in section 5301.48 of the Revised Code, which operates to extinguish such interests and claims, existing prior to the effective date of the root of title * * *.' A 'root of title' is defined in subsection (E) as 'that conveyance or other title transaction in the chain of title of a person, upon which he relies as a basis for the marketability of his title, and which was the most recent to be recorded as of a date forty years prior to the time when marketability is being determined.'" *Heifner v. Bradford*, 4 Ohio St.3d 49, 446 N.E.2d 440 (1983). However, in the situation of a severed mineral interest with its own chain of title, the MTA alone proved to have limited ability to reunite the same with the surface estate. The *Heifner* case demonstrated this limitation:

> Ohio's Marketable Title Act is taken primarily from the Model Marketable Title Act. In fact, R.C. 5301.49(D) is virtually identical to Section 2(d) of the Model Act. This being the case, we are convinced that the General Assembly and the drafters of the Model Act intended that a title transaction under R.C. 5301.49(D) and Section 2(d), respectively, may be part of an entirely independent chain of title.

Heifner, 4 Ohio St.3d at 51-52 (internal citations omitted). Thus, where a severed mineral interest was demonstrable by chain of title independent of that associated with the surface estate, a conveyance, including a conveyance by will or descent, would operate to preserve the severed mineral estate from abandonment under the MTA: "The Act defines a 'title transaction' to include the passage of 'title by will or descent.' Thus, the 1957 conveyance of the oil and gas rights which passed under the terms of Elvira Sprague's will must be considered a 'title transaction' under R.C. 5301.49(D)." *Heifner*, 4 Ohio St.3d at 51.

In 1989, in a move oft-cited to be the result of the *Heifner* case,[24] the General Assembly amended the Marketable Title Act, R.C. § 5301.57 *et seq*. to provide a method for terminating dormant mineral interests by vesting them in surface owners, absent certain occurrences, within the preceding 20 years, plus a 3-year grace period. *Corban* at 5. The mineral interest "shall be deemed abandoned and vested in the owner of the surface" unless it was coal, held by the United States, the state of Ohio, or other political body described, or was subject to one of six savings events described. *Id*. In 2006, the DMA was again amended to require notice to the severed mineral interest owner and additional procedures in order for the surface owner to merge the mineral interest back into the surface. *Id*. at 7-8. If, after meeting the procedural requirements, the severed mineral interest was not preserved, then a notice of abandonment is to be recorded. *Id*.

Over the years since the enactment of the 1989 DMA and its 2006 amendment, a split of authority among the Ohio Courts of Appeal developed as to whether the abandonment and vesting under the 1989 DMA was automatic, or required action by the surface owner, and whether an action based upon abandonment under the 1989 DMA could be brought after the 2006 amendment.[25] Those familiar with these developments know that the answer to these questions very much would determine ownership of minerals, and for many oil and gas producers that forayed into Ohio, whether they actually leased the minerals. From the perspective of most oil and gas producers and title attorneys, it seemed a foregone conclusion that the 1989 DMA was

[24] "Our interpretation of the MTA in *Heifner* was '[t]he impetus for the creation of the DMA.'" *Corban v. Chesapeake Expl., L.L.C.*, Slip Opinion No. 2016-Ohio-5796, ¶ 61 (Ohio).

[25] The Supreme Court of Ohio also ruled that the 1989 DMA had a fixed 20-year lookback period, as opposed to a "rolling" 20-year lookback, though that is of little consequence in light of the Court's more global ruling that the 1989 DMA cannot apply after June 30, 2006. *Eisenbarth v. Reusser*, Slip Opinion No. 2016-Ohio-5819 (2016).

automatic and could enforced after the 2006 DMA amendment. However, *Corban* proved otherwise.

In *Corban*, the Supreme Court of Ohio ruled that the 1989 DMA was *not* self-executing; surface owners must have brought an action to quiet title in order to merge the severed minerals back with the surface. *Corban v. Chesapeake Expl., L.L.C.*, Slip Opinion No. 2016-Ohio-5796, ¶ 28 (Ohio). Moreover, after the amendment to the DMA on June 30, 2006, *all* claims that a severed mineral estate was abandoned to the surface owner had to meet with the requirements of the 2006 DMA. *Id.* at ¶ 31. That is, even if a surface owner had met the requirements of the 1989 DMA, if that surface owner had not quieted title before June 30, 2006,[26] she could no longer claim under the 1989 DMA, but had to meet the 2006 DMA requirements.

In Ohio, the 1989 DMA provided many surface owners with a claim to title that served as the basis for quiet title actions pending in Ohio courts. Regardless of whether the Supreme Court of Ohio's goal was to clear courts' dockets, the end result is that *Corban* has purged the courts of many quiet title actions. Of course, there is always the likelihood that additional litigation will result to clarify some nuance of the decision, but without question, the 1989 DMA was the foundation for many quiet title actions, and unless the plaintiff also complied with the 2006 DMA, the claim is now dead on arrival. The ripple-effect of *Corban* has been far-reaching, especially for oil and gas companies trying to sort through whether they leased from the right person.

[26] It is not clear to this author precisely what would have to have been done before June 30, 2006 to preserve a claim quieting title under the terms of the 1989 DMA, but it seems that filing the complaint to quiet title would be sufficient.

II. LEASE BUSTING AND CONTINUOUS OPERATIONS

Probably the largest category of the three, when the wave of new leasing opportunities and large bonus payments became a real potential with the Marcellus and Utica, many landowners looked for ways to get out from their existing leases. This is what we fondly refer to as lease busting. And although oil and gas companies view them with disdain, they have provided opportunities to get answers to important questions about lease interpretation and function from courts in the Appalachia states.

A. Pennsylvania

1. *Hite v. Falcon Partners*, 13 A.2d 942 (Pa. Super 2011)

Hite v. Falcon Partners,[27] involved a dispute between lessors and a lessee over whether the primary term of the leases could be extended solely through continued payment of delay rentals—even though the lessee had not "taken any action to actually commence drilling" on the leased properties. The following language was specifically at issue:

> 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 for the Property, whichever shall last occur.[28]

While the above-quoted language appears to favor the lessee's position that the payment of delay rentals could extend the lease beyond its primary term, the court held differently. It held that once the one-year primary terms had expired, the mere payment of delay rentals could not

[27] *Hite*, 13 A.3d 942.

[28] *Id.* at 944.

hold the leases because to do so would deprive the lessor of the benefits of production. The court explained:

> 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 Court, at odds with the presumed intention of the parties in executing the leases in the first place, and in stark contrast to the clear opinions of the courts of Pennsylvania that the obligation to pay delay rentals is intended to spur the lessee toward development.[29]

Hite seems to constitute a rare departure from the principle that the language of the lease is controlling and it is not wholly clear whether it signifies a new direction or will be viewed as an historical anomaly. And even though *Hite* appears inconsistent with the Pennsylvania Supreme Court's opinion in *Jacobs v. CNG Transmission Corp.*, 565 Pa. 228, 772 A.2d 445 (Pa. 2001),[30] it serves as an important reminder that courts remain mindful of the overall purpose of an oil and gas lease: to produce oil and gas.

2. *T.W. Phillips Gas and Oil v. Jedlicka*, 42 A.3d 261 (Pa. 2012)

Production in paying quantities is the near-universal standard by which an oil and gas lease is held beyond its primary term. In the realm of lease busting, the 2012 *Jedlicka* case stands as the

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[29] *Id.* at 928 (quotations and citations omitted). In *Linder v. SWEPI LP*, 2013 WL 521898, **1, 8 (M.D. Pa. Feb. 11, 2013), Judge Rambo held that an extension of term provision in a lease that allowed the lessee to "extend the primary term for one additional period equal to the primary term by paying to Lessor at any time within the primary term an Extension Payment equal in amount to the annual Delay Rental as herein described" was enforceable. Judge Rambo distinguished the case before her from *Hite* on the grounds that the extension provision before her "only allowed Defendant to extend the lease for one additional primary term, or for 10 years[,]" while the provision in the *Hite* case did not contain any similar limiting language. *Id.* at *8. She explained: "*Hite* does not stand for the broad proposition that a lessee cannot extend the terms of the lease by payment of a delay rental; rather, *Hite* explains that a lessee may not extend a lease *indefinitely* through the tendering of a delay rental." *Id.* (emphasis in original).

[30] In *Jacobs*, the Court, considering a question certified from the United States Court of Appeal for the Third Circuit, held that "[a]n 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 not implied obligation to engage in extraction activities. Thus, 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." *Id.* at 244-45, 772 A.2d at 455 (footnote omitted).

seminal Pennsylvania case setting the standard for what is production in paying quantities and providing guidance on how one determines whether a lease is producing in paying quantities.

The plaintiff in *Jedlicka* was a lessor who filed a declaratory judgment action to determine whether a nearly eighty-year-old oil and gas lease had terminated for failure to produce in paying quantities.[31] The plaintiff argued that the lease had terminated because the lessee had incurred a $40 loss as a result of its operations under the lease in 1959, forty-six years before the plaintiff filed her lawsuit.[32] The Court held that the lessor was required to present evidence that the lessee had failed to operate the wells drilled under the lease in good faith, and that because she failed to do so, the trial court was correct in finding that the lease had not terminated.[33] In doing so, the *Jedlicka* Court set forth the following guidance for determining whether production is "in paying quantities":

> [W]e hold that, if a well consistently pays a profit, however small, over operating expenses, it will be deemed to have produced in paying quantities. Where, however, production on a well has been marginal or sporadic, such that, over some period, the well's profits do not exceed its operating expenses, a determination of whether the well has produced in paying quantities requires consideration of the operator's good faith judgment in maintaining operation of the well. In assessing whether an operator has exercised his judgment in good faith in this regard, a court must consider the reasonableness of the time period during which the operator has continued his operation of the well in an effort to reestablish the well's profitability.[34]

According to the majority in *Jedlicka*, the above-quoted standard adequately protects lessors from lessees that attempt to hold "onto otherwise unprofitable wells for merely speculative,

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[31] *Id.* at 203-05, 42 A.3d at 263-65.

[32] *Id.* at 225, 42 A.3d at 277.

[33] *Id.* at 225-26, 42 A.3d at 277-78.

[34] *Id.* at 224, 42 A.3d at 276.

as opposed to productive, purposes" because if a well "fails to pay a profit over operating expenses, and the evidence established that the lessee was not operating the wells for profit in good faith, the lease will terminate."[35] Moreover, it "protects a lessee from lessors who, by exploiting a brief period when a well has not produced a profit, seek to invalidate a lease with the hope of making a more profitable leasing arrangement."[36]

Companies operating in Pennsylvania, especially those operating older, shallow wells, must be fully aware of *Jedlicka* and the standard for production in paying quantities. Moreover, if the company's financial documentation cannot backup its position that the well is, or is expected to become, profitable, the company's "good-faith judgment" may be called into question and become the focus of a lessor's lease-busting efforts. Of course, *Jedlicka* also affirms that the burden of proof that the lease is not producing in paying quantities remains with the lessor.

3. *Messner v. SWEPI, LP*, 2013 WL 4417723 (Aug. 14, 2013), *aff'd*, 574 Fed.Appx. 96 (3d Cir. 2014)

Can a lease be held through shut-in payments where the well has never actually produced? This was the question presented to Judge Brann out of the United States District Court for the Middle District of Pennsylvania. In *Messner*, the lessors claimed that the 2006 lease terminated because although the defendant-lessee's predecessor had unitized the property into two units and drilled a well on each unit, no production had occurred. Instead, the lessee tendered shut-in royalty payments pursuant to paragraph 12 of the lease, which provided:

> If during or after the primary term of this lease, all wells on the leased premises or within a unit that includes all or a part of the lease premises, **are shut-in, suspended or otherwise not producing for any reason whatsoever** for a period of twelve (12) consecutive

[35] *Jedlicka*, 615 Pa. at 224-25, 42 A.3d at 277.

[36] *Id.*

> months, and there is no current production of oil or operations on said leased premises sufficient to keep this lease in force and this lease is not otherwise kept in force by other provisions of this lease, Lessee may maintain this lease in effect by tendering to Lessor a shut-in royalty equal to the Delay Rental as found elsewhere in this lease. Said shut-in royalty shall be paid or tendered to the Lessor within ninety (90) days after the next ensuing yearly anniversary of the Effective Date of this lease, and thereafter on or before each yearly anniversary of the Effective Date hereof while the wells are shut-in or production therefrom is not being marketed by Lessee. Upon payment of the shut-in royalty as provided herein, this lease will continue in force during all of the time or times while such wells are shut-in but failure to properly pay shut-in royalties shall [r]ender Lessee liable only for the amount due and shall not operate to terminate this lease.

Messner v. SWEPI, LP, 574 F. App'x 96, 97 (3d Cir. 2014) (bold typeface added). Lessor refused the shut-in payments and filed suit. The case was removed to the Middle District of Pennsylvania and the lessee thereafter filed a motion to dismiss, arguing that the plain language of the shut-in royalty provision was dispositive. The matter was referred to a magistrate judge, whose report and recommendation was for dismissal of the complaint. *Id.* at 98. Judge Brann agreed, specifically pointing to the bolded language in the quote above and holding that under this language, the lease may be extended by shut-in royalty payments even where the well has never produced oil and gas and is not capable of producing oil and gas. *Id.* On appeal, the Third Circuit affirmed, stating that "[d]espite Messner's claims to the contrary, there is absolutely nothing in the language of the Shut–In Royalty provision that requires that wells in question must produce paying quantities of gas. The lease expressly permits SWEPI to extend the lease beyond the primary term by payment of the Shut–In Royalty payment whenever the wells that have been drilled have been shut-in, or suspended, or otherwise are not producing for any reason whatsoever. And SWEPI complied with these terms in acting to extend the lease." *Id.*

Messner demonstrates the importance of the specific language of a shut-in royalty provision versus the common understanding of what a "normal" shut-in provision is supposed to do. The lessor argues that a shut-in royalty requires, as a precondition, that the well be capable of production. Generally speaking, this is how most shut-in royalty provisions function. But the shut-in royalty provision in this case really went beyond this by removing the requirement that a well be capable of production for a shut-in royalty payment to be valid. Proving, yet again, that courts care about the actual language—not a general understanding what a certain provision "normally" does.

4. ***Good Will Hunting Club, Inc. v. Range Resources - Appalachia, LLC*, No. 4:11-CV-1152, 2013 WL 2297170 (MD Pa. May 24, 2013); *Roe v. Chief Exploration & Development LLC*, 4:11-cv-00816, 2013 WL 4083326 (M.D. PA Aug. 13, 2013); *Neuhard v. Range Resources - Appalachia, LLC*, 29 F.Supp.3d 461 (MD PA 2014)**

Although not binding precedent, these three cases impact leasing and lease busting because they provide guidance on what it means to commence a well in Pennsylvania.

In *Good Will Hunting Club, Inc.*, the court was asked to determine whether the lessee complied with the lease's requirement that operations be commenced before the end of the 5-year primary term. In particular, the lease provided that it

> shall remain in force for an initial term of five (5) years from the date above stated (hereinafter designated "Primary Term"), and shall continue from year to year thereafter for so long as oil and/or gas or other liquid hydrocarbons are produced in Paying Quantities from the Leased Premises or after the development of the First Well in accord with the provisions of Article 8 below, the Lessee is engaged pursuant to Article 9 of this Agreement in a bona fide attempt to secure or restore the production of oil and/or gas or other liquid hydrocarbons by conducting additional drilling operations on the Leased Premises, or Lessee is engaged in the plugging of wells or the removal of equipment there from [sic] pursuant to the Provisions of Article 19 of this Agreement.

Good Will Hunting Club, Inc., LLC, at *11. The lease further provided in Section 8.1, entitled FIRST WELL that "[u]nless sooner terminated as otherwise herein provided, Lessee shall commence a well on the Leased Premises ... within five (5) years from [June 6, 2006] and shall drill said well with due diligence." *Id.* The lease went on to provide that "[i]n the event the aforesaid well is not commenced within such five (5)-year period, this Agreement shall be automatically terminated in its entirety." *Id*. The Middle District agreed with Range that it satisfied these requirements through the following actions prior to the expiration of the 5-year primary term: "The Court agrees with Bly and Range and finds that Range took several actions before the Lease expired in June 2011 to constitute commencing a well, including staking a drill site, obtaining several permits and easements, clearing timber, constructing roads to the Well site, and beginning construction of the pad site….Thereafter, Range took steps to drill the Well and completed the Well in March 2012." *Id.* at 18.

Roe v. Chief Exploration & Development LLC, 4:11-cv-00816, 2013 WL 4083326 (M.D. PA Aug. 13, 2013) involved a situation similar to *Good Will Hunting Club, Inc.* with similar conclusions by the Middle District, holding that the operator's actions in establishing the well location, conducting field surveys, staking the well location, obtaining a vertical drilling permit and other related permits, staking the property on the last day of the primary term and delivering a bulldozer, and, 3-4 days later, beginning clearing for the well pad, were sufficient to commence operations. *Id.* at *2.

Likewise, in *Neuhard v. Range Resources - Appalachia, LLC*, 29 F.Supp.3d 461 (MD PA 2014), citing both *Good Will Hunting Club, Inc.* and *Roe*, the Middle District held that the operator's actions in obtaining permits and approvals, staking the well location for the drill site, obtaining easements, removing timber, and constructing road access and the pad site for the well to begin drilling constituted commencement of a well within the terms of the lease. *Id.* at 469-70.

These cases illustrate the importance of specific language in leases setting forth what actions will satisfy the requirement to hold the lease past the primary term. Moreover, leases should be drafted assuming that work may not begin on the leases until very close to the expiration of the primary term and that the lessor will assert that the lease has terminated.

5. *Caldwell v. Kriebel Resources Co., LLC,* 2013 PA Super 188, 72 A.3d 611 (2013)

Caldwell involved the question of whether an implied duty to develop all formations covered by a lease exists. The facts are relatively simple. The Caldwells entered into an oil and gas lease in 2001 that covered "all oil, gas, surface, and Drilling Rights…owned or claimed by landowners." *Caldwell,* 72 A.3d 611, 613. The lessee drilled a shallow well before the end of the primary term that the Caldwells agreed was producing. Nevertheless, the Caldwells asserted that the lessee also must drill into the Marcellus shale under an implied duty to develop and brought suit to terminate the lease for the alleged breach of this duty. The lessee filed preliminary objections, arguing that because the lease disclaims all implied duties. The trial court agreed, dismissing the complaint. The Superior Court agreed, citing *Hutchison v. Sunbeam Coal Corp.*,513 Pa. 192, 519 A.2d 385 (1986) and *Jacobs v. CNG Transmission Corp.*, 565 Pa. 228, 772 A.2d 445 (2001), and holding that "under Pennsylvania law, we are not authorized to impose an implied duty on the lessee to develop the various strata in light of the language contained in their contract. *Caldwell,* 72 A.3d 611, 615.

Caldwell could be viewed as standing for the proposition that Pennsylvania law does not recognize an implied duty to develop all formations covered by a lease that could possibly be developed. Stated another way, that so long as there is production in paying quantities from some formation, the lease will be satisfied (assuming no specific requirements otherwise). However, it must also be remembered that the lease in *Caldwell* explicitly disclaimed any implied covenants, so even though the *Caldwell* court discusses implied covenants, arguably the question of whether Pennsylvania actually recognizes such an implied covenant was not squarely addressed. The takeaway? Don't rely on the law to fill in the terms for you because you may not like what you get. If you want certainty in what is required under the lease, spell it out with specific language.

6. *McCausland v. Wagner*, 2013 PA Super 256, 78 A.3d 1093 (2013)

Does the location of a provision within a lease make a difference? Yes, it can. *McCausland* involved the question of whether the failure to make a royalty payment was fatal to the lease where the lease contained a specific provision stating that a "failure to make any one of such payments…shall render this lease null and void." *McCausland*, 78 A.3d 1093, 1104. However, within the form lease, the royalty provision was 3 paragraphs above this provision, while the delay rental provision was immediately above it. *Id.* The Superior Court found this significant. It explained:

> [W]e conclude that the placement of the language of the forfeiture clause renders the McCausland Lease null and void **only** upon the failure to make rental payments, since such provision immediately follows the paragraph dealing with rental payments. There is no doubt that a clear reading of the McCausland Lease indicates that the forfeiture clause **only** relates to the payment of delay rentals or the failure to complete a well on the premises, and **not** the payment of royalties.

Id. at 1105 (emphasis in original). Likewise, this interpretation fit with the customs of the oil and gas industry: "it is our determination that forfeiture clauses in oil and gas leases customarily applied to the failure to complete a well or to pay delay rentals during the initial term of the lease, as is clearly expressed in the McCausland Lease. *Id.* at 1105–06.

The takeaway? It's not just the language courts will construe, but the agreement as a whole, including the order and relative location of provisions, especially where an important provision hinges on a general reference to something prior—like "such payments…."

7. *Harrison v. Cabot Oil & Gas Corp.*, 110 A.3d 178 (Pa. 2015)

In August 2007, Harrison entered into a lease with Cabot. By the terms of the lease, Cabot agreed to pay an initial bonus of $100 per acre plus a 1/8 royalty on oil & gas successfully produced from the land. The lease had a primary term of five years, with an option to extend it for an additional five years.

During the primary term, the lessors filed suit, seeking a declaration that the lease was invalid on the basis that the lessee had fraudulently induced them to enter into it by telling them that they would never receive more than $100 per acre as a bonus payment from a gas producing company. After signing the leases, the lessors later learned of others receiving higher bonus payments. Cabot filed a counterclaim, seeking a declaratory judgment that, in the event the plaintiff's suit failed, the primary term of the lease would be equitably tolled while the suit was pending and would be extended for an equivalent period of time beyond what was provided by its terms. Cabot alleged that the suit prevented the company from taking steps to develop or commence operations on the leasehold. The district court awarded summary judgment on the claim to invalidate the lease in Cabot's favor, but held that equitable extensions of oil and gas leases are not provided for under the circumstances. *Harrison v. Cabot Oil & Gas Corp.*, 110 A.3d 178 (Pa. 2015). Cabot filed an appeal in the federal appellate court. It also filed a motion requesting certification by the Supreme Court of Pennsylvania, and the Third Circuit granted the request. *Id*. at 181. It was a case of first impression for the court, and it stated that "It is widely recognized, however, outside the oil-and-gas context at least, that the filing of declaratory judgment action merely contesting the validity or scope of an agreement does not entail such an unequivocal refusal to perform." *Id.* at 185. It noted that other jurisdictions had adopted a special approach pertaining to oil and gas leases, but declined to do so itself. *Id*.

Be aware that, absent clear lease language to the contrary, the primary term of a lease will not be tolled due to a suit contesting the validity of the lease; however, actual refusal to surrender possession of leasehold premises may constitute a repudiation, and thus allow tolling of the primary term. Additionally, operators may want to ensure that their leases include tolling provisions that take into account delays due to lease challenges by lessors.

B. West Virginia

1. *Smith v. Chestnut Ridge Storage, LLC,* No. 14-0136 (W. Va. Nov. 21, 2014)

In 1987, the predecessors to the plaintiffs in *Smith* entered into a lease with Fox Oil and Gas. *Smith v. Chestnut Ridge Storage, LLC,* No. 14-0136 (W. Va. Nov. 21, 2014). The lessee assigned its rights under the lease to R.E. Fox and Associates and in 1993, the lessors granted R.E. Fox the additional right to store gas in any depleted oil and gas stratum on the leased premises. R.E. Fox then assigned certain interests in the lease to various parties, who later assigned all of their right, title and interest in and to the lease, but limited to only the horizontal and vertical limits of the "Storage Prospect", to Chestnut Ridge. The Federal Energy Regulatory Commission approved Chestnut Ridge's application for a certificate, valid for two years, authorizing construction and operation of a natural gas storage field.

The plaintiff brought suit, alleging breach of contract, and claiming that the defendants were obligated to develop the Marcellus Shale within the Storage Prospect. The circuit court dismissed the case on summary judgment. On appeal, the court held that although an oil and gas lessee has an implied duty to develop the minerals under its lease, the parties expressly waived that duty by including language in the lease by stating that "[i]t is agreed that Lessee may drill or not drill on said land as it may elect, and the consideration and rentals paid and to be paid hereunder constitute adequate compensation for such privilege." *Id.* Furthermore, it noted that at the time of the Gas Storage Addendum, no one would have contemplated producing natural gas in commercial quantities from the Marcellus Shale. *Id.* It held that because the Marcellus Shale was intended as a caprock for gas storage by the parties, production from the Marcellus would therefore be inconsistent with its use as caprock. *Id*.

Parties may waive the implied duty to develop minerals under a lease by express language or when parties to an oil & gas lease agree to payment in a form other than royalties.

2. ***Dwyer v. Range Res.-Appalachia, L.L.C.*, Civil Action No. 5:14CV21 (STAMP) (N.D.W. Va. Jan. 26, 2015)**

The plaintiffs in *Dwyer* entered into oil and gas leases with Great Lakes Energy. *Dwyer v. Range Res.-Appalachia, L.L.C.*, Civil Action No. 5:14CV21 (STAMP) (N.D.W. Va. Jan. 26, 2015). Each lease contained a habendum clause stating that the lease shall continue for a term of 5 years, and so much longer thereafter as oil, gas and/or coalbed methane gas, or their constituents are produced or are capable of being produced on the premises in paying quantities, or as the premises shall be operated by lessor in the search for oil, gas, and/or coalbed methane gas. They also contained a clause stating that "[r]egardless of any language to the contrary, this is a paid up lease for a period of five (5) years." The lessors received a paid-up delay rental, in accordance with their leases, and the lease was then assigned to Chesapeake.

The plaintiffs brought suit, alleging that (i) the leases were void for a lack of a definite term and unconscionable because the language permitted lessees to possess a leasehold interest for an indefinite amount of time; and (ii) the leases expired by their own terms after five years. Chesapeake moved for summary judgment and the court granted its motion, noting that habendum clauses within oil and gas leases are a recognized practice. *Id.* The court held that the provisions within the lease are clear and unambiguous and that Paragraph 22 relates only to the payment of the five-year term and does not alter the duration of the lease. *Id.*

When a habendum clause clearly provides the standard "primary" and "secondary" terms found in such clauses, the court will interpret the lease as conveying a "determinable" interest. However, the court will also consider the lease as a whole, so it is advisable that the lease contain no conflicting terms.

C. <u>Ohio</u>

1. ***Riggs v. Patriot Energy Partners, L.L.C.*, 7th Dist. Carroll No. 11 CA 877, 2014-Ohio-558**

Riggs v. Patriot Energy Partners, L.L.C., 7th Dist. Carroll No. 11 CA 877, 2014-Ohio-558 is important because it is one of the very few Ohio cases to provide guidance on the arbitrability of claims deriving from an oil and gas lease in light of R.C. 2711.01 *et seq*., which generally provides that arbitration is favored and arbitration agreements will be enforced with the exception for questions of title and/or possession to property.

Riggs involved a dispute centered on oil and gas leases containing a broad arbitration provision, which provided:

> NOTICES AND ARBITRATION * * * Any controversy arising out of or relating to this agreement shall be settled by arbitration. Either party may initiate any arbitration proceeding by notifying the other party in writing, but only after the aforementioned notice of breach has been served and the time period for cure provided for in this lease has expired. The procedure to be followed in the event of any arbitration shall be that prescribed in the Rules of the American Arbitration Association. Judgment upon the award rendered by the arbitrators may be entered in any Court having jurisdiction thereof.

Riggs at ¶ 5.

The plaintiffs/lessors there filed a lawsuit asserting several claims:

> The Amended Complaint asserts individual and class action claims against all 10 named Appellees for rescission of the oil and gas leases; damages for "notary fraud" related to the leases; "land fraud" relating to the leases; disgorgement of profits; civil conspiracy; unjust enrichment; quiet title/declaratory judgment; slander of title; rescission and nullification of the assignments and overriding royalty interests related to the leases; and fraudulent concealment and disgorgement of profits "promoted by speculators" related to the leases.

Riggs at ¶ 8. The defendants moved to stay the lawsuit pending arbitration, which the lower court granted. *Id.* at ¶ 9. In assessing the plaintiffs' argument that their claims were not subject to arbitration pursuant to the exemption in R.C. 2711.01(B)(1), the *Riggs* Court noted that this exemption "should be narrowly construed * * * to apply only where the arbitration agreement submits the ultimate question of title to or possession of the real estate." *Id.* at ¶ 18 (citing *Trust Co. v. Abbott Laboratories*, 5th Dist., No. CA-2821, 1982 WL 3020, *6 (June 11, 1982)) (internal quotation marks omitted). This has included: (1) claims for specific performance of a real estate purchase agreement; (2) claims for foreclosure; (3) and an order appointing a receiver with authority to take immediate possession. *Riggs* at ¶ 19 (internal citations omitted). Conversely, issues involving breach of a contract to purchase real estate and a condominium unit owner's alleged breach of a restrictive covenant regarding laboratory services did not involve title to or possession of real estate. *Id.* at ¶¶ 20-21 (discussing *Mears Harding L.L.C. v. Ferri*, 5th Dist. No.2011CA00253, 2012–Ohio–2878, ¶ 25, and *Blanchard Valley Health Sys. v. Canterbury Holdings, Inc.*, 3d Dist. No. 5–12–08, 2012–Ohio–5134, respectively). Of note, the *Blanchard Valley Health Sys.* Court referenced that the exemption in 2711.01(B)(1) was not involved because "neither party has initiated an action to quiet title."

In light of this jurisprudence, the *Riggs* Court rejected the argument that the arbitration clause was unenforceable because the lessee allegedly failed to comply with the delay rental provision, thus resulting in the failure of the lease as a whole. *Riggs* at ¶ 34. As it stated therein, under Ohio law, "an arbitration clause is, in effect, a contract within a contract" and "an alleged failure of the contract in which it is contained does not affect the provision itself[.]" *Id.* at ¶¶ 32-33. Thus, "a general challenge to the entire contract must be submitted to the arbitrator to determine the contract's validity[.]" *Id.* at ¶ 33. Importantly, the determination that challenges to the lease as a whole are arbitrable was distinguished from a quiet title action under R.C. 5303.01, the latter of which the *Riggs* Court determined directly involved the question of title to property and thus, fell within the exemption under R.C. 2177.01(B)(1). *See Blanchard Valley Health Sys.*, No. 3d Dist. No. 5–12–08 at ¶¶ 18-19 (A dispute over interpretation of restrictive covenant was arbitrable because it did not involve question of title to or possession of property).

Likewise, the *Riggs* Court rejected plaintiffs' argument that because the defendants seeking to enforce the arbitration provision were not signatories to it, they could not enforce it. Citing the broad language of the arbitration provision at issue, along with lease provision binding successors and assigns to the covenants and conditions therein, the *Riggs* Court stated that the plaintiffs, as signatories to the leases containing the arbitration provision, were estopped from avoiding the arbitration agreement because their claims were "intertwined with the leases containing the arbitration clause." *Riggs* at ¶¶ 40-43 (internal citations and quotation marks omitted).

Arbitration provisions should not be relegated to realm of forgotten lease provisions; they can be a useful way to avoid having to litigate a case in an unfriendly venue and in Ohio, they are heavily favored. For this reason, attention should be paid to the language used, the breadth of what is to be arbitrated, and what procedure must be followed to invoke it.

2. *Marshall v. Beekay Co.*, 2015-Ohio-238, 27 N.E.3d 1 (4th Dist. 2015)

Similar to the issue involved in *Caldwell*, *supra*., *Marshall* involved the question of whether producing shallow wells were sufficient to hold the lease as to all depths even though the deep rights and shallow rights were owned by separate companies. Also similar to *Caldwell*, the Fourth District Court of Appeals said yes, it was.

The facts are straight-forward. Plaintiffs owned 99 acres that had been leased in 1901 and 1904 (two leases). *Marshall*, 27 N.E.3d 1, 2. In 1960, the lease was assigned, but the deep rights were reserved. *Id*. Fifteen wells were drilled and producing in paying quantities from shallow formations on the leases. *Id.* at 2-3. Nevertheless, plaintiffs brought suit claiming that defendants breached the implied duty to explore for and produce from the deeper formations and as such, the deep rights had been abandoned. The trial court denied plaintiffs' motion for summary judgment, but granted defendants' on the grounds that the shallow wells held the lease as to all formations. *Id.* at 3.

The plaintiffs' argument was dependent upon a finding that the 1960 assignment split the lease into two leases, each with separate obligations: "in setting forth this argument, Appellants contend that the 1960 assignment 'essentially broke the oil and gas estate into two different distinct pieces—shallow and deep.'" *Marshall*, 7 N.E.3d 1, 6. And while the *Beekay* court acknowledged the motivation for plaintiffs' argument, it was not persuaded, finding no authority supporting it and finding ample, factually similar authority for the conclusion that an assignment of a lease covering all formations does not sever it and, therefore, held in its entirety by producing wells. *Id.* at 6-8.

The takeaway: owners of deep rights in leases held by shallow wells appear safe so long as the lease covers all oil and gas and does not contain any language calling for a severance of the lease upon assignment. Ohio will not imply that term. However, as should be clear by now, the actual language of the lease matters and a small change could have a big effect.

3. ***Hogue v. Whitacre*, 2017-Ohio-9377, 103 N.E.3d 314, *appeal not allowed*, 2018-Ohio-1990, 152 Ohio St. 3d 1480, 98 N.E.3d 294**

Hogue provided useful guidance for producers in Ohio on whether overhead/administrative costs are considered a cost of production in a production-in-paying-quantities analysis, as well as application of the temporary cessation doctrine.

Unlike other cases, the facts of *Hogue* are somewhat involved, but they can be summarized as follows. Whitacre Enterprises leased the 78.5 acres at issue in 2006 and drilled one well—the Hogue # 1. However, Whitacre Enterprises, though it held the lease, had no employees, office space, etc. and it did not operate the well. That duty was handled by its affiliate, Whitacre Store. For this duty, Whitacre Enterprises paid to Whitacre Store a flat $250/month or $3,000/year. Early years of production were good and the Whitacre financial records showed a profit against the flat monthly payments. However, in later years, production tailed off and financial records showed this as a loss for some years (as against the $250/month payment). This was due in part to downtime of the midstream gatherer, Dominion. During the pendency of the lawsuit, production numbers increased, as a new compressor had been installed and the facilities of the midstream gathering company, Dominion, were repaired and running. The lessor sued arguing that the lease terminated because it was not producing in paying quantities for several years. Despite the Whitacre financial documents showing losses for certain years, the defendants broke the flat monthly payments down into "direct" and "indirect" costs of production, with "indirect" consisting of those overhead and administrative expenses that would be paid regardless of whether the Hogue # 1 well existed. All parties filed motions for summary judgment. The trial court denied the plaintiffs' and granted the defendants', holding that the flat royalty payments could not be considered costs of production because the indirect costs within that flat rate was not for the production of the well. As for the years of low or no production, the court found it to be the result of a temporary cessation of production out of the control of the producer.

In affirming the trial court's decision, the Seventh District first acknowledged that "[t]here is no Ohio precedent directly addressing whether the "paying quantities" analysis includes indirect expenses such as business overhead costs." *Hogue*, 103 N.E.3d 314, 321. But, the Seventh District immediately thereafter pointed out that they "recently cited to a Williams & Myers, Oil and Gas Law, footnote which noted that a regulation of the United States Department of Interior has interpreted the term 'paying quantities' as 'a positive stream of income after subtracting normal expenses, which include royalties and *direct* operating costs.'" *Id.* Thus, the *Hogue* court concluded that "in a 'paying quantities' analysis, we look to direct operating costs and exclude any indirect costs that do not contribute to the production of oil or gas." *Id*. Examining the relevant facts *de novo*, the Seventh District first noted that the unrebutted testimony was that the flat monthly payments to Whitacre Store were for its entire operation—not just for production of the Hogue # 1 well—and therefore could not be considered a cost of production in a PPQ analysis. *Id*.

at 321-22. It thereafter reviewed the direct costs, indirect costs, and revenue for each year from 2012 through 2015, finding a profit in 2012 and 2013 and determining that the failure to show a profit in 2014 and 2015 was because of a temporary cessation of production. *Id.* at 322-25.

In addition to dealing with an issue of first impression in the direct v. indirect cost distinction, the *Hogue* decision also highlights the importance of accounting and financial records of operating companies. In essence, the Whitacre defendants' financial records were not designed to show profit and loss from a production-in-paying-quantities perspective. Add to this the somewhat unusual structure of having one company (Whitacre Enterprises) hold the lease and provide a flat payment to another (Whitacre Store) to not only operate the well but to cover all other overhead and administrative expenses, and it becomes clear how financial records can impact a dispute over production in paying quantities.

III. ROYALTY PAYMENTS AND POOLING

A. Pennsylvania

1. *Kilmer v. Elexco Land Servs., Inc.*, 605 Pa. 413, 990 A.2d 1147 (2010)

One of the earlier cases in the 10-year range covered here, *Kilmer* was (and remains) an important decision in Pennsylvania. Given its age and impact, much has been written about *Kilmer*, so we will not indulge in a full-blown review here. However, we would be remiss not to include a brief summary and discussion of its impact.

Kilmer involved the question of whether the lessees violated Pennsylvania's Guaranteed Minimum Royalty Act (GMRA), 58 P.S. § 33, by utilizing a "net-back method" of calculating the royalties due to the lessors, which involved deducting the proportionate value (1/8th) of post-production costs incurred after the wellhead from the royalties payable, which appeared (to the lessors/plaintiffs) to reduce the net royalty payment to less than 1/8th, which was the minimum royalty under the GMRA. The royalty provision at issue provided:

> 3. Royalty Payment. For all Oil and Gas Substances that are produced and sold from the leased premises. *Lessor shall receive as its royalty one eighth (1/8th) of the sales proceeds actually received by Lessee from the sale of such production, less this same percentage share of all Post Production Costs,* as defined below, and this same percentage share of all production, severance and ad valorem taxes. As used in this provision, Post Production Costs shall mean (i) all losses of produced volumes (whether by use as fuel, line loss, flaring, venting or otherwise) and (ii) all costs actually incurred by Lessee from and after the wellhead to the point of sale, including, without limitation, all gathering, dehydration, compression, treatment, processing, marketing and transportation costs incurred in connection with the sale of such production. For royalty calculation purposes, Lessee shall never be required to adjust the sales proceeds to account for the purchaser's costs or charges downstream from the point of sale.

Kilmer, 605 Pa. 413, 417, 990 A.2d 1147, 1150. The Pennsylvania Supreme Court engaged in an extensive analysis of the arguments of both sides, but ultimately concluded that because the GMRA does not include any language about *where* the royalty calculation is to be made, nor does it actually define the term "royalty," the Court must determine which side's position is most consistent with the GMRA. *Id.* at 605 Pa. 413, 428, 990 A.2d 1147, 1157. In finding the lessees' position most consistent, the *Kilmer* Court utilized the oil and gas industry definition of royalty—being a lessor's share of production, free of the costs of production—and from there determined that while production costs are always borne entirely by the lessee, post-production costs are often born in proportion by the lessor and lessee. *Id.*, 605 Pa. 413, 429, 990 A.2d 1147, 1157. Accordingly, the GMRA's directive does not prohibit calculation of royalties payable at the wellhead using the net-back method and leases that permit the lessee to do not are not invalid under the GMRA. *Id.* 605 Pa. 413, 430-31, 990 A.2d 1147, 1157.

2. *Southwestern Energy Production Co. v. Forest Resources, LLC,* 83 A.3d 177 (Pa. Super. Ct. 2014)

Lessors in this case leased their interest in the subject property to Lancaster Exploration & Development on June 17, 2002. The agreement was evidenced by a recorded lease, as well as a "Letter Agreement". The parties then executed a second "Letter Agreement" extending the lease on June 22, 2005, and amending the royalty consideration so that lessor would retain 50% of the 12.5% royalty and Lancaster would be assigned the remaining 50%. Southwestern Energy Production Company was the successor-in-interest to Lancaster and filed suit seeking to quiet title.

The lessors filed a counterclaim and a cross-claim against Southwestern, as well as a joinder complaint against Lancaster. The trial court granted Lancaster's motion for judgment on the pleadings in part and found in favor of Lancaster on the claim for a declaration that the lessors "must execute an assignment to Lancaster of 50% of its royalty" under the subject leases, pursuant to the agreements between the parties. The lessors appealed, raising the issue as to whether an oil and gas lease that results in an effective royalty of 1/16 by requiring the lessor to assign one half of the 1/8 royalty back to the original lessee violates Pennsylvania's Guaranteed Minimum Royalty Act.[37] The appellate court reviewed the lease, as well as both letter agreements and noted that the lease and the 2002 letter agreement reference and incorporate each other with the clear intent they should be interpreted as a single agreement, and that the 2005 letter agreement clearly identifies itself as an amendment of the 2002 agreement. *Southwestern Energy Production Co. v. Forest Resources, LLC,* 83 A.3d 177 (Pa. Super. Ct. 2014). As a result of the language used, the court held that the lease and both letter agreements must be construed together to interpret the terms of the lease agreement. It went on to state that "a provision in a lease couched in the guise of an

[37] Act of July 20, 1979, P.L. 183, No. 60 § 1, 58 P.S. § 33.

assignment back of a portion of a defined royalty that results in a lessor's net royalty being less than one-eighth fails to guarantee the minimum royalty mandated by the GMRA." *Id*. at 190.

Operators should be aware that when a provision in a lease or other similar agreement requires the lessor to assign back of a portion of the production royalty to the lessee, if the lessor retains less than a 12.5% royalty, the lease will be invalid under the GMRA.

B. <u>West Virginia</u>

1. *American Energy – Marcellus, LLC v. Poling, et al.*, Circuit Court of Tyler County, West Virginia, Civil Action No. 15-C-34

In 1894, successors to the parties entered into an oil and gas lease, which did not provide an express pooling provision. The landowners claimed that American Energy – Marcellus could not pool the premises without an amendment to the oil & gas leases.

American Energy – Marcellus filed suit seeking a declaratory judgment that it had an implied right to pool the lease, and the court held that "there is an implied right to pool or unitize the oil and gas at issue in this matter with other mineral and leasehold interests for the purpose of developing oil and gas". *American Energy – Marcellus, LLC v. Poling, et al.*, Circuit Court of Tyler County, West Virginia, Civil Action No. 15-C-34. In its analysis, the court reasoned that the purpose of the lease was to develop and produce oil and gas and that pooling allows horizontal drilling and production to be done in an economically viable manner. *Id.* As a result, the court concluded that the lessee had the implied right to pool in order to do whatever was necessary to accomplish the purpose of the lease. *Id.*

Operators should keep in mind that as technology changes, new methods to extract oil and gas, as well as other advancements not taken into account at the time of the lease, may come into play further down the road.

2. *Gastar Expl., Inc. v. Contraguerro*, 239 W. Va. 305, 800 S.E.2d 891 (2017)

On February 25, 2011, PPG Industries and Gastar Exploration USA entered into a lease covering over 3,000 acres in Marshall County, including a 105.9-acre parcel of which the plaintiffs owned an NPRI. PPG owned the executive rights, along with the surface, but did not own any royalty interest in and to the 105.9 acres. On March 7, 2012, Gastar recorded in Marshall County a designation of pooled unit, known as the Wayne/Lily Unit, covering 700 acres under the lease, including the subject 105.9 acres. The NPRI holders were not asked to consent to the pooling of their royalty interest within the unit. Gastar then asked each NPRI holder to sign a ratification of the lease between PPG and Gastar. According to the NPRI holders, they had previously been unaware of their royalty interests, and when they requested that Gastar provide them with the details of the lease, the company refused to do so. As a result, they declined to sign the ratifications and filed suit seeking a declaratory judgment.

At issue in the case was whether the pooling provision in the lease between PPG and Gastar was valid and whether the Wayne/Lily Unit was dependent upon the consent and ratification of the NPRI holders. The circuit court granted partial summary judgment in favor of the NPRI holders and PPG and Gastar appealed. The Supreme Court of Appeals of West Virginia rejected the circuit court's reliance on Texas decisions based on the cross-conveyance theory. *Gastar Expl., Inc. v. Contraguerro*, 239 W. Va. 305, 800 S.E.2d 891 (2017). Under that theory, the lessors within a unit would each own an undivided interest in each other's interest. Instead, the court held that the pooling of interests in order to form a unit does not create a joint or undivided property interest in the oil and gas underlying the pooled tracts, rather it results in a "consolidation of contractual and financial interests regarding the drilling and production of oil & gas from the combined parcels of land." *Id.* at 899. It also specifically noted that ratification or consent to pool by parties who only hold an NPRI interest, without any rights to the oil and gas in place or executive leasing rights is not necessary.

Operators should be aware that it is not necessary to seek ratification of leases from owners of only an NPRI interests when forming a unit.

3. *Leggett v. EQT Production Co.,* 800 SE 2d 850 (W. Va. 2017)

Plaintiffs in *Leggett* owned a 75% undivided interest in the gas estate of a 2,000 acre tract in Doddridge County. *Leggett v. EQT Production Co.,* 800 SE 2d 850 (W. Va.). Some of the wells on the property were "flat-rate" wells, which under West Virginia Code § 22-6-8, are allowed only if lessee swears by affidavit to pay no less than one-eighth "of the total amount paid to or received by or allowed to [the lessee] at the wellhead for the oil or gas so extracted, produced or marketed[.]"

The plaintiffs filed suit for underpayment of royalties, due to certain deductions for post-production costs. The District Court certified a question to the Supreme Court of Appeals of West Virginia, who reformulated it as two separate questions: (i) are royalty payments pursuant to an oil and gas lease governed by West Virginia Code § 22-6-8,(e) (1994) subject to pro-rate deduction or allocation of post-production expenses by the lessee; and (ii) may an oil and gas lessee utilize the "net-back" or "work-back" method to calculate royalties owed to a lessor pursuant to a lease governed by West Virginia Code § 22-6-8? *Id.* at 867. The court determined that the phrase "at the wellhead" is not ambiguous as it was used in West Virginia § 22-6-8. *Id.* at 864. It also noted that "permitting lessors to benefit from royalties based upon an enhanced, downstream price without commensurately sharing in the expense to create the enhanced value" does not effectuate the just compensation sought by the statute. *Id.* at 865. Furthermore, it held that "the most logical way to ascertain the wellhead price, is, in fact, to deduct the post-production costs from the 'value-added' downstream price in an effort to replicate the statutory wellhead value." However, it continued on, stating that permitting lessees to *carte blanche* allocate post-production costs without additional guidance is too broad a rule, and as a result specified that royalty payments under a lease governed by West Virginia Code § 22-6-8(e) may be subject to "pro-rata deduction or allocation of all reasonable post-production expenses actually incurred by the lessee." *Id.* at 867-68.

Operators should be aware that the reasonableness of the post-production expenses is a question for the fact-finder. Additionally, it is important to note that the lease in this case differed drastically from that in *Tawney v. Columbia Natural Resources, L.L.C.*, 219 W.Va. 266, 633 S.E.2d 22 (2006), as it was a flat-rate lease and the royalty provision was therefore amended by operation of West Virginia Code § 22-6-8, while in *Tawney,* the parties were free to negotiate.[38]

It is also important to note that in response to *Leggett*, the West Virginia Legislature amended West Virginia Code § 22-6-8, effective May 31, 2018, to provide that whenever an operator applies to West Virginia's Department of Environmental Protection for a permit to drill, redrill, deepen, fracture, stimulate, pressure, convert, combine or physically change to allow the migration of fluid from one formation to another, and the permit pertains to lands covered by a flat-rate lease, the operator must certify that the lessor will be paid "not less than one eighth of the gross proceeds, free from any deductions for post-production expenses, received at the first point of sale to an unaffiliated third-party purchaser in an arm's length transaction for the oil and gas so extracted,

[38] In *Tawney*, the court held that language in a lease intended to allocate the costs of marketing and transporting oil and/or gas between lessor and lessee must expressly provide that the lessor shall bear some parts of the costs incurred between the wellhead and the point of sale, identify the specific deductions the lessee intends to take from the lessor's royalty, and indicate the method of calculating the amount to be deducted for post-production costs.

produced or marketed…."[39] Thus, *Leggett* does not apply to leases that are effectively converted from flat-rate leases to percentage royalty leases under West Virginia Code § 22-6-8 after May 31, 2018.

C. Ohio

1. *Lutz v. Chesapeake Appalachia, L.L.C.*, 148 Ohio St.3d 524, 2016-Ohio-7549, 71 N.E.3d 1010 (2016)

In *Lutz,* the U.S District Court for the Northern District of Ohio certified to the Ohio Supreme Court the question of whether Ohio follows the "at the well" rule or the "marketable product" rule. However, the Supreme Court of Ohio declined to specifically answer the question of whether Ohio follows the "at the well" rule or the "marketable product" rule, stating instead that Ohio interprets oil and gas leases using traditional rules of contract interpretation. *Lutz*, 71 N.E.2d 1010, 1013.

Nevertheless, in its subsequent ruling, U.S. District Court for the Northern District of Ohio has predicted that the Supreme Court of Ohio, *if directly presented with this issue*, would follow the "at the well" rule, as that most closely follows Ohio's rules for the interpretation of oil and gas leases. *Lutz v. Chesapeake Appalachia, LLC,* 2017 WL 4810703 (N.D. Ohio, 10/25/2017). Thus, applying a contract interpretation analysis to the royalty provision at issue, which provided, in part "the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale…", the *Lutz* court interpreted the "at the well" language to constitute the location at which to value the gas for determining the royalty payable, meaning that if additional costs are incurred after this location, the lessor's pro-rata share of that (1/8th) can be deducted. *Id*. In rejecting the marketable product

[39] W. Va. Code § 22-6-8(e).

rule, the *Lutz* court stated that "the Ohio Supreme Court has cautioned that an implied covenant 'arises only when the lease is silent on [a] subject.'" *Id*. at p. 8. Thus, "[c]onstruing the lease under the 'marketable product' rule would ignore the clear language that royalties are to be paid based on the 'market value *at the well*.'" *Id.* (emphasis in original).

While neither decision here is definitive on the question of whether Ohio is an "at the well" or "marketable production" jurisdiction, the Ohio Supreme Court's strict adherence to rules of contract interpretation for oil and gas lease interpretation seems to be a good indicator that it would walk the "at the well" path, as that is often cited as most faithful to giving effect to the plain language.