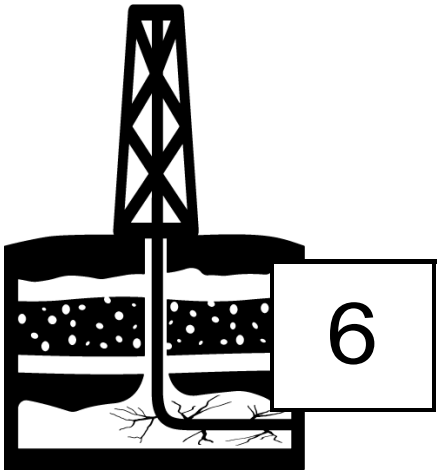

6 Implied Covenants

George A. Bibikos

Under the express terms of a typical oil and gas lease, a lessor conveys his or her oil and gas interests to a lessee in exchange for the opportunity to receive royalties on production from the property. The lessee, in turn, bargains for the right to produce the oil and gas resources and maintain the lease after achieving production for as long as it is profitable to do so. This is the basic relationship that a lease creates.

Although oil and gas leases may vary in degree of detail and complexity, the agreement may not always specify all the particulars of the relationship. That sometimes has led to disputes over performance obligations that the parties allegedly contemplated when entering into the arrangement but are not governed by the express terms of the lease. To resolve these types of disputes, courts in oil- and gas-producing jurisdictions, including Pennsylvania, have sometimes implied certain covenants into a lease. These include an implied standard of performance to which a lessee may be bound in carrying out activities authorized by the lease, along with specific implied covenants governing various stages of the lessor/lessee relationship.

There are challenges associated with analyzing implied covenants in Pennsylvania. The case law in Pennsylvania on implied covenants is relatively dated and not as well developed as the case law in other oil- and gas-producing jurisdictions.[1] At the same time, much of the extant case law deals with implied covenant disputes during periods of more conventional oil and gas development in Pennsylvania, as opposed to shale gas development. Because shale gas development is different in significant ways, the extent and applicability of implied covenants in the shale gas era remains to be fully adjudicated and refined.[2]

1. George A. Bibikos and Jeffrey C. King, *A Primer on Oil and Gas Law in the Marcellus Shale States*, 4 Tex. J. Oil Gas & Energy L. 155 (2009).

2. George A. Bibikos, *A Review of the Implied Covenant of Development in the Shale Gas Era*, 115 W. Va. L. Rev. 949 (2013); Keith B. Hall, *The Continuing Role of Implied Covenants in Developing Leased Lands*, 49 Washburn L.J. 313 (2010) (describing the applicability (or inapplicability) of traditional implied covenants to unconventional resource plays).

The goal of this chapter is, therefore, to provide a concise and general overview of implied covenants under Pennsylvania law and to discuss how Pennsylvania courts have addressed questions involving the application and extent of specific implied covenants in oil and gas leases. In particular, this chapter addresses the following general topics:

- the origins of implied covenants;
- the reasons for implying covenants in oil and gas leases;
- limitations on the application of implied covenants;
- Pennsylvania decisions regarding a lessee's implied standard of performance;
- specific implied covenants recognized in Pennsylvania, including the "protection" covenant, the "development" covenant, and the "marketing" covenant; and
- remedies for breach of implied covenants.

6-1 ORIGINS OF IMPLIED COVENANTS IN OIL AND GAS LEASES

Since at least the late 1800s, courts in Pennsylvania have recognized that, unless there is express language to the contrary, oil and gas leases may contain certain implied covenants. In *Stoddard v. Emery*,[3] for example, the parties executed an oil and gas lease in which the operator agreed to drill a well within eight months of the execution date and one additional well at some unspecified time after that. The landowner claimed that the operator breached the lease by failing to drill additional wells pursuant to an oral agreement between the parties. The Pennsylvania Supreme Court concluded that, because the lease expressly provided the number of wells the operator was obliged to drill, "there is no room for any implication that there should be some other number."[4] However, the court's dicta suggested that certain promises may be implied in oil and gas leases given the nature of those agreements:

> Had there been nothing said in the contract on the subject, there would of course have arisen an implication that the property should be developed reasonably, and evidence of a custom of reasonable development by boring a given number of wells in a certain space of time, would have been competent and perhaps controlling. But that doctrine has no application in a case where the parties have expressly agreed in the contract how many wells shall be bored.[5]

In *Brewster v. Lanyon Zinc Co.*,[6] the United States Court of Appeals for the Eighth Circuit expanded on the implied-covenant concept. In *Brewster*, the lessee drilled a producing well during the primary term but did not drill any other wells. The lessor sued, contending that the lessee had an obligation to drill additional wells and protect the premises from drainage by wells in the vicinity. On appeal, the Eighth Circuit addressed whether the lessee had any further obligations beyond drilling the producing well during the primary term without express language requiring that the lessee do so. In discussing covenants that may be implicit in a lease, the court acknowledged that both parties have an interest in diligent operation of the leased premises even though the agreement may not state all the details of the agreement. The lessor, on one hand, has a royalty interest that hinges on the diligent operation of the leasehold by the lessee. The

3. *Stoddard v. Emery*, 18 A. 339 (Pa. 1889).
4. Id. at 339.
5. Id.
6. *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905).

lessee, in turn, bears all the costs of production and has a right to a return on its investment. In view of the relationship, the court concluded that implied promises fill in the gaps of the agreement and may, under some circumstances, obligate the lessee to operate the premises with reasonable diligence if, in doing so, the lessee has the ability to earn a profit.[7]

6-2 REASONS FOR IMPLYING COVENANTS IN OIL AND GAS LEASES

For more than a century after the statements in *Stoddard* and *Brewster*, courts and commentators have struggled to agree on a precise rationale underlying the creation of implied covenants in oil and gas leases. The debate usually is whether courts should imply covenants as a matter of fact or as a matter of law.[8]

Some have argued that courts imply covenants as a matter of fact because the parties to a lease cannot possibly set forth all the details of their transaction. Under these circumstances, courts may fill in the gaps in the lease with implied promises that both parties must have contemplated given the nature of their agreement.[9] Others have suggested that courts imply covenants in a lease as a matter of law or public policy in order to balance a perceived imbalance in bargaining power that favors the production company.[10] Others say it is both.[11] Still others say courts imply covenants based on a general contract duty of cooperation.[12]

Whatever the competing views, courts in Pennsylvania have long refused to rewrite the parties' express agreement in order to achieve a supposedly more balanced or fair contract and, therefore, tend to imply covenants only when necessary based on the intent of the parties entering into the lease.[13] As a result, the parties may (and often do) agree to disclaim, waive, or limit implied covenants in their agreement.[14]

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7. Id. at 814 ("The large expense incident to the work of exploration and development, and the fact that the lessee must bear the loss if the operations are not successful, require that he proceed with due regard to his own interests, as well as those of the lessor. No obligation rests on him to carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result from them").

8. John S. Lowe, *Oil and Gas Law in a Nutshell*, 5th ed., 316–52 (Thomson West 2009).

9. David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 Rocky Mtn. Min. L. Inst. 10-1, at § 10.05 (2002) (discussing the marketing covenant).

10. Maurice H. Merrill, *The Law Relating to Covenants Implied in Oil and Gas Leases*, 2nd ed. § 69 at 176 (Thomas Law Book Co. 1940).

11. Patrick H. Martin and Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law* § 803 at 23 (Matthew Bender 2012) (finding "a large element of truth on both sides of the implied 'in law'/implied 'in fact' controversy").

12. *Williams & Meyers*, footnote 11 above, § 802.1 at 7 ("The principle of cooperation requires that parties to a contract cooperate in order to carry out the purposes of the agreement. It is based upon both the reasonable expectations of the parties when they enter into an agreement and ethical concepts of conduct").

13. *Amoco Oil Co. v. Snyder*, 478 A.2d 795, 799 (Pa. 1984) ("It may be that it was unwise for Snyders to have entered into this agreement, but it is not our function to rewrite agreements for the parties and to strike a better bargain than they themselves were able to accomplish. Courts are not super-negotiators. Where the language of the instrument is clear, as it is in this case, we are constrained to give effect to what the parties have agreed to"); *Ray v. West Pennsylvania Natural Gas Co.*, 20 A. 1065, 1066 (Pa. 1891) ("The clear purpose of the lessor was to have his lands operated for oil or gas, and the condition was inserted for his benefit. Whilst the obligation on part of the lessee to operate is not expressed in so many words, it arises by necessary implication"); *Kleppner v. Lemon*, 35 A. 109, 109–10 (Pa. 1896) (lessee not obligated to drill wells that do not justify the expense); *Young v. Forest Oil Co.*, 45 A. 121, 121–22 (Pa. 1899) (acknowledging lessee's cost-bearing interest); *Colgan v. Forest Oil Co.*, 45 A. 119, 120 (Pa. 1899) ("[T]he lessee is not bound to work unprofitably to himself for the profit of the lessor").

14. See, e.g., *Caldwell v. Kriebel Resources Co.*, 72 A.3d 611 (Pa.Super. 2013) (court concluded that lease expressly disclaimed implied covenants such that the lessor seeking a remedy for breach of implied covenant to develop deeper strata could not state a viable claim).

6-3 EFFECT OF LEASE ON IMPLIED COVENANTS

As noted in the previous section, the express provisions of an oil and gas lease limit the application of implied covenants in Pennsylvania.[15] Although an oil and gas lease is often characterized as a unique agreement, the principles of interpreting these types of agreements are the same as the principles for interpreting other contracts. In other words, oil and gas leases are interpreted in accordance with general principles of contract interpretation.[16]

Under Pennsylvania law, a court's fundamental goal in interpreting any agreement—including an oil and gas lease—is to effectuate the intent of the parties based on the words used in the agreement.[17] As the Pennsylvania Supreme Court has stated, an oil and gas lease "must be construed in accordance with the terms of the agreement as manifestly expressed, and '[t]he accepted and plain meaning of the language used, rather than the silent intentions of the contracting parties, determines the construction to be given the agreement.'"[18] In addition to the usual rules of contract interpretation, Pennsylvania courts have interpreted oil and gas leases for over 135 years "with a due regard to the known characteristics of the business." In other words, courts interpret the words used in oil and gas leases not in a vacuum, but in the context of the oil and gas business to determine the rights and obligations of the parties.[19]

As a result of the general rules of contract interpretation, the express language of a lease should trump any implied covenant.[20] For example, the lease may disclaim implied covenants altogether. If covenants are disclaimed, courts in Pennsylvania enforce the disclaimer as written and do not read any otherwise-disclaimed provision into a lease.[21] Implied covenants may also be limited if they conflict with other express provisions of the lease or their application is inconsistent with other provisions of the lease. In other words, the lease need not expressly disclaim any implied covenants to limit their applicability. For example, many leases—particularly older leases—may specify the number of wells that the lessee agreed to drill. If a provision in the lease specifies the number of wells, that number should control, and there should be no implied covenant to drill more.[22] As a result, many cases involving a claim that a lessee has breached an implied covenant may be decided based on the lease language, and sometimes as a matter of law, without the need for protracted discovery or litigation.[23]

15. Owen L. Anderson, et al., *Hemingway Oil and Gas Law and Taxation*, 4th ed., § 8.1 at 402 (Thomson West 2004) ("To the extent these matters are addressed in a lessee-oriented lease, express provisions tend to limit what would otherwise be the implied obligation").
16. *Amoco Oil Co.*, 478 A.2d at 798.
17. See *Seven Springs Farm, Inc. v. Croker*, 801 A.2d 1212, 1215 (Pa. 2002).
18. *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 42 A.3d 261, 267 (Pa. 2012) (quoting *Willison v. Consolidation Coal Co.*, 637 A.2d 979, 982 (Pa. 1994)).
19. See *McKnight v. Manufacturer's Natural Gas Co.*, 23 A. 164, 165 (Pa. 1892) (citing *Brown v. Vandergrift*, 80 Pa. 142 (1875)); *Kleppner v. Lemon*, 35 A. 109 (Pa. 1896) ("The case must therefore depend upon the proper interpretation of the contract, *aided by the necessities and usages of the business to which it relates*") (emphasis added).
20. *Hutchison v. Sunbeam Coal Co.*, 519 A.2d 385, 388 (Pa. 1986).
21. *Caldwell v. Kriebel Resources Co.*, 72 A.3d 611 (Pa.Super. 2013).
22. *Stoddard v. Emery*, 18 A. 339 (Pa. 1889) (stating that when the lease provides for a fixed number of wells to be drilled, no implied covenant is needed to further develop); *Jacobs v. CNG Transmission Corp.*, 772 A.2d 445, 455 (Pa. 2001) (explaining that express terms may render implied covenant of further development inoperative).
23. Bibikos, footnote 2 above, at 972.

6-4 STANDARD OF PERFORMANCE

If implied covenants apply, the question then becomes how to evaluate the lessee's actions or inactions. Courts in most oil- and gas-producing jurisdictions, including Pennsylvania, have concluded that a lessee is bound by a certain implied standard of performance, although Pennsylvania's standard is different from the one applied in most jurisdictions.

6-4.1 The "Prudent-Operator" Standard

Under the "prudent-operator" standard of performance followed by courts in most states,[24] a lessee must perform under the lease as would a reasonable and prudent operator in the same or similar circumstances, recognizing the "special skills and expertise regarding oil and gas operations."[25] The prudent-operator standard generally requires that a lessee perform its obligations in good faith, competently, and with due regard to the interests of both the lessor and the lessee.[26] The inquiry is not whether the particular operator in question believes its course of conduct was reasonable, but whether in the ordinary course of business a hypothetical prudent operator faced with the same or a similar situation would have proceeded the same way.[27] Some early Pennsylvania cases discussed a lessee's standard of performance as though it were a more objective standard,[28] though none of the cases ever adopted the prudent-operator standard by that name.

6-4.2 The "Good-Faith" Standard

By contrast, Pennsylvania courts have long applied a more narrow and subjective "good-faith" standard of performance. This standard defers to the particular lessee's good-faith judgment in performing his or her obligations under the contract unless the lessor bears the heavy burden of demonstrating bad faith or fraud.[29]

For example, in *Colgan v. Forest Oil Co.*, the landowner sought forfeiture of an oil and gas lease because the operator refused to drill additional wells on an unproven portion of the plaintiff's land.[30] In that case, the lessee drilled five wells in one area of the plaintiff's land, but none in another area. On adjacent lands near that area (subject to a lease with a different landowner), the lessee drilled three producing wells that were "light producers" and not profitable.[31] There was no evidence of fraud or bad faith. Consequently, the court held that, without proof of fraud or bad faith, the judgment of that lessee could not be questioned:

24. Among others, Arkansas, California, Colorado, Idaho, Illinois, Kansas, Kentucky, Louisiana, Michigan, Mississippi, Montana, Nebraska, New Mexico, North Dakota, Oklahoma, and Texas have adopted the "prudent-operator" standard. *Williams & Meyers*, footnote 11 above, § 806.3 at 36–43.

25. Anderson, et al., footnote 15, above, § 8.5 at 433.

26. Lowe, footnote 8 above, at 311.

27. *Williams & Meyers*, footnote 11 above, § 806.3 at 42.1 ("Since the standard of conduct is objective, a defendant cannot justify his act or omission on personal grounds or by reference to his peculiar circumstances").

28. *Kleppner v. Lemon*, 35 A. 109, 109–10 (Pa. 1896); *McKnight v. Manufacturer's Natural Gas Co.*, 23 A. 164 (Pa. 1892).

29. *Adams v. Stage*, 18 Pa. Super. 308, 312 (1901) ("If the judgment of the defendant was exercised in good faith, and involved no manifestly fraudulent use of opportunities, we cannot say that he failed to discharge any duty to the plaintiff arising out of his contract and the operations thereunder").

30. *Colgan v. Forest Oil Co.*, 45 A. 119 (Pa. 1899).

31. Id. at 121.

> So long as the question is one of business judgment and management, the lessee is not bound to work unprofitably to himself for the profit of the lessor, and the parties must be left, as in other cases, to their own ways. It is only when a manifestly fraudulent use of opportunities and control is shown that courts are authorized to interfere. . . .
>
> . . . So long as the lessee is acting in good faith, on business judgment, he is not bound to take any other party's, but may stand on his own. Every man who invests his money and labor in a business does it on the confidence he has in being able to conduct it in his own way. No court has any power to impose a different judgment on him, however erroneous it may deem his to be. Its right to interfere does not arise until it has been shown clearly that he is not acting in good faith on his business judgment, but fraudulently, with intent to obtain a dishonest advantage over the other party to the contract.[32]

Likewise, in *Young v. Forest Oil Co.*, decided the same day as *Colgan*, the plaintiffs sought forfeiture, damages, or specific performance of the implied duty to further develop the property because the lessee allegedly drilled wells on adjacent lands that drained the oil and gas from beneath the plaintiffs' land.[33] Again, there was no evidence of fraud or bad faith. In refusing relief, the court stated:

> The operator, who has assumed the obligations of the lease, has put his money and labor into the undertaking, and is now called upon to determine whether it will pay to spend some thousands of dollars more in sinking another well to increase the production of the tract, is entitled to follow his own judgment. If that is exercised in good faith, a different opinion by the lessor, or the experts, or the court, or all combined, is of no consequence, and will not authorize a decree interfering with him.[34]

Finally, in *Barnard v. Monongahela Natural Gas Co.*, the court upheld, per curiam, the trial court's determination that the operator in that case exercised good faith by working a well on an adjacent property that incidentally drained the plaintiffs' oil.[35] The trial court concluded that because the plaintiffs failed to prove the operator's fraud or bad faith, they could neither enjoin the drilling of the well on the adjacent land nor recover damages for any depletion of the oil underneath their land.[36]

In 2012, the Pennsylvania Supreme Court held in *T.W. Phillips Gas & Oil Co. v. Jedlicka*[37] that courts should evaluate a lessee's good-faith judgment to determine whether or not any given well is producing in "paying quantities" in order to keep a lease alive in its secondary term.[38] In that case, a producing well drilled in 1929 suffered a $40 loss in 1959, but had otherwise paid a profit since its inception. The lessor sued to cancel the lease for lack of production in paying quantities during the secondary term based on that $40 loss. The court rejected that theory. The Pennsylvania Supreme Court held that if the well's profitability is marginal or sporadic over some period of time, the courts may consider the lessee's good-faith judgment in maintaining the well in an effort to re-establish its profitability before concluding that the secondary term of a lease has expired. Thus, the court in *Jedlicka* endorsed the good-faith standard of performance

32. Id. at 120–21.
33. *Young v. Forest Oil Co.*, 45 A. 121, 121–22 (Pa. 1899).
34. Id. at 122.
35. *Barnard v. Monongahela Natural Gas Co.*, 65 A. 801 (Pa. 1907).
36. Id.
37. *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 42 A.3d 261 (Pa. 2012).
38. Id. at 276–78; *Colgan v. Forest Oil Co.*, 45 A. 119, 121 (Pa. 1899); *Young v. Forest Oil Co.*, 45 A. 121, 123 (Pa. 1899).

at least in the context of defining "paying quantities" and implicitly endorsed that good-faith standard of performance as the general rule in Pennsylvania as opposed to the prudent-operator standard.[39]

6-5 SPECIFIC IMPLIED COVENANTS RECOGNIZED IN PENNSYLVANIA

In addition to an implied standard of performance, Pennsylvania courts have recognized several implied covenants that may govern certain specific aspects of the lessor/lessee relationship. These include the implied covenant to protect the leased premises against drainage, the implied covenant of development, and the implied covenant to market production.

6-5.1 The "Protection" Covenant

The protection covenant is designed to protect the leased premises from drainage by nearby operations. As a general matter, oil and gas in conventional reservoirs move toward the path of least resistance. If a wellbore on one property pierces a common source of supply that underlies adjacent properties, that wellbore might drain the oil and gas located beneath the adjacent parcel. Under the rule of capture, a landowner (or his or her lessee) who drills a well within the boundaries of his or her property and happens to drain oil or gas from beneath his or her neighbor's land is not liable to his or her neighbor for damages for the drainage.[40] Thus, without an offset well[41] to capture the oil and gas, those resources may be depleted by neighboring operations without any recourse against the neighboring operator. Consequently, unless there is lease language to the contrary, a lessee may have an implied obligation to drill an offset well to secure oil and gas underlying the leased premises and protect against drainage. In most states, the courts have held that the implied covenant does not apply unless (1) substantial drainage has occurred, and (2) the offset well will produce in paying quantities.[42]

There is scant case law in Pennsylvania defining the protection covenant. In *Barnard v. Monongahela Natural Gas Co.*, the court suggested in passing that a lessee may have an obligation to "protect" the leased premises from fraudulent drainage, or risk claims of breaching the good-faith standard of performance.[43] Likewise, in *Kleppner v. Lemon*,[44] the court noted that as part of the implied covenant to develop the leased premises, the lessee had an obligation to secure the oil and gas, given the allegation that the lessee's wells on adjacent lands were depleting the plaintiff's oil.[45] Finally, in *Hamilton v. Foster*, the court acknowledged that the lessee in that

39. In his dissenting opinion, Justice Saylor highlighted the differences between the prudent-operator standard and the good-faith standard and argued that the court in the future should instead move toward the more objective prudent-operator standard applied by courts in other oil- and gas-producing jurisdictions. *Jedlicka*, 42 A.3d at 278 (Saylor, J. dissenting).

40. *Barnard v. Monongahela Natural Gas Co.*, 65 A. 801 (Pa. 1907).

41. An offset well is defined as "a well drilled on one tract of land to prevent the drainage of oil or gas to an adjoining tract of land, on which a well is being drilled or is already in production." *Williams & Meyers*, footnote 11 above, at 684.

42. See, e.g., *Ramsey Petroleum Corp. v. Davis*, 85 P.2d 427, 429–30 (Okla. 1938).

43. *Barnard v. Monongahela Natural Gas Co.*, 65 A. 801 (Pa. 1907).

44. *Kleppner v. Lemon*, 35 A. 109 (Pa. 1896).

45. Id. at 109.

case properly drilled an offset gas well to protect the lessor's property from nearby operations even though the lessee drilled that well in a location not authorized by the lessor.[46]

6-5.2 The "Development" Covenant

The development covenant essentially is designed to ensure that a lessee reasonably develops the leased premises.[47]

6-5.2.1 Reasonable Development

In *Jacobs v. CNG Transmission Corp.*,[48] the Pennsylvania Supreme Court reaffirmed that Pennsylvania law recognizes an implied covenant of development. After reviewing prior case law,[49] the court concluded as a general matter that a lessee may be under the implied obligation to develop the leased premises unless the lease states otherwise or the lessor receives compensation in lieu of development.[50] As applied, the implied covenant to develop only arises after a lessee obtains production from a proven formation that yields oil or natural gas in paying quantities.[51] The development covenant does not compel the lessee to drill a well during the primary term.[52] However, once a lessee elects to drill a well and a formation yields production in paying quantities, the lessee generally may be under an implied obligation to drill a sufficient number of additional wells in order to extract the oil and gas from that "proven" formation.

6-5.2.2 Further Exploration

Although not widely recognized as a separate covenant, Professor Charles Meyers suggested long ago that a lessee may be under the implied obligation to "further explore" the leased premises to discover and ultimately produce from unproven or possibly deeper strata.[53] Under the so-called further exploration covenant, a lessee would have an implied duty (unless there is express language to the contrary) to explore potentially productive but unproven strata on the leased premises.[54]

As of the date of this writing, only two courts in Pennsylvania have addressed this issue in the context of deeper shale gas development. In *Delmas Ray Burkett, II Revocable Trust v. EXCO Resources (PA), LLC*,[55] the federal court denied a motion to dismiss a claim that the lessee in the case breached an implied duty to explore the Marcellus Shale after having held the leasehold premises by shallow production for a great many years. Although the claim survived, the court

46. *Hamilton v. Foster*, 116 A. 50, 53–4 (Pa. 1922) ("[The] lessee in such cases must act with great promptness in sinking and due care in selecting the place to bore a well, lest others are drilled on adjoining property (and in this territory there are many others already in operation), which will exhaust the gas to the detriment of the lessor. It follows that the drilling of well No. 4, at the point in lots 28 and 29 was a wise act, and the purpose to be conserved thereby, namely, the protection of well No. 3, was a proper purpose").

47. See, e.g., *Williams & Meyers*, footnote 11 above, § 832 at 220 and n.1.

48. *Jacobs v. CNG Transmission Corp.*, 772 A.2d 445 (Pa. 2001).

49. Id. at 453 (citing *Baird's Appeal*, 6 A.2d 306 (Pa. 1939); *Aye v. Philadelphia Co.*, 44 A. 555 (Pa. 1899); *McKnight v. Manufacturer's Natural Gas Co.*, 23 A. 164 (Pa. 1892)).

50. *Jacobs*, 772 A.2d at 455.

51. *Highfield Co. v. Kirk*, 93 A. 815, 817 (Pa. 1915) ("As we have repeatedly held, it is an implied condition of every lease of land for the production of oil therefrom that when the existence of oil in paying quantities is made apparent the lessee shall put down as many wells as may be reasonably necessary to secure the oil for the common advantage of both lessor and lessee. This, the lessees say they have done, and for that reason decline to make any further expenditure in the development of the property").

52. *Jacobs*, 772 A.2d at 455.

53. Charles J. Meyers, *The Implied Covenant of Further Exploration*, 34 Tex. L. Rev. 553, 557 (1956).

54. *Williams & Meyers*, footnote 11 above, § 831 at 214.3.

55. *Delmas Ray Burkett, II Revocable Trust v. EXCO Resources (PA), LLC*, Civil Action No. 2:11-cv-1394 (W.D. Pa. March 26, 2012).

seemed to express doubt about the viability of a claim to cancel a lease as to strata below the currently producing horizon but denied a motion on the theory that the plaintiff satisfied pleading standards.

By contrast, the Pennsylvania Superior Court recently concluded that there is no implied covenant to further develop shale gas from deeper strata where a lease is held by production from shallow formations and the lease contains an express provision disclaiming implied covenants.

In *Caldwell v. Kriebel Resources, Co.*,[56] the parties entered into an oil and gas lease with a two-year primary term that extended as long as oil and gas were being produced. The lease expressly disclaimed implied covenants with the following language: "[n]o inference or covenant shall be implied as to either party hereto since the full contractual obligations and covenants of each party [are] herein fully and expressly set forth."[57] The lessee obtained production from shallow formations, and later assigned the "deep rights" to another operator.

The plaintiffs acknowledged that there was production from shallow wells on the property, but contended in their complaint that the lease should be terminated because the lessee breached an alleged implied covenant of reasonable development, which they argued required development of the deeper Marcellus Shale formation. The lessees filed preliminary objections seeking to dismiss the case, arguing that (among other things) the lease expressly disclaimed the implied covenant of reasonable development and that the extant wells produced in paying quantities sufficient to keep the lease alive. The trial court sustained the preliminary objections and dismissed the plaintiffs' complaint. The plaintiffs appealed.

On appeal from the trial court's order dismissing the plaintiffs' complaint, the plaintiffs essentially argued that the implied covenant of reasonable development should be interpreted to require lessees to develop every strata, ostensibly obligating the lessees to develop the Marcellus Shale formation despite the existing shallow production or suffer a forfeiture of the lease. In response, the lessees relied in part on *Hutchison v. Sunbeam Coal Corp.*, in which the Pennsylvania Supreme Court stated that "[t]he law will not imply a different contract than that which the parties have expressly adopted. To imply covenants on matters specifically addressed in the contract itself would violate this doctrine."[58] In addition, lessees argued that the plaintiffs' theory would create a new implied duty under Pennsylvania law.

The Superior Court rejected the plaintiffs' contentions and affirmed the order dismissing the case. In affirming, the Superior Court held that "under Pennsylvania law, [the court is] not authorized to impose an implied duty on the lessee to develop the various strata in light of the language contained in their contract. This is so, particularly in light of the fact that the Defendants are producing gas pursuant to the Agreement, a fact that Appellants acknowledge."[59]

56. *Caldwell v. Kriebel Resources Co.*, 72 A.3d 611 (Pa.Super. 2013).

57. Id. at 615.

58. *Hutchison v. Sunbeam Coal Co.*, 519 A.2d 385, 388 (Pa. 1986).

59. *Caldwell*, 72 A.3d at 615. The plaintiffs also contended that the lease should expire for lack of production from shallow wells "in paying quantities." With respect to this argument, the plaintiffs alleged that the trial court erred in granting the operators' preliminary objections because the lessee acted in bad faith by paying only the minimum royalty on production from the shallow formation. "Paying quantities," they argued, should be based on the oil and gas available in all strata. The court disagreed and affirmed the trial court's decision. In doing so, the court stated that "Defendants have produced a paying quantity, albeit not to the extent Appellants desire." Id. at 616.

6-5.3 The "Marketing" Covenant

Finally, the implied marketing covenant seeks to ensure that oil and gas produced from the leased property is marketed so the lessor realizes royalties on production. Thus, as a general rule, and unless there is lease language to the contrary, a lessee may be under the implied obligation, considering all the circumstances of the case, to diligently market oil and gas produced from a lessor's property (1) within a reasonable time after production, and (2) for a reasonable price.[60] The analysis necessarily involves consideration of impediments to marketing such as lack of infrastructure (for example, gathering systems or gas processing systems), constraints on pipeline capacity, low gas prices, and related matters.

In *Iams v. Carnegie Natural Gas Co.*, the Pennsylvania Supreme Court acknowledged that a lessee has an obligation to market its production from the leased property.[61] In that case, the lease provided that if any gas would be found on the premises in quantities "sufficient to justify the defendant in marketing"[62] the gas, the lessor would receive a one-eighth royalty on the production. The lessee produced gas from the lessor's property but did not market it. The trial court instructed the jury that the lessee had the obligation to market any gas found on the lessor's land. The trial court stated that "the defendant [lessee] was bound to market [the production], or show some good reason for not having done so."[63] The trial court also instructed the jury that the lessee "would not be required to market the gas at a loss, but only at a reasonable profit; and in determining whether it could be so marketed, the distance to market, the expense of marketing and everything of that kind should be taken into consideration."[64] On appeal, the Pennsylvania Supreme Court upheld the instructions to the jury and concluded that the lessee, after producing the resource, "was then under an 'obligation to operate for the common good of both parties, and to pay the rent or royalty reserved.'"[65]

6-6 REMEDIES

If an implied covenant applies and the lessor demonstrates a breach, the question then becomes one of remedy. As a threshold matter, many jurisdictions require that, before a lessor sues for breach of an implied covenant, the lessor must provide notice to the lessee and an opportunity to respond to the alleged breach.[66] In addition, although landowners sometimes seek cancellation for breach of implied covenants, that is an extraordinary remedy.[67] Covenants are promises and not conditions on the continued validity of the lease, so courts should rarely, if ever, order cancellation for breach of an implied covenant. Likewise, Pennsylvania law abhors a forfeiture of an

60. Maurice H. Merrill, *The Law Relating to Covenants Implied in Oil and Gas Leases*, 2nd ed., § 84 at 212 (Thomas Law Book Co. 1940); David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 Rocky Mtn. Min. L. Inst. 10-1 at § 10.05 (2002) (discussing the marketing covenant).

61. *Iams v. Carnegie Natural Gas Co.*, 45 A. 54, 54–55 (Pa. 1899).

62. Id. at 54.

63. Id. at 55.

64. Id. at 54.

65. Id. at 55 (quoting *Glasgow v. Chartiers Oil Co.*, 25 A. 232 (Pa. 1892)).

66. Bibikos, footnote 2 above, at 969–70 (collecting cases regarding implied development covenant and notice and cure requirements).

67. Bibikos and King, footnote 1 above, at 180–88 (citing cases).

oil and gas lease for breach of a covenant, consistent with a majority of jurisdictions.[68] Accordingly, Pennsylvania courts have concluded that damages are the appropriate remedy for the breach of a lease covenant[69] except under extraordinary circumstances.[70]

68. *Penn-Ohio Gas Co. v. Franks's Heirs*, 185 A. 280, 281 (Pa. 1936); *Marshall v. Forest Oil Co.*, 47 A. 927, 929 (Pa. 1901).

69. See, e.g., *Girolami v. Peoples Natural Gas Co.*, 76 A.2d 375, 377 (Pa. 1950) (noting that damages, rather than forfeiture, are the adequate remedy for breach of covenant to pay royalties).

70. *Kleppner v. Lemon*, 35 A. 109, 110 (Pa. 1896) (cancellation for breach of protection covenant appropriate after lessor sustained burden of proving fraudulent drainage).