

AN OVERVIEW OF OIL AND GAS LEASE EXPIRATION ISSUES

George A. Bibikos
Cozen O'Connor

- I. General Rules for Lease Interpretation
 - A. The language of the oil and gas lease governs.
 - B. In Pennsylvania, lease agreements are interpreted based on general contract law principles. *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 42 A.3d 261 (Pa. 2012).
 - C. Courts in Pennsylvania also have recognized that the oil and gas industry uses words that have developed a peculiar meaning in the industry. *See, e.g., Jacobs v. CNG Transmission Corp.*, 332 F. Supp. 2d 759, 779 (W.D. Pa. 2004) (“Instruments conveying property rights in minerals such as oil and gas are executed in the context of an industry that is highly technical in nature and employs distinct terminology used by those involved in the business.”); *Daset Mining Corp. v. Industrial Fuels Corp.*, 473 A.2d 584, 592 (Pa. Super. 1984).
- II. The Basics of the Lease
 - A. Lease usually provides for a primary term (e.g., 3 or 5 years) within which the operator must comply with certain terms (pay delay rentals or commence operations) plus a period for “so long thereafter” as oil or gas is produced on the premises.
 1. The “so long thereafter” or “so long as” clause in a lease creates determinable fee in lessee. *Brown v. Haight*, 255 A.2d 508, 510 (Pa. 1969); *Snyder Bros., Inc. v. Peoples Natural Gas Co.*, 676 A.2d 1226, 1230 (Pa. Super. 1996).
 2. If production is obtained during the primary term, the lease extends into the secondary term for as long as gas is produced. *Balfour v. Russell*, 31 A. 570 (Pa. 1895).
 3. A lease may also be extended if within the primary term the lessee meets requirements other than production in order to perpetuate the lease, such as operations or preparations for drilling a well.
 - B. If the lessee satisfies the special limitation, the lease is extended beyond the primary term.

III. Keeping the Lease Alive

A. Primary Term Requirements

1. Delay Rentals

- a. Delay rentals replace the old implied covenant to drill a test well. *Aye v. Philadelphia Co.*, 44 A. 556 (Pa. 1899) (implied duty to drill additional test wells).
- b. Delay rentals create an option to keep the lease alive for the primary term so the operator may, if it chooses, drill a well during that time. *Glasgow v. Chartiers Oil Co.*, 25 A. 232 (Pa. 1892); *Bertani v. Beck*, 479 A.2d 534 (Pa. Super. 1985).
- c. Delay rentals keep the lease alive for the primary term only, not the secondary (perpetual) term. *Western Pa. Gas Co. v. George*, 28 A. 1004 (Pa. 1894); *Hite v. Falcon Partners*, 2011 PA Super 2, 2011 Pa. Super. LEXIS 3 (Pa. Super. 2011).
- d. The delay-rental provision is strictly construed in some oil-and-gas jurisdictions. Generally, payment must be (1) timely made (2) to the proper person (3) in the proper amount and (4) in the proper manner.
- e. In Pennsylvania, however, absent a time-is-of-the-essence provision, late delay rental payments are not material breaches sufficient to terminate the lease. *Linder v. SWEPI, LP*, 2013 WL 521898 (M.D. Pa. Feb. 11, 2013) (non-unitized portion of leasehold acres did not expire as a result of late delay rental payments); *Sylvester v. Sw. Energy Prod. Co.*, 2009 WL 3633834 (M.D. Pa. Nov. 2, 2009); *Dewing v. Abarta Oil & Gas Co.*, No. 268 MDA 2015 (Pa. Super. 2015) (unpublished).

2. Extension Payments

- a. Some leases have clauses authorizing the lessee to extend the primary term of the lease for an additional term of years (usually a term equal to the term of the original primary term).
- b. The same rules apply.
- c. Extension or Other Payments after Change of Ownership. Payment to the original lessor in the absence of documentation about a subsequent sale to a new lessor is sufficient under the lease's "change-of-ownership" clause to effectuate the extension

payment. *Danko Holdings LP v. EXCO Resources (PA) LLC et al.*, Docket No. 4:14-cv-00274 (M.D. Pa. 2014).

3. Commencing Operations

- a. Absent lease language to the contrary, "commencing operations" during the primary term should be enough to keep the lease alive beyond the expiration of the primary term.
- b. It does not take much under existing PA case law to qualify as "commencing operations."
 - i. In *Henderson v. Ferrell*, 38 A. 1018 (1898), for example, the lease required operations within the first 30 days of the primary term. The lessee entered the leased premises on the last of the 30-day primary term, staked the well, and followed up with an attempt to deliver timber to the well site. This was sufficient to qualify as "commencing operations" under the lease and keep the lease alive.
 - ii. In *Pemco Gas, Inc. v. Bernardi*, 5 Pa. D. & C. 3d 85, 1977 WL 260 (Pa. Com. Pl. 1977), the lease had a primary term of 10 years and "as long after commencement of operations as said land is operated for the exploration or production of gas and oil" The court held that the following activities were sufficient to qualify as commencing operations under the lease: (1) surveying property; (2) negotiating well sites with the landowner; (3) negotiating rights of way with neighbors; (4) contracting for excavation work; (5) obtaining a well permit; (6) placing materials on the site. The court noted, however, that the lessee must conduct such preliminary operations "with the good faith intent to proceed until a gas producing well was completed."
 - iii. *Roe v. Chief Exploration & Development, LLC*, No. 11-00816, 2013 WL 4083326 (M.D. Pa. Aug. 13, 2013).
 - (a) Habendum Clause: "This Lease shall remain in force for a primary term of five (5) years from [commencement], and ... for as long thereafter as operations are conducted on the Leasehold in search of production of oil, gas, or their constituents ..."

- (b) Before termination of primary term, production company pooled the leased properties and did field work on the unit, staked the well site, obtained drilling and environmental permits, executed a unit declaration, delivered a bulldozer to the well site, cut several trees.
 - (c) Production company continued work until it completed a well.
 - (d) Holding: Even minimal activity may suffice to commence operations so long as it is accompanied by the *bona-fide* intent to continue work until there is a well. Evidence that the production company in fact completed a well without substantial interruption creates a presumption that those early activities were undertaken with the intention to complete a well.
- iv. *Good Will Hunting Club, Inc. v. Range Res.*, 2013 WL 2297170 (M.D. Pa. May 24, 2013).
 - (a) The lessee engaged in staking a drill site, obtaining permits, obtaining easements, clearing timber, and beginning construction of a well pad clearly constituted commencement of drilling operations required by the lease's habendum clause.
 - (b) After the primary term in the lease ended, Range continued and completed the construction, and drilled and completed the well.
 - (c) The court concluded that the lessee commenced operations sufficient to keep the lease alive.
- c. Diligence after Commencing Operations
 - i. Lessee should proceed with reasonable diligence to maintain lease in secondary term after commencement of operations.
 - ii. *Dannic Energy Corporation v. Stoughton*, Case No. AD 08-10518 (Butler Cnty. C.P. 2014) (delay during litigation caused lease to expire in secondary term) (case settled before appeal).

4. Equitable Extension of Primary Term

- a. Equitable doctrine recognized by virtually all oil and gas jurisdictions holding that a lessor repudiates a lease by challenging its validity; if the lessor is unsuccessful, the lessee is entitled to an extension of the primary term for the same amount of time it took to litigate the unsuccessful lease validity claim.
- b. Two Pennsylvania federal district judges rejected the equitable extension doctrine based on a prior decision of a Pennsylvania intermediate appellate court and suggestions of public policy.
- c. *Harrison v. Cabot Oil & Gas Corp.*, 110 A.3d 178 (Pa. 2015).
 - i. The Third Circuit Court of Appeals certified the question to the Pennsylvania Supreme Court of “whether Pennsylvania would adopt the principle that, when an oil-and-gas lessor files an unsuccessful lawsuit to invalidate a lease, the lessee is entitled to an equitable extension of the lease term equal to the length of time the lawsuit was pending.”
 - ii. Pennsylvania Supreme Court declined to adopt the equitable extension principle, reasoning that the mere filing of a declaratory judgment action was not an unequivocal repudiation of a contract for which equitable relief was available.
 - iii. The Supreme Court left open the question of whether other equitable principles might apply and serve to extend the lease in an amount equal to the time it took to litigate the case.

B. Secondary Term

1. The secondary term is a term of indefinite duration. The lease lasts as long as there is production or some substitute for production.
2. Production
 - a. If production is required during the primary term to perpetuate the lease:
 - i. Actual Production. Absent lease language to the contrary, many states have concluded that production means “actual” production and marketing. *Stanolind Oil & Gas*

Co. v. Barnhill, 107 S.W.2d 746 (Tex. Civ. App. 1937);
Hanna v. Shorts, 125 N.E.2d 338 (Ohio 1955).

- ii. Capable of Production. Absent lease language to the contrary, some states have concluded that production means a well is “capable” of producing in paying quantities. *Summerville v. Apollo Gas Co.*, 56 A. 876 (Pa. 1904) (gas discovered that would produce in paying quantities was sufficient to hold the lease based on rationale that lessor was receiving fixed royalty payments); *T.W. Phillips Gas & Oil Co. v. Komar*, 227 A.2d 163 (Pa. 1967) (gas discovered in paying quantities during primary term, shut in to await pipelines, and lessee paid pressure-based flat rate royalties in the meantime; court held that is sufficient to hold the lease beyond the primary term based on *Summerville* rationale).

b. Production means “production in paying quantities”

- i. “Paying quantities” means the well pays a profit, however, small, over well operating costs. *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 42 A.3d 261 (Pa. 2012) (citing *Young v. Forest Oil Co.*, 45 A. 121, 122-23 (Pa. 1899) (producing in paying quantities based on subjective good faith of lessee and means profit - however small - over the cost of operating well)).
 - (a) Operating costs include, for example, labor, trucks, transportation, day-to-day costs.
 - (b) Capital costs of building the well generally excluded from “operating” costs of well.
- ii. In Pennsylvania, the default rule is that “paying quantities” is determined based on good-faith judgment of the lessee. *Young; Jedlicka*.
 - (a) “If a well consistently pays a profit, however small, over operating expenses, it will be deemed to have produced in paying quantities.”
 - (b) “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."

(c) "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."

- iii. Using produced gas from well for domestic purposes is not production in paying quantities. *Babb v. Clemensen*, 687 A.2d 1120 (Pa. Super. 1996).
- iv. If a lease specifies the amount of production required, the specified amount controls. *Moritz v. Fisher*, 6 Pa. D. & C.2d 25, 33 (1935) (minimum amount of oil per month required to keep the lease alive; otherwise, it automatically terminated).

3. Constructive Production (a.k.a. substitutes for production)

- a. When the lease provides that some event other than production keeps the lease alive.
- b. Dry Hole Clauses. Under a "dry hole" clause, if a lessee drills a well that does not produce, the lease does not terminate, and the lessee may keep the lease alive by paying delay rentals for the rest of the primary term or engaging in additional reworking operations within a specified time.
- c. Express Operations Clauses
 - i. Type 1: Well Completion. Operator who commences a well during the primary term but does not produce gas before the term expires has the right to complete that well and produce gas within the time specified by the lease (e.g., 60 days) without having the lease expire.
 - ii. Type 2: Continuous Operations. Operator who commences any operations on the leased premises but does not produce gas before the primary term expires has the right to complete a well and produce gas within the

time specified by the lease (e.g., 60 days) without having the lease expire.

d. Shut-in Royalty Clauses.

- i. *Shrader v. T. W. Phillips Gas & Oil Co.*, 44 Pa. Super. 55, 58 (Pa. Super. Ct. 1910) (fixed royalty of \$300 per quarter for gas produced “and marketed”; lessee chose not to market but (1) shut in the well to maintain reserves for the winter; (2) used gas on the lease for operations; and (3) sold it to other customers; the court held that lessee had every right to do all these things but was obligated to pay rentals).
- ii. *Messner v. SWEPI, LP*, 574 Fed. Appx. 96 (2014) (payment of shut-in rentals “for any reason whatsoever” sufficient to hold the lease; well need not be “capable of production” before exercising the shut-in rental right).

e. Pooling Clauses

- i. Pooling clause authorizes lessee to combine leases. *Snyder Bros., Inc. v. Yohe*, 676 A.2d 1226 (Pa. Super. 1996) (concluding that a pooling clause authorized the lessee to combine the plaintiff’s land with adjacent land leased by the same operator).
- ii. Absent contrary language in the lease, operations or production on any part of the unit holds all pooled leased acreage beyond the primary term. *Fox v. Wainoco Oil & Gas Co.*, 64 Pa. D. & C.3d 439 (Crawford County C.P. 1986).
- iii. If the lessee relies on the pooling clause to extend a lease within the unit and the lessee exercised the pooling clause properly, the lease is extended. *Cf. Neuhard v. Range Resources Appalachia, LLC*, Docket No. 11-1989 (M.D. Pa., April 30, 2014) (commencing operations on improperly pooled property ineffective to keep the lease alive).

f. Storage Clauses

- i. Leases that Grant Storage Rights. *Warren v. Equitable Gas Company, LLC*, No. 697 WDA 2014 (Pa. Super Ct. Feb. 4, 2015). The lease granted storage rights. The habendum clause stated that the lease would extend beyond its 10-year primary term “so long as said land is operated for the

exploration or production of gas or oil ... or as long as said land is used for the storage of gas or the protection of gas storage on lands in the general vicinity of said land.” Given that the lease granted storage rights, the lessee’s storage operations extended the lease in the absence of production.

- ii. Leases that Do Not Grant Storage Rights. In the absence of a lease that expressly grants storage rights, storage operations alone will not extend the lease. *Pomposini v. T.W. Phillips Gas and Oil Co.*, 580 A.2d 776 (Pa. Super. 1990); *Penneco Pipeline Corp. v. Dominion Transmission, Inc.*, No. 05–49, 2007 WL 1847391, at *13 (W.D. Pa. June 25, 2007), *aff’d*, 300 Fed. Appx. 186 (3d Cir. 2008); *Jacobs v. CNG Transmission Corp.*, 332 F. Supp. 2d 759 (W.D. Pa. 2004).

4. Cessation of Production

a. Permanent

- i. *General Rule*: Absent lease language to the contrary, cessation of production during the secondary term automatically terminates the leasehold. At that point, a tenancy at will is created that can be terminated by either party upon notice. *Heasley v. KSM Energy, Inc.*, 52 A.3d 341 (2012); *White v. Young*, 186 A.2d 919 (Pa. 1963); *Cassell v. Crothers*, 44 A. 446 (Pa. 1899).
- ii. *Alternative Rule*: Lessee has abandoned the lease. Absent lease language to the contrary, an unexplained and permanent cessation of production based on the intent of the lessee is an abandonment. *Clark v. Wright*, 166 A. 775 (Pa. 1933); *Williams v. Guffy*, 35 A. 875 (Pa. 1896).

b. Temporary

- i. *Express Cessation-of-Production Clauses*. Under a cessation-of-production clause, a lease will not expire in its secondary term when an operator/lessee finds it necessary to take a well temporarily out of production. For example, some leases may address the stoppage of production during the secondary term by specifying the circumstances that justify a break in production and

specifying a period of time in which production must resume before the lease expires.

ii. Temporary Cessation of Production Doctrine.

(a) A temporary cessation of production during the secondary term does not terminate the lease. *Cole v. Phila. Co.*, 26 A.2d 920 (Pa. 1942); *Burgan v. South Penn Oil Co.*, 89 A. 823 (Pa. 1914); *Double v. Union Heat & Light Co.*, 33 A. 694 (Pa. 1896); *Stock v. Inter*, 57 Pa. D. & C.2d 531 (Warren County 1972); *Mealy v. Clark*, 9 Pa. D & C.3d 566 (Warren County 1978). The test:

(b) A temporary cessation of production in order to find a market; get equipment; disconnect lines to drill deeper (*Cole*); repair a damaged well (*Burgan*); stimulate a meager/marginal well (*Stock*); move lines and tanks to comply with regulations and avoid pollution (*Mealy*) does not terminate the lease.

(c) Lessee must act diligently to resume production.

C. If the lease expires and lessee otherwise has no rights, lessee becomes a trespasser. *Shellar v. Shivers*, 33 A. 95 (Pa. 1895).

D. Other Attempts to Terminate and Oil and Gas Lease

1. Failure to Pay Cases

a. Lessors often contend that a failure to make certain payments required by the lease results in a termination, but these claims are very frequently unsuccessful.

b. Payment requirements under a lease are covenants or promises, not conditions. The usual remedy for breach of a covenant or promise is damages, not forfeiture.

c. Delay in payment was not a grounds for automatic forfeiture of an "or" type lease. *Westmoreland N. Gas Co. v. DeWitt*, 130 Pa. 235, 254, 18 A. 724, 727 (1889).

d. Leases should not be forfeited based on failure to pay royalties. *Girolami v. Peoples Natural Gas Co.*, 76 A.2d 375 (Pa. 1950).

- e. *McCausland v. Wagner*, 78 A.3d 1093 (Pa. Super. 2013). A lease that has been developed such that it is properly held by production beyond its primary term would not be subject to a forfeiture provision for failure to timely pay royalties.
2. Breach of Implied Covenants.
- a. Absent lease language to the contrary, courts sometimes read into the lease certain “implied covenants” such as the covenant to develop the leased premises and to market production. *See The Law of Oil & Gas in Pennsylvania, Implied Covenants*, Chapter 6 (PBI 1st ed.) (September 2014).
 - b. Lessors often seek to cancel leases based on a breach of implied covenants, but those, too, are often unsuccessful given that the lessors are asking courts to forfeit a vested property right for breach of a promise when the usual remedy is damages.
 - c. In *Seneca Resources Corporation v. S&T Bank*, No. 2057 WDA 2014 (Pa. Super. Aug. 31, 2015), the landowners argued that they had the right to terminate their lease with respect to un-operated acreage after the 40-year primary term of the lease expired for failure to develop the undeveloped acreage. The lease provided that it would continue if operations or production occurs on “all or any portion of said leased premises.” The court noted that it was “undisputed that Seneca continues to drill and withdraw gas from a portion of the leased premises” and concluded that “the Lease between the Appellants and Seneca forecloses a finding of a breach of the implied covenant to develop and produce oil and gas on the unoperated acreage.”
 - d. *See also Caldwell v. Kreibel Resources, Co., LLC*, 72 A.3d 611 (Pa. Super. Ct. 2013). Lessor not entitled to terminate a producing lease for failure to develop deeper strata. The express terms of the lease disclaiming implied covenants trump any covenant to develop deeper strata.
- E. “Recording of Surrender Documents from Oil and Natural Gas Lease Act,” 58 P.S. §§ 901-905.
- 1. The Act Requires lessees to provide a surrender document in recordable form to a lessor within 30 days of the “termination, expiration or cancellation” of an oil and gas lease.

2. The surrender document must include a description of the land subject to the lease and the municipality; a statement that “the oil or natural gas lease is terminated, expired or cancelled pursuant to the terms of the lease”; the date of termination; a statement that the “lessee surrenders all of the lessee’s rights, duties and interests under the lease”; and the lessee’s signature. 58 P.S. § 902.
3. If the lessee does not timely deliver a surrender document to the lessor, the lessor send a notice to the lessee that includes the following statements: the lease has terminated, expired or been canceled and the date; the lessor has failed to receive a timely surrender document from the lessee as required by the Act; if the lessor does not receive a timely notice, the lessor has the right to record an affidavit of termination.
4. The lessee may challenge the notice in writing within 30 days after its receipt. If the lessee does not timely challenge the notice, the lessor may record the affidavit of termination.