

Natural Gas Case Law Brief

Jacobs v. CNG Transmission Corp.

96-cv-319; 332 F. Supp. 2d 759 (W.D. Pa. July 6, 2004)

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This case concerned a lease agreement that was entered into by the predecessor of Jacobs, the plaintiff landowner, and the predecessor of CNG Transmission Corp (CNG), the defendant gas company. The lease agreement provided that the lessee would pay a \$30.00 quarterly rental starting in the summer of 1956 until a well yielding royalty to the lessor was constructed on the property, or the sand strata below the property was used to store non-native gas, or until ten years passed. Once wells were constructed on the property or the sands were used for non-native gas storage, the payment shifted to \$50.00 quarterly or to a royalty depending on the case. The occurrence of one of these two scenarios would shift the lease into its secondary term.

CNG and its predecessors had stored non-native gas under the land since the start of the lease. No wells had ever been built upon the land, however, and CNG, having sold all of its equipment, no longer had the capacity to drill for additional natural gas. Jacobs and CNG agreed that there were valuable natural gas deposits below the sand strata, but the parties disagreed on who had ownership rights to that gas. Whereas Jacobs argued that CNG surrendered its rights to the natural gas by not drilling a well, CNG argued that its use of the sand strata for storage pushed the lease into its secondary term, thus giving CNG rights to the natural gas at any time so long as the \$30.00 quarterly rental was paid.

Jacobs entered into negotiations with CNG soon after he purchased the lands in question. The parties were unable to reach an agreement regarding their respective rights to the natural gas, and Jacobs entered into a new gas lease with co-plaintiff Pennoco Energy Corp. The resultant litigation started in the District Court for the Western District of Pennsylvania. Judge D. Brooks Smith ruled that the storage and development clauses of the original lease agreement could not be severed, and he also ruled that there was no implied duty to develop the lands included in an oil and gas lease. The decision was appealed to the Third Circuit Court of Appeals, and it was remanded for this decision after the Pennsylvania Supreme Court answered two relevant questions of law. The Pennsylvania Supreme Court found that the intent of the parties regarding severability of contract provisions does not have to be ambiguous before considering all aspects of the parties' relationship to determine severability, and also that there is an implied duty to develop the lands included in an oil and gas lease when the payment of royalties is the sole

source of consideration for the lessor, but not necessarily when delayed rental or bonus payments are paid to the lessor in addition to royalties. *Jacobs v. CNG Transmission Corp.*, 772 A.2d 445 (Pa. May 29, 2001).

On remand, the Court addressed two issues: (1) *were the storage and development clauses of the lease between Jacobs and CNG severable?*, and (2) *was there an implied duty on the part of CNG to develop the leased land for its oil and gas potential?*

The Court held that the storage and development clauses of the lease between Jacobs and CNG were not severable. According to the Court, the severability of contractual provisions is determined by the intent of the contracting parties. When there is a written document embodying an unambiguous intent, that intent is enforced by the court. Only when there is ambiguity in the writing should the court consider extrinsic circumstances.

As noted by the Court, the best indicator of severability is often the consideration exchanged by the parties. “The apportionment of consideration to distinct and separate components of an agreement is in general an indication that the parties intended to create an agreement with severable provisions.” *Shields v. Hoffman*, 204 A.2d 436 (Pa. 1964).

The contract in this case was facially ambiguous on the issue of severability, but after examining the consideration exchanged and the circumstances surrounding the execution of the lease, the Court determined that the parties intended the lease to be entire and not severable. As stated by the Court:

When the lease was executed it was without question that the provisions of an oil and gas lease would be understood as forming an agreement with a central objective: promoting the development of the property for the mutual benefit of the parties. In light of this understanding, the dual purposes identified in the granting clause of the lease properly are understood as interrelated components designed to accomplish this central goal.

That the agreement was not severable does not necessary mean that CNG still had rights to the subsurface natural gas reserves, however. *CNG had an implied duty to develop the land for its natural gas, and CNG failed to perform that duty.* The terms of the contract provided that delayed rent could be paid during the initial lease term. This allowed the lessee to maintain rights to the natural gas without having to develop the land. But when the primary term kicked into the secondary term following the start of storage below the surface, the lessee had an implied duty to develop the land because the lessee was no longer bound to pay delayed rental on the land. The storage rental payments related only to the subsurface sand strata. It did not follow that simply by paying the storage rental the lessee would also maintain rights to the native natural gas below the land. Allowing CNG to maintain the gas rights would deprive the lessor of the consideration rightfully deserved for his property. It also goes against public policy by leaving the natural gas rights with a company incapable of drilling for it.

Furthermore, even if CNG could have maintained rights to the natural gas by paying \$120.00 yearly in storage fees, CNG abandoned that right as a matter of law. According to the Court, the lessee in an oil and gas lease who is not paying delayed rental has an implied

obligation to develop the land with reasonable diligence, and the failure to do so amounts to abandonment. Abandonment is generally a question of fact, but where, as here, the lessee sold all of its drilling equipment and failed to build a well on the land over the course of nearly forty-eight years, abandonment is determinable as a matter of law.

Jacobs' motion for summary judgment was granted and CNG's motion for summary judgment was denied.



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