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2009 Pennsylvania Oil and Gas Case Law Update for Pennsylvania Natural Gas Summit

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Prepared by Ross H. Pifer, Center Director
with research assistance provided by Robert M. Jochen

Pennsylvania Minimum Royalty Act litigation

- *Kilmer v. Elexco Land Services, Inc.*, No. 2008-57, slip op. (Susquehanna Ct. Com. Pl. Mar. 3, 2009), *appeal docketed* 464 MDA 2009 (Pa. Super. Ct. Mar. 10, 2009), *allocatur granted* 46 MM 2009 (Pa. June 16, 2009), *appeal docketed* 63 MAP 2009 (Pa. June 16, 2009).

    - The Court of Common Pleas upheld the validity of a lease agreement that deducted post-production costs prior to the calculation of the landowner's royalty. The court found that the parties were free to determine how the royalty was calculated. The lease in question, therefore, did not violate Pennsylvania's minimum one-eighth royalty requirement.

    - Kilmer appealed the ruling of the Court of Common Pleas to the Pennsylvania Superior Court. On June 16, 2009, in response to a defense request, the Pennsylvania Supreme Court granted a Petition for Exercise of Extraordinary Jurisdiction. The issue accepted for review by the Supreme Court was "Whether 58 PA. STAT. § 33 precludes parties from contracting that post-production costs be factored into the determination of the amount of royalty payable under an oil or natural gas lease." The parties argued the issue before the Supreme Court on September 16, 2009. The court has not yet ruled on this matter.

    - The interpretation of Pennsylvania's minimum royalty act is at issue in dozens of active cases in the state and federal court systems. It is believed that all of these cases are on hold pending the Supreme Court's ruling in *Kilmer*.

- *Kropa v. Cabot Oil & Gas Corp.*, 609 F.Supp.2d 372 (M.D. Pa. Apr. 17, 2009).

- Landowner John Kropa sought to terminate his natural gas lease based upon noncompliance with 58 PA. STAT. § 33, which requires that a natural gas lease guarantee payment of at least a one-eighth royalty. Kropa argued that this statutory minimum royalty provision had been violated because his lease authorized post-production expenses to be deducted from his one-eighth royalty. Cabot Oil & Gas Corporation filed a motion to dismiss.

- The court denied the motion to dismiss. After consideration of whether the term "royalty" should be construed according to its common usage or to its peculiar meaning within the industry, the court concluded that neither party, at this stage of litigation, had established the meaning of the term. The court recognized that there were two schools of thought as to the definition of "royalty." To ascertain its proper meaning, the court opined that it would need to review additional documents as the case proceeded.

- *Stone v. Elexco Land Services, Inc.*, No. 3:09-cv-264, 2009 WL 1515251 (M.D. Pa. June 1, 2009).

    - In a case involving similar factual allegations and legal claims as in *Kropa*, the court dismissed a motion to dismiss filed by the defendant. The legal analysis in this opinion largely mirrored that in *Kropa*. Both opinions were written by Judge Munley.

- *Price v. Elexco Land Services, Inc.*, No. 3:09-cv-433, 2009 WL 2045135 (M.D. Pa. July 9, 2009).

    - In another case involving similar factual allegations and legal claims as in *Kropa*, the court dismissed a motion to dismiss filed by the defendant. The legal analysis in this opinion largely mirrored that in *Kropa* and *Stone*. This opinion also was authored by Judge Munley.

- For more thorough coverage of this legal topic, see Robert T. Jochen, *Emerging Case Law Interpreting Pennsylvania's Minimum Royalty Act: 58 Pa. Stat. § 33*, The Agricultural Law Resource and Reference Center (Aug. 7, 2009), http://law.psu.edu/_file/aglaw/Pennsylvania_Minimum_Royalty_Act.pdf. This document is contained within the Natural Gas Exploration Resource Area of the Penn State Agricultural Law Center Web site.

Request for Invalidation of Lease Due to Untimely Tender of Payment

- *Sylvester v. Southwestern Energy Production Co.*, No. 3:09-cv-1653, 2009 WL 3633835 (M.D. Pa. Nov. 2, 2009).

- Plaintiffs sought a declaratory judgment that a ten-year natural gas lease entered into between the parties was null and void. The lease provided that Plaintiffs were to receive the sum of $15,665.00 ($162.50 per acre) within 60 days after the signed order of payment was returned to the gas company. The gas company tendered payment in full to Plaintiffs 23 days after the passage of the due date. Plaintiffs marked the check as void and returned it to the gas company. Plaintiffs filed suit seeking a declaration that the lease was unenforceable, and Defendant responded by filing a motion to dismiss.

- The court granted Defendant's motion to dismiss, ruling that the 23 day delay in providing payment did not constitute a material breach of the lease terms. In reaching this conclusion, the court considered several factors. First, Plaintiffs could still receive their benefit of the bargain by accepting a reissued payment from Defendant. Second, the lease provided that 90 days notice of default was to be provided by Plaintiff prior to filing suit. Although notice of default was not given, Plaintiff would have received the lease payment well within this cure period had notice been provided. Finally, the lease did not contain a provision stating that "time was of the essence." Since time was not of the essence, a brief delay in payment did not give rise to a breach of the lease agreement. As such, Plaintiffs could not establish a claim to void the lease agreement.

Breach of Contract for Failure to Approve Lease Agreement

- *Hollingsworth v. Range Resources – Appalachia, LLC,* No. 3:09-cv-838, 2009 WL 3601586 (M.D. Pa. Oct. 28, 2009).

  - Plaintiffs filed suit alleging that Range Resources (Range) failed to make a bonus payment as provided in a five-year lease agreement executed by Plaintiffs and submitted to Range. The relationship between the parties was initiated on or about June 8, 2008, when Range sent a "Dear Property Owner" letter to Plaintiffs. The letter stated that Range would pay Plaintiffs the sum of $165,000 ($2,500 per acre) within 90 days after execution of the lease agreement. The lease, however, contained language stating that payment of the lease bonus was "subject to approval of title and management lease review." Plaintiffs submitted the executed (by Plaintiffs), notarized lease to Range on August 23, 2008. Range failed to make any payment to Plaintiffs, and on December 16, 2008, sent a letter to Plaintiffs notifying them that the lease had not been approved by management. Plaintiffs filed suit on March 30, 2009, seeking a declaration that the lease agreement was valid and that Range was required to make the bonus payment as specified in the agreement. Range filed a motion to dismiss asserting that a valid contract had not been formed.

  - The court agreed with Range that a valid contract did not exist and granted the motion to dismiss. According to the court's opinion, the initial "Dear Property

Owner" letter did not constitute an offer as Range "did not sign the lease and stated that plaintiffs' signed lease would be subject to review." *Id.* at *3. By executing the lease agreement and submitting it to Range, the court found that Plaintiffs were the party extending the offer and that Range rejected this offer. Because a contract did not exist, Plaintiffs could not prove a claim for breach of contract. Furthermore, the court determined that the issue in question was to be resolved using contract law rather than real property law. As such, it was irrelevant whether Plaintiffs had delivered the lease to Range.

- *Lyco Better Homes, Inc. v. Range Resources – Appalachia, LLC*, No. 4:09-cv-249, slip op. (M.D. Pa. May 21, 2009), *appeal docketed*, No. 09-2645 (3rd Cir. June 2, 2009).

    - This unreported case was relied upon heavily in the Report and Recommendation of the Magistrate Judge in *Hollingsworth*. One potentially notable difference between *Lyco* and *Hollingsworth* is the allegation that Range management did approve the Lyco lease agreement prior to disapproving it. Lyco is currently on appeal before the United States Court of Appeals for the Third Circuit.

Use of Surface Estate Where Natural Gas Rights Have Been Severed from Surface Estate

- *Belden & Blake Corp. v. Commonwealth Dep't of Conservation and Natural Res.*, 969 A.2d 528 (Pa. Apr. 29, 2009).

    - Belden & Blake Corporation (Belden) owned oil and natural gas leases on parcels within Oil Creek State Park and sought to develop gas wells on the parcels. The Department of Conservation and Natural Resources (DCNR), however, would not permit surface access unless Belden complied with a "coordination agreement" that provided for a performance bond and double stumpage fees for removed timber. DCNR cited its status as a trustee for the Commonwealth's public natural resources as a basis for imposing conditions on the use of the surface estate. Belden filed suit seeking to enjoin DCNR from interfering with its implied easement to enter upon the parcels to exercise its ownership of the natural gas rights. The Commonwealth Court ruled in Belden's favor on a motion for summary judgment, and DCNR appealed to the Supreme Court.

    - The Supreme Court, in a 4-2 opinion, affirmed the ruling of the Commonwealth Court in holding that DCNR could not require that Belden comply with the "coordination agreement."

        - In its opinion, the court first addressed the relationship between the owners of the surface estate and the subsurface estate. The court reaffirmed *Chartiers Block Coal Co. v. Mellon*, 25 A. 597 (Pa. 1893) as the governing law on this issue and relied upon *Chartiers* for the proposition that "an owner of an underlying estate, such as Belden &

Blake here, has the right to go upon the surface in order to reach the estate below, 'as might be necessary to operate his estate.'" *Belden* at 532. The owner of the subsurface rights is constrained by the fact that his surface use must be reasonable, but the court found that *Chartiers* places the burden on the surface owner, not the subsurface owner, to file a legal action to challenge the reasonableness of the surface use.

- After finding that Belden's use of the surface estate would be reasonable, the court addressed the impact of DCNR's statutory duties to preserve and maintain natural resources. On this issue, the court ruled that "[a] subsurface owner's rights cannot be diminished because the surface comes to be owned by the government." *Belden* at 532. DCNR could negotiate a surface use agreement with the energy company just as a private landowner could do so. If a voluntary agreement was not reached, DCNR could impose conditions only through the exercise of eminent domain, and payment of just compensation would then be required for the diminution of the subsurface owner's rights.

- The dissenting opinion, authored by Justice Saylor, opined that DCNR's status as a custodian and trustee of the Commonwealth's natural resources was a relevant factor in the application of *Chartiers*. As such, the proper inquiry should have been whether the conditions required by DCNR were reasonable.

Lease Interpretation – Meaning of Phrase "Produced in Paying Quantities"

- *T.W. Phillips Gas and Oil Co. v. Jedlicka*, 964 A.2d 13 (Pa. Super. Ct. Dec. 29, 2008), *appeal docketed*, 19 WAP 2009 (Pa. July 30, 2009).

  - The Pennsylvania Superior Court upheld the validity of an oil and gas lease executed in 1928. The plaintiff gas company filed suit seeking a declaratory judgment as to the rights of the parties under the 1928 lease. The lease was to last for two years "and as long thereafter as oil or gas [was] produced in paying quantities." The gas company drilled its first wells under the lease in 1929 and subsequently drilled wells in 1986, 2004, and 2005. Prior to filing suit, it sought to drill four additional wells. The defendant landowner, a successor in title to the original lessor, argued that the lease terminated in 1959 because the lease was not profitable in that year. Since that time, defendant argued, the lease had operated as a tenancy at will. Relying upon the 1899 Supreme Court precedent established in *Young v. Forest Oil Co.*, 45 A. 121 (Pa. 1899), the trial court ruled that the phrase "produced in paying quantities" was to be determined by the gas company so long as this determination was made in good faith and not for the purpose of "holding the land for purely speculative purposes." The Superior Court affirmed the application of a subjective standard and ruled that Defendant, as the party

seeking lease forfeiture, had not sustained her burden to prove that the gas company had acted in bad faith.

- Jedlicka filed a Petition for Allowance of Appeal to the Pennsylvania Supreme Court challenging the Superior Court's reliance on a subjective standard. On July 29, 2009, the Supreme Court granted the Petition, accepting the following issue for review: "Did the Superior Court misapply the decision of this Court in *Young v. Forest Oil Co*., 45 A. 121 (Pa. 1899), by holding that Pennsylvania employs a purely subjective test to determine whether an oil or gas lease has produced 'in paying quantities.'" Briefing of the issue was completed by the parties on October 27, 2009. The case remains pending before the Supreme Court.

Extent of Partnership Operations – Does Partnership Encompass All Wells Drilled on Leasehold?

- *Szymanowski v. Brace*, No. 1703 WDA 2008, 2009 WL 3790561 (Pa. Super. Ct. Nov. 13, 2009).
  - The parties entered into a partnership agreement to drill a total of two gas wells on two leaseholds held by Brace. Through an investment of $15,000 per well, Szymanowski and fellow Plaintiff Wheeling each acquired a 10% net interest in the two wells to be drilled. The two partnership wells were drilled as proposed on the Danylko and Dougherty leaseholds. Danylko #1 ceased production in February 2005, yielding a total return of $454,913.80 to Szymanowski and Wheeling after a mere 28 month productive life. In 2004, Brace, in his individual capacity, completed two additional wells on the Danylko leasehold. These wells were located approximately 1,100 and 1,200 feet from Danylko #1. Szymanowski and Brace filed suit, arguing that these two additional wells on the Danylko leasehold should have been treated as partnership wells.

  - On November 13, 2009, the Superior Court affirmed the ruling of the Erie County Court of Common Pleas granting summary judgment in favor of Brace. According to the court, the governing principle in this case was to "ascertain and effectuate the intention of the parties." *Id.* at *1. After reviewing the Gas Well Agreement, the court concluded that the scope of the partnership was narrowly focused on the development of the two specifically identified gas wells. The court opined that the parties had no expressed intention to include additional wells, or the leaseholds themselves, within the partnership operations. Plaintiffs also argued that general partnership law supported their claim that the two additional wells were partnership assets. The court rejected these arguments, finding that Brace's retention of an overriding royalty and the deduction of intangible drilling costs on the partnership tax returns did not support Plaintiffs claim. Finally, the court found that there was no evidence supporting the claim that the two additional Danylko wells had impacted production from the partnership wells.

Private Party Intervention in Forest Service Litigation

- *Forest Service Employees for Envtl. Ethics v. United States Forest Service*, No. 1:08-cv-323, 2009 WL 960244 (W.D. Pa. Apr. 7, 2009).

    - Plaintiffs, including the Allegheny Defense Project and the Sierra Club, claimed that the United States Forest Service (USFS) had violated the National Environmental Policy Act (NEPA) by failing to conduct Environmental Impact Statements or Environmental Assessments prior to issuing Notices to Proceed (NTP) for natural gas exploration and development activities within the Allegheny National Forest. Plaintiffs sought a declaration that USFS had failed to comply with NEPA as well as an injunction barring the USFS from issuing any NTPs until it complied with these statutory requirements. The Pennsylvania Oil and Gas Association (POGAM) and the Allegheny Forest Alliance (AFA) filed a motion for leave to intervene in the action. POGAM is a trade association representing oil and gas producers within the Commonwealth and AFA is a coalition of public and private entities who are directly impacted by activities within the Allegheny National Forest.

    - In granting the motion for leave to intervene as to both proposed intervenors, the court relied upon the analytical framework expressed in *Kleissler v. United States Forest Service*, 157 F.3d 964 (3rd Cir. 1998). According to *Kleissler*, the four elements that must be established by a proposed intervenor are "first, a timely application for leave to intervene; second, a sufficient interest in the litigation; third, a threat that the interest will be impaired or affected, as a practical matter, by the disposition of the action; and fourth, inadequate representation of the prospective intervenor's interest by the existing parties to the litigation." *Id.* at 969. Of these elements, Plaintiffs challenged whether the proposed intervenors had a sufficient direct interest that would be affected by the litigation. The court reviewed applicable case law in the Third Circuit and concluded that POGAM and AFA did have significant interests in the litigation. Thus, the court approved intervention.

- *Forest Service Employees for Envtl. Ethics v. United States Forest Service*, No. 1:08-cv-323, slip op. (W.D. Pa. May 12, 2009), *appeal docketed*, No. 09-3036 (3rd Cir. July 16, 2009).

    - On April 9, 2009, two days after the order granting intervention, Plaintiffs and USFS filed a stipulation of dismissal with attached settlement agreement. The terms of the settlement recognized that USFS had legal authority to establish reasonable conditions upon the use of the surface estate. USFS agreed to undertake NEPA analysis prior to issuing NTPs in the future, and Plantiffs agreed not to challenge NTPs previously issued unless they authorized drilling in

specifically designated sensitive areas. USFS also agreed to pay Plaintiffs' attorney fees. Neither POGAM nor AFA were parties to the proposed settlement, and on April 13, 2009, both filed a motion to stay the entry of the settlement. The court denied this motion in an unreported opinion. POGAM and AFA have appealed this order to the United States Court of Appeals for the Third Circuit. The propriety of the settlement terms also is at issue in *Minard Run Oil Co. v. United States Forest Service*, No. 1:09-cv-125 (W.D. Pa. filed June 1, 2009).

Municipal Regulation of Natural Gas Operations – Oil and Gas Act Preemption

- *Huntley & Huntley, Inc. v. Borough of Oakmont*, 964 A.2d 855 (Pa. Feb. 19, 2009).
    - Huntley & Huntley sought to drill a well in order to extract natural gas from two parcels comprising a total of ten acres. Both of these five-acre properties were located in an R-1 zoning district. DEP granted a permit for the drilling operation at the desired location, but the borough ordered that drilling operations cease until the borough had ruled on a conditional use application. The borough ultimately denied the conditional use.
    - The issue presented to the Supreme Court was whether the borough could regulate the location of gas wells through its zoning ordinance or whether such a restriction had been preempted by section 205 of the Oil and Gas Act. The court analyzed both prongs Oil and Gas Act preemption – features and purposes – and found that neither had been violated.
        - With respect to the location of a well being a prohibited feature, the court ruled that "'features of oil and gas well operations regulated by this act' pertains to technical aspects of well functioning and matters ancillary thereto, rather than the well's location." *Id.* at 864. The court provided some examples of these preempted ancillary matters such as registration, bonding, and well site restoration.
        - With regard to the second prong – purposes – the court found that the purposes of the zoning ordinance were different than the purposes of the Oil and Gas Act. The court noted that the purposes of zoning were to authorize uses that considered "the community's development objectives, its character, and the 'suitabilities and special nature of particular parts of the community.'" *Id.* at 866.
    - In concluding, the court stated that the ordinance's "overall restriction on oil and gas wells in R-1 districts [was] not preempted" by the Oil and Gas Act. *Id.* It is interesting to note the court's specific reference to the R-1 district. Would the ruling have been different if the drilling was proposed in a less restrictive zoning district? That is not clear from the opinion and undoubtedly will be the subject of

debate and possibly future litigation. Nevertheless, the Oakmont opinion establishes the proposition that municipalities do have some ability to regulate oil and gas operations within their borders.

- *Range Resources v. Salem Twp.*, 964 A.2d 869 (Pa. Feb. 19, 2009).

    - Salem Township enacted a subdivision and land development ordinance that contained a number of requirements regulating oil and gas drilling activities. Salem Township's ordinance contained provisions relating to permitting, bonding, location of facilities, groundwater protection, restoration of well sites, well casing, and plugging.

    - In reviewing the two prongs of section 602, the court found that the ordinance violated both aspects of Oil and Gas Act preemption – features and purposes. The ordinance regulated features of oil and gas operations addressed by the Oil and Gas Act through the various requirements that overlapped with – and in cases that were more restrictive than – Oil and Gas Act requirements. The court also found that the ordinance's purpose of "enabling continuing oil and gas drilling operations . . . while ensuring the orderly development of property" was also one of the purposes of the Oil and Gas Act. *Id.* at 876.

    - The court summarized its ruling by stating, "[n]ot only does the Ordinance purport to police many of the same aspects of oil and gas extraction activities that are addressed by the Act, but the comprehensive and restrictive nature of its regulatory scheme represents an obstacle to the legislative purposes underlying the Act." *Id.* at 877. The court went on to conclude, "Furthermore, [the ordinance's] stated purposes overlap substantially with the goals as set forth in the Oil and Gas Act, thus implicating the second statutory basis for express preemption of MPC-enabled local ordinances." *Id.* Salem Township requested that the court rule on each of its requirements individually, but the court refused to do so. The court invalidated the entire ordinance. It is possible that some of the requirements contained in the ordinance would have been upheld individually, but as a whole these requirements violated the preemptive provisions of the Oil and Gas Act.

- *Arbor Resources LLC v. Nockamixon Twp.*, 973 A.2d 1036 (Pa. Commw. Ct. May 12, 2009)

    - Four gas companies sought a declaration that the Oil and Gas Act precluded Nockamixon Township from applying its zoning ordinance to regulate drilling operations. In response, the township filed preliminary objections, arguing that the matter was not properly before the court because the gas companies had not presented the matter to the township's Zoning Hearing Board prior to filing suit. In granting the preliminary objections, the Bucks County Court of Common Pleas acknowledged that the Oil and Gas Act had some preemptive effect on municipal

regulation. The court, however, concluded that it could not reach the question of whether any township ordinances had been preempted in the instant case because the gas companies had failed to utilize available statutory remedies.

- The Commonwealth Court affirmed the ruling of the Court of Common Pleas. The court reviewed applicable case law to determine whether the ordinance in question contained operational regulations or zoning regulations. After doing so, the court concluded that the ordinance did not contain operational requirements. As such, the trial court did not have subject matter jurisdiction to rule on this zoning question because the Municipalities Planning Code had vested original jurisdiction in the township's Board of Supervisors or Zoning Hearing Board.

- *Range Resources – Appalachia, LLC v. Blaine Twp.*, No. 09-355, 2009 WL 3515845 (W.D. Pa. Oct. 29, 2009).

  - Blaine Township, Washington County, adopted certain ordinances restricting corporate activities within the township. Range Resources challenged these ordinances as being unconstitutional and an improper exercise of police power. Range Resources also argued that these ordinances were preempted by various Pennsylvania statutes including the Oil and Gas Act.
  - The court granted a motion for judgment on the pleadings filed by Range Resources. One of the bases for the ruling was Oil and Gas Act preemption. The court found that the township's Disclosure Ordinance had been preempted since this ordinance, as applied, directly conflicted with provisions of the Oil and Gas Act.
  - In *Range Resources – Appalachia, LLC v. Blaine Twp.*, No. 09-355, 2009 WL 1783529 (W.D. Pa. June 23, 2009), the court previously had denied a motion to dismiss filed by the township.