

# **Gas Lease Termination Issues: Shut-In Royalties, Delay Rentals and Other Failure to Develop Claims**

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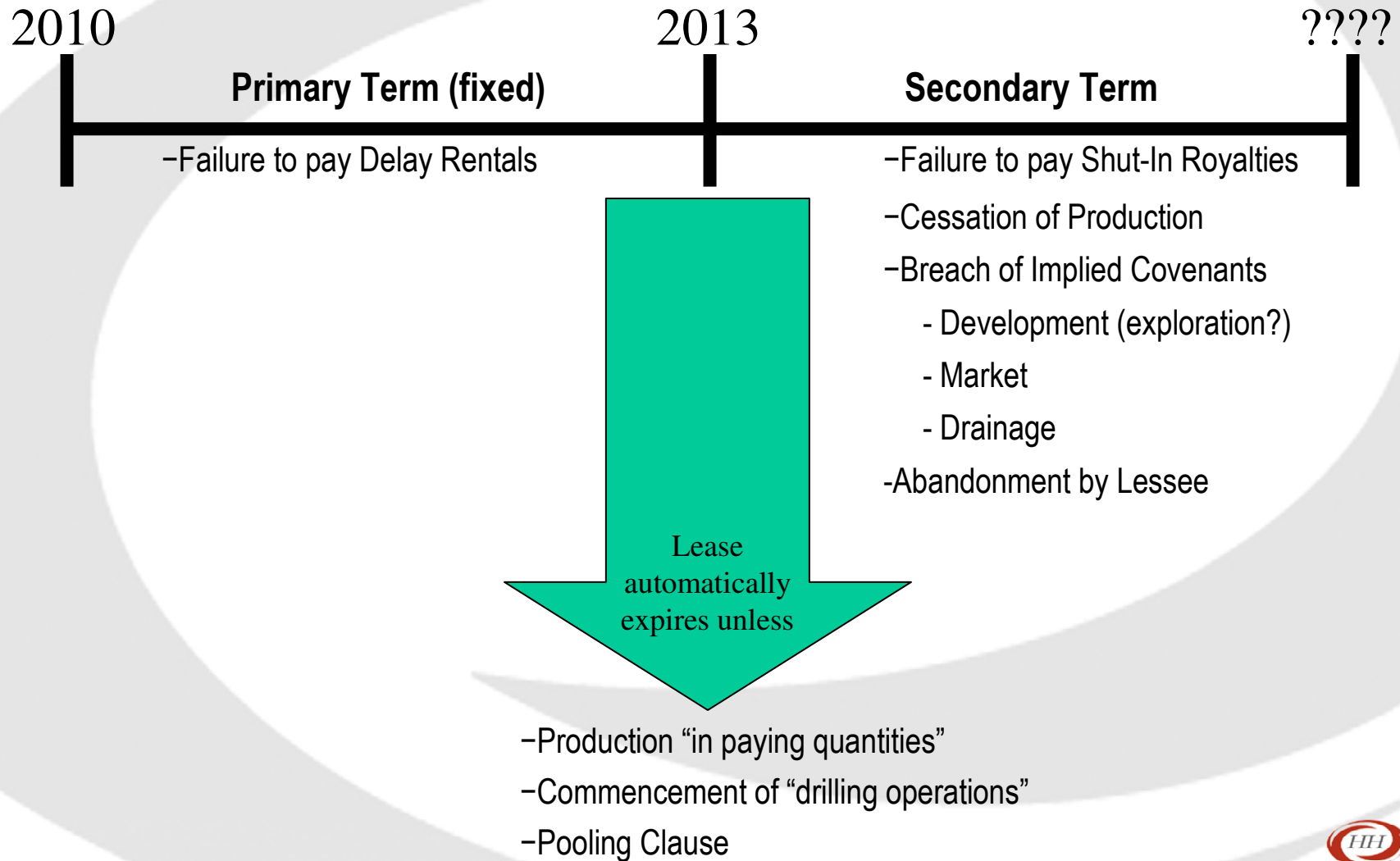
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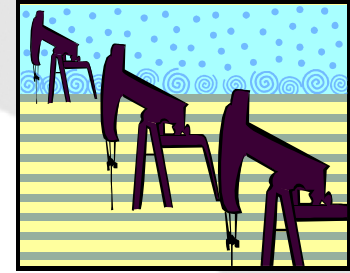


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# Termination of gas lease:



# What is the “Primary Term”?



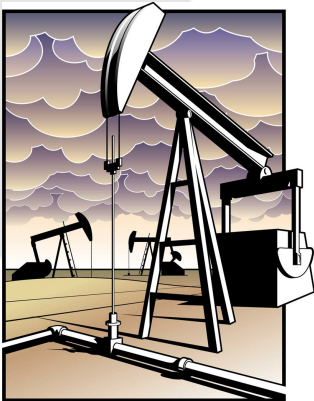
- The period, typically three to five years, during which the Lease may be kept alive by a Lessee by virtue of drilling operations or the payment of delay rentals
- During the Primary Term, the Lessee has the opportunity, but not the duty, to explore, drill and produce gas

# What is the “Secondary Term”?

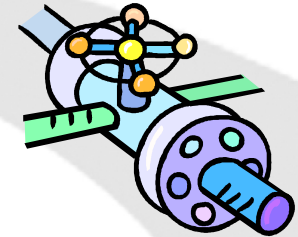
- Indefinite duration provided the wells produce gas “in paying quantities”
- Cessation of production will generally terminate the Secondary Term

# Termination During the Primary Term:

- Failure to Pay Delay Rentals
  - Can result in early Lease termination, depends on language in the Lease
  - Delay rentals are “in the nature of liquidated damages for the lessee’s decision to forgo production and are viewed as the consideration paid to the landowner in lieu of a royalty...”
  - Keeps the Lease “alive” absent actual production during the Primary Term



# Two Types of Delay Rental Clauses:



- “Unless” Clause
  - If no production, then the Lease will terminate “unless” delay rentals are paid
  - Most common type of Delay Rental Clause
- “Or” Clause
  - Provides that the Lessee may “drill or pay delay rental”; failure to pay delay rental gives rise to claim for money damages only
  - Uncommon
- Payment of Delay Rental after expiration of the Primary Term will not extend the Lease. See, Jacob v. CNG Transmission, 332 F.Supp.2d 759, 790 (W.D.Pa. 2004)

# Automatic Termination Rule:

- Triggered at the expiration of the Primary Term
- Lease *automatically* terminates unless “drilling operations” have commenced or if gas is being produced “in paying quantities”
- Equitable remedies, such as waiver and estoppel, are generally not available to avoid the Automatic Termination Rule

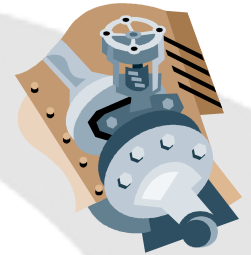


# Failure to commence drilling operations:



- Most Leases provide that the Lease will not terminate so long as the Lessee “commences operations for drilling” by the end of the Primary Term
- Specific language of the Lease is critical!
- General Rule: Acts preparatory to actual drilling are sufficient to constitute “commencement of operations”
- Selecting the well location, hauling lumber onto the site, erecting derricks, providing a water supply, moving machinery onto the site, when performed in good faith, are sufficient. See, Pemco Gas v. Bernardi, 5 D.&C.3d 85 (Armstrong County 1977)

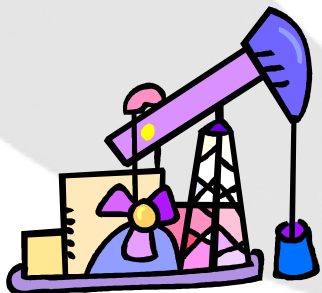
# Lack of Production:



- For a Lease to remain in effect into the Secondary Term, a well must be capable producing “in paying quantities”
- Production “in paying quantities” has been defined as “those quantities of gas which will produce a profit, however small, over operating expenses...” See, Young v. Forrest Oil, 45 A. 121 (Pa. 1899)
- Pennsylvania has been a “discovery rule” jurisdiction, i.e., the mere discovery of gas from a well capable of producing in paying quantities is sufficient. See, Summerville v. Apollo Gas, 56 A. 876 (Pa. 1903) – most states require the Lessee to both “discover” and “market” the gas (Texas, Ohio, Oklahoma, Kansas)

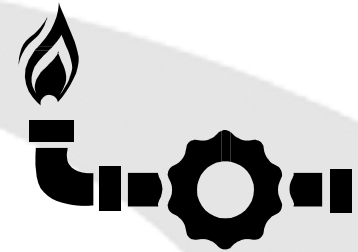
# Lack of Production (cont'd):

- What costs are to be considered? Must be a profit in excess of “lifting expenses”, *i.e.*, those costs associated with lifting the gas from the ground after the well has been drilled
- Lifting expenses consist of the following: costs of pump operation, pumper’s salaries, costs of supervision, gross production taxes, royalties, electricity and other utilities, depreciation and other costs
- One time expenses, such as drilling, equipping and reworking costs, are capital expenditures and are not to be considered



•But, unclear if Pennsylvania follows “lifting expenses” doctrine. See, Carlson v. Hunt, 1 D&C.3d 428 (Warren County 1975)

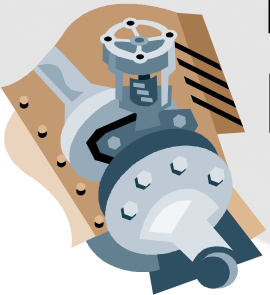
# Lack of Production (cont'd):



- To prove that a Lease is not producing “in paying quantities”, the Lessor must show both that the Lease operated at a loss over a reasonable period of time and that the Lessee has, in bad faith, failed to perform or maximize production. See, T.W. Phillips v. Jedlicka, 969 A.2d 13 (Pa. Super 2008)
- Pennsylvania has long used a “subjective good faith” standard when evaluating Lessee conduct. Under this standard, the courts defer to the Lessee’s business judgment and a Lessor cannot recover unless he or she proves bad faith
- Majority of jurisdictions apply the “reasonably prudent operator” standard, *i.e.*, whether a reasonably prudent operator would not continue operating under the circumstances (Texas, Oklahoma, Kansas)

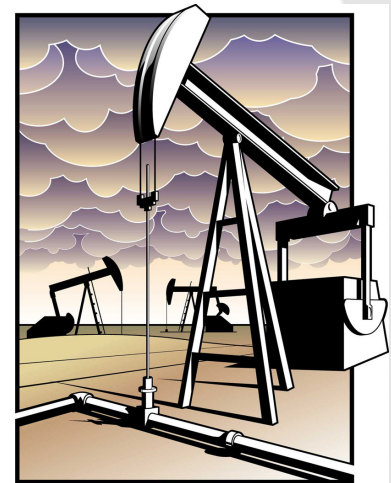
# Pooling Clause:

- Pooling refers to the integration of smaller leased tracts into a single larger unit for drilling operations
- A pooling clause enables the Lessee to preserve its Lease by producing “in paying quantities” from *anywhere* in the pooled unit
- General Rule: There is no right to pool absent the consent of the Lessor
- Involuntary Pooling? May become economic necessity for most Marcellus wells in Pennsylvania. See, House Bill No. 2213



# Termination During the Secondary Term:

- Failure to pay Shut-In Royalty
- Cessation of Production
- Breach of Implied Covenants
- Abandonment by Lessee



# Failure to Pay Shut-In Royalty:

- When is a well “shut-in”?
  - A shut-in well is defined as a *producing* well that has been closed down temporarily for repairs, cleaning out, building up pressure or lack of a market...”
  - Voluntary act of the Lessee to physically “close the valves” and stop the flow of gas



# Failure to Pay Shut-In Royalty (cont'd):

- Can result in early termination of Lease during the Primary or Secondary Term
- Language of the shut-in clause is critical – special limitation or mere promise to pay?
- If clause creates special limitation, then the failure to pay royalty will terminate the Lease
- Shut-in royalties are often referred to as “constructive production”



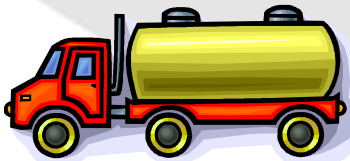
# Failure to Pay Shut-In Royalty (cont'd):



- The clause was developed to protect against automatic termination where a gas well was drilled, but no market existed for that gas
- “The shut-in royalty is a substitute for production: a cessation of shut-in royalty payments is a cessation of production and terminates the lease...” See, Blackmon v. XTO Energy, Inc., 276 S.W.3d 600 (Tex. App.-Waco 2008)
- The well must be actually capable of producing gas in paying quantities
- If further work on the well is required before the well will be capable of producing gas, then even paying shut-in royalties will not prevent termination of the Lease

# Cessation of Production:

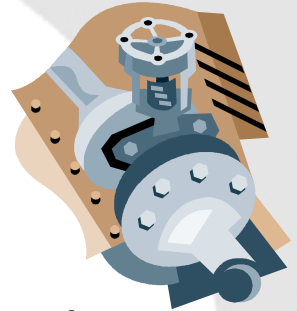
- General Rule: Periods of non-production during the Secondary Term automatically terminates the Lease
- To mitigate the harshness of this Rule, courts have developed and applied the “temporary cessation of production (“TCOP”) doctrine” (Texas, Ohio, Oklahoma)
- The TCOP Doctrine presumes that the parties understood that mechanical problems, reworking operations or similar other events would inevitably interrupt production from time-to-time
- Has not yet been formally adopted in Pennsylvania



# Cessation of Production (cont'd):

## TCOP Doctrine

- i) Burden on Lessor to show actual cessation of production;
- ii) The Lessee must then demonstrate that the cessation was due to a “sudden stoppage of the well or some mechanical breakdown of equipment...”; AND
- iii) The Lessee must exercise reasonable diligence to remedy the defect and resume production within a reasonable period of time



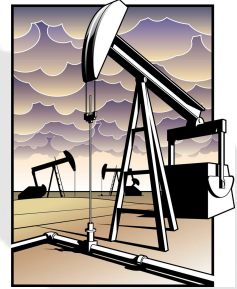
NOTE: Market-induced interruptions generally do not satisfy the first prong of the TCOP test (i.e., the Lessee should shut-in the well!)

# Breach of Implied Covenants:

- Implied covenant to develop (exploration?)
- Implied covenant to market
- Implied covenant to prevent drainage



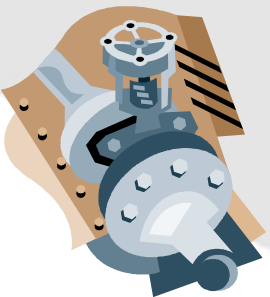
# Implied Covenant of Reasonable Development:



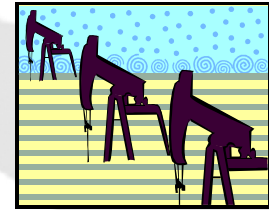
- Well-recognized in every jurisdiction for over 100 years
- Upon discovery of gas in paying quantities, the Lessee is under an obligation to drill additional wells as reasonably necessary to extract the remaining gas
- Lessor must prove that further development would be profitable
- Profitable production does not mean mere production “in paying quantities” – requires evidence that the additional well or wells would recoup a reasonable profit over and above the costs of drilling, completion and day-to-day operations. See, Kleppner v. Lemon, 35 A. 109 (Pa. 1896)

# Implied Covenant of Reasonable Development (cont'd):

- Under Pennsylvania law, there is no duty to develop if the Lease itself provides the Lessor compensation (*i.e.*, delay rentals) during the period of non-production. See, Jacobs v. CNG Transmission, 772 A.2d 445 (Pa. 2001)
- “An implied covenant to develop the underground resources appropriately exists where the only compensation to the landowner...is royalty payments resulting from extraction...” Jacobs, 772 A.2d at 455.
- See also, Penneco Pipeline Co. v. Dominion Transmission, Inc., 2007 WL 1847391 (W.D.Pa. 2007) (payment of gas storage fees precluded application of implied covenant)

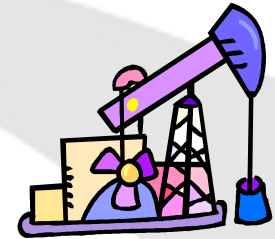


# Is there an Implied Covenant of Further Exploration?



- A minority of courts have recognized an implied covenant to explore unproven formations (Colorado, Kansas)
- The covenant of further exploration has been defined as the obligation to develop “every part of the lease...whether the undeveloped portion be a single tract remote from the rest, or a considerable portion of a very large tract, or a deeper stratum...” See, Fox Petroleum v. Bocker, 253 p. 33 (Okla. 1926).
- To prove breach, Lessor must show “reasonability of the Lessee in not exploring” undeveloped formations. See, Gillette v. Pepper Tank Co., 694 P.2d 369 (Colo. App. 1981).

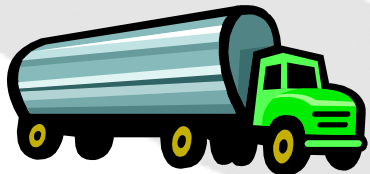
# Implied Covenant of Further Exploration:



- Pennsylvania *may* recognize implied duty to explore and test unproven formations. See, Aye v. Philadelphia Co., 44 A. 555 (Pa. 1899)
- The Aye court noted that the Lessee was under an implied obligation “to proceed with the exploration and development of the land with reasonable diligence...” or risk abandonment of the lease
- Unclear in 2010 whether Pennsylvania will still recognize this implied covenant with respect to the deeper Marcellus formation

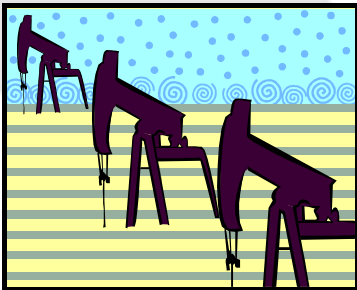
# Implied Covenant to Market:

- Seeks to guarantee that any gas produced from the property will be marketed so the Lessor actually realizes payment
- The covenant requires that the Lessee exercise “reasonable diligence” to market the gas
- Some form of the covenant has been part of Pennsylvania jurisprudence since 1899. See, Jams v. Carnegie Natural Gas Co., 45 A. 54 (Pa. 1899)
- Does payment of shut-in royalty satisfy this covenant?



# Implied Covenant to Prevent Drainage:

- Under the “rule of capture”, each landowner is entitled to all of the gas he can lawfully produce through wells on his land, regardless of whether that gas originated under his land
- Courts have held that there is an implied covenant to drill wells “offsetting” those on adjoining lands that are draining gas from the leased property
- Recognized by Pennsylvania Supreme Court in Kleppner v. Lemon, 35 A. 109 (Pa. 1896)



# Defenses to Lease Termination:

- Waiver/Estoppel:
  - Production prevented by Lessor's misconduct
  - Suspended operations during Lease challenge
  - Acceptance of "free gas" by Lessor
- Adverse Possession
- Force Majeure



# Any Questions?



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