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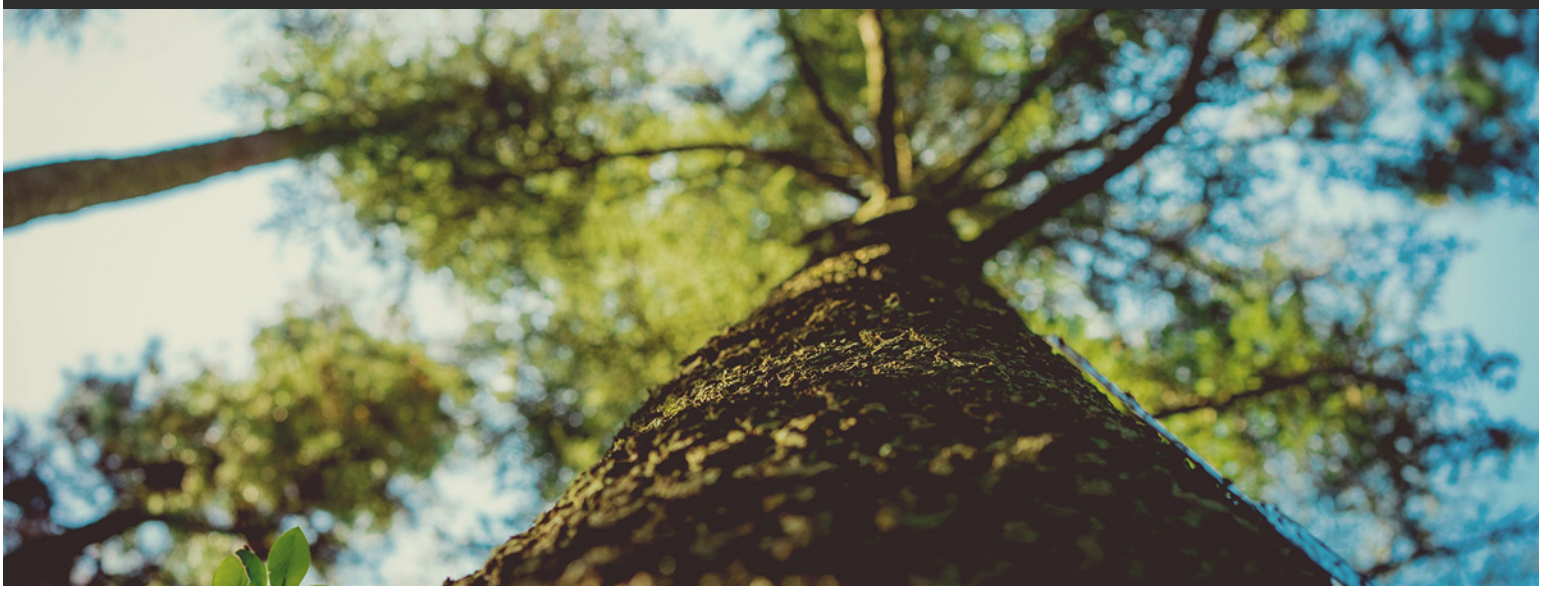
Is the Oil and Gas Lease Over? Court Ruling Offers Guidance



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Roughly 15 years ago, many Pennsylvania landowners entered into oil and gas leases in the expectation of receiving royalties for the extraction of shale gas and oil underlying their properties. Today, as natural gas prices remain low, and fossil fuels generally—including methane leaks specifically—encounter policy and regulatory resistance because of attention to climate change, lessees may not move as rapidly to develop marginal leaseholds. Indeed, some may not continue exploration or production at all, raising the question of when a lease ends. Last month, the Pennsylvania Supreme Court offered some guidance in *SLT Holdings v. Mitch-Well Energy,* No. 6 WAP 2020 (Pa. Apr. 29, 2021).

Oil and gas leases were not new when the Marcellus Shale boom hit Pennsylvania. As is well-known, Pennsylvania was the original oil and gas state; Edwin Drake dug his oil well near Titusville in 1859. The oil and gas estate has been severed and conveyed—in fee or by lease—at least once for many parcels in the commonwealth. So, the question of when a lease terminates is hardly novel, but it was controversial enough to warrant litigation through the Supreme Court.

To recall, an oil and gas lease is the conveyance of the oil and gas estate for an initial term of years, and then in fee simple determinable. In the primary term, the lessee pays a rent, often paid-up for the full primary

term at inception with a "bonus" payment. During that term, if the lessee drills a well that produces oil or gas at a rate that covers the variable costs of production (not the literally sunk cost of the well), then the lease enters the secondary term. The lessee may hold the lease past the termination date of the primary term if the lessee is engaged in "operations"; in the core case, "operations" are activities like drilling a well that has not been completed before the end date of the primary term. In some circumstances, the lessee may delay production or operations within the primary term, and pay the lessee a "delay rent." However, the reasons for delay and the process for invoking a delay are typically spelled out in a lease, otherwise the ability to make delay rental payments to hold the lease would make the lease indefinite; the lessee could keep the oil and gas interest forever by just paying a nominal rent.

Once the primary term ends without operations that will hold the lease, without production in paying quantities, and without some other ground for extending the primary term, then the lease terminates.

After the lease enters the secondary term by production, the term continues for so long as a well continues to produce in paying quantities. It may also continue if wells that *could* produce are shut in voluntarily for an acceptable reason, during which time the lessee typically pays a shut-in rent at a rate similar to the delay rent. Other actions may hold the lease, such as reworking a well after an involuntary cessation of operations. But the interest the lessee holds during the secondary term is determinable. It ends when production in paying quantities ends without some other of those extending events.

No celestial trumpet sounds to mark the end of the secondary term. Indeed, "production in paying quantities" has to be determined over some period of time; one week in which oil or gas prices drop does not terminate a lease. Unless the lease specifies otherwise, that period is a reasonable period in the circumstances, as decided in *T.W. Phillips Gas & Oil v. Jedlicka*, 42 A.3d 261 (Pa. 2012). And yet, eventually one will have to be able to say that on one day there was a lease in force, and on the next there was not.

SLT Holdings was a case in which the landowner and the lessee disagreed over whether the lease had ended. Termination of a lease can be costly for the lessee. It must abandon all of its investment in the leasehold, including the wells. If the wells are truly unusable, they are abandoned and must be capped. But if one could use them for production, they are typically multi-million dollar items. Moreover, if the oil and gas interest has value as a speculative asset, the lessee would lose its bonus payment and any other investments it made in preparing the leasehold for development.

The leases in *SLT Holdings* included provisions under which the lessor could provide notice to the lessee of a breach of the lessee's obligations to explore for oil and gas, to produce those hydrocarbons, and to market them. If the lessee did not cure the breach within a specified time, then the lessor could sue for breach. The lessor's only remedy would be termination.

The lessee in that case did not produce oil or gas or pay a shut-in rent from 1996 to 2013, which is when the lessor sued. The lessor pursued recovery of the oil and gas interest on an equitable theory of abandonment. That is, it asserted as the fee owner that the lessee had walked away. The problem, of course, was that the lessee elected to defend the case, meaning that it had not completely abandoned its interest.

The court held that the lessor could not seek an equitable remedy unless it could show that it had no adequate legal remedy. The landowner should have pursued the contractual process and sought enforcement of the lease's terms, which would have terminated the lease.

The court expressed further skepticism that the doctrine of laches would permit the lessor to pursue an equitable remedy after the lessor allowed 17 years to go by without seeking production, shut-in rental or termination. Moreover, the court speculated that the limitations period might have expired on the contract

claim, explaining the landowner's reliance on an abandonment theory. One can imagine that the lessor might have acquiesced in delaying further development as inconvenient or as economically prudent, and if it had, perhaps it should not be allowed to change course abruptly and to seek termination.

So the lesson here is that the boilerplate termination provisions in an oil and gas lease have to be followed if the landowner wishes to end the relationship. That is true, and perhaps particularly true, even after a long period of inactivity.

About the Author:

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