



JONES DAY
COMMENTARY

NO IMPLIED DUTY FOR OPERATORS TO DEVELOP “EACH ECONOMICALLY EXPLOITABLE STRATA,” SAYS PENNSYLVANIA SUPERIOR COURT

In a published opinion on July 12, the Pennsylvania Superior Court—an intermediate appellate court—adhered to the express terms of an oil and gas lease, and affirmed the trial court’s decision rejecting the landowners’ attempts at terminating the lease due to the operator’s failure to develop the Marcellus Shale formation. In formulating its decision in *Caldwell v. Kriebel Res. Co.*,¹ the Superior Court demonstrated strong judicial adherence to the specific agreements of the parties contained in the lease, and the Superior Court refused to read into the lease a new implied duty to develop the various economically exploitable strata where gas was being produced in accordance with the lease from shallow wells drilled on the leased premises.

THE IMPLIED COVENANT TO DEVELOP

The implied covenant to develop requires oil and gas lessees in Pennsylvania to operate their leaseholds “in a proper manner and with reasonable diligence.”² This covenant, like the implied covenant to market and the implied covenant to protect against drainage, informs the standard of care that lessees must exercise, absent terms to the contrary in their leases. A lessee’s failure to comply with the implied covenant to develop may warrant a determination that it has partially or completely surrendered its leasehold.³

THE *CALDWELL* DECISION

In *Caldwell*, the lessors (or “the *Caldwells*”) of a mineral estate brought suit seeking a declaratory judgment to terminate the oil and gas lease, contending, among other things, that the defendants failed to produce gas in paying quantities or develop the

Marcellus Shale formation. It was undisputed that the defendants had drilled on the shallow formations and that gas was being produced and royalties were being paid from those shallow wells. Specifically, the Caldwells argued that the defendants' limited production from the shallow formations and their failure to tap the gas trapped in the Marcellus Shale formation constituted a breach of the implied covenant to develop. The defendants filed the Pennsylvania state court equivalent of a motion to dismiss, and subsequently, the Clearfield County Court of Common Pleas dismissed the Caldwells' amended complaint for failure to state a claim.

On appeal, the Superior Court declined to accept the Caldwells' argument that the implied covenant to develop "attaches to each economically exploitable strata of natural gas of the lessee." To do so, as argued by one of the defendants, would read a substantial new implied duty to develop different strata into every oil and gas lease in Pennsylvania. The Superior Court adhered to the Pennsylvania Supreme Court's decision in *Jacobs v. CNG Transmission Corp.*,⁴ recognizing that the implied covenant to develop applies when the lessor's only source of compensation is royalty, but that the covenant may nonetheless be precluded by the language of the specific lease. Such language expressly rejecting all implied covenants appeared in the *Caldwell* lease. Additionally, the lease in question guaranteed that the lessors would receive delay rentals in the event that no gas were produced. It was not disputed by the parties that the defendants were in fact producing gas pursuant to the lease, and the Superior Court held that oil and gas lessees in Pennsylvania are not required "to drill additional wells to different depths to completely develop the entire property."

The Superior Court also declined to remand the case to allow the Caldwells to pursue the theory that there "is an implied duty to develop in paying quantities" or to present evidence of defendants' bad faith. The Superior Court

emphasized that the lease at issue did not contain the term "paying quantities." The Superior Court also found, in any event, that, in accordance with the definition of "paying quantities" set forth in *T.W. Phillips Gas & Oil Co. v. Jedlicka*⁵—that the well consistently pays a profit over operating expenses—defendants did in fact "produce a paying quantity, albeit not to the extent [the lessors] desire." Finally, the Superior Court commented that it was not convinced "that the legal theory set forth in *Jedlicka* [requiring the operator's good faith judgment in maintaining operation of the well] should be expanded "to include a good faith standard for all aspects of the [gas] industry that affect production of lessors' natural gas." As a result, the Superior Court affirmed dismissal of the lessors' claims.

WHERE DOES THE IMPLIED COVENANT TO DEVELOP STAND IN PENNSYLVANIA?

As *Caldwell* demonstrates, the implied covenant to develop continues to apply in Pennsylvania oil and gas leases when compensation to the lessor is based solely upon royalties. However, Pennsylvania courts will not read the implied covenant to develop into an oil and gas lease when that lease contains express contractual language disclaiming implied covenants. Further, by refusing to impose an implied covenant to develop all economically exploitable strata, the *Caldwell* decision evidences a judicial preference to stay within the confines of the lease itself and established Pennsylvania case law standards in analyzing whether contractual obligations relating to "production" or "production in paying quantities" are being fulfilled under an oil and gas lease.

As with all matters relating to the leasing of oil and gas interests, stakeholders should consult experienced oil and gas attorneys to answer any questions that they may have with regard to implied covenants in oil and gas leases.

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ENDNOTES

- 1 2013 PA Super. 188 (July 12, 2013).
- 2 *Jacobs v. CNG Transmission Corp.*, 332 F. Supp. 2d 759, 779 (W.D. Pa. 2004).
- 3 *Id.* at 796; *Kleppner v. Lemon*, 35 A. 109, 110 (Pa. 1896) (mandating that a lessee drill an additional well within a period of 20 days or lose those portions of the leasehold not currently being produced by an existing well).
- 4 772 A.2d 445 (Pa. 2001).
- 5 42 A.3d 261 (Pa. 2012).

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