SEPTEMBER 2017
VOL. 17-8

PRATT'S

ENERGY LAW REPORT

LexisNexis®

Pratt's Energy Law Report

VOLUME 17 **NUMBER 8** **SEPTEMBER 2017**

LexisNexis®

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please email:
Jacqueline M. Morris at ..... (908) 673-1528
Email: ..... jacqueline.m.morris@lexisnexis.com
Outside the United States and Canada, please call . . . . . (973) 820-2000

For assistance with replacement pages, shipments, billing or other customer service matters, please call:
Customer Services Department at . . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . . (518) 487-3385
Fax Number . . . . . (800) 828-8341
Customer Service Website . . . . . http://www.lexisnexis.com/custserv/

For information on other Matthew Bender publications, please call
Your account manager or . . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . . (937) 247-0293

ISBN: 978-1-6328-0836-3 (print)
ISBN: 978-1-6328-0837-0 (ebook)
ISSN: 2374-3395 (print)
ISSN: 2374-3409 (online)

Cite this publication as:

[author name], [*article title*], [vol. no.] Pratt's Energy Law Report [page number] (LexisNexis A.S. Pratt);
Ian Coles, *Rare Earth Elements: Deep Sea Mining and the Law of the Sea*, 14 Pratt's Energy Law Report 4 (LexisNexis A.S. Pratt)

An A.S. Pratt® Publication

Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

(2017–Pub.1898)

Editor-in-Chief, Editor & Board of Editors

Hydraulic Fracturing Developments

Eric Rothenberg
Partner, O'Melveny & Myers LLP

Pratt's Energy Law Report is published 10 times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway Suite 18R, Floral Park, New York 11005, smeyerowitz@meyerowitzcommunications.com, 718.224.2258. Material for publication is welcomed—articles, decisions, or other items of interest to lawyers and law firms, in-house energy counsel, government lawyers, senior business executives, and anyone interested in energy-related environmental preservation, the laws governing cutting-edge alternative energy technologies, and legal developments affecting traditional and new energy providers. This publication is designed to be accurate and authoritative, but neither the publisher nor the authors are rendering legal, accounting, or other professional services in this publication. If legal or other expert advice is desired, retain the services of an appropriate professional. The articles and columns reflect only the present considerations and views of the authors and do not necessarily reflect those of the firms or organizations with which they are affiliated, any of the former or present clients of the authors or their firms or organizations, or the editors or publisher.

POSTMASTER: Send address changes to Pratt's Energy Law Report, LexisNexis Matthew Bender, 121 Chanlon Road, North Building, New Providence, NJ 07974.

Under Scrutiny: PA Superior Court Splits from Own Precedent and Allows Unilateral Oil & Gas Lease Severance in *Montgomery*

By Jeremy A. Mercer*

Lessees of oil and gas leases in Pennsylvania who have been assigned or are assigning less than all of the geologic strata under lease should give careful attention to whether those leases have been severed vertically by unilateral actions. A lease may not be held by production if that production is in a geologic strata not included in the assignment of rights. This article explains a recent decision on the issue.

By its 2-to-1 non-precedential decision that an oil and gas lease unilaterally can be severed horizontally and vertically, the Superior Court of Pennsylvania appears to have split from its own published precedent and created new law in Pennsylvania—leaving lessees in limbo, possibly giving unscrupulous lessors a unilateral tool to terminate oil and gas leases, and ultimately harming both lessors and lessees in the process.

The Superior Court decided the case *Montgomery v. R. Oil & Gas Enterprises, Inc.*,[1] earlier this year. Judges Shogan and Strassburger, over a well-reasoned dissent, concluded that the subject oil and gas could be severed vertically and horizontally by unilateral actions of the lessee and the lessor respectively. In that case, the Superior Court upheld the trial court's decision that the severed oil and gas lease had expired as to the shallow rights for the portion of the lease sold to the new lessors. No application for reargument was filed, and no petition for allowance of appeal was filed with the Supreme Court.

FACTUAL HISTORY

In 1975, the original lessors (Donald and Melvena MacDonald) leased 240 acres of land, consisting of several tracts, to Quaker State Oil Refining Corporation. The recorded lease made no distinction as to vertical strata leased and contained no provisions requiring development of different strata to hold those strata. "Rather, the terms of the Lease grant the lessee exclusive drilling rights to any oil and gas found under the 240 acres of surface land covered by

---

* Jeremy A. Mercer, a partner at Blank Rome LLP, is a litigator who focuses his energy industry practice on oil and gas counsel and litigation. He may be reached at jmercer@blankrome.com. The author would like to thank Lisa McManus, Chris Trejchel, Amy Barrette, and Ron Frank for their suggestions, comments, and critiques of this article throughout the drafting process. Their input helped make the final product a much better product.

[1] No. 1164 WDA 2015.

the Lease."[2] The primary lease term was 10 years and as long thereafter as oil and gas could be produced in paying quantities.

In 1991, Quaker State assigned its right to the oil and gas above the Onondoga formation ("shallow rights") but retained the rights to the Onondoga formation and below. The shallow rights subsequently were assigned several times until they resided with R. Oil & Gas Enterprises.[3] On February 17, 2010, the MacDonalds sold a 32.218 acre parcel of land to the Montgomerys, subject to the oil and gas lease.

Unstated in either the trial court opinion or the appellate opinion is any description of development of the deep rights. However, given the arguments made and the parties sued, one can presume that Quaker State engaged in development of the deep rights sufficient to transition the lease into its secondary term prior to the assignment, which development continued through the filing date of the lawsuit by the Montgomerys. We do know that after Quaker State assigned the shallow rights, there was some development of those shallow rights by an intermediary lessee, but that development ceased by the end of 2001.[4]

TRIAL COURT PROCEEDINGS

After noting representatives of R. Oil & Gas on their land, the Montgomerys filed a lawsuit on April 10, 2014, seeking a declaration that R. Oil & Gas no longer possessed the oil and gas lease as to the shallow rights under their property.[5] The Montgomerys did not join the MacDonalds or Quaker State in the lawsuit. R. Oil & Gas filed an Answer and New Matter, claiming that the

---

[2] Opinion, p. 2.

[3] The Superior Court notes that R. Oil & Gas obtained the shallow rights from Pennsylvania General Energy Corp. in a January 26, 2009, assignment. *See* Opinion, p. 2. The trial court found, however, that R. Oil & Gas obtained the shallow rights from Harmony Oil & Gas Company, Inc. in a January 26, 2009, assignment. *See* Exhibit A to Opinion (Trial Court's June 30, 2015, Opinion), p. 2.

[4] *See* Trial Court Opinion, p. 12.

[5] It does not appear that R. Oil & Gas raised the statute of limitations or laches as a defense to the declaratory judgment count. *See* Trial Court Opinion, p.1 ("Plaintiffs . . . commenced this lawsuit by filing a two-count Complaint sounding in Declaratory Judgment and Action in Trespass . . . .") Even assuming the Montgomerys did not have actual knowledge of the lease as part of the purchase transaction, because the lease was recorded, the Montgomerys were charged with knowledge of it. *See, e.g.*, *Weik v. Estate of Brown*, 794 A.2d 907, 911 (Pa. Super. Ct. 2002) ("Clearly, the recording statute has been given effect beyond determining priority of title. It has been interpreted to give notice to the public of title transfer and the contents of a deed."); *Wagner v. Kemp*, No. 1191 MDA 2013, 2014 Pa. Super. Unpub. LEXIS 2295, at *14 (Pa. Super. Ct. Oct. 14, 2014) (*appeal denied*, 114 A.3d 1041 (Pa. 2015)); *Pfeifer v. Westmoreland Cnty. Tax Claim Bureau*, 127 A.3d 848, 854 (Pa. Commw. Ct. 2015). The Montgomerys purchased the

Montgomerys failed to join an indispensable party and, therefore, the court lacked jurisdiction. But, in ruling on the Montogmerys' motion for judgment on the pleadings, the trial court evidently overruled that objection and granted judgment in favor of the Montgomerys—finding the lease was abandoned and no longer valid as to the shallow rights under the Montgomery's property.[6] R. Oil & Gas filed an appeal.

APPELLATE PROCEEDINGS

On appeal, the panel issued a 2-to-1 unpublished decision affirming the trial court's granting of the motion for judgment on the pleadings. The majority, Judges Shogan and Strassburger, addressed four issues raised on appeal:

1) whether the lease was severable;
2) whether the Montgomerys failed to join an indispensable party;
3) whether a question of fact remained as to the ability to produce oil and gas; and
4) whether the trial court improperly considered statements in a consent order and agreement in reaching its decision.[7]

According to the majority, there was no indispensable party that would need to be joined if the lease was, in fact, severable both horizontally (*e.g.,* surface ownership) and vertically (*e.g.,* the various geological strata underlying the surface).[8] Therefore, the majority addressed the first two issues together (severability and indispensable party), starting by noting that a lease does not have to be determined to be ambiguous before the court can consider extrinsic evidence on the issue of severability.[9]

Citing its prior decision in *Seneca Resources Corporation v. S & T Bank*,[10] the majority distinguished the MacDonald lease from the one found not to be

---

property more than four years before they filed the lawsuit. The statute of limitations for a declaratory judgment claim in Pennsylvania is four years.

[6] The trial court's decision on the motion for judgment on the pleadings was included as an attachment to the Superior Court majority's decision as the majority incorporated some of the underlying analysis. That underlying decision, though, does not address the issue of failure to join an indispensable party. The Superior Court also cited to a later opinion by the trial court, likely the 1925(b) opinion, but did not include that opinion.

[7] Only the first two issues are within the scope of this article. However, for a full description of the majority's opinion, this article will include, *infra*, a brief description of that opinion as to issues three and four.

[8] *See* Opinion, p. 6.

[9] *See* Opinion, pp. 6–7.

[10] 122 A.3d 374 (Pa. Super. Ct. 2015).

severable in the *Seneca Resources* case by noting the MacDonald lease (i) covered "a number of distinct parcels," (ii) expressly gave the lessee the right, among others, to "subdivide and release" the leased acreage, and (iii) expressly provided that the lease was "binding upon and extend[ed] to the parties hereto and their respective heirs, personal representatives, successors and assigns."[11] Those provisions, coupled with the unilateral action of the lessor in selling a part of the leased property and the unilateral action of the lessee in assigning the shallow rights, "support a finding that the Lease is severable, both with respect to surface land ownership and to the ownership of oil and gas rights above and below the top of the Onondoga Formation."[12]

Based on its conclusion that the lease was severable, the majority determined that there was no failure to join an indispensable party. "Thus, the record supports the trial court's determination that it had subject matter jurisdiction over this case as the merits could be determined without prejudice to the rights of an absent party."[13]

In addressing the third issue (ability to produce oil and gas), the majority agreed with "the well-reasoned opinion of the trial court and, following our review of the certified record, the parties' briefs, and the relevant law, we conclude that the opinion of the Honorable Robert L. Boyer states findings of fact that are supported by the record, evidences no abuse of discretion or error of law, and thoroughly and correctly addresses and disposes of Appellant's third issue and supporting argument."[14]

---

[11] Opinion, p. 9.

[12] *Id.*

[13] Opinion, p. 10. The majority did not address the fact that it was not until after the merits were determined (*e.g.*, the lease was severable and therefore expired) that it reached the conclusion that the merits could be determined without prejudice to the rights of an absent party. It is not hard to imagine, though Quaker State having an interest in the issue of whether the lease—under which it is a lessee—was severable. *Cf. Krupa v. Hilcorp Energy I LP*, Civ. A. No. 2:13-cv-1542 (W.D. Pa. June 3, 2014) ("Nonetheless, as in *Hartzfeld*, the assignors/assignees here possess interests that would be adversely affected if a declaratory judgment is entered declaring the Leases void ab initio, thus making them indispensable parties."); *see also, e.g., Northern Forests II, Inc. v. Keta Realty Co.*, 130 A.3d 19, 28–29 (Pa. Super. Ct. 2015) (test for indispensable party); *Grow v. Ohio Ky. Oil Corp.*, No. 222 WDA 2012, 2014 Pa. Super. Unpub. LEXIS 935, at *15 (Pa. Super. Ct. Feb. 26, 2014) (party was indispensable when he negotiated with lessee a royalty agreement).

[14] Opinion, p. 12 (adopting the trial court's decision on that topic as its own). Yet, the "well-reasoned" opinion of the trial court started its abandonment analysis by attributing to the U.S. Court of Appeals for the Third Circuit a lengthy legal proposition that was contained in a brief of a party before the Third Circuit, not the Third Circuit's decision. *See* Trial Court Opinion, p. 7. Moreover, the trial court identified the parties as proceeding *pro se*, despite the

As for the fourth issue (consideration of the consent order and agreement), the majority cited cases standing for the proposition that it is for the court to decide what evidence can be used, not parties to an agreement. It also noted that R. Oil & Gas was trying to have both sides of the argument—it attached the consent order and agreement to its answer and then argued that reliance on it was improper.[15]

Judge Olson dissented and addressed the first two issues only. Focusing on the vertical severability of the lease, Judge Olson took the majority to task for its conclusion of severability. First, she addressed the language of the lease itself, concluding that it indicated the lease was not severable.

> No express language in the Lease addresses whether the agreement is entire or severable. Nonetheless, principles of construction indicate that the Lease is not vertically severable. Specifically, nowhere in the Lease is the word "Onondaga" mentioned. Instead, the Lease only speaks to the entirety of the oil and gas estate below the earth's surface. The word "Onondaga" was not relevant to the Lease until 16 years after its execution when Quaker State reserved to itself and its successors and assignees all oil and gas rights found below the Formation. There is nothing in the Lease that indicates that the MacDonalds and Quaker State, at the time the Lease was signed, viewed the area above the Formation differently from the area below the Formation. *Cf. Vernon Twp. Volunteer Fire Dep't, Inc. v. Connor*, 855 A.2d 873, 879 (Pa. 2004) (citation omitted) ("It is a fundamental rule of contract interpretation that the intention of the parties at the time of contract governs[.]"). No terms of revenue or consideration turn on generation of oil and gas from the area above the Formation as opposed to the area below the Formation. To the contrary, the Lease addresses as a whole the entirety of the oil and gas estate below the surface lands of the 240 acres covered by the Lease.[16]

---

defendant being a corporation and despite noting that the plaintiffs "secured legal counsel" prior to filing suit. *See* Trial Court Opinion, pp. 1–2.

[15] Curiously, in rejecting the Appellant's argument, the majority also stated that the "consent order and agreement at issue has no bearing on whether the Montgomerys' Land remains subject to the Lease." Opinion, p. 14. If that truly were the case, the majority failed to explain why it was necessary for the trial court to cite to the consent order and agreement in reaching its conclusion that the land was not subject to the lease.

[16] Dissent, pp. 1–2.

Then, Judge Olson criticized the majority for attempting to discern the parties' mutual intent based on the unilateral conduct of one party.[17]

Concluding her decision that the lease was not severable vertically, Judge Olson noted that the majority's decision was in conflict with a prior reported decision by the Superior Court—*Loughman v. Equitable Gas Company, LLC*.[18] In *Loughman*, the Superior Court determined that a lessee who assigned the production rights but kept the gas storage rights under a lease did not sever the lease.

Following from her conclusion that the lease was not severable vertically, Judge Olson determined that Quaker State was a necessary party as it had the deep rights under the lease at issue. Because the Montgomerys did not join Quaker State, Judge Olson concluded the trial court lacked subject matter jurisdiction over the dispute.[19]

ANALYSIS AND CRITIQUE

The majority ignored precepts of Pennsylvania law and prior reported decisions, while focusing on the unilateral actions of a party to the lease, coupled with standard lease provisions, to find vertical severability. Respectfully, the majority erred.

As Judge Olson noted in her dissent, contract interpretation must discern the intent of the parties at the time of forming the contract. The Pennsylvania Supreme Court has "held that it is the parties' *mutual* actions that must be considered when determining if a lease is entire or severable—not a party's unilateral actions."[20] Here, though, the majority looked simply to the actions of one party to determine vertical severance. Many unanswered questions and potential traps for a lessee appear to follow from that conclusion.

Why Did the Majority Ignore Myriad Precepts of Pennsylvania Law?

The first and largest question to arise from the Opinion is why the majority ignored so many precepts of Pennsylvania law in reaching its decision. First, it is a longstanding principle of Pennsylvania law that oil and gas leases must be

---

[17] *Id.*, at pp. 2–3.

[18] 134 A.3d 470 (Pa. Super. Ct. 2016).

[19] Judge Olson did not address the horizontal severability of the lease.

[20] Dissent, pp. 2–3 (citing *Jacobs v. CNG Transmission Corp.*, 772 A.2d 445, 452 (Pa. 2001)) (emphasis in original). Moreover, one must use those actions to determine the intent of the parties at the time of contracting, not at some later point. *Stewart v. Chernicky*, 266 A.2d 259, 263 (Pa. 1970) (it is the intention of the parties at the time of contracting that matters). This should have been considered when determining whether Quaker State—the original, contracting lessee—was an indispensable party to the litigation.

construed with references to the known industry practices and customs in place at the time of contracting.[21] But, no such analysis was undertaken here as to the industry custom or understanding of lease severability based on the lease language used.

Second, Pennsylvania law plainly and clearly holds that once there is development of oil and gas rights, a property right vests in the holder of those oil and gas rights.[22] The majority noted that the lease at issue in *Montgomery* conveyed all of the oil and gas underlying the leased property.[23] Yet, the majority then ignored the vested title in a huge swath of that oil and gas without explanation as to how or why that title was lost.[24]

Third, it is an accepted principle of Pennsylvania law that, when looking at the severability of a contract, if the consideration cannot be apportioned, the contract is not severable.[25] The consideration at issue in the *Montgomery* case was single—it was a single royalty that did not differentiate from what strata the

---

[21] *Venture Oil Co. v. Fretts*, 25 A. 732 (Pa. 1893); *Sunbeam Corp. v. Liberty Mut. Ins. Co.*, 781 A.2d 1189, 1193 (Pa. 2001) ("In the absence of an express provision to the contrary, custom or usage, once established, is considered part of a contract and binding on the parties though not mentioned therein, the presumption being that they knew of and contracted with reference to it."); *Roe v. Chief Exploration & Dev. LLC*, Case Nos. 4:11-cv-00816, 4:11-cv-00697, 4:11-cv-00579, 2013 U.S. Dist. LEXIS 113914, at *31–34 (M.D. Pa. Aug. 13, 2013) (Brann, J.) (enforcing industry definition in oil and gas lease).

[22] *Calhoon v. Neely*, 50 A. 967, 968 (Pa. 1902); *see also Burgan v. South Penn Oil Co.*, 89 A. 823, 826 (Pa. 1914) (inchoate title to oil and gas until such are found).

[23] *See* Opinion, p. 2 ("[T]he Lease grant[s] the lessee exclusive drilling rights to any oil and gas found under the 240 acres of surface land covered by the Lease.").

[24] Nor did it explain how assigning vested rights to certain strata would divest those rights. For example, assume one acquired fee ownership of a 100 acre parcel of land for as long as the land was used for farming. Assume further that the owner farmed 60 of those acres but left the other 40 acres fallow. The owner then assigned those fallow 40 acres to another farmer who did not immediately farm the 40 acres but did not put them to any other use either. Or, assume that the assignee of those 40 acres farmed them for a period of time but then stopped farming, let the fields go fallow again, and then assigned the 40 acres to another farmer. No one would argue that the fee ownership to those assigned 40 acres was divested, voided, or otherwise compromised by the assignment or subsequent farming activity. But that is what the majority holds here as to oil and gas rights.

[25] *Jacobs v. CNG Transmission Corp.*, 772 A.2d 445, 451 (Pa. 2001) ("If the consideration is single, the contract is entire . . . whatever the number or variety of items embraced . . . but, if the consideration is apportioned, either expressly or by necessary implication . . . the contract will generally be held to be severable . . . .") (quoting *Heilwood Fuel Co., Inc. v. Manor Real Estate Co.,* 175 A.2d 880, 884–85 (Pa. 1961)); *see also Lucesco Oil Co. v. Brewer*, 66 Pa. 351 (1870).

gas was produced.[26] Yet, the majority found the lease to be severable—without explaining how it did so in contravention of this principle.

Standard Language being Misused or Misinterpreted?

In addition to unilateral actions, the majority looked to the language of the lease to determine severability. But the majority looked only at a portion of three clauses: (i) the habendum clause and primary term language (presumably because it referenced successors and assigns and contained the "as long thereafter as oil and gas is or can be produced in paying quantities" secondary term language), (ii) a provision allowing lessee the right to subdivide and release the premises, and (iii) a provision that expressly makes the lease binding on successors and assigns.[27] However, the provisions it highlighted are provisions that likely appear in most, if not all, leases.[28] One is forced to wonder what oil and gas lease could not be found to be severable if these types of provisions justify severability.

Contrary to *Loughman,* so Just Ignore It?

Another, and very important, deficiency in the majority's opinion is its failure to discuss or address how the lease here was found to be severable but the lease in the *Loughman* case was found not to be severable.[29] In *Loughman*, the oil and gas lease at issue ("Loughman Lease") allowed for development and gas storage and had a two-stage compensation provision—providing compensation to the lessor both for development and for storage of gas. At some point after execution of the Loughman Lease, the original lessee assigned its interests in the development rights under the lease but kept the storage rights. A subsequent lessor then brought an action seeking a declaration that the lease had been severed and the development rights lost. The Superior Court panel unanimously affirmed the trial court's decision that no severance occurred as a result of the assignment.

---

[26] *See, e.g.*, Opinion, p. 2 ("The Lease itself makes no distinction between oil and gas interests above and below the Formation.").

[27] Opinion, pp. 8–9.

[28] *See* James W. Adams, Jr., et al., Pennsylvania Oil and Gas Law and Practice 39-10, 39-49, 39-53 (1st ed. 2012) (citing form leases that contain the release, assignment, and binding successor language); *cf Frost Family, L.P. v. NCL Appalachian Partners, L.P.*, No. 20092923 (Ct. Com. Pl. Centre Cnty. July 21, 2011) (sale of undeveloped deep rights covered by a lease permitting assignment by lessee did not breach the lease).

[29] *Loughman v. Equitable Gas Co., LLC*, 134 A.3d 470 (Pa. Super. Ct. 2016). The majority did not address the *Loughman* decision at all, despite Judge Shogan having been on the panel in the *Loughman* case as well.

So, in a case where the lease allowed for both storage and development and provided for separate compensation to the lessor for each activity, the assignment of one of those activities did not sever the lease as to the other.[30] Yet, without ever citing to or explaining away *Loughman*, the majority concluded that the unilateral assignment of shallow development rights from deep development rights severed the MacDonald lease, which did not provide separate compensation for or differentiate between geological strata.

Distinctions without a Difference?

Unlike the *Loughman* case, the majority did attempt to distinguish the MacDonald lease from the lease at issue in the *Seneca Resources* case.[31] In *Seneca Resources*, the Superior Court also determined that the lease at issue there was not severable.[32] The lease there differentiated operated from non-operated acreage but leased the entire 25,000 acres for the exploration and development of the oil and gas thereunder. The court there held that the assignment of a portion of the leased acreage did not sever the lease.

The majority distinguished the *Seneca Resources* case as follows:

> First, unlike the lease in *Seneca Res. Corp.*, the 240 acres at issue herein consisted of a number of distinct parcels. Further the terms of the [MacDonald] Lease specifically grant the lessee the right to "subdivide and release" the property. . . . Additionally, the final paragraph provides that the [MacDonald] Lease terms are "binding upon and extend to the parties hereto and their respective heirs, personal representatives, successors and assigns."[33]

Even assuming those distinctions to be accurate, *but see infra*, are they merely distinctions without a difference?

---

[30] The Western District of Pennsylvania also found no severance in a storage and production lease, which provided for distinct compensation schemes and provided for different abilities vis-à-vis deep strata. *Jacobs v. CNG Transmission Corp.*, 332 F. Supp. 2d. 759, 774–783 (W.D. Pa. 2004). Although the court later found that the payment of rentals for storage only over a span of 40+ years did not maintain the development rights beyond the primary term for any strata other than the one where gas was stored, the court based that conclusion on the language of the lease that specifically allowed the storage rentals to substitute for "all delay rentals or royalty due or to become due for the right to produce or for production of oil or gas *from the sands, strata, or horizons where gas may be stored as herein provided*." *Jacobs*, 332 F. Supp. 2d at 788 (emphasis in original). The court noted that a different result would have attained as to the question had the parties not limited the language to the specific horizon, *etc*. where the gas was stored. *Id.*

[31] *See* Opinion, p. 9.

[32] *Seneca Res. Corp. v. S & T Bank*, 122 A.3d 374 (Pa. Super. Ct. 2015).

[33] Opinion, p. 9.

As to the first distinction, it is beyond the pale to think that a lease of 25,000 acres was a single parcel. A simple review of the lease at issue in the *Seneca Resources* case confirms that it covered numerous parcels.[34] As to the second and third distinctions, the majority does not identify whether those same or similar provisions were in the lease at issue in the *Seneca Resources* lease, likely because similar provisions did exist.[35] And, the majority undertakes no analysis of how or why those two lease provisions contemplate that the lease would be severed.[36]

The majority also fails to address the guiding principle in Pennsylvania law that when interpreting contracts, a court must construe all provisions of the contract to give effect to each, not interpreting one provision in a manner that annuls another provision.[37] But here, the majority essentially cherry-picks three form provisions and interprets them in a manner that annuls the lease as to a giant swath of the leased premises vertically. The majority recognizes that the lease "makes no distinction between oil and gas interests above and below the Formation. Rather, the terms of the Lease grant the lessee exclusive drilling rights to *any* oil and gas found under the 240 acres of surface land covered by the Lease."[38] Yet it interprets the lease provisions (and unilateral conduct) to annul rights to a significant portion of the oil and gas.

Duty to Develop all Strata Effectuated by Implication?

Another unanswered question is how the majority reached its decision when it runs afoul of Pennsylvania law holding that there is no duty to develop other strata. Has the majority now attempted to create, through the backdoor, a duty to develop that has been rejected by the Superior Court in a head-on

---

[34] *See* Jefferson County Recorder of Deeds, Deed Book 356, Pages 127–136 (April 17, 1962, Oil and Gas Lease covering property conveyed to Humphrey Industries via three distinct deeds and "any other deed or instrument"; Exhibit A thereto lists at least 46 different parcels).

[35] *See* James W. Adams, Jr., et al., Pennsylvania Oil and Gas Law and Practice 39-10, 39–49, 39–53 (1st ed. 2012) (citing form leases that contain the release, assignment, and binding successor language); *see also* Jefferson County Recorder of Deeds, Deed Book 356, Pages 127–130, 133 (myriad provisions designating lease as binding on successors and assigns and allowing for surrender of parts of the lease).

[36] Even assuming the "subdivide and release" provision contemplates possible lease severance, doesn't the subsequent "binding upon" language cut the other way as there is no lease to be binding if the lease is severed and not developed—like in the case before the court?

[37] *Murphy v. Duquesne Univ.*, 777 A.2d 418, 429 (Pa. 2001); *Capek v. Devito*, 767 A.2d 1047, 1050 (Pa. 2001); *see also McCausland v. Wagner*, 78 A.3d 1093, 1102 (Pa. Super. Ct. 2013) ("We observe it is an oft-stated maxim that the law abhors a forfeiture.").

[38] Opinion, p. 2 (emphasis added).

challenge?[39] And not only does the majority appear to require further development, it appears to require that development to occur within the primary term to avoid a later argument of abandonment should an assignment occur. Under the majority's analysis, any lessee with a lease containing a few form provisions must develop every conceivable oil or gas producing strata prior to the expiration of the primary term or risk an argument later that the lease is abandoned as to undeveloped strata. That simply is not the law in Pennsylvania.

Horizontal Severance Based on What?

In addition to finding the lease to have been severed vertically, the majority found the lease to have been severed horizontally as well.[40] Interestingly, though, the majority focused on nothing more to reach this conclusion than it did to reach the conclusion that the lease was severed vertically. Essentially, it reached its decision as to horizontal severance by reliance on (i) the unilateral action of the original lessor to sell a portion of the land under lease, (ii) the fact that the lease originally covered distinct parcels, and (iii) the provision in the lease making it binding on successors and assigns.[41] So, under the majority's analysis, the presence of one form provision in a lease that originally covered distinct parcels, coupled with unilateral action by the lessor, results in horizontal severance. How that can be evidence of the *parties'* intent is questionable at best.

Tool for the Malicious Lessor to Bust a Lease?

And does the majority's decision mean that lessors who have a decades-old lease that is held only by shallow production can convey the deep rights to a family member, a family trust, or some other related entity and thereby sever those deep rights from the shallow rights and invalidate the lease as to those deep rights? Under the majority's analysis, as long as the lease has some standard provisions allowing for release and addressing the effect of the lease on assigns, that unilateral conduct could sever the shallow and deep rights.[42] In that situation, the lessee would be at a loss to try to maintain the deep rights if the primary term had expired.

Moreover, it seems the majority's opinion would allow a lessor bent on ousting an assigned lessee to do so even after development occurs if that strata

---

[39] *Caldwell v. Kriebel Res. Co., LLC*, 72 A.3d 611 (Pa. Super. Ct. 2013); *see also Delmas Ray Burkett, II Revocable Trust ex rel. Burkett v. EXCO Res. (PA), LLC*, Civ. A. No. 2:11-cv-1394 (W.D. Pa. Feb. 14, 2014).

[40] Opinion, p. 9.

[41] The remaining two lease provisions relied upon to find vertical severance apply only to the lessee, not the lessor. *See* Opinion, p. 8.

[42] *But see Lansford Bldg. & Loan Ass'n v. Sheerin*, 190 A. 901, 902 (Pa. 1937) ("A unilateral intention cannot prevail over a contractual obligation.").

development occurred after the primary term ended. Assume an assignment of undeveloped deep rights from the developed shallow rights after the primary term of the oil and gas lease expired. Under the majority's analysis, the lease at that point would be abandoned as to the deep right, turning the relationship between lessor and lessee into one of a tenancy at will, subject to termination by the lessor at any time.[43] Assume further that the lessee then, years later, drills a well to the Utica shale formation and begins to produce natural gas. Could the lessor eject the lessee? Under the majority's analysis, it seems as though the lessor would be able to terminate the lease and hold the gas rights and well for itself.[44]

Majority's Decision Actually Harm Lessors?

Despite its apparent win for lessors, the majority's decision actually is likely to harm lessors in the long run. The actions undertaken by the lessee in the *Montgomery* case were actions undertaken to spur additional development of the lease. That additional development would have resulted in additional income to the lessors in the form of royalties (assuming the development was fruitful).

Such a course of action is fairly commonplace in the industry, especially when the lessee is, for example, focused on shallow rights or, as in the

---

[43] *See* Trial Court Opinion, p. 12; Opinion, p. 12 (adopting Trial Court Opinion, pp. 7–14).

[44] A question arises as to whether the lessee would be entitled to offset for the cost of developing the well/property. As the Superior Court noted in *Sabella*,

> when improvements to land are made by a good-faith trespasser, the injured party is entitled, in effect, to the trespasser's net profits, *i.e.*, the revenues generated upon the land less the moneys expended in facilitating the profitable activity. However, when a party trespasses in bad faith, the injured party is entitled to all moneys derived from the trespass without any offset for the cost of generating those moneys.

Sabella v. Appalachian Dev. Corp., 103 A.3d 83, 98 (Pa. Super. Ct. 2014). Would a subsequent court interpret the *Montgomery* decision as one putting operators on notice (similar in effect to the recording statute addressed in *Sabella*) such that any actions on undeveloped, "severed" acreage after expiration of the primary term is bad faith trespassing? Would it make a difference if there is a recorded pooling notice, which limits the pooled acreage to the Marcellus, by an operator that then assigns the undeveloped shallow acreage after the primary term expiration? Would that recorded notice along with the lack of any other recorded designation of production from the shallow acreage mean the assignee is a bad faith trespasser if it attempts to develop the shallow acreage?

But, if the decision is viewed as having the constructive notice effect of a recorded document, is a better view that it does not provide that notice given Pennsylvania law that oil and gas rights in undeveloped acreage is inchoate? The constructive notice of the recording act applies to "purchasers" but an assignment of undeveloped oil and gas rights likely would not equate to a "purchase" of those rights. *See Sabella*, 103 A.3d at 102–04 (interpreting, in context of oil and gas lease, applicability of act providing constructive notice of recorded instruments).

Montgomery case, the deep rights only. That lessee then assigns the rights to the other areas to another E&P company who is focusing on that geological area to further develop the lease (something the original lessee has no obligation to do per the Superior Court's *Caldwell* decision).

But now, the market for post-primary term assignments is likely to dry up if the acreage to be assigned has not had some form of development prior to expiration of the primary term.[45] What operator is going to purchase an assignment of acreage if a lessor can declare the assigned acreage to be free from the lease? So, along with the market's drying up, the lessors likely are to see a possible additional revenue stream dry up as well. Those lessors who have had their oil and gas rights held by shallow (*e.g.*, above the Marcellus shale) production for decades who might have been able to get in on the Marcellus resurgence or the Utica development by way of an assignment of those deeper rights likely are to remain recipients of those shallow development royalties only for the foreseeable future thanks to the majority in *Montgomery*.[46]

Practical Considerations/Tips?

So, in light of the majority's decision, what does a prudent operator do if it is contemplating assignment or purchasing an assignment of a subset of the strata leased? Several considerations come to mind, but there is no guarantee that any or all would defeat a severability conclusion if a court were to apply the majority's rationale in *Montgomery*.

What should be the most likely option to defeat severance would be if entirety language exists in the leases being assigned. This would entail a review of each lease included in the assignment. If that language does not exist, an operator could consider approaching the lessors to obtain an amendment to include that language in the lease at issue. While such an approach may tip off the lessors to a possible cause of action should they hold out, this is where knowledgeable and experienced landmen may be able to explain to the lessors

---

[45] And given the time to develop an unconventional well, it likely also will dry up any assignments of primary term acreage if the lease is set for expiration within a year of the assignment—depending on whether the lease allows for "operations" to perpetuate the lease into a secondary term.

[46] It could be argued that the severance of the oil and gas rights allows the lessor to re-lease those rights for development, giving the lessor not only the additional royalties but an additional "bonus" payment. Unfortunately, that fact situation is unlikely to occur unless based upon unilateral conduct by the lessor. But, as noted above, that unilateral conduct by the lessor should not serve as evidence, let alone the sole evidence, regarding the severability of the lease. Moreover, given the majority's decision, it is unlikely an operator would engage in the underlying assignment transaction (*e.g.*, pay for an assignment of undeveloped acreage held by production from a different strata) that results in the purported severance.

that the amendment and the resulting assignment would be for the benefit of the lessors as it will allow for further development of the lease (and, if that development is successful, additional revenue to the lessor), which the lessors could not force the lessee to undertake under the current state of Pennsylvania law. This, though, could be a time-consuming and possibly expensive proposition depending on the acreage at issue.

Additional considerations include:

- Constructing the transaction as a sublease, farmout, or something other than an outright assignment, such that the lessor has a more difficult time arguing that the developed and undeveloped acreage have been split.
- Ensuring language is in the assignment representing that the assignment is subordinate to the leases at issue and is not intended to sever those leases.[47]
- Obtaining affidavits of production (the obverse of affidavits of non-production) wherein the lessors relate their understanding that the existing production holding the lease holds the entire lease.
- If you are the assignee, including a representation or warranty that the assignor has engaged in operations sufficient to hold the entire lease and that it will not do anything to cease those operations without sufficient advance notice to the assignee to allow that assignee to commence operations timely.
- Obtaining a ratification of the lease from the lessors after assignment.
- Working to obtain a legislative fix to the issue.

Given that the facts of any specific situation are important, if you find yourself in a situation where severance and lease expiration/abandonment is an issue or may become an issue, you should consult legal counsel as to your options.

CONCLUSION

By ignoring well-established principles of Pennsylvania law and published precedent, focusing on unilateral conduct, and relying on plain vanilla form lease provisions, the Superior Court has found an oil and gas lease to be severable both vertically and horizontally. It appears to have given lessors bent on invalidating oil and gas leases another tool to use. But when the majority's opinion is put under even minor scrutiny, it does not hold up and actually is

---

[47] *Loughman*, 134 A.3d at 474.

one that will operate to the long-term detriment of lessors and lessees. Hopefully, any court to which the case is cited[48] will give the opinion close scrutiny and determine, like Judge Olson, that the prior, reported *Loughman* and *Seneca Resources* opinions provide the better view of Pennsylvania law on lease severance.

---

[48] Of course, the decision cannot be cited to the Superior Court itself. *See* 210 Pa. Code § 65.37.