

April 4, 2012

Practice Group(s):

**Energy, Infrastructure
and Resources**

Oil & Gas

K&L Gates Represents Oil and Gas Producers in Major Pennsylvania Supreme Court Victory

By David R. Overstreet and V. Abe Delnore

On March 26, 2012, the Pennsylvania Supreme Court issued its long-awaited decision in *T.W. Phillips Gas & Oil Co. v. Jedlicka*, ___ A.3d ___, Docket No. 19 WAP 2009 (Pa. March 26, 2012). In a major victory for Pennsylvania's oil and gas producers and K&L Gates, the Court held that, under standard oil and gas lease language requiring that oil or gas be "produced in paying quantities," any operational profit suffices to hold the lease, and even if a well experiences periods of unprofitability, the producer's subjective good faith in continuing to operate suffices to hold the lease. The decision thus affirms the validity of many older leases that have been held by continuous, albeit low-level, production for decades in regions that are now experiencing a new wave of development.

The dispute arose out of a 1928 lease of oil and gas rights in a 163-acre tract in North Mahoning Township, Indiana County, Pennsylvania, under which defendant T.W. Phillips Gas & Oil Co. was lessee. The lease would last "for the term of two years, and as long thereafter as oil or gas is produced in paying quantities." The tract was subsequently subdivided. Plaintiff Ann Jedlicka came to own 70 acres, on which lay one of the four wells originally drilled in 1929. In 2004, T.W. Phillips assigned the leasehold to codefendant PC Exploration, Inc., who promptly drilled four further wells on Jedlicka's property and planned to drill four more.

The litigation began in 2005, when Jedlicka filed declaratory judgment action in the Court of Common Pleas of Indiana County, Pennsylvania. Jedlicka argued that T.W. Phillips and PC Exploration had not "produced in paying quantities" for the entire lease term because, in 1959, the wells had recorded a \$40 loss. Jedlicka identified no other period in which the wells had not shown a profit. Nonetheless, Jedlicka sought to have the lease declared canceled as to her property. T.W. Phillips and PC Exploration, on the other hand, argued that the lease remained valid because it had paid a profit over any longer term and because they had operated in good faith.

The trial court held a nonjury trial on April 16, 2007, at the conclusion of which the court held that the lessees had produced gas "in paying quantities" throughout the life of the lease, notwithstanding the 1959 loss. The trial court noted its reliance on *Young v. Forest Oil*, 45 A. 1 (Pa. 1899), for the proposition that courts owe deference to a lessee's good faith judgment that a well is producing "in paying quantities."

Jedlicka appealed to the Superior Court, which affirmed in a decision dated December 29, 2008. *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 964 A.2d 13 (Pa. Super. Ct. 2008). The Pennsylvania Supreme Court granted Jedlicka's petition for appeal to consider whether the Superior Court had misapplied *Young*.

After able handling by trial counsel, T.W. Phillips and PC Exploration retained K&L Gates as appellate counsel at the Superior and Supreme Court phases. Pittsburgh-based K&L Gates partner Walter Bunt assembled a team for briefing and argued the case on April 10, 2010.

K&L Gates Represents Oil and Gas Producers in Major Pennsylvania Supreme Court Victory

Although it took nearly two years for the Pennsylvania Supreme Court to issue its decision affirming, the result was a clear win for lessees, affirming the continuing vitality of both well-established Pennsylvania precedent and thousands of oil and gas leases across the Commonwealth.

Justice Todd, writing for a four-justice majority, held that the courts below had properly applied *Young*, especially when that case was read in conjunction with another one that was decided the same day, *Colgan v. Forest Oil Co.*, 45 A. 119 (Pa. 1899), which emphasized the deference lessors and courts owed to lessees' business judgment. Justice Todd's opinion synthesizes *Young* and *Colgan* to present the following test:

[W]e hold that, if a well consistently pays a profit, however small, over operating expenses, it will be deemed to have produced in paying quantities. Where, however, production on a well has been marginal or sporadic, such that, over some period, the well's profits do not exceed its operating expenses, a determination of whether the well has produced in paying quantities requires consideration of the operator's good faith judgment in maintaining operation of the well.

Jedlicka, slip op., at 22. The Court did not define precisely over what period profitability should be judged, holding that this would have to be determined on a case-by-case basis.

Significantly, although the Court cited some cases from other jurisdictions, it expressly did not adopt the "prudent operator" standard, which would have injected an objective standard into Pennsylvania's long-standing "subjective good faith" test. Rather, the *Jedlicka* decision emphasizes that the actual lessee's own situation and conduct are what matters. This emphasis on the lessee's perspective, the Court reasoned, is necessary to protect lessees from lessors who seek to terminate leases on the basis of isolated, long-ago periods of unprofitability, which is how the Court characterized *Jedlicka*'s lawsuit. *Id.* at 23.

The Court thus held that, in this specific case, *Jedlicka* had failed to establish the lessees' lack of good faith. *Id.* at 24. The Court also suggested that the trial court could have properly found that a single year was not a reasonable period over which to assess profitability, in which case the good faith inquiry would not have been necessary. *Id.*

Justice Eakin wrote a short concurring opinion, in which he observed that the lease language in question had originally been introduced to benefit the lessee. Justice Eakin strongly rejected *Jedlicka*'s contention that showing a one-year period of unprofitability could throw a "paying quantities" lease into question. Thus, he would not have reached the question of T.W. Phillips' good faith.

Justice Saylor, alone, dissented. Justice Saylor would have inverted the majority's test and held that, in order to hold a lease by production, the lessee must show both that the well is profitable and that lessee is operating according to objective standards of good faith. Justice Saylor would therefore have remanded for further factual development.

Justice Orié Melvin, who had been part of the Superior Court panel that heard this case, recused herself.

The *Jedlicka* decision thus vastly circumscribes the number of situations in which a decades-old business decision or market condition will reach forward and invalidate a lease. The decision gives comfort to those Pennsylvania producers operating old leases.

Jedlicka is the fourth oil and gas case K&L Gates has successfully litigated before the Pennsylvania Supreme Court in recent years, following *Kilmer v. Elexco Land Services Company, Range*

K&L Gates Represents Oil and Gas Producers in Major Pennsylvania Supreme Court Victory

Resources-Appalachia, LLC, et al. v. Salem Township, et al., and Belden & Blake Corp. v. Commonwealth of Pennsylvania, Department of Conservation and Natural Resources. In each case, the Pennsylvania Supreme Court reaffirmed Pennsylvania’s long-standing pro-development policies. This victory marks a “hat trick” for Walter Bunt, who also argued *Range Resources-Appalachia* and *Belden & Blake*. Pittsburgh associate Michael Ross assisted in *Jedlicka*.

Authors:

David R. Overstreet

david.overstreet@klgates.com

+1.412.355.8263

V. Abe Delnore

abe.delnore@klgates.com

+1.412.355.6425

K&L GATES

Anchorage Austin Beijing Berlin Boston Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg
Hong Kong London Los Angeles Miami Milan Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh
Research Triangle Park San Diego San Francisco São Paulo Seattle Shanghai Singapore Spokane Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of more than 40 fully integrated offices located in North America, Europe, Asia, South America, and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information about K&L Gates or its locations and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2012 K&L Gates LLP. All Rights Reserved.