



# MARCELLUS SHALE: A Game Changer?



## Impact of Implied Covenants on Marcellus Production Rights

Thank you for joining us today  
The webinar will begin promptly at 12 pm

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# Today's Presenter: James A. Russell



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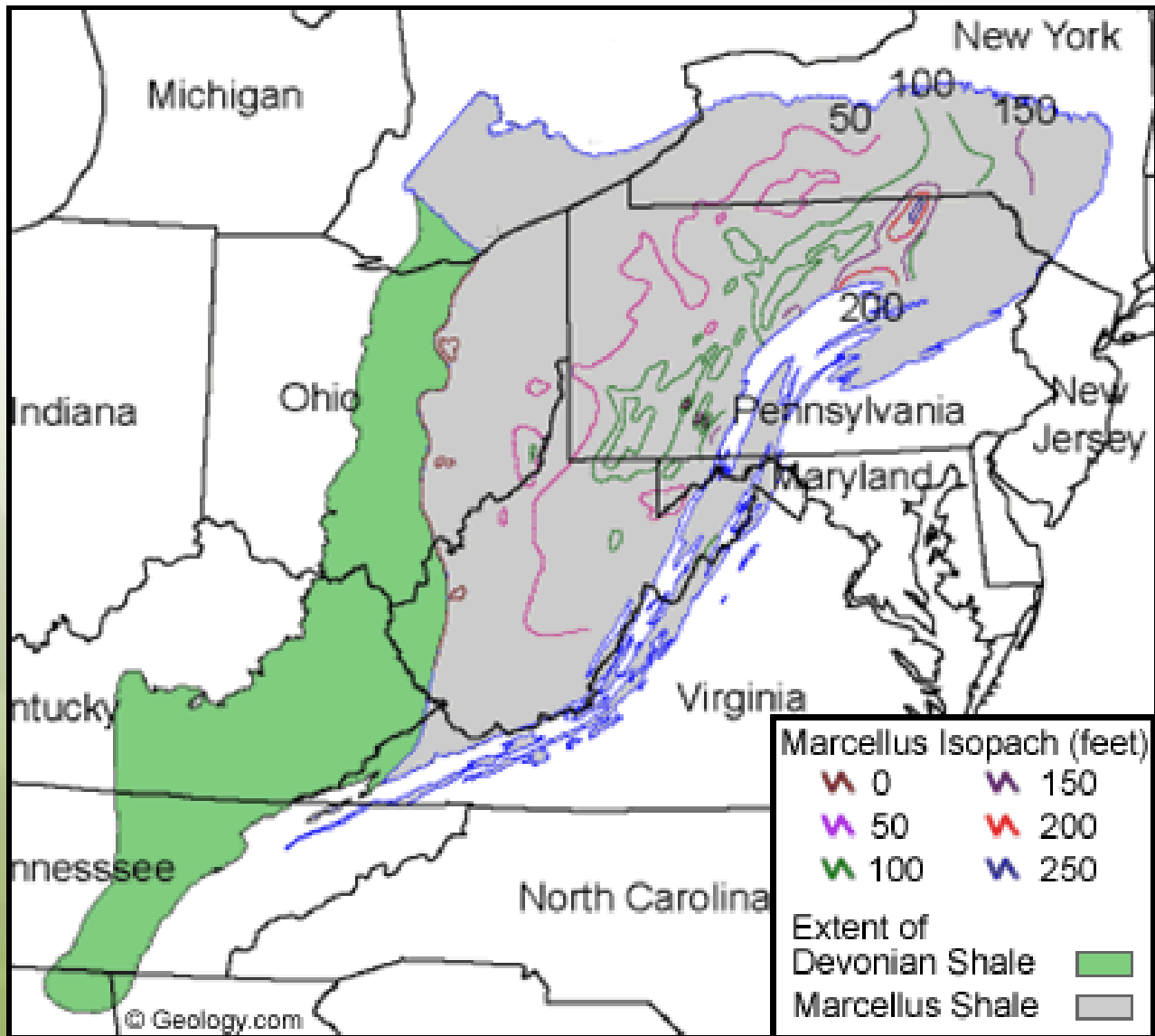
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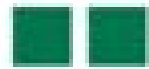
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Impact of  
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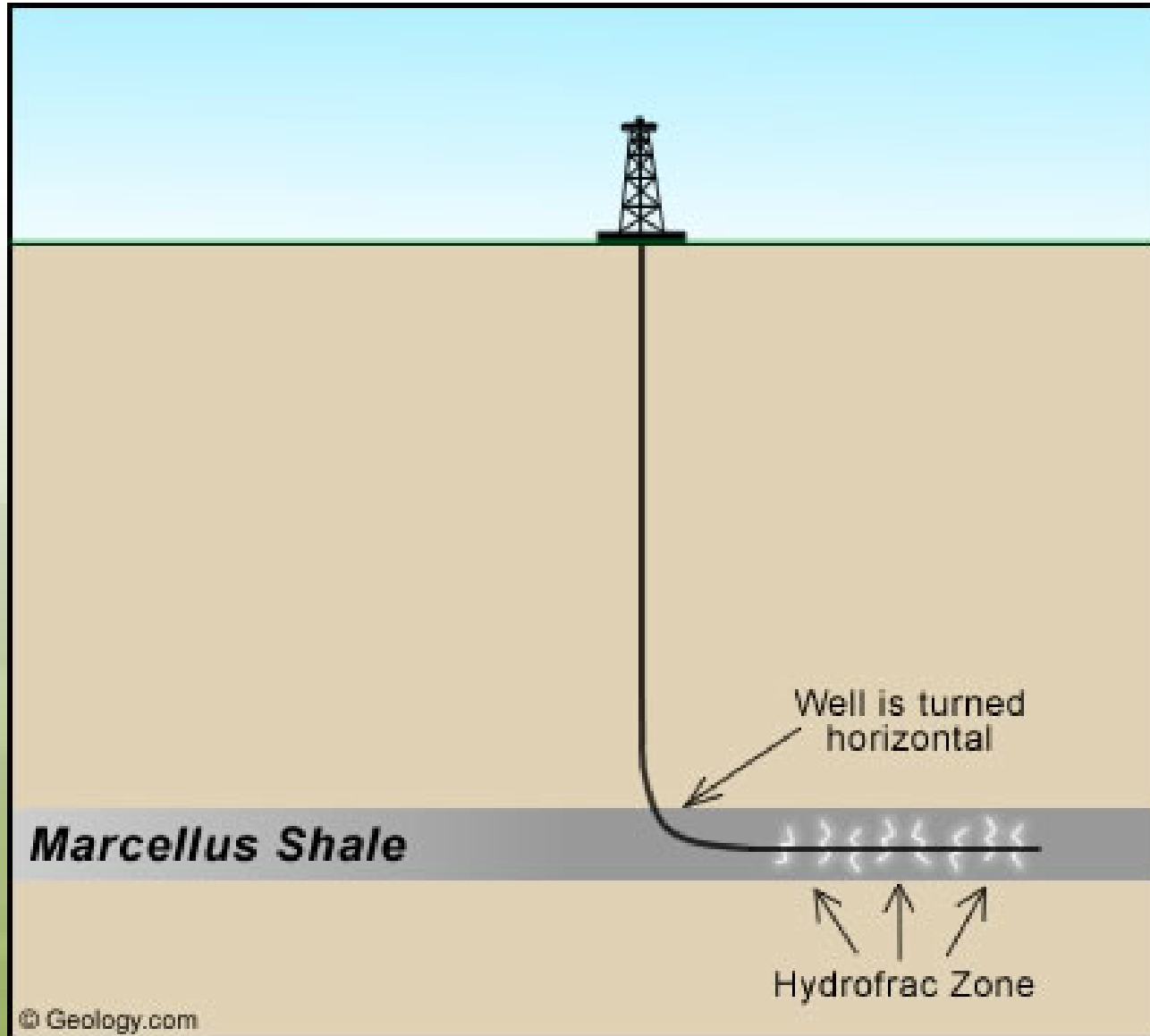
# Marcellus Shale



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# How does it work?





## Dual Nature of an Oil and Gas Lease



### 1. Conveyance:

- Exclusive right to explore
- Vested right to produce upon discovery
- Ownership of produced minerals

### 2. Contract:

- Express covenants
  - *E.g.*, pay royalties as per lease
  - Drilling commitment
  - Restore surface
- Implied covenants

Unless excluded by:

- Express negation of implied covenants
- Inconsistent with express covenant(s)



## Commonly Recognized Implied Covenants



- Covenant to drill a well
- Covenant to protect against drainage
- Covenant to market production
- Covenant to conduct prudent operations
- Covenant of reasonable development
- Covenant of further exploration



# Implied Covenant of Reasonable Development



## Implied Covenant of Reasonable Development

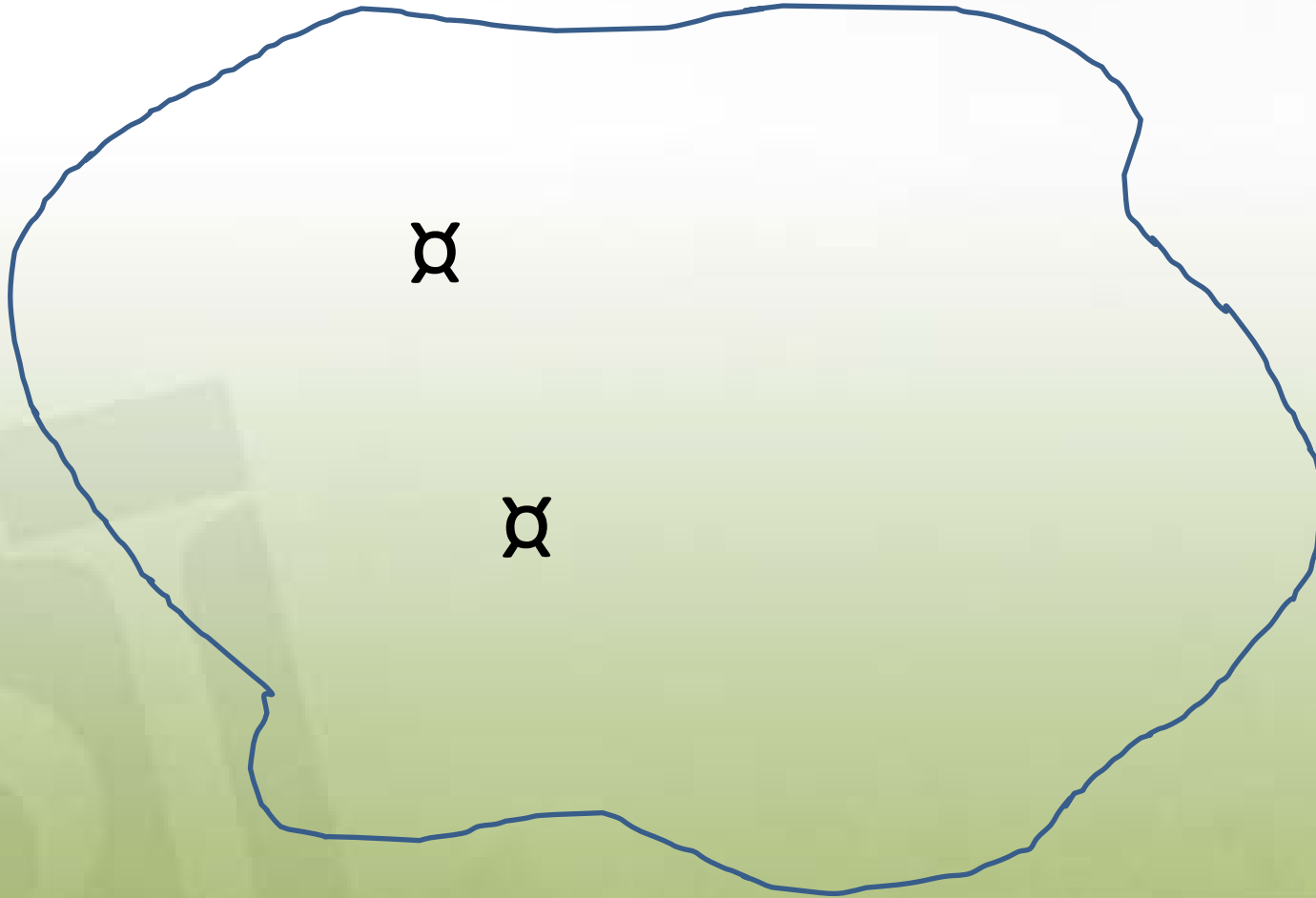


Concise Statement  
Of Covenant:

“Upon securing production of oil or gas from the leasehold, the lessee is bound thereafter to drill such additional wells to develop the premises as a reasonably prudent operator, bearing in mind the interests of both lessor and lessee, would drill under similar circumstances.”

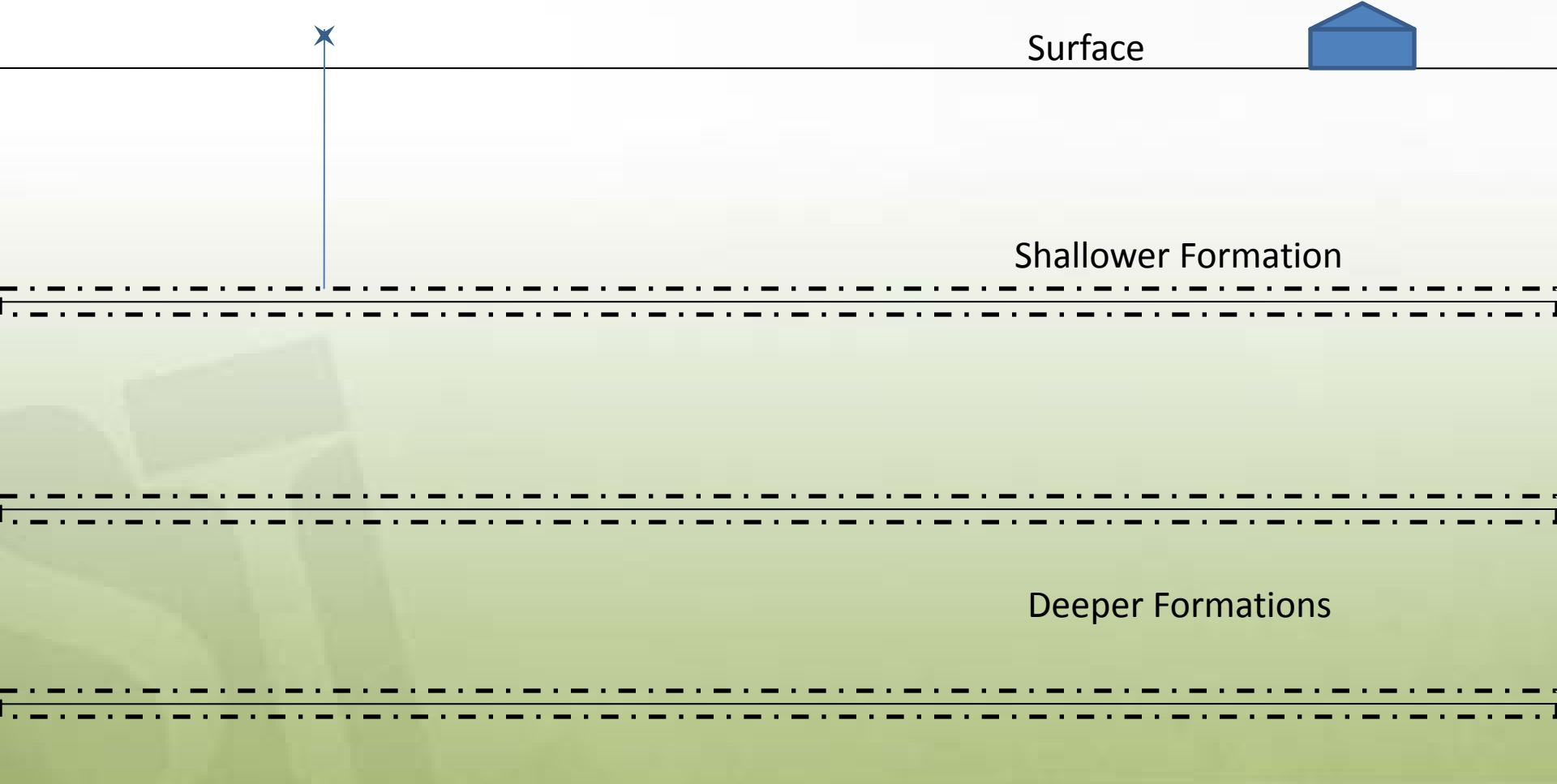


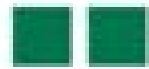
## Horizontal Context: Duty to drill in undeveloped part?





# Vertical Context: Duty to drill to deeper formation?





## Distinctive Features of Development Case

1. Proof of profitability is required
2. Applies to proven reserves
3. Pre-suit demand usually required
4. Variable remedies if breach established:
  - Damages are often preferred remedy
    - Lost royalties
      - \$\$ credited against future production
    - Interest on lost royalties
    - Cancellation if damages are inadequate or breach is  
flagrant
      - Lessee retains existing productive wells
    - Conditional cancellation
      - Lease cancelled (except as to productive wells)  
unless Lessee drills within specified period of time



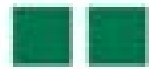
# IMPLIED COVENANT OF FURTHER EXPLORATION



## Concise Statement of Implied Covenant of Further Exploration



“... development of every part of the lease is an implied condition. Therefore, 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**, the existence of which may be doubtful...it is an implied condition that the lessee will test every part. When he abandons all further testing and disclaims any obligation to test, he may be required likewise to surrender all claims to the property.”



## Distinctive Features of Exploration Case



1. Proof of **profitability** is **not required**
  - Prudent operator factors considered
2. Applies to unproved areas and formations
3. Demand for drilling always required
4. Remedy is cancellation of undeveloped areas or strata
  - Cancellation could be conditional



## Factors Affecting Application of Further Exploration Covenant



- Prior exploratory efforts
- Operator's plans (or lack of plans) to explore
- Elapsed time since last well drilled
- Size of lease vs. extent of unexplored areas/formations
- Location and density of wells
- Favorable geology
- State of available technology
- Market conditions
- Another operator willing to drill



## Comparison of Covenants



### Reasonable Development

Premise: Lessee hasn't drilled enough wells to adequately develop proven productive reserves when it would be profitable to do so

Universally established

Applies to proven reserves

Requires proof of profitability

Damages are preferred remedy; cancellation available when damages are inadequate.

### Further Exploration

Premise: Lessee should drill a well to test unproven areas or strata without proof of profitability when it would be prudent to do so

Not well established in the Appalachian Basin

Applies to unproven areas and strata

Does not require proof of profitability; based on prudent operator standard

Cancellation is a remedy



## Two Recent PA Cases Involved Challenges to Control of Deep Rights



**Jacobs v. CNG Transmission Corp. (2004)**

**Penneco Pipeline Corp. v. Dominion Transmission (2007)**

- Both cases involved production-storage leases with virtually identical lease provisions
- In both cases, the only activity for decades had been storage
- Both cases involved claims that the lessee had lost production rights in deeper formations below the storage zones
- The claims in both cases were made on the same grounds – breach of implied covenant to develop the leasehold and abandonment



## Two Recent PA Cases Involved Challenges to Control of Deep Rights (cont.)



**Jacobs v. CNG Transmission Corp. (2004)**

**Penneco Pipeline Corp. v. Dominion Transmission (2007)**

### The Results:

- Both cases were in the same judicial district – W. D. Pa.
- The cases had different outcomes:
  - In *Jacobs*, the deep rights were lost
  - In *Penneco Pipeline*, the deep rights were preserved



# Conclusion



1. Increased focus on Marcellus potential should result in increased frequency of challenges to control of Marcellus rights.
2. Factual nature of dispute makes outcome hard to predict.
3. Lines between covenants are blurring.



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**Thank you for participating!**

**March 17, 2010**

Staying Upright in a World of Horizontal Drilling

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