[J-21-2010]
IN THE SUPREME COURT OF PENNSYLVANIA
WESTERN DISTRICT

CASTILLE, C.J., SAYLOR, EAKIN, BAER, TODD, McCAFFERY, ORIE MELVIN, JJ.

T.W. PHILLIPS GAS AND OIL CO. AND PC EXPLORATION, INC.,	: No. 19 WAP 2009
Appellees	: Appeal from the Order of the Superior Court entered December 29, 2008 at No. 1918 WDA 2007, affirming the Order of the Court of Common Pleas of Indiana County, entered October 19, 2007 at No. 10362 CD 2005.
v.	:
ANN JEDLICKA,	: 964 A.2d 13 (Pa. Super. 2008)
Appellant	: ARGUED: April 13, 2010

OPINION

MADAME JUSTICE TODD **DECIDED: MARCH 26, 2012**

This Court granted allowance of appeal in the instant case to determine the proper test for evaluating whether an oil or gas lease has produced "in paying quantities," as first discussed by this Court in Young v. Forest Oil Co., 194 Pa. 243, 45 A. 1 (1899). After careful consideration, we hold that, where, as here, production on a well has been marginal or sporadic, such that for some period profits did not exceed operating costs, the phrase "in paying quantities" must be construed with reference to an operator's good faith judgment. Furthermore, as we find the lower courts considered the operator's good faith judgment in concluding the oil and gas lease at issue in the instant case has produced in paying quantities, we affirm the order of the Superior Court affirming the judgment entered by the trial court in favor of T.W. Phillips Gas and Oil Co. and PC Exploration, Inc. (collectively, "Appellees").

Appellant, Ann Jedlicka, is the owner of a parcel of land consisting of approximately 70 acres located in North Mahoning Township (the "Jedlicka tract"). Title to the Jedlicka tract was conveyed from James and Anna Jedlicka, husband and wife, to Anna Jedlicka and Ann Jedlicka, mother and daughter, in October 1979. The Jedlicka tract is part of a larger tract of land consisting of approximately 163 acres, which was conveyed to Samuel Findley and David Findley by deed dated February 24, 1925 (the "Findley property"). In 1928, Samuel Findley and David Findley conveyed to T.W. Phillips Gas and Oil Co. ("T.W. Phillips") an oil and gas lease covering all 163 acres of the Findley property (the "Findley lease"), which included the Jedlicka tract. The Findley lease, characterized as a pressure lease, established royalty payments to the lessor based upon the pressure of the well. The lease also contains a habendum clause, which provides:

> To have and to hold the above-described premises for the sole and only purpose of drilling and operating for oil and gas with the exclusive right to operate for same for the term of two years, and as long thereafter as oil or gas is produced in paying quantities, or operations for oil or gas are being conducted thereon, including the right to drill other wells.

Lease, July 2, 1928, at 1 (R.R. at 13a-14a). Notably, the term "in paying quantities" is not defined in the lease. Subsequently, the Findley property was subdivided and sold — including the Jedlicka tract — subject to the Findley lease.

In 1929, pursuant to the Findley lease, T.W. Phillips drilled four gas wells, identified as Well Nos. 1 through 4. Well No. 4 is situated on what is now the Jedlicka tract. Well No. 2 was temporarily abandoned in 1955, and Well No. 4 was temporarily abandoned in 1953. All four wells were fractured in 1967[1] and eventually assigned to PC Exploration, Inc. ("PC

[1] Hydrofracturing, or fracking, is a method used to stimulate production of a well. A specially blended liquid is pumped down the well and into a formation under pressure high enough to cause the formation to crack open, forming passages through which oil or gas can flow into the wellbore. See, e.g., U.S. Steel Corp. v. Hoge, 503 Pa. 140, 144 n.1, 468 (continued…)

Exploration") on June 15, 2004. Thereafter, PC Exploration drilled four additional wells, identified as Well Nos. 6 through 9.[2] Jedlicka has received royalties and free gas throughout the life of the lease.

Subsequently, PC Exploration made plans to drill four more wells — Well Nos. 10 through 13 — on the Jedlicka tract. Jedlicka objected to the construction of these new wells, claiming that T.W. Phillips failed to maintain production "in paying quantities" under the habendum clause of the Findley lease, and, as a result, that the lease lapsed and terminated. Specifically, Jedlicka argued that there has not been continuous production in paying quantities on the wells because, in 1959, T.W. Phillips suffered a loss of approximately $40 as a result of operations under the Findley lease.

In 2005, Appellees filed a declaratory judgment action against Jedlicka to determine their rights with regard to the Jedlicka tract under the Findley lease. Appellees maintained that the Findley lease remains valid; that the wells on the original Findley property have produced gas in paying quantities because they have continued to pay a profit over operating expenses; and that they have operated the wells in good faith to make a profit. Prior to trial, Jedlicka filed a motion *in limine* to exclude evidence of Appellees' post-1974 operating expenses and revenues for Well Nos. 1 through 4 because Appellees did not have any depletion schedules[3] for those wells after 1974. The trial court denied the motion and allowed Appellees to introduce other evidence of expenses, revenue, and production.

(…continued)
A.2d 1380, 1382 n.1 (1983) ("Hydrofracturing is the forcing of fluids under pressure into the well so as to cause a fracturing of the target stratum.").

[2] The parties do not make reference to a Well No. 5.

[3] Depletion schedules are used to show the operating expenses and amount of revenue generated by each well.

Appellees then filed a motion *in limine*, opining that Jedlicka's claims were barred by operation of Rule 1901 of the Pennsylvania Rules of Judicial Administration.[4] Appellees noted that, in 1988, Jedlicka commenced an action by writ of summons challenging the validity of the Findley lease, but that action was dismissed with prejudice as an inactive case pursuant to Pa.R.J.A. 1901. Appellees further noted that Jedlicka failed to allege any reasons for such inactivity in a timely petition for permission to reinstate the cause of action. Accordingly, Appellees argued that Jedlicka should be precluded from presenting any evidence or testimony regarding the production or operation of the wells on the Findley property prior to 1988. The trial court heard testimony on Appellees' motion and determined that the lease at issue in the 1988 action was the same as the lease at issue in the case *sub judice*; however, the trial court was unable to conclude that the issues in the two actions were identical, or that Jedlicka was attempting to argue the same claims, and thus denied Appellees' motion.[5]

[4] Rule 1901, titled "Prompt Disposition of Matters; Termination of Inactive Cases," permits a court, after giving a minimum of 30 days notice, to enter an order terminating a matter where the matter has been inactive for an unreasonable period of time. Pa.R.J.A. 1901(a).

[5] Shortly prior to trial, Jedlicka filed a supplemental trial memorandum arguing that Appellees breached the Findley lease by failing to meter Well No. 4 and pay a 1/8 royalty as set forth in 58 P.S. §§ 33-35. Section 33, titled "Guarantee of minimum royalties," provides that an oil or gas lease which does not guarantee the lessor at least 1/8 royalty of all oil, natural gas, or gas removed or recovered from the property is invalid. 58 P.S. § 33. Sections 34 and 35 provide for the metering and escalation of royalties under leases which do not provide for a 1/8 royalty at the time of the April 1985 effective date of the Oil and Gas Act, 58 P.S. §§ 601.101 *et seq*. (the "Act"). Appellees objected to her filing on the basis that they did not have an opportunity to respond to or challenge the Act's constitutionality. Noting that Jedlicka had not previously raised this argument, thus depriving Appellees of an opportunity to argue the constitutionality of the Act, the trial court held that Jedlicka was precluded from raising the issue, "without prejudice to raise it appropriately." T.W. Phillips Gas and Oil Co. and PC Exploration, Inc. v. Jedlicka, No. 10362 CD 2005, unpublished memorandum opinion at 4 (Indiana Cty. Common Pleas filed July 16, 2007). This issue is not presently before this Court.

On April 16, 2007, a bench trial was held before President Judge William J. Martin of the Indiana County Court of Common Pleas. Following trial, President Judge Martin determined that, notwithstanding the $40 loss suffered in 1959, Appellees had produced gas on their leasehold in paying quantities, and, therefore, that the Findley lease remained in effect. In determining that Appellees produced gas in paying quantities, the trial court relied on this Court's 1899 decision in Young v. Forest Oil, wherein we held that consideration should be given to a lessee's good faith judgment when determining whether oil was produced in paying quantities. The trial court noted that Appellees "continued efforts in production after 1959 and [the owners of the Jedlicka tract] continued to receive royalty payments per the lease for more than thirty years without asserting that the lease had expired." T.W. Phillips Gas and Oil Co. and PC Exploration, Inc. v. Jedlicka, No. 10362 CD 2005, at 5.

Additionally, the trial court rejected Jedlicka's suggestion that, instead of the Young test, the court should apply a test utilized by federal and some state courts, under which courts "interpret[] gas leases in a more objective manner using a computation of production receipts minus royalty minus expenses including marketing, labor, trucking, repair, taxes, fees and other expenses." T.W. Phillips Gas and Oil Co. and PC Exploration, Inc., No. 10362 CD 2005, at 5-6. Recognizing that the objective approach favored by Jedlicka incorporates the concern that "lessees should not be allowed to hold land indefinitely for purely speculative purposes," the trial court noted that Pennsylvania has not adopted this objective approach, and nevertheless concluded that "based upon all of the testimony and other evidence presented, the rationale utilized in support of a completely objective test is not applicable herein." Id. at 6. The trial court explained, in particular, that the Findley lease "is a pressure lease, not a 1/8 royalty lease," and "[t]he evidence indicates that the lessees were operating the wells in good faith and there was no evidence that they were holding the land for purely speculative purposes." Id.[6]

On November 26, 2008, the Superior Court affirmed the decision of the trial court in an unpublished memorandum opinion, which, upon joint motion of the parties, was subsequently published. T.W. Phillips Gas and Oil Co. and PC Exploration, Inc. v. Jedlicka, 964 A.2d 13 (Pa. Super. 2008). The Superior Court first concluded that our decision in Young, although more than a century old, remains good law. The Superior Court further found that, under Young, "the good faith of the lessee is a necessary determination," and held that Jedlicka failed to carry her burden of establishing that Appellees acted in bad faith. T.W. Phillips Gas and Oil Co. and PC Exploration, Inc., 964 A.2d at 19. Jedlicka petitioned for allowance of appeal, and, on July 29, 2009, this Court granted her petition to consider the following issue: "Did the Superior Court misapply the decision of this Court in Young v. Forest Oil Co.,194 Pa. 243, 45 A. 121 (Pa. 1899), by holding that Pennsylvania employs a purely subjective test to determine whether an oil or gas lease has produced 'in

[6] We note that, under the habendum clause, the Findley lease remains valid as long as "oil or gas is produced in paying quantities," **or** as long as "operations for oil or gas are being conducted thereon, including the right to drill other wells." Lease, July 2, 1928, at 1 (R.R. at 13a-14a) Thus, even if gas or oil were not produced in paying quantities, Appellees' rights under the lease would remain intact for as long as "operations" are conducted. The trial court did not address this possibility in its opinion, and, despite Appellees' assertions that "[f]rom the date of the Findley Oil and Gas Lease to the present, . . . operations for oil or gas have been conducted," see Appellees' Pretrial Memorandum, at 3 (R.R. at 60a), a review of the trial transcript reveals that there was some dispute, not only as to whether Appellees conducted operations for gas during the period of the lease, but also as to what activities constituted "operations" in the first instance. As a result, we are unable to determine whether the Findley lease remains valid under the second part of the habendum clause. Given our disposition of the "in paying quantities" issue, however, such determination is unnecessary.

paying quantities.'" T.W. Phillips Gas and Oil Co. v. Jedlicka, 602 Pa. 154, 978 A.2d 347 (2009) (order).[7]

When reviewing the findings of a court in equity, an appellate court's review "is limited to a determination of whether the chancellor committed an error of law or abused his discretion. A final decree in equity will not be disturbed unless it is unsupported by the evidence or demonstrably capricious." Kepple v. Fairman Drilling Co., 532 Pa. 304, 312, 615 A.2d 1298, 1302 (1992) (internal quotation marks omitted). Although facts found by the chancellor, when supported by competent evidence in the record, are binding, no such deference is required for conclusions of law, which we review *de novo*. Id.

Furthermore, a lease is in the nature of a contract and is controlled by principles of contract law. J.K. Willison v. Consol. Coal Co., 536 Pa. 49, 54, 637 A.2d 979, 982 (1994). It must be construed in accordance with the terms of the agreement as manifestly expressed, and "[t]he accepted and plain meaning of the language used, rather than the silent intentions of the contracting parties, determines the construction to be given the agreement." Id. (citations omitted). Further, a party seeking to terminate a lease bears the burden of proof. See Jefferson County Gas Co. v. United Natural Gas Co., 247 Pa. 283, 286, 93 A. 340, 341 (1915).

In order to better assess the parties' arguments in the case *sub judice*, we consider briefly the unique characteristics of an oil and gas lease. As this Court recognized in Brown v. Haight, "[t]he traditional oil and gas 'lease' is far from the simplest of property concepts. In the case law oil and gas 'leases' have been described as anything from licenses to grants in fee." 435 Pa. 12, 15, 255 A.2d 508, 510 (1969). Generally, however, the title

[7] The Pennsylvania Oil and Gas Association and the Independent Oil and Gas Association of Pennsylvania have filed a joint *amicus* brief in support of the position of Appellees, i.e., that this Court's decision in Young, requires consideration of an operator's good faith judgment when determining whether a well has produced in paying quantities.

conveyed in an oil and gas lease is inchoate, and is initially for the purpose of exploration and development. Calhoon v. Neeley, 201 Pa. 97, 101, 50 A. 967, 968 (1902); Burgan v. South Penn Oil Co., 243 Pa. 128, 137, 89 A. 823, 826 (1914) ("The title is inchoate, and for purposes of exploration only until oil is found." (internal quotation marks omitted)); see also Hite v. Falcon Partners, 2011 WL 9632 (Pa. Super. filed Jan 4, 2011) (same); Jacobs v. CNG Transmission Corp., 332 F.Supp.2d 759, 772 (W.D. Pa. 2004) (same).

If development during the agreed upon primary term is unsuccessful, no estate vests in the lessee. If, however, oil or gas is produced, a fee simple determinable is created in the lessee, and the lessee's right to extract the oil or gas becomes vested. Calhoon, 201 Pa. at 101, 50 A.2d at 968; Jacobs, 332 F. Supp.2d at 772-73. A fee simple determinable is an estate in fee that automatically reverts to the grantor upon the occurrence of a specific event. Brown, 435 Pa. at 18, 255 A.2d at 511. The interest held by the grantor after such a conveyance is termed "a possibility of reverter." Higbee Corp. v. Kennedy, 428 A.2d 592, 595 (Pa. Super. 1981). Such a fee is a fee simple, because it may last forever in the grantee and his heirs and assigns, "the duration depending upon the concurrence of collateral circumstances which qualify and debase the purity of the grant." Id. at 595 n.4 (quoting Slegel v. Lauer, 148 Pa. 236, 241, 23 A. 996, 997 (1892)).

Within the oil and gas industry, oil and gas leases generally contain several key provisions, including the granting clause, which initially conveys to the lessee the right to drill for and produce oil or gas from the property; the habendum clause, which is used to fix the ultimate duration of the lease; the royalty clause; and the terms of surrender. Jacobs, 332 F.Supp.2d at 764 (citing 3 Howard R. Williams & Charles J. Meyers, Oil and Gas Law § 601 (2003)). Further,

> A habendum clause is used to fix the ultimate duration of an oil and gas lease. 2 Summers, THE LAW OF OIL AND GAS § 281. "The habendum clause of the modern oil and gas lease is the result of a long process of development, in which many influences have aided in shaping its final form," chief of which

> have been the [distinct] interests of the lessor and lessee, the peculiar needs of the industry and the interpretation and enforcement of certain phrases by the Courts. Id. at § 282 Experimentation in the industry for a suitable durational term progressed from definite term leases, which placed the lessee at a disadvantage if production was only attained late in the term or extended beyond the term, to a definite term with an option to renew, to long term leases with conditional clauses extending the term through the production life of the land. Id. at §§ 283-287.

Jacobs, 332 F.Supp.2d at 765 n.1.

Typically, as herein, the habendum clause in an oil and gas lease provides that a lease will remain in effect for as long as oil or gas is produced "in paying quantities."[8] Traditionally, use of the term "in paying quantities" in a habendum clause of an oil or gas lease was regarded as for the benefit of the lessee, as a lessee would not want to be obligated to pay rent for premises which have ceased to be productive, or for which the operating expenses exceed the income. Swiss Oil Corp. v. Riggsby, 67 S.W.2d 30, 31 (Ky. 1933). More recently, however, and as demonstrated by the instant case, these clauses are relied on by landowners to terminate a lease.

As noted supra, the habendum clause contained in the lease at issue provides that Appellee shall have the right to drill for oil and gas for the term of two years "and as long thereafter as oil or gas is produced in paying quantities, or operations for oil or gas are being conducted thereon." Lease, July 2, 1928, at 1 (R.R. at 13a-14a). It is the meaning of the term "in paying quantities," which is not defined in the lease, that is the crux of the dispute between the parties; however, the parties agree that the lease is controlled by our 1899 decision in Young.[9]

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[8] In some jurisdictions, the phrase "in commercial quantities," as opposed to "in paying quantities," is used. See, e.g., Texaco, Inc. v. Fox, 618 P.2d 844 (Kan. 1980); Landauer v. Huey, 352 P.2d 302 (Colo. 1960).

[9] Jedlicka argues in her brief to this Court that the trial court improperly held that she waived her right to challenge the validity of the Findley lease by accepting royalties from (continued…)

In Young v. Forest Oil, the plaintiff landowner sought a declaration of forfeiture of an oil lease held by the defendant due to the defendant's alleged failure to develop the land. The trial court found that the defendant had "sufficiently developed" the west end of the plaintiff's farm. However, the court determined that the drilling of a single well on the north and east portions of the plaintiff's farm, which admittedly revealed no oil or gas, did not support the defendant's refusal to drill additional wells on the remainder of the farm, because "[t]here remains a large portion of plaintiff's farm which . . . ought to produce oil in paying quantities, with a reasonable degree of certainty." Id. at 248-49, 45 A. at 122. As a result, the trial court determined, "under the circumstances of this case the defendant's refusal to sink additional wells on plaintiff's farm is a wrongful act, amounting to a fraudulent use of the lease, to plaintiff's injury." Id. at 249, 45 Pa. at 122.

On appeal, this Court reversed, noting that the trial court's conclusion "proceed[ed] from an erroneous view of the law,"[10] and stating:

(…continued)
Appellees. Jedlicka contends such a finding is contrary to established law, particularly, Brown, supra. Jedlicka argues that, under Brown, when Appellees failed to produce gas in paying quantities in 1959, any interest Appellees had in the land "lapsed as a matter of law into a tenancy at will, terminable by Ms. Jedlicka at any time," and, therefore, "there can be no waiver of any right to challenge the validity of the lease." Appellant's Brief at 16. Contrary to the terminology used by Jedlicka, the trial court in the instant case did not hold that Jedlicka *waived* her challenge to the validity of the lease. The trial court simply noted, in its discussion of the $40 loss suffered by T.W. Phillips in 1959, that Jedlicka "continued to receive royalty payments per the lease for more than thirty years without asserting that the lease had expired," and, thus, received the benefit of the bargain since the inception of the Lease in 1928. T.W. Phillips Gas and Oil Co. and PC Exploration, Inc., No. 10362 CD 2005, at 5. The court then went on to address her arguments under the lease. Thus, we need not address Jedlicka's waiver contention any further.

[10] Specifically, this Court concluded the trial court had "misapprehended" the scope of Kieppner v. Lemon, 176 Pa. 502, 35 Atl. 109. We explained in Young that Kieppner

> was not meant to stretch the jurisdiction of equity beyond its regular and established limits, nor to blaze out any new path for proceedings on oil or gas leases, differing from ordinary remedies between lessor and lessee. It rested on fraud

(continued…)

> In the present case the conclusion of the court rests on nothing else than such a difference of judgment. There is not a scintilla of evidence for any other basis. The lessee contracted to put down one paying well. He did in fact put down five, four of which produced oil for a time. Even considering the plaintiff's side alone, the weight of the evidence in favor of the court's conclusion is exceedingly light. Passing over the plaintiff's extraordinary reasoning, that, because one well put down in the alleged insufficiently tested part of the farm proved to be a dry hole, therefore another hole in the same portion would produce a paying well, we have looked in vain for any testimony that even the experts are willing to stake their judgments on any such result. Not a single witness says so. . . . Even if [a witness] had said so, with sufficient positiveness to convince the court as a matter of judgment, it would not have been enough. . . . The operator, who has assumed the obligations of the lease, has put his money and labor into the undertaking, and is now called upon to determine whether it will pay to spend some thousands of dollars more in sinking another well to increase the production of the tract, is entitled to follow his own judgment. If that is exercised in good faith, a different opinion by the lessor, or the experts, or the court, or all combined, is of no consequence, and will not authorize a decree interfering with him.

Id. at 249-50, 45 A. at 122.

With regard to the plaintiff's argument to this Court that the lease had expired because oil was no longer produced in paying quantities, we noted that, despite declining to grant the plaintiff relief on this ground, the trial judge found it unnecessary to determine the exact meaning of the phrase "in paying quantities." However, we nevertheless agreed the trial court was correct not to grant relief on this ground, explaining:

> The phrase 'found or produced in paying quantities' means paying quantities to the lessee or operator. If oil has not been

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(…continued)

> alleged and proved, and fraud in fact, not merely inferred from a difference of judgment between the defendant and the court as to the profitable development of the leased premises.

Young, 194 Pa. at 249, 45 A. at 122.

> found and the prospects are not such that the lessee is willing to incur the expense of a well (or a subsequent or second well, as the case may be), the stipulated condition for the termination of the lease has occurred. So, also, if oil has been found, but no longer pays the expenses of production. But if a well, being down, pays a profit, - even a small one, over the operating expenses, - it is producing in 'paying quantities,' though it may never repay its cost, and the operation as a whole may result in a loss. Few wells, except the very largest, repay cost under a considerable time; many never do; but that is no reason why the first loss should not be reduced by profits, however small, in continuing to operate. The phrase 'paying quantities,' therefore, is to be construed with reference to the operator, and by his judgment when exercised in good faith.

Id. at 250-51, 45 A. at 122-23.

In Colgan v. Forest Oil Co., 194 Pa. 234, 45 A. 119 (Pa. 1899), which we issued on the same day as our opinion in Young, we elaborated on the concept of good faith judgment. Therein, the owner of land (lessor) filed a bill in equity against the lessee for specific performance of convenants contained in an oil lease, or, alternatively, for forfeiture of the lease. The lessee challenged the number of wells put down by the lessor, as well as the location of the wells. Concerning the lessee's good faith judgment, we stated:

> So long as the lessee is acting in good faith on business judgment, he is not bound to take any other party's, but may stand on his own. Every man who invests his money and labor in a business does it on the confidence he has in being able to conduct it in his own way. No court has any power to impose a different judgment on him, however erroneous it may deem his to be. Its right to interfere does not arise *until it has been shown clearly that he is not acting in good faith on his business judgment, but fraudulently, with intent to obtain a dishonest advantage over the other party to the contract.* Nor is the lessee bound, in case of difference of judgment, to surrender his lease, even *pro tanto*, and allow the lessor to experiment. Lessees who have bound themselves by covenant to develop a tract, and have entered and produced oil, have a vested estate in the land, which cannot be taken away on any mere difference of judgment.

Id. at 242, 45 A. at 121 (emphasis added).

Jedlicka argues that the lower courts in the instant case erroneously interpreted our decision in Young as providing for a "purely subjective," rather than objective, test to determine whether a gas or oil lease is producing in paying quantities.[11] Specifically, Jedlicka argues:

> [W]hile there are some subjective factors to consider in the overall analysis, the test is not purely subjective, as the trial court found in the instant case. Rather, the threshold inquiry is whether, objectively, the lease is making a profit, "however small" over its operating expenses. The operating expenses referred to here are the day to day costs of operating the well. Some courts have referred to these expenses as "lifting expenses." The Court in Young was clear that if the wells do not pay this minimal cost of production, they will not be deemed to produce in paying quantities.
>
> The subjective element is the second layer of analysis which only enters the determination when the wells have already been found to be producing in paying quantities, but that the profits are insufficient to offset the total expenses incurred in the operation as a whole — particularly those expenses associated with the exploration, drilling and inception of oil or gas extraction. In such case, the Court in Young explained, it is necessary to determine whether the lessee is exercising its good faith judgment as to whether the wells are being operated for revenue. Provided that it is, and the wells are producing in paying quantities, the lease will not lapse.

Appellant's Brief at 11-12 (citations omitted).

Based on her interpretation of Young, and, because it was "conclusively established that the wells under the Lease incurred a net loss in 1959 when their combined revenues were insufficient to overcome the expenses of their operation," id. at 15, Jedlicka contends:

> [i]t was unnecessary, unprecedented and, indeed, improper, for the trial court to then inquire as to the subjective good faith of

[11] Jedlicka emphasizes she is not suggesting that Young be overruled. Indeed, she states: "To be abundantly clear, [Jedlicka] is not advocating that this Court overturn Young. . . . It has always been [Jedlicka's] contention that Young was properly decided . . . and should, therefore, be affirmed and applied to this case." Appellant's Reply Brief at 9 n.8.

> T.W. Phillips and [PC Exploration] in operating under the Lease. Once there failed to be a profit, however small, the Lease lapsed by operation of law into a tenancy at will, terminable by Ms. Jedlicka at any time.

Appellant's Brief at 15 (footnote and citations omitted).

Appellees, conversely, argue that Jedlicka's proposed construction of Young is inconsistent with the very language and intent of that decision. Appellees further maintain that, to the extent Young requires consideration of an operator's good faith when determining whether a lease has produced in paying quantities, Young is "reflective" of "national authority," in that

> [a] number of the jurisdictions that have embraced what Jedlicka terms an "objective" standard for "paying quantities" have explicitly held that the term to be used in assessing the performance of the lease should be one long enough to "provide the information which a prudent operator would take into account in [deciding] whether to continue or abandon operation."

Appellees' Brief at 16 (citing, *inter alia*, Fisher v. Grace Petroleum Corp., 830 P.2d 1380, 1386 (Okla. App. 1991); Ross Explorations, Inc. v. Freedom Energy, Inc., 8 S.W.3d 511 (Ark. 2000); and Texaco, Inc. v. Fox, supra).

Alternatively, Appellees argue that, even if Young is not consistent with current prevailing authority, the Findley lease must be interpreted in accordance with the prevailing law at the time the parties entered into the Lease — namely, Young. Appellees' Brief at 18 (citing, *inter alia*, DePaul v. Kaufmann, 441 Pa. 386, 398, 272 A.2d 500, 506 (1971) ("[T]he laws in force when a contract is entered into become part of the obligation of [the] contract 'with the same effect as if expressly incorporated in its terms.'")).

As a preliminary matter, we recognize that our decision in Young is more than a century old; thus, there is bound to be uncertainty as to how such precedent applies to disputes involving an industry that has changed rapidly over that same time period. As previously noted, while habendum clauses traditionally were used to protect the interests of lessors, see Swiss Oil, 67 S.W.2d at 31, the clauses are now viewed as a protection for lessees. Moreover, Young left room for interpretation; although Young specifies that whether a lease makes a profit is key to determining if it produces in paying quantities, it does not address over what time period such an assessment is to be made. Further, Young broadly focuses on the good faith judgment of the operator, but without specifying precisely when the operator's judgment comes into play. The present case allows us to address these open issues.

Jedlicka casts Young as prescribing an objective test — a mathematical calculation of profits — which, if the elements are not met, indicates the lease is not producing in paying quantities. She further contends that the good faith judgment of the operator is relevant only where a lease is producing in paying quantities — i.e., making a profit — but yet may not offset its total operational expenses. There are two inherent flaws in this argument. First, by its terms, Young requires consideration of the operator's good faith judgment *as part of* the assessment of whether the lease produces in paying quantities. See Young, 194 Pa. at 250-51, 45 A. at 122-23 ("The phrase 'paying quantities,' therefore, is to be construed with reference to the operator, and by his judgment when exercised in good faith."). Second, Jedlicka's argument overlooks the fact that profits must be measured over some time period, and, as we discuss below, setting a reasonable time period necessarily implicates the operator's good faith judgment. Thus, in assessing whether a lease is producing in paying quantities, Young places the principal focus on the good faith judgment of the operator.

Initially, we note that the courts of many of our sister states have concluded that the determination of whether a lease has produced in paying quantities requires consideration of the operator's good faith judgment. Indeed, some of these courts have relied on

Young.[12] In the landmark case of Clifton v. Koontz, the Texas Supreme Court acknowledged the "generally accepted" definition of production "in paying quantities": "If a well pays a profit, even small, over operating expenses, it produces in paying quantities, though it may never repay its costs, and the enterprise as a whole may prove unprofitable." 325 S.W.2d 684, 690-91 (Tex. 1959) (quoting Garcia v. King, 164 S.W.2d 509, 511 (Tex. 1942)).[13] The court, however, continued:

> In the case of a marginal well, such as we have here, the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated.
>
> In determining paying quantities, in accordance with the above standard, the trial court necessarily must take into consideration all matters which would influence a reasonable and prudent operator. Some of the factors are: The depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the

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[12] The dissent suggests that our interpretation of Young is based, not on its plain language, but on how other courts have interpreted Young, and avers, "[w]hile arguably reflecting a more modern view of 'paying quantities,' these cases are in conflict with the plain terms of Young, which impose a threshold, marginal profitability requirement." See Dissenting Opinion, slip op. at 3. The dissent further posits that the decisions on which we rely "did not elaborate on the original formulation of the 'paying quantities' test," set forth in Young, but rather "effectively displaced that standard where well production was marginal or sporadic." Id. at 5-6. The Young decision is more than 100 years old, and was decided at a time when habendum clauses were used to protect the interests of lessors, not lessees. See Swiss Oil, supra. Often, this Court is called upon to interpret established case law against new facts, which is what we do in the case *sub judice*. Moreover, Young failed to address the necessary aspect of the time period over which an assessment of whether a lease has made a profit should be made, and failed to specify at what point an operator's good faith judgment becomes a relevant factor; thus, we merely look to other jurisdictions for guidance in construing language similar to Young, and, at times, Young itself.

[13] We note that this formulation by the Texas Supreme Court in Clifton may be traced to this Court's decision in Young. See Clifton, 325 S.W.2d at 690-91, quoting Garcia, 164 S.W.2d at 511; which in turn quotes Gypsy Oil Co. v. Marsh, 248 P. 329, 333 (Okla. 1926); which in turn cites, *inter alia*, Young, 45 A. at 121.

> area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes.

Clifton, 325 S.W.2d at 691.

Thus, to the extent the "profit over operating expenses" test comprised the entire test for determining whether a well produced in paying quantities under Garcia, the Clifton court held that such test was but one of several elements a court must consider when determining whether a reasonably prudent operator would continue to operate a lease for the purpose of making a profit and not for speculation. Another relevant factor in determining whether a well has produced in paying quantities under the reasonable and prudent operator standard is whether the lessee is holding the lease for the purpose of making a profit, and not merely for speculative purposes. See Clifton, 325 S.W.2d at 691. This inquiry necessarily implicates the issue of whether a lessee has exercised his judgment in good faith.

In Pack v. Santa Fe Minerals, the Oklahoma Supreme Court likewise held that an operator's good faith is a necessary consideration in determining whether a well has produced in paying quantities. The court, in holding that a failure to market oil or gas did not alone operate to terminate a lease under a "cessation or production" clause, explained:

> More recently, in Stewart v. Amerada Hess Corp., 604 P.2d 854 (Okla. 1979), we reaffirmed the rule that an oil and gas lease could not be terminated under the habendum clause merely because the subject well ceased production in paying quantities. Rather, the finder of fact must also look into the circumstances surrounding the cessation, including the "[d]uration and cause of the cessation, as well as the diligence or lack of diligence exercised in the resumption of production." 604 P.2d at 858, fn. 18. In so holding we affirmed our rejection of a literal construction of the habendum clause stating:
>
>> "Under a literal or strict interpretation of the 'thereafter' provision in a habendum clause, uninterrupted production - following expiration of

> primary term - would be indispensable to maintain a lease in force. This would mean, of course, that *any* cessation of production [in the paying-quantities sense of the term], however slight or short, would put an end to the lease. Oklahoma has rejected that literal a view. Our law is firmly settled that the result in each case must depend upon the circumstances that surround cessation. Our view is no doubt influenced in part by the strong policy of our statutory law against forfeiture of estates.

869 P.2d 323, 326-27 (Okla. 1994) (alterations and emphasis original). The court concluded "[i]n short, the lease continues in existence so long as the interruption of production in paying quantities does not extend for a period longer than reasonable or justifiable in light of the circumstances involved. Id. at 327 (emphasis original).

In Swiss Oil, supra, the Supreme Court of Kentucky acknowledged the term "paying quantities":

> is usually defined as being such quantities as will pay a profit, but at least the cost of operating the well. The lessee is not required to market the gas at a loss, but only when there is a reasonable profit, and in determining whether it could be so marketed, the distance to the market, the expense of marketing, and every similar circumstance should be taken into consideration. In determining whether or not a gas or oil well is productive to this extent, the judgment of an experienced operator or lessee, *if exercised in good faith,* will prevail as against that of a lessor without experience.

67 S.W.2d at 31 (emphasis added). Thus, although the court in Swiss Oil viewed the phrase "paying quantities" as a measure to protect a lessee from his obligation to continue operations under an unprofitable lease, it too found the good faith judgment of the lessee to be a relevant consideration in determining whether a well has produced in paying quantities.

As the above cases reveal, in determining whether a well that has suffered marginal or sporadic production for some period should be deemed to have failed to produce in paying quantities, "a majority of jurisdictions apply a subjective approach and will look to a number of factors and relevant circumstances to determine whether or not a prudent lessee would continue to operate the lease for profit and not for speculation." Richard W. Hemingway, Law of Oil and Gas 320 (3rd ed. 1991).[14]

Regarding Jedlicka's position that, under Young, a determination of whether a well has produced in paying quantities must be based on an objective mathematical calculation of profits,[15] we note that the test for determining in paying quantities could never be *purely*

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[14] Jedlicka contends, and commentators agree, that Kansas has expressly adopted a purely objective test for determining whether a well has produced in paying quantities, and has held that good faith of the operator is not a factor. Indeed, in Reese Enterprises, Inc. v. Lawson, 553 P.2d 885 (Kan. 1976), the Kansas Supreme Court, after expressing concern that the subjective approach, which leaves the matter "to the sole judgment of the lessee," does not adequately protect a lessor from "the very real factor that the lessee may be interested in preserving his interest for speculative purposes," explained:

> In our opinion the better approach is to . . . apply an objective test, where the determination of 'paying quantities' turns upon a mathematical computation. This approach recognizes the interest of both the lessor and the lessee, and it gives the lessor some protection when the burdens of the lease far exceed the meager royalty payments, when they fall below the customary delay rental.

Id. at 897 (citations omitted). The court acknowledged, however, that "application of the objective standard to a determination of whether an oil and gas lease is producting [sic] oil in 'paying quantities' under the 'thereafter' clause of the lease is not free from difficulties." Id. The court further stated that its opinion "should not be construed as requiring an eighteen month period of unprofitable operation to terminate an oil and gas lease," but that "[t]he time factor in the formula . . . is a question we leave open," thus suggesting that a lease may be terminated based on unprofitable operation over a period of less than eighteen months. Id. at 899.

[15] Jedlicka argues that Young is consistent with decisions from other jurisdictions that have adopted an objective test for determining whether a well has produced in paying quantities. Appellant's Brief at 17 (citing, *inter alia*, Reese Enterprises, 553 P.2d at 897) (to avoid termination of the lease, a lessee must "produce those quantities of oil or gas which will produce a profit, however small, over operating expenses, after eliminating the initial cost of drilling and equipping the well"); Sheffield v. Exxon Corp., 424 So.2d 1297, 1303 (Ala. 1983) ("[p]aying quantities means production in quantities sufficient to yield a return in excess of operating costs, even though drilling and equipment costs may never be repaid (continued…)

(…continued)
and the undertaking considered as a whole may ultimately result in a loss"); Landauer, supra (same); Kerr v. Hillenberg, 373 P.2d 66 (Okla. 1962) (same); Blausey v. Stein, 400 N.E.2d 408 (Ohio 1980) (same); Ross Explorations, Inc. supra (same); Swiss Oil Co., supra (same); and Vance v. Hurley, 41 So.2d 724 (La. 1949) (same)). However, simply characterizing Young as consistent with the law of other jurisdictions in this regard does not make it so.

Furthermore, in several instances, Jedlicka characterizes certain jurisdictions as having expressly adopted an objective test, when, in fact, the decisions cited by Jedlicka do not support her contention. For example, in Blausey, and Vance, it was not necessary for the courts to consider the good faith of the operator because the question of whether the leases produced in paying quantities was not seriously at issue; the courts determined, as a preliminary matter, that the wells in question had paid a profit. See Blausey, 400 N.E.2d at 410 (holding that the trial court erred in including value of appellee's labor in calculating operating expenses, and thus erred in finding the well was not profitable); Vance, 41 So.2d at 728 ("It is our opinion . . . that the well drilled on the property of the plaintiffs is producing in paying quantities within the meaning and contemplation of the parties as set out in the terms of their contract of lease."). Interestingly, in Vance, the Louisiana Supreme Court took note of an apparent lack of good faith by the plaintiff-lessors:

> The plaintiffs by their own actions showed they never entertained any doubt but that the well was producing in paying quantities, for the record shows although they were not satisfied with the production of the well, they never voiced any serious complaint with respect thereto, but, instead accepted the monthly royalty payments due thereunder during more than two years and that it was only upon the expiration of the third year, and only after they had failed in their effort to collect from their leases personally under the contemporaneous agreement, that they first entertained the idea of cancelling the lease on this ground.

Id. at 727.

In Ross Explorations, the Arkansas Supreme Court specifically declined to consider the appellant's assertion that the trial court erred in refusing to apply a "reasonably prudent operator rule" to determine whether a well had produced in paying quantities, noting that the argument had not been raised before the trial court and the absence of the trial court's ruling constituted a procedural bar to the court's review. 8 S.W.3d at 516.

Finally, in Kerr, the Oklahoma Supreme Court did not apply an objective test for determining whether a well had produced in paying quantities. Indeed, it did not consider the issue of paying quantities, noting that, if the plaintiffs were entitled to prevail, it was "because of the cessation of actual production." 373 P.2d at 69. The court ultimately concluded the temporary cessation in production did not operate to terminate the lease
(continued…)

objective, absent picking an arbitrary time period.[16] Profits must be measured over some time period and establishing what is a reasonable time period warrants consideration of the particular characteristics of a given leasehold. See Clifton, 325 S.W.2d at 691 (one factor to be considered in determining paying quantities is "a reasonable period of time under the circumstances"). An operator, exercising his good faith judgment, may be willing to wait longer for one lease to become "profitable" than he is willing to wait for another well to become profitable, and unless it can be established that he is not acting in good faith on his business judgment, but instead is acting with fraudulent or dishonest intent, he does not forfeit his rights under the lease based on a difference in such judgment. Colgan, 194 Pa. at 242, 45 A. at 121.

Thus, with regard to what constitutes a reasonable time period by which to determine whether a well is profitable, we decline to establish a definite rule. Although Jedlicka maintains a one-year period of loss is sufficient to conclude that a well has failed to produce in paying quantities, courts have been disinclined to impose such a rigid term. For example, in Texaco, Inc. v. Fox, supra, in addressing an argument that a 13-year period was sufficient to determine the profitability of a lease, the court explained:

> it is generally accepted that profitability on an oil and gas lease should be determined over a relatively long period of time in order to expose the operation to the leveling influences of time. The arbitrary use of a short period of time while a well is down for a workover is obviously untenable. On the other hand, the use of an unreasonably long period would entail using past glories during flush production to determine a lease's present condition, which would give a distorted result not reflective of the current status of the lease. The better rule precludes the

(…continued)
where the lessee made persistent and good faith efforts to repair the mechanical problems that caused the cessation of production.

[16] Kansas is the only jurisdiction that has seemingly established an arbitrary time period over which to measure profits. See Reese Enterprises, supra n. 14.

> use of a rigid fixed term for determination of profitability and uses a reasonable time depending upon the circumstances of each case, taking into consideration sufficient time to reflect the current production status of the lease and thus to "provide the information which a prudent operator would take into account in whether to continue or to abandon the operation."

618 P.2d at 848 (citation omitted). Ultimately, the court found the 13-year accounting period unreasonably long, but held such finding was irrelevant in light of its determination on a depreciation issue. See also Ross Explorations, 8 S.W.3d at 516 (noting that appropriate period for determining profitability depends "upon the facts of the particular case and the specific reasons production waned or ended," and holding that, "[u]nder the facts of the instant case," a 24-month period was reasonable for determining profitability); Fisher, 830 P.2d at 1386 ("[t]he appropriate time period for determining profitability is a time appropriate under all the facts and circumstances of each case.").[17] Ultimately, under Young, we conclude that even the determination of what constitutes a "reasonable time period" by which to evaluate whether a well has produced in paying quantities must be based on the unique circumstances of each individual case, and be driven by consideration of the good faith judgment of the operator.

Accordingly, and for the reasons stated above, we 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. In assessing

[17] Jedlicka also cites Buehler v. Angle, 79 P.3d 1093 (Kan.App. 2003), for the proposition that nine months is a reasonable period to use in determining paying quantities; however, that decision is unpublished and non-precedential, and, in any event, the court recognized that rigid fixed terms are disfavored, and limited its conclusion to the facts of that case.

whether an operator has exercised his judgment in good faith in this regard, a court must consider the reasonableness of the time period during which the operator has continued his operation of the well in an effort to reestablish the well's profitability.[18]

Although Jedlicka suggests that, "if only a subjective standard is used to determine paying quantities, oil and gas companies may choose to hold onto otherwise unprofitable wells for merely speculative, as opposed to productive, purposes," Appellant's Brief at 19, we disagree. Under the standard set forth above, a lessor will be protected from such acts because, if the well fails to pay a profit over operating expenses, and the evidence establishes that the lessee was not operating the wells for profit in good faith, the lease will terminate. Consideration of the operator's good faith judgment in determining whether a well has produced in paying quantities, however, also protects a lessee from lessors who, by exploiting a brief period when a well has not produced a profit, seek to invalidate a lease with the hope of making a more profitable leasing arrangement. In the instant case, for example, Jedlicka seeks to invalidate a nearly 80-year-old lease based on a single-year loss which occurred more than more than 45 years ago, after which the wells resumed and continued production at a profit.

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[18] We note that, in cases which expressly provide for consideration of an operator's good faith judgment, some courts have held the good faith judgment of an operator should be considered as a preliminary factor in determining whether a well has produced in paying quantities, see Clifton, 325 S.W.2d at 691 ("In determining paying quantities . . . the trial court necessarily must take into consideration all matters which would influence a reasonable and prudent operator."), while others have suggested that a determination that an operator has operated a well in good faith may save a lease from termination following a determination that a well did not produce in paying quantities, see Pack, 869 P.2d at 327 ("[T]he lease continues in existence so long as the interruption of production in paying quantities does not extend for a period longer than reasonable or justifiable in light of the circumstances involved."). In Pennsylvania, we find this to be a distinction without a difference. A lease terminates when it ceases to produce in paying quantities, but, as discussed herein, that determination incorporates an operator's good faith judgment.

Turning now to the specific circumstances of the instant case, Jedlicka contends that, because there was a $40 loss in 1959, the subject wells failed to produce in paying quantities, resulting in termination of the lease. The trial court, without expressly finding that a one-year period in the context of a nearly 80-year-old lease was not a "reasonable time period" in which to conclude that the wells were not profitable, determined that "[t]he evidence indicates that the lessees were operating the wells in good faith," and, on this basis, that the wells had produced in paying quantities. T.W. Phillips Gas and Oil Co. and PC Exploration, Inc., No. 10362 CD 2005, at 6. Based on our review of the record, we find no error in this regard.

As explained above, pursuant to Young, the operator's good faith judgment is the principal focus in determining whether a lease has produced in paying quantities. Thus, as we have construed Young, the trial court properly considered Appellees' good faith judgment in its consideration of whether the wells had produced in paying quantities.

Here, Jedlicka presented no evidence to suggest that Appellees have not operated the wells in good faith. Significantly, as Appellees emphasize, Jedlicka's own expert witness, Wayne Leeper, a petroleum geologist, testified he would have continued to operate the well that had sustained the $40 loss in 1959 because the well "makes money." N.T. Trial, 4/17/07, at 191 (R.R. at 353a). The witness further testified that the other wells on the Jedlicka property, including Well Nos. 6, 7, 8, and 9, are favorably producing. Id. at 205-05 (R.R. at 367a-368a). Accordingly, we find the record supports the trial court's conclusion that the lease was being operated in good faith and that Jedlicka failed to sustain her burden of establishing a lack of good faith by Appellees. See Jefferson County Gas Co., supra. As a result, we agree she failed to prove that the wells had not produced in paying quantities. For these reasons, we affirm the order of the Superior Court.

Order affirmed.

Madame Justice Orie Melvin did not participate in the consideration or decision of this case.

Mr. Chief Justice Castille and Messrs. Justice Baer and McCaffery join the opinion.

Mr. Justice Eakin files a concurring opinion.

Mr. Justice Saylor files a dissenting opinion.