Federal Court: Fracking Disputes Are Not a Force Majeure

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A federal court sitting in New York’s “natural gas patch” recently answered the question of whether the Empire State’s pending moratorium against “fracking” constituted a force majeure event that would forestall the expiration of drillers’ leasehold rights. While deciding that the current ban against fracking was not such an event and thus did not extend the drillers’ rights, the decision provides a crucial lesson in the workings of this ancient legal doctrine, as it collides with a more modern controversy that we have recently dealt with in these pages.

As for the old, some years ago we addressed force majeure, a legal doctrine that excuses performance of a contract by one or both parties. There we dealt at length with how the principle, also known as “acts of God,” can only rescue a party from performing if they had the foresight to anticipate such a contingency in the written agreement.

As to the new, we refer to last year’s update on how Pennsylvania had decided to both regulate and tax exploration and development via fracking in the Marcellus Shale, which the Keystone State shares with New York and others. Hence the linkage and counterpoint to the New York case that we are about to discuss, for while Pennsylvania has authorized fracking on its side of the Marcellus Shale, New York’s refusal to follow set the stage for this new case. That being said, let us look at the decision that brings force majeure and fracking together, and probably not for the last time.

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PLAIN VANILLA LEASING AGREEMENT

Aukema v. Chesapeake Appalachia, LLC, comes from the federal court overseeing part of the Empire State’s “Southern Tier,” its lengthy border with neighboring Pennsylvania. Plaintiffs included more than 50 landowners who had entered into oil and gas leases with the defendants, energy industry developers interested in what lay underneath the plaintiffs’ lands.

The relevant leases were all strikingly similar in language, and fairly prosaic by the standards of the modern natural gas exploration industry, employing the traditional terms found in such agreements between landowners and drillers. The agreements’ key attributes were setting a fixed duration for each lease, at the end of which the drillers’ rights would expire, barring extension if certain prescribed conditions were met. The energy companies were required to explore via drilling, extract natural gas from the ground, and then remit royalty payments to the landowners. Should the defendants choose to forego drilling, they would be required to pay “delay rentals,” a fixed sum of money payable...
to the landowners in lieu of royalties on actual production. As this readership well knows, these are standard terms found in thousands of energy exploration lease arrangements across America.

Of greatest significance, each lease contained a force majeure clause, and again a fairly standard one. The text of each excused the driller from performing in a number of circumstances, including various enumerated natural disasters, labor strife, war, and similar cataclysms not within the drillers’ control nor avoidable by the exercise of ordinary due diligence.

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ATTEMPT TO USE FORCE MAJEURE AS AN OUT

The trouble began when these defendants decided to neither drill nor remit the delay rental payments. Citing regulatory constraints that allegedly prevented them from performing, the drillers declared a force majeure event under the relevant lease agreements, and so notified the landowners that not only was the drillers’ performance excused, the clock had stopped ticking on the time their leaseholds had to run.

The years remaining on their leases, asserted these defendants, had been extended by New York’s pending moratorium on fracking. By postulating this defense, by necessity District Judge David N. Hurd was compelled to review the current history of natural gas drilling in New York state.

Expiration of the current drillers’ rights would free the drillers up to contract anew with other developers, and probably for more money.

Such activity, the court explained, is overseen by the state’s Department of Environmental Conservation (DEC). The DEC’s last major endeavor in the energy field was a Generic Environmental Impact Statement (GEIS) promulgated in 1992. Obvious from the date, that regulation addressed drilling by what we now regard as “conventional” exploration methods; fracking was not so widespread at the time the current GEIS came into existence.

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This all started to change in the late 2000s, when the commercial viability of fracking made possible the exploitation of the gargantuan reserves of the Marcellus Shale. And “vast” is an apt, yet modest, adjective in describing the incredible riches to be found within the formation; even the Aukema court noted that the strata might contain up to 489 trillion cubic feet of natural gas. To put this in perspective, as Judge Hurd observed, New York state currently uses a little over 1 trillion cubic feet of natural gas a year; in other words, a potential supply that could last, not for mere decades, but for several centuries.

The confluence of these events put New York’s regulators in a quandary; how to open up development of this bountiful domestic energy resource, while still protecting the environment? Then-New York Gov. David Paterson had ordered the DEC to update the 1992 GEIS, but, notwithstanding efforts begun no later than July 2008, it was not until late

The landowners, incensed at this lack of result, were probably also enraged because there was evidence that the value of their leaseholds had risen tremendously since they signed the original accords. In other words, the lawful expiration of the current drillers’ rights would free the drillers up to contract anew with other developers, and probably for more money. Thus refusing to concede to an unwanted extension of the defendants’ rights, the landowners formed ranks and sued to have the leases terminated. Douglas Aukema became the nominal plaintiff here by virtue of alphabetical order.

Opposing termination of their leaseholds, the drillers put forth the following defense. The years remaining on their leases, asserted these
2011 that the DEC could even release a draft revision for public comment. To date, noted the Aukema court, no decisive action has been taken by the state. During this interregnum, the DEC had effectively maintained a moratorium on fracking, by holding in abeyance any requested permits to drill via the new technology. Judge Hurd accurately characterized this unfortunate state of affairs as one that “has effectively brought natural gas development in New York State to a screeching halt.”

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It was now up to the federal court to decide how this bureaucratic paralysis impacted the respective rights of the drillers and the landowners, if at all. Fundamentally, were the plaintiffs right in their quest to have the leases formally declared expired by the simple turning of the calendar? Or were the defendant/drillers in the right because the sovereign’s actions worked an unforeseeable cataclysm that both prevented their performance, and simultaneously suspended time from running on their rights to drill? To answer these questions, the court properly turned to the underlying contracts.

As already noted, these lease deals were all quite similar, as well as quite traditional under the norms of energy exploration contracts. Notwithstanding these shared attributes, District Judge Hurd still divided the leases into approximately half a dozen categories, each category defined by the distinct characteristics of its own text. The most illustrative (for our purposes) were what Judge Hurd entitled the “Phillips Leases.” Indeed, lead plaintiff Aukema was a lessor under one of the Phillips Leases.

The salient point of the Phillips Leases was their duration. Each ran for either 10 years in total or a term of only 5 years, coupled with the right to a 5-year extension; basically, a decade all told. And as they had been executed in 2000, a reckoning by the calendar—and the plaintiffs—indicated time had run out.

Thus, the defendants turned to force majeure to stop the clock. Our leaseholds cannot have expired, asserted the defendants, because New York’s moratorium on fracking was precisely the kind of unforeseeable and uncontrollable “act of God” the force majeure clause contemplated. With force majeure in effect, the defendants claimed their performance was excused, and, moreover, their contractual rights pursuant to the leases were preserved.

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**CONTRACT LAW RULES**

Having sorted out the competing legal arguments made, the court commenced its analysis by first positing some bedrock principles of contract law, lessons well heeded in the context of natural gas exploration deals, as well as generally.

Judge Hurd reminds of the well-settled axioms that, with respect to contract interpretation, the intention of the parties controls. The best evidence of those intentions is found in the very text of the contract itself, and, should that text be clear and unambiguous, then the cardinal rule is for the courts to then enforce the contract as written, in accord with the plain meaning of its own words. Lastly, if an ambiguity is found in that same contract, that flaw is to be construed against the drafter, essentially holding any mistakes against whoever wrote them into the document (that final point was to take on great significance later). As in any contract dispute, these maxims of contract law would come into play in adjudicating the present case.

Then refining his legal analysis, District Judge Hurd, to his credit, relied upon key precedents stemming from energy industry cases, as decided by his supervising tribunal, the US Court of Appeals for the Second Circuit, as well as fellow New York federal trial courts. First, Judge Hurd recollected that the “primary purpose” behind the force majeure doctrine is to relieve a party from performing its contractual obligations when that performance
The plaintiffs had, in contradistinction, argued that common law force majeure is but a narrow doctrine, applicable only when the subject matter underlying the contract has been physically destroyed. Because that clearly was not the case here, that aspect of the doctrine was inapplicable, they said.

District Judge Hurd implicitly adopted the plaintiffs’ point of view, and thus rapidly dismissed the defendants’ assertion of force majeure as a matter of its own common law. Yet in doing so, the Aukema court seized upon something that was even more pivotal to the legal analysis here, both with regard to common law force majeure and its invocation as a matter of contract rights.

That was the matter of the foreseeability of New York’s prohibition on fracking.

FEDERAL JUDGE SAYS NY ACTION WAS FORESEEABLE

After all, could the parties, and especially these experienced drillers, have foreseen the possibility of state intervention that would have foreclosed one or more technologies that the drillers would have wished to use to develop the resources found under the plaintiffs’ lands? And if such events were foreseeable, what inclusion, if any, did the parties give in their contractual stipulations as to what constituted a force majeure event?

It was undeniable that the defendants had neither drilled nor made delay rental payments.

That all being said, the Aukema court then reviewed the irrefutable events leading up to the instant controversy. Time, at least as measured by the calendar, had inarguably lapsed on the respective 10- and 5-year terms of the Phillips Leases. During their lifetimes, it was undeniable that the defendants had neither drilled nor made delay rental payments. The sole legal question was whether or not New York’s moratorium on fracking was indeed a force majeure event that not only excused the nonperformance of the defendants, but also rescued their drilling rights from expiration.

It is interesting to note that the defendants here were not content to merely allege force majeure as a stipulated contractual event. They likewise made the notable move of arguing for the doctrine’s application on the further notion of a common law force majeure—that is, that the state’s prohibition on issuing fracking permits would, by any measure, be recognized as some variation of an “act of God,” falling within the broad confines of what centuries of force majeure doctrine have been recognized as unforeseeable and uncontrollable catastrophes. Credit the defendants for not leaving any argument unturned, although it availed them nothing, as we shall shortly witness.

Moreover, the Aukema court pointed to the fact that the defendants here had leased rights from the plaintiffs to generally drill, explore, and produce, without limitation and...
This related doctrine operates where both parties are capable of rendering performance, but as a result of unforeseeable events, the performance of A would no longer give B what induced B to enter into the contract in the first place. Application of the frustration of purpose maxim hinges upon catastrophic events that are wholly unforeseeable.

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This is where the defendants’ second argument failed. The parties entered into these leases when the operative regulations were the ones promulgated in 1992. Those restrictions contemplated older technology vastly different from that currently used for present-day fracking. “Therefore, it was foreseeable that a non-conventional drilling method such as [fracking] would require additional environmental review,” declared Aukema; hence, the moratorium was, in fact, not unforeseeable. Thus, Judge Hurd ruled, the defendants could not avail themselves of the doctrine of frustration of purpose.8 The final decision remained unaltered. The plaintiffs had prevailed in having the leases declared unexpired, and of no further force and effect. The drillers, who had done nothing, were accordingly left with nothing.

**TAKEAWAYS**

In overviewing Aukema, we are at first intrigued by this intersection between New York’s ongoing moratorium on fracking and the attempted invocation of the hoary legal doctrine of *force majeure*—truly a case of the old meeting the new. But more important, we take full realization of the ever-present possibility of governmental interfere in any business operation, particularly with regard to new and controversial technology. It is the foreseeability of such regulatory impediments that proved decisive in this case.

Note well the points made by Judge Hurd. Point One: the environmental regulations prevailing when these parties contracted in 2000 contemplated then-existing technology,
and thus was not inclusive of innovations yet to come. The defendants here should have anticipated that future methodologies might be stymied by regulatory prohibitions.

This, declared Aukema, made New York’s moratorium foreseeable. Moreover, such foreseeability was, by itself, sufficient to knock out claims of force majeure, frustration of purpose, and related doctrines. Point One leads to Lesson One from Aukema: energy industry players must anticipate evolving technologies, shifting regulatory environments, and changing conditions that can impact deals, and craft their arrangements with that uncertain, but foreseeable, future in mind.

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Point Two: Aukema employed the doctrine of ambiguity to reject the defendants’ arguments here, as the drillers were in fact the principal drafters of the leasehold documents. Certainly, it is routine in the industry for the exploration and production companies to draft their lease documents, not the landowners. But as the scribes behind these complicated documents, the industry clearly has the onus to assure that these lease agreements included the detail necessary to carry out their intentions. Point Two begets Lesson Two; if you are doing the drafting, do everything possible to anticipate the need to vindicate your position in a courtroom in the days to come. And that leads to Point Three, our last.

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What Aukema stands for, above all else, is that force majeure is not some malleable, liberally applied doctrine. Quite the opposite: it demands that the parties diligently draft appropriate language, of significant length and vital specificity, that thoroughly encompasses any and all catastrophes, cataclysms, and disasters that would excuse the parties from performing. The failure to be far-ranging will nearly always place the doctrine out of the parties’ reach. Put another way, an ultrapessimistic mind set is the key to drafting a reliable force majeure clause.

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CONCLUSION

In conclusion, Aukema may have been a loss to industry participants, but it was the right decision for the right reason. The defendants here knew or should have done a better job of anticipating changing circumstances. They should have drafted a more inclusive force majeure clause. As we said at the outset, we have little doubt that this ruling will strongly influence the drafting of exploration leases for years to come.

NOTES

4. See Note 2 for details of the Marcellus Shale formation.
5. 782 F.2d 314, 319 (2d Cir. 1985).
6. Ibid.
8. In a companion case decided by Judge Hurd the same day as Aukema, a different set of defendant/drillers offered the additional defense of impossibility, which, like the doctrine of frustration of purpose, absolutely requires that the debilitating event be wholly unforeseeable. For the same reasons as set forth in Aukema, the court again found the New York moratorium foreseeable, and the impossibility defense inapplicable. Because the remainder of that second decision is nearly identical to Aukema, we need only mention it in passing, while highlighting its one distinguishing feature. See Beardslee v. Inflexion Energy, LLC, ___ F.Supp.2d ___, 12-cv-00242 (N.D.N.Y. November 15, 2012), available at www.nynd.uscourts.gov.