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### **Permit to Drill Well Does Not Constitute Title Defect Within the Terms of Top Lease Agreement**

The Second Circuit recently handed down a decision concerning the obligations created in negotiation of a top lease. *Pilkinton v. Ashley Ann Energy, L.L.C.*, 2011 WL 5170296 (La. App. 2nd Cir. 11/2/11). The property at issue was subject to a lease executed in 2005, when Amy and Roy Pilkinton leased 86.20 acres in Bossier Parish to KCS Resources. The lease had a three-year primary term that expired on December 1, 2008. In June of 2008, Ashley Ann Energy, LLC (“AAE”), representing Chesapeake Louisiana, L.P., discussed with the Pilkintons the possibility of Chesapeake/AAE obtaining a top-lease, effective upon the expiration of the KCS lease. On August 7, 2008, the Pilkintons executed the top lease in favor of AAE. The top lease was on a standard printed Bath form mineral lease. The top lease was subject to a three-year primary term which was not to commence until December 2, 2008. It included an addendum containing additional provisions, three of which were pertinent to the disposition of the case. The first of the three provisions recognized that the agreement was a top lease subject to the prior KCS lease, was not intended in any way to cloud or impair the rights of the parties to the KCS lease, and would come into being “only following the termination” of the KCS lease, at which time the remaining bonus was to be paid. The second provision was a warranty waiver which further emphasized that Lessor would not be obligated to return any bonus consideration on account of a failure of title. The third provision made clear that in event of a conflict, the terms of the addendum were to prevail over the terms of the top lease.

The parties negotiated and agreed that upon execution of the top lease, the Pilkintons would receive one-quarter of the total bonus payment, with the other three-quarters to be paid should the KCS lease terminate. On the face of the draft given for the one-quarter bonus, AAE included a provision that stated “upon approval of title but not later than 20 banking days after sight.”

On August 21, 2008, two weeks after the execution of the top lease (and within the 20-day provision contemplated in the draft), KCS secured a drilling permit for a unit well. The property subject to the lease was included within this unit. Viewing this drilling permit as a title defect, AAE refused to honor the draft, then executed and recorded a release of the top lease. The Pilkintons filed suit, and secured partial summary judgment upholding the validity of the top lease agreement. This partial final judgment was the subject of the appeal.

Upon appeal, the defendants first argued that the 20-day provision included on the draft when read together with the addendum to the top lease set up a 20-day period within which the top lease agreement could fail to become effective because of a “title defect.” Had KCS not gotten a drilling permit, or had no other “title issue” been discovered during that 20-day period, then the draft would have been honored, the defendants argued.

The appellate court, however, agreed with the district court that the language of the top lease was clear and unambiguous. The Court stated that a top lease, at its inception, exists as a “mere hope or expectancy in the extinction of existing superior leasehold rights”(citing Patrick C. Tracy Jr., *The Effects of Top Leasing in the Louisiana Law of Oil and Gas*, La. L. Rev. 1189 (1983)). The court honed in on the following language included in the addendum to the lease agreement:

*This lease is subject to a Prior Lease and Lessee recognizes that this Lease . . . will cover and affect the lands at depths described in the Prior Lease only following the termination of the Prior Lease.*

This language, the Court found, showed that the defendants clearly acknowledged the continued existence of the KCS lease through the end of its primary term on December 1. Read together with language evidencing the parties intention that the top lease not cloud title and ownership of the KCS lease, the above quoted language demonstrated the understanding of the parties that the existence of either lease was not meant to cloud the other.

The Court noted the difference between the effects of permitting a well and those of drilling a well, on the maintenance of a lease beyond its primary term under the standard habendum clause. Because the KCS well permit could not have a bearing on whether the KCS lease was extended, the Court found it could not be considered a flaw in the Pilkinton’s title. The Court noted that this did not preclude some other type of title flaw—like another party’s ownership of the mineral servitude burden on the land—triggering the 20-day provision in AAE’s favor.

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