The Ohio Shale Boom

Why Courts and Attorneys Need to Understand 19th Century Law to Navigate this 21st Century Phenomenon

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Before Texas and Oklahoma, there was Ohio. The discovery of oil under northwestern Ohio ignited a huge boom in the late 1800s. Landmen flocked towards the Toledo area to lock up drilling rights. Wildcatters erected acres of derricks and laid miles of pipeline. And makeshift towns sprouted up overnight. During an eight-year span, Ohio produced more oil than any other state in the country.[1] While companies eventually headed west, large-scale production continued here for a number of years. By 1950, Ohio had pumped out 615 million barrels of oil.[2]

Ohio is anticipating another boom — this time fueled by the prospect of syphoning out natural gas trapped thousands of feet below ground in Utica and Marcellus shale formations. Companies already have begun extracting gas using a highly technical process called hydraulic fracturing, although the majority of production is on hold while a large-scale distribution system is built. Meanwhile, developers are busy leasing mineral rights from landowners and current, shallow well drillers.

The challenge for lawyers who represent these parties is trying to fit this 21st Century technology into 19th and early 20th Century case law developed during Ohio's oil boom. Ohio has a rich body of case law on oil and gas transactions that typically favors production over speculation. It also favors landowners over drillers, unlike states such as Texas and Oklahoma. This tendency can be found in Ohio's use-it-or-lose-it approach to drilling,[3] which many attorneys are wrestling with as they hammer out mineral rights leases for Utica and Marcellus shale.

A typical mineral rights lease has a primary and secondary term. The primary term operates for a set period of time, usually between one and 10 years, while secondary term continues for as long "thereafter as oil, gas or other constituents are produced in paying quantities."[4] These leases can be entered into directly with landowners in return for rent and royalties[5] or they can be purchased from drillers who already have a lease on the property.[6]

Existing leases are often decades old and often have been conveyed multiple times. Issues arise when landowners contend these old leases are no longer valid because they are not "held by production." The term "held by production" is a concept often included in standard industry leases and it dictates that a lease will remain in effect as long as some portion of the leased area is being used for drilling.[7] Landowners may challenge these clauses by claiming that the developer stopped producing oil and gas in "paying quantities."[8] Even when there is a producing well on the property, landowners may claim that some portion of their land is exempt from the old lease because the developer failed to properly develop that portion of the land.[9]

There are clear benefits for landowners to invalidate old leases. They have more control in choosing who will develop their Utica and Marcellus shale rights; they can negotiate more favorable terms compared to the old leases; and they can reap lucrative signing bonuses. Not surprisingly, developers are vigorously defending their existing leases so they can continue conventional well production and also protect their right to assign their Utica shale rights to large producers.[10]

So, what's a court to do? In 1897, the Ohio Supreme Court in *Harris v. Ohio Oil Co.* laid out an approach that courts still follow in deciding whether an oil and gas lease is valid.[11] First, they examine what rights, if any, the landowner and the developer have under the express terms of the lease.[12] Second, if there are no express terms that cover the controversy, courts will look at whether an implied covenant may apply to the situation.[13]

Courts typically abide by "held by production" clauses where developers can prove continual production in "paying quantities." However, several issues may make it difficult to prove there was continual production:

- First, developers may be unable to prove continual production because of missing or inconsistent data.[14]
- Second, there may have been a gap in production. Courts are willing to overlook temporary lapses in production, but the Fourth Appellate District in *Wagner v. Smith* held that a span of more than two years was an unreasonable because the developer failed to act diligently in correcting a well defect.[15]
- Third, the well may not be producing in "paying quantities." In *Tisdale v. Walla,* the court defined "paying quantities" as production in "profitable" quantities.[16] Household use by a landowner connected directly to the well does not qualify as a paying quantity.[17]

Ohio currently has more than 60,000 producing wells, although most are referred to as "stripper" wells that produce *less* than 10 barrels of oil or 56,000 cubic feet of natural gas per day.[18] Given the new intense leasing and drilling activity in Ohio, it is likely that many landowners will challenge whether these "stripper" wells qualify as producing in "paying quantities."

When there are no express lease terms governing production, Ohio courts will examine whether there is a breach of an implied covenant to reasonably develop the land for mineral production. This implied covenant protects the interest of landowners to have their land sufficiently developed in order to reap royalties.[19] Ohio courts apply the "prudent operator" standard in weighing the implied covenant, which generally requires a developer to perform its obligations in good faith, with competence, and with due regard to the interest of both the lessor and the lessee.[20]

The implied covenant of production can be applied to an entire tract of land, if it remains undeveloped. More importantly for landowners who may have wells on only a portion of their land, the implied covenant can be applied to the undeveloped portion of the land. In 1934, the U.S. Supreme Court in *Sauder v. Mid-Continent Petroleum Corp.* held, "The production of oil on a small portion of the leased tract cannot justify the lessee's holding the balance indefinitely and depriving the lessor not only of the expected royalty from production …, but of the privilege of making some other arrangement for availing himself of the mineral content of the land."[21] Developers will often argue that landowners who accept royalty checks are bound by the lease, even though only a portion of the land is being drilled. Courts have rejected this line of thinking, finding that royalty payments only bind the land actually being drilled.

When there is a breach of the implied covenant, Ohio courts generally award money damages.[22] This is particularly important for developers who want to assign their Utica and Marcellus shale rights to large producers.[23] While they may have to pay some money upfront to quell the controversy, they will ultimately be able to sell their rights under the lease. Yet the news is not all bad for landowners. Courts have cancelled leases, either partially or entirely, where money damages were insufficient to right the wrong. The Ohio Supreme Court, in *Ionno v. Glen-Gery Corp.,* held that cancellation is permitted "when necessary to do justice to the parties" once a landowner makes a "strong showing of a violation" by the developer.[24]

The dueling concepts of held by production and the implied covenant of production will also pose significant challenges for Utica and Marcellus shale developers going forward. Given the depths of the shale and the extraction techniques used, drilling for natural gas using hydraulic fracturing tends to be much more complex than conventional drilling.[25] Well sites are much larger in scale and can take years and many millions of dollars to complete.[26] Because of the fluctuating price of natural gas, a developer may make a business decision to hold off on drilling or to limit the number of wells drilled.[27] If that happens, the question is how a court would apply Ohio's 19th Century law to this 21st Century technology. To be sure, attorneys can avert some of these problems by limiting the implied covenant of development through express terms in the lease. But it remains to be seen what factors a court would consider in determining whether to impose monetary damages or to forfeit the lease entirely for a breach of the implied covenant.

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[1] Ohio Department of Natural Resources, Oil and Gas Fields Map of Ohio, http://www.dnr.state.oh.us/Portals/10/pdf/pg01.pdf.

[2] Ohio History Central, Oil Industry, http://www.ohiohistorycentral.org/w/Oil_Industry?rec=1539.

[3] *Harris v. Ohio Oil Co.,* 50 Ohio St. 118 (Ohio 1897).

[4] *Lake v. Ohio Fuel Gas Co.,* 2 Ohio App. 2d 227, 229 (5th Dist. 1965).

[5] Jamison Cocklin, "Leases Held by Production Creating Legal Hurdles," The Vindicator, April 28, 2013, http://www.vindy.com/news/2013/apr/28/as-drilling-pumps-up-legal-issues-sink-i/.

[6] Timothy M. McKeen & Kristen L. Andrews, "The Effect of Missing Production on Ohio's Held by Production Oil and Gas Leases," 73 Ohio St. L.J. Furthermore 13 (2012) http://moritzlaw.osu.edu/students/groups/oslj/files/2012/04/Furthermore.McKeen.pdf.

[7] Alan D. Wenger, "David v. Goliath: Representing Oil and Gas Lessors," Ohio Lawyer, May/June 2012.

[8] *Tisdale v. Walla,* 1994 WL 738744 at *4 (11th Dist. 1994) (The lease terminated automatically for lack of required production without the necessity of notice, demand or judicial ascertainment.) *Brown v. Fowler,* 65 Ohio St. 507 (1902) (Since the term of the lease, after its initial fixed term or terms, was dependent upon continued production of oil or gas in paying quantities, the issue is not one of forfeiture as upon a condition or covenant, but whether the lease expired by failure to produce gas or oil in paying quantities.)

[9] *Beer v. Griffith,* 118 (1980). (With respect to wells requiring future efforts to be productive and with respect to all unexploited acreage, forfeiture of lessee's interest is warranted in order to assure the development of the land and the protection of the lessor's interest.)

[10] Supra, note 6.

[11] Supra, note 3.

[12] *Id.*, at 126.

[13] *Id.*, at 126.

[14] Supra, note 6.

[15] *Wagner v. Smith,* 8 Ohio App. 3d 90, 95, (4th Dist. 1982).

[16] *Tisdale v. Walla,* 1994 WL 738744, *8 (11th Dist. 1994).

[17] *Id.*

[18] Supra, note 1.

[19] *Ionno v. Glen-Gery Corp.,* 2 Ohio St.3d 131, 132 (1983).

[20] George A Bibikos, "A Review of the Implied Covenant of Development in the Shale Gas Era," 115 W. Va. L. Rev. 949, *957, Spring 2013.

[21] *Sauder v. Mid-Continent Petroleum Corp.,* 292 U.S. 272, 281 (1934).

[22] Supra, note 21, at *973-74.

[23] *Id.*, at *974.

[24] Supra, note 20, at *135.

[25] Supra, note 21, at *953.

[26] *Id.*, at *953-57.

[27] *Id.*, at *957.