MY BENESCH MY TEAM

# Ohio Oil & Gas DISPUTES

February 2014

# Ohio Oil & Gas Lease Disputes

## I. General Provisions – "Mineral Rights"

A. Under Ohio law, the term "mineral" generally includes oil and gas unless the language in the granting instruments suggests the parties intended otherwise. *Kelly v. Ohio Oil Co.*, 57 Ohio St. 317 (1897).

B. Ohio has been producing oil and natural gas since the late 1800's. There is an established body of case law that tends to support *production* and *exploitation* of mineral interests for the benefit of the landowner.

C. "Rule of Capture" generally encourages oil and gas development. Permits landowner to develop oil and gas production on landowner's property irrespective of impact on adjoining property.

D. "Rule of Capture" is limited, however, by the "Doctrine of Correlative Rights." A landowner who exercises the right to produce oil and gas also has a duty to exercise that right without negligence or waste. R.C. 1509.01(l) defines "correlative rights" as the reasonable opportunity to recover and receive oil and gas in and under the person's tract without having to drill unnecessary wells or incur other unnecessary expense. R.C. 1509.01(H) defines "waste" to include locating, drilling, equipping, operating or producing an oil or gas well in a manner that reduces the quantity of oil or gas ultimately recoverable under prudent and proper operations from the pool or that causes or tends to cause unnecessary or excessive surface loss or destruction of oil or gas.

E. Correlative Rights addressed in Chapter 1509, Ohio Revised Code:

- R.C. 1509.20 requires well owners to use every reasonable precaution to stop and prevent waste of oil or gas. Limits "flare off" of natural gas.
- R.C. 1509.06 establishes a limited term for a drilling permit.
- R.C. 1509.021 addresses minimum separation for surface location of wells.
- R.C. 1509.24-27 establishes minimum acreage for drilling units, voluntary pooling agreements, mandatory pooling orders and unitization of pool.

## II. The "Held By Production" Doctrine

A. The "Habendum Clause" – Extending the Oil and Gas Lease

1. "Held By Production" is a general concept not a legal principle. The focus for the legal inquiry is on terms of the lease that may operate to extend the lease beyond the original term (the "primary term") to an extended term (the "secondary term"). The later is referred to as an "habendum clause" and may be triggered by continuing production, operations or other events as defined in the lease.

2. There are three seminal decisions of the Ohio Supreme Court over the years that have impacted Ohio Oil and Gas Law:

- *Harris v. Ohio Oil Co.*, 57 Ohio St. 118 (1897). Held: The rights and remedies of parties to an oil and gas lease are determined by the terms of the written instrument. Each lease is a contract that must be applied in accordance with its terms. The parties are bound by the production requirements of the lease. ("Use it or lose it").
- *Beer v. Griffith*, 161 Ohio St. 2nd 119 (1980). Held: There is an implied covenant to "reasonably develop" all tracts subject to an oil and gas lease and if certain separable tracts are not developed, the lease may be terminated as to those undeveloped tracts.
- *Ionno v. Glen Gerry Corp.*, 2 Ohio St. 3d 131 (1983). Held: Absent express exclusion, there is an implied covenant in every oil and gas lease to "reasonably develop the land."

3. Lease Terms May Vary
   - *Older Version* – The term of the lease is . . . for five (5) years and so much longer thereafter as oil, gas or their constituents are produced in paying quantities thereon."
   - Primary term is five (5) years.
   - Extension or secondary term is dependent on (continuous) production in "paying quantities." The unanswered question is: what are "paying quantities"?
   - *Modern Leases* – With horizontal drilling and more complicated operational requirements to permit, drill, and complete horizontal wells for production, the emphasis on the secondary term is now on "operations" rather than "production" and includes such acts as site preparation, exploration, pooling and permitting activities. See *Henry v. Chesapeake Appalachia LLC*, Sixth Circuit, Case No. 12-4090, January 14, 2014 (Chesapeake's filing a Declaration and Notice of Pooled Unit (DPU) including plaintiffs land was a defined "operation" extending the lease to the secondary term.
4. Assignment of Lease
   - Oil and gas leases typically are decades old and have been conveyed, assigned, or transferred in a variety of ways over the years. Oil and gas lease rights may be assigned, devised, licensed, partitioned, pledged or released and may be conveyed by various instruments including Sheriff's deed, bankruptcy or receivership actions, probate, judgment entry or other means of assignment.
   - Per R.C. 5301.09, leases, licenses and assignments of natural gas and oil rights must be filed for record without delay. No such lease or license is valid until it is filed for record except as between the parties, unless the person claiming thereunder is in actual and open possession.
   - An oil and gas review will typically require a comprehensive title search to determine the title chain, reservation of mineral interests and recording of oil and gas leases. A good title search will include a "working interest" analysis to address whether there has been continuous production or operation of a given well or wells. The "working interest" review will likely focus on public ODNR well logs and production reports.
   - The "assignment" creates no greater rights than provided in the "root" lease. The assignees' rights and remedies are determined by the terms of the written instrument, the conduct of predecessor – in-interest and applicable Ohio law. *Harris v. Ohio Oil Co.*, 57 Ohio St. 118 (1897).

B. Express Lease Terms Control – Failure of required production required by the express lease terms results in automatic termination.

   1. Is an oil and gas lease a fee simple determinable which automatically reverts to the lessor upon failure of performance or a fee simple subject to a condition subsequent which may give rise to a claim for termination?

   2. Under Ohio law, a leasehold in an oil and gas lease terminates automatically without any requirement of notice or judicial ascertainment in the event of failure of production at or after the end of the primary term. *Hanna v. Shorts*, 163 Ohio St. 44 (1955) (Since no oil or gas was produced for sale during the term of the lease, the lease automatically expired by its terms); *American Energy Services, Inc. v. Lekan*, 75 Ohio App.3d 205 (5th Dist. 1992) (If after the expiration of the primary term of an oil and gas lease the conditions of the secondary term are not continuing to be met, the lease terminates by the express terms of the contract and by operation of law and revests the leased estate in the lessor.); *Wagner v. Smith*, 8 Ohio App.3d 90 (4th Dist. 1984) citing *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); *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.); *Moore v. Adams*, 2008 WL 4907590 (5th Dist. 2008) citing *North Star Oil & Gas Co. v. Blubaugh*, 1981 WL 6434 (5th Dist. 1981) (Lessee's failure to operate a well or pay shut-in royalties for more than six (6) years caused the lease to terminate by its terms); *Kramer v. PAC Drilling Oil & Gas LLC*, 2011 WL 6917588 at *3 (9th Dist. 2011) (An oil and gas lease is a fee simple determinable.).

   3. Evidence of non-qualifying production can include ODNR well logs and production reports, tax reports, royalties paid, the duration of non-production and the reasons.

      ODNR records may be incomplete. Production reporting may be suspect and identification of wells and well coordinates may have errors.

4. Courts generally consider the circumstances of the non-production: (1) the duration of non-production; (2) cause of the cessation; and (3) the lessee's diligence in restoring production. *Wagner v. Smith*, 8 Ohio App. 3d 90 (4th Dist. 1984).

5. If the landowner currently accepts royalty payments under the lease, the lease may be held to be ratified. *Litton v. Geisler*, 76 N.E. 2d 741, 743 (4th Dist. 1945). *Contra, Bonner Farms Ltd. v. Fritz*, 355 F. App'x 10, 16 (6th Cir. 2009). (Landowner is entitled to royalty payments and acceptance is not a ratification of non-performance of the lease.).

6. The definition of "paying quantities" requires some commercial production generally at a profit over costs of operation. Production for domestic use only is not "commercial production" in "paying quantities." *Tisdale v. Walla*, 1994 WL 738744 (11th Dist. 1994).

7. The doctrine of apportionment of rents does not dispose of the rights of separate owners of separate tracts subject to a lease. *Northwestern Ohio Natural Gas Co. v. Ullery*, 68 Ohio St. 259 (1903). Quite to the contrary, since no royalties attributable to production from any well have been paid, it follows that the lease has been forfeited and abandoned for lack of production. See *Northwestern Ohio Natural Gas Co. v. Davis*, 3 Ohio Dec. 282 (Cir. Ct. 1895) aff'd 59 Ohio St. 591 (1898); *Anderson v. Chief Drilling, Inc.* 1983 WL 6351 (5th Dist. 1983); *Beer v. Griffith*, 1979 WL 210970 (5th Dist. 1974), aff'd 61 Ohio St.2d 119 (1980).

C. Production must apply to all tracts. "Held by production" may be limited to a producing tract.

1. *Applies to Producing Tract*

Where only a portion of the entire leasehold property subject to an oil and gas lease is actually developed for oil and gas production, the lease is forfeited for non-production as respects the portions undeveloped. See *Northwestern Ohio Natural Gas Co. v. Davis, supra* (Tract purchased by a subsequent owner is held to be treated as a separate tract under an oil and gas lease and the lease expires on its own terms as to that separate tract where gas was no longer found in paying quantities on that tract.); *Anderson v. Chief Drilling, Inc., supra* (Where there was no production on two tracts of land subject to an oil and gas lease, the lease is cancelled by its terms as to those tracts notwithstanding production from a third tract.); *Beer v. Griffith, supra* (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.); *Coffenberry v. Sun Oil*, 68 Ohio St. 488 (1903).

In *Anderson v. Chief Drilling*, there were originally a 160, 60 and 108 acre tract that comprised the leasehold. The 60 and 108 acre tract were subsequently transferred to one individual while another owned the 160 acre tract. Any production on the 160 acre tract did not operate to bind the balance of the tracts. In *Beer v. Griffith*, the court ordered forfeiture of the lease as to the portions of the leased property not developed.

2. *May be limited to the operational "footprint" of the well.*

*Zimmerman v. Mormack Industries, Inc.* 1989 WL 50677 (9th Dist. 1989) (Court ordered forfeiture of all 322 acre lease parcel for non-production except for the 20 acres upon which one production well was sited to comply with then current ODNR well-spacing requirements). *Brannon v. King*, 1985 WL 6153 (9th Dist. 1985) (Court ordered forfeiture of the majority of the leased property for non-production except for the one (1) acre site upon which a producing well was located,); *Lake v. Ohio Fuel Gas Co.*, 2 Ohio App.2d 227 (5th Dist. 1965) (Lessor waived a claim of forfeiture of lease premises by accepting royalties but not as to the portion of the property for which there was no production.) citing *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 54 S.Ct. 671, 78 L.Ed. 1255 (1934) (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 pursuant to the lease, but of the privilege of making some other arrangement for availing himself of the mineral content of the land.).

D. No Requirement Of Advance Notice

There is no advance notice or demand requirement to trigger forfeiture for non-production. See *Harris v. Ohio Oil Co.*, 57 Ohio St. 118 (1897) (While a demand was made, the court did not hold notice and demand was required.); *Zimmerman v. Mormack Industries, Inc.*, 1989 WL 50677 (9th Dist. 1989) (While notices and demands were made, the court did not hold that these were required for a claim of forfeiture.); *Brannon v. King*, 1985 WL 6153 (9th Dist. 1985) (The court actually held notice and demand was of no consequence because no notice or demand is required as a condition to a forfeiture action.). See also *Hanna v. Shorts, supra*, *Anderson Energy Service, Inc. v. Lekan, supra* and other cases cited above for the proposition that an oil and gas lease terminates automatically without any requirement of notice or judicial ascertainment in the event of failure of production at or after the end of the primary term.

E. "Implied Covenants"

1. In the absence of an express exclusion, there is an implied covenant in every oil and gas lease to "reasonably develop the land" for mineral production. The purpose of this implied covenant is to ensure reasonable and timely development of mineral interests and the protection of the lessor's interest. *Ionno v. Glen-Gerry Corp.*, 2 Ohio St. 3d 131 (1983); *Beer v. Griffith, supra*.
2. Ohio cases have addressed other "implied covenants" including:
   - The covenant of reasonable development and additional exploration;
   - The covenant to market the product;
   - The covenant to conduct all operations that affect the lessor's royalty interest with reasonable care and due diligence.

See, *American Energy Services, Inc. v. Lekan*, 598 N.E. 2d 1315 (1992) 212 citing *Williams & Meyers, Oil and Gas Law* (1991); *Moore v. Adams*, 2008 WL 4907590 (5th Dist. Nov. 17, 2008).

3. Implied covenants can be disclaimed. *Holonko v. H.D. Collins*, 1988 WL 70900 (7th Dist. June 29, 1988); *Bushman v. MFC Drilling Inc.*, 1955 WL 434409 (9th Dist. July 19, 1995).
4. Forfeiture is an equitable remedy which will only apply where damages are inadequate. Where an implied covenant is breached, forfeiture of the lease may apply but only where damages are not an adequate remedy. *Ionno v. Glen-Gerry Corp., supra* at 134-135.
5. If a lease continues under "held by production", damages may still apply to compensate for non-performance.

## III. Mandatory Pooling Orders

A. If the landowner declines to grant a lease, the developer or other landowners can still pursue alternative unitization or mandatory pooling options addressed in Chapter 1509, Ohio Revised Code. These alternatives can force inclusion of land within a drilling unit subject to ratable compensation.

B. Relevant provisions of Chapter 1509, Ohio Revised Code are:

R.C. 1509.26 – *Agreements to Pool Tracts to Form Drilling Unit*

Owners of adjoining tracts may agree to pool the tracts to form a drilling unit that forms to minimum acreage and distance requirements. Agreement shall be in writing and submitted to the division with the permit application required by R.C. 1509.05.

R.C. 1509.27 – *Mandatory Pooling Orders*

If a tract of land is of insufficient size or shape to meet the requirements for a drilling unit and owner of tract who is also owner of mineral interest has been unable to form a drilling unit under agreement under R.C. 1509.26, owner may make application for a mandatory pooling order.

Application shall include information required by Chief and shall be accompanied by an application for a permit under R.C. 1509.05. Chief shall notify owners of land within the area to be included in drilling unit and provide for a hearing. Chief may issue a mandatory pooling order which would include:

- Description of boundaries of drilling unit
- Proposed production site
- Description of each tract of land pooled
- Allocation on a surface acreage basis or pro rate portion of production to each tract owner. May vary as to specific geology circumstances
- Specify the basis for sharing expenses if owner elects to participate in drilling
- Designate the person to whom the permit shall issue

Statute also addresses rights and duties of a non-participating owner.

R.C. 1509.28 – *Order Providing for Unit Operation*

Chief, upon own motion or upon application by the owners of 65% of the land overlying the pool, shall hold a hearing to consider the need for operation of the pool as a unit. Chief may issue an order providing for unit operation if such operation is reasonably necessary to substantially increase ultimate recovery of oil and gas. Statute further provides for requirements of an order. Order conditioned upon approval of 65% of the owners of the plan for unit operation.

R.C. 1509.29 – *Order Establishing Exception Tract*

Upon application by an owner of a tract for which a drilling permit may not be issued and the owner is unable to enter into a voluntary pooling agreement or a mandatory pooling order, Chief may issue a permit and order establishing the tract as an exception tract. Statute further provides additional conditions for the exception tract.

## IV. Ohio's Forfeiture Statute

R.C. 5301.332 provides a mechanism for a lessor to have a lease cancelled of record where there has been no sufficient production under the terms of the lease.

R.C. 5301.332 provides that whenever leases concerning lands upon which there are no producing or drilling oil and gas wells become forfeited, the lessor may file for record an *affidavit of forfeiture*.

Lessor shall give notice by certified mail and, upon failure, by publication, upon lessee, successors or assigns. Affidavit shall identify lease, state the cause of forfeiture and shall state lessor's intent to file an affidavit of forfeiture.

After 30 days and not more than 60 days after notice, lessor may file affidavit of forfeiture identifying the lease, stating the cause of forfeiture, confirming that there are no producing or drilling wells and lease has been forfeited.

If lessee, successors or assigns contest forfeiture, lessor or assigns shall notify the lessor filing the affidavit of forfeiture within 60 days after notice. Lessee or assigns shall file for record an affidavit denying the lease has been forfeited.

If lessee or assigns do not contest forfeiture, county recorder shall note the lease cancellation of record.

## V. Ohio's Dormant Minerals Act

R.C. 5301.56 provides a surface owner with the opportunity to clear title to previously severed mineral interests if those interests have not been "used" during a 20 year look-back period. The 1989 version of the statute is a "use it or lose it" statute. If rights have not been exercised within a 20 year look-back time period, rights are automatically vested in surface owner. The 2006 version of R.C. 5301.56, which was substantially amended, provides that the surface owner must follow a notice and multi-step process to invalidate an interest.

The "savings" exceptions are:

a. A "title transaction" filed or recorded in the county recorder's office;
b. Actual production of oil or gas by the mineral interest owner;
c. Underground storage operations on the property;
d. Issuance of a drilling or mining permit to the mineral interest owner;
e. The recording of an affidavit to preserve the mineral interest; or
f. The creation of a separate tax parcel for the severed mineral interest.

The owner must serve notice by certified mail to each holder or each holder's successors or assignees, at the last known address of each, of the owner's intent to declare the mineral interest abandoned. If certified mail notice is not possible, the surface owner must publish notice at least once in a newspaper of general circulation n each county in which the land is located.

The owner may then file in the county recorder's office an affidavit of abandonment at least 30, but not later than 60, days after the date on which the notice was served or published. The affidavit must contain: (i) a statement that the person filing the affidavit is the surface owner; (ii) the volume and page number of the recorded instrument of the mineral interest; (iii) a statement that the mineral interest has been abandoned; (iv) the facts constituting the abandonment; and (v) a statement that notice was served on each mineral interest holder or their successors or assignees.

There are significant issues in the operation of R.C. 5301.56. These issues include:

1. Which version of statute applies?

   *Wendt v. Dickerson*, Tuscarawas Cty. C.P., Case No. 2012CV0135 (February 21, 2013). Held: 1989 version applies since 2006 amendment cannot affect rights "previously acquired" under 1989 law.

2. Is the statute constitutional?

   *Tribett v. Shepherd*, Belmont Cty. C.P. Ct., Case No. 12-CV-180 (July 22, 2013). 1989 version is constitutional relying on *Texaco v. Short*, 454 U.S. 516.

3. If 1989 version applies, what is the 20 year look-back period? Various interpretations – Fixed period March 22, 1969 through March 22, 1989 or March 22, 1972 through March 22, 1992 or 20 years prior to date of inquiry.

4. What "title transactions" are covered?

   – Oil and gas lease covered – *Bender v. Morgan*, Columbiana Cty. C.P., Case No. 2012-CV-378 (Mar. 20, 2013).

   – Transfer of surface property that referenced the severed mineral interest. *Croskey v. Dodd*, Harrison Cty., C.P., Case No. CVH-2011-0019 (Oct. 29, 2012).

## VI. Recent Cases

*Chesapeake Exploration, LLC v. Oil and Gas Commission*, Slip Op. No. 2013-Ohio-224 (January 30, 2013) – Writ of prohibition granted prohibiting Ohio Oil and Gas Commission from exercising jurisdiction in an appeal from issuance of a drilling permit. A leaseholder appealed. Held: Pursuant to R.C. 1509.06(F), issuance of a permit shall not be considered an order of chief. No appeal rights to Oil & Gas Commission.

*Wendt v. Dickerson*, Tuscarawas Cty. C.P. Case No. 2012-CV-02-0135 (February 21, 2013). Plaintiffs filed complaint for declaration regarding their ownership of mineral rights and to quiet title. Held: 1989 version of R.C. 5301.56 applies. Under that version, severed mineral interests were automatically abandoned.

*Mong v. Kovach Holdings LLC*, 2013-Ohio 882 (11th Dist. Trumbull Cty. 2013). Held: Reformation of an instrument is not justified where contract of sale indicates the reservation of oil and gas rights but the deed omits such reservation.

*Bilbarin Farm, Inc. v. Bakerwell, Inc.*, 2013 – Ohio – 2487 (5th Dist. Knox, June 12, 2013). Held: Oil and Gas lease expressly disclaimed any implied covenant to reasonably develop the property.

*Henry v. Chesapeake Appalachia, LLC*, Sixth Circuit, January 14, 2014, Case No. 12-4090. Lease provided for a five-year term through October 17, 2011 to be extended on occurrence of various events including conduct of "operations" on the leasehold or on lands pooled, unilized or combined with all or a portion of the leasehold, with no cessation greater than 180 consecutive days, provided such operation results in a well capable of producing oil and/or gas. The term" operations" included bona fide efforts to prepare the surface, drilling, testing, completing, any acts in search of or in an endeavor to obtain, maintain or increase production and any acts similar or incident to the foregoing. Held: Chesapeake filing a Declaration and Notice of Pooled Unit (DPU) including the subject property was an "operation" extending the lease.

## Additional Information

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