

What goes up...quick glance #2 at Ohio oil and gas leases in bankruptcy

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As Ohio enjoys its latest boom in oil and gas exploration, it is important to understand how oil and gas leases are treated in bankruptcy. The importance of these issues are underscored by the frequency with which the courts confront them; hence we visit again this unsettled area and consider further the question of the ownership of unextracted oil and gas in a bankruptcy context.

In the recent case of *In re Cassetto*, 475 B.R. 874 (Bankr. N.D. Ohio 2012), a bankruptcy court for the Northern District of Ohio examined whether a bankruptcy trustee charged with administering the assets of an individual chapter 7 debtor could enter into an oil and gas lease despite the debtor's objections, and, if so, whether the debtor's homestead exemption would apply to the signing bonus for such lease.

The lease the trustee sought to enter into had a five year term and would permit the extraction of oil and gas in exchange for a \$3,900 per acre signing bonus and royalties of 17.5% of the value of any oil and gas produced from the property. The trustee sought to enter into the lease, receive the signing bonus and thereafter abandon the lease to the debtor such that the debtor would be entitled to any royalty payments under the lease.

The debtor objected to the lease claiming that "(i) there are alleged environmental issues associated with hydraulic fracking; (ii) even without any environmental concerns, the massive machinery and noise would impair the use and enjoyment of the homestead and devalue the Debtors' property (iii) the Debtors' interest in the oil and gas is 'unsevered' from the Real Estate; and (iv) in the alternative, [the debtor] is entitled to her Homestead Exemption" from the signing bonus.

The court quickly dispensed with the first two issues finding that the debtor's claims to environmental issues were "unspecific and unsupported," and similarly that the debtor had offered "no support for the proposition that the alleged impairment in use and enjoyment and/or diminution in value of the Real Estate is sufficient reason to prohibit the Trustee from maximizing the value of the bankruptcy estate."

As to the debtor's third and fourth grounds for objection, the debtor argued that, because the oil and gas rights had not been severed from the debtor's residential property, such oil and gas rights were subject to her homestead exemption. Relying on the case of *In re Thexton*, 39 B.R. 367 (Bankr. Kan. 1984) (applying Kansas law), the debtor argued that the homestead exemption prevented the trustee from entering into the lease. The court, however, explained that, while under Kansas law, a homestead exemption would apply all future royalty payments under an oil and gas lease, "the homestead exemptions in Kansas and Ohio are in no way similar."

Relying heavily on the decision in *In re Loveday*, No. 10-64110, 2012 WL 1565479 (Bankr. N.D. Ohio May 2, 2012) (for a discussion of *Loveday*, see our previous blog post [HERE](#)), the court held that, despite a split among Ohio state courts, the better view of the ownership of unextracted oil and gas “recognizes the migratory nature of oil and gas, and requires actual possession to establish ownership of the resource, and the right held by the landowners is the right to reduce the oil and gas to possession or to sever this right for economic consideration” (referred to as the “nonownership theory”). Thus, under the nonownership theory:

[B]ecause the oil and gas rights cannot be valued until they are either removed from real estate or there is, at minimum, an offer to purchase the right to remove the oil and gas, the Homestead Exemption cannot apply to such rights. The Homestead Exemption exempts certain property of a debtor-up to a specified dollar amount-from execution by a creditor. If the oil and gas rights cannot be valued, how can a creditor know if the rights constitute an asset? How can a creditor execute on unvalued oil and gas rights? If a value cannot be placed on the property right, how can one know if the specified dollar exemption applies? Indeed, until oil and gas rights are valued by removal of the oil and/or gas or an agreement to remove, it is impossible to ascertain whether such alleged rights have any value.

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Moreover, the Homestead Exemption does not apply to oil and gas once these resources are severed from the realty because, at that time, such oil and gas become personal property and cannot be part of the homestead.

Furthermore, the court noted that the only real question is whether the signing bonus is subject to the homestead exemption. The court explained that “[t]he Signing Bonus is separate and apart from the unsevered oil and gas rights,” and held that the signing bonus constitutes personal property. Because it is personal property, a simple judgment lien would not attach to the signing bonus and in a related fashion, neither would Ohio’s homestead exemption. Accordingly, the trustee was authorized to enter into the lease.

The *Cassetto* decision, case like *Loveday*, serves to highlight the far reaching implications of the determination of whether unextracted oil and gas is owned by the landowner or not. Different states have answered this question in different ways, and, while Ohio courts are split on the issue, the clear trend among the state’s bankruptcy courts is to recognize the nonownership theory of oil and gas rights, which requires extraction of oil and gas to establish ownership.