

## What goes up ... Quick glance #3 at Ohio oil and gas leases in bankruptcy

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As with our prior posts on oil and gas leases in bankruptcy (located [here](#) and [here](#)), this post presents another thorny issue – namely, “Is an oil and gas lease a lease at all?”

Whether an oil and gas lease is a “lease” is significant in the bankruptcy context, because the Bankruptcy Code has several provisions regarding the treatment of leases.

This post considers two cases that interpret 11 U.S.C. § 365(d)(4), which provides that unless the bankruptcy court orders an extension, “an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by ... the date that is 120 days after the date of the order for relief [(typically, the commencement of the case)]....” The Code further provides that “the rejection of an ... unexpired lease of the debtor constitutes a breach of such contract or lease ... immediately before the date of the filing of the petition.”

The Code’s treatment of nonresidential real property leases stands in contrast to the general treatment of executory contracts, which, in a chapter 11 bankruptcy, generally may be assumed or rejected at any time prior to the confirmation of a plan of reorganization. Section 365(d)(4)’s provisions can be problematic for two reasons. First, in order to assume a nonresidential real property lease, a debtor must first cure any monetary default, which, depending of the amount owing, may be more difficult early in a bankruptcy. Second, the fact that nonresidential real property leases are treated differently than personal property leases and executory contracts occasionally results in an inattentive debtor’s counsel missing this deadline, especially when the purported nonresidential real property lease is not a typical lease of commercial space.

In *In re Gasoil, Inc.*, 59 B.R. 804 (Bankr. N.D. Ohio 1986), the court concluded that an oil and gas lease is in fact a lease of nonresidential real property. After reviewing the requirement of Section 365(d)(4), the court reasoned that, at least as used in Section 365, the term “lease” was intended to be expansive. Indeed, 11 U.S.C. § 365(m) expressly provides that “[f]or purposes of this section 365 ... leases of real property shall include any rental agreement to use real property.” Given this language, the court concluded that “[i]t does not matter whether these oil and gas leases are viewed as licenses, granting only the right to go upon the land and search for oil, or as leases. For purposes of section 365, they are ‘leases’ since they at least convey a right to use real property.” As to whether such leases were of nonresidential real property, even when the parcel to which the lease related may serve as a residence, the court noted:

[T]here is in each lease a requirement that no well be drilled closer than 200 feet to a residence. Even if these parcels do have people residing on them, Gasoil's use would not affect those portions where persons do reside. ... Under Ohio law, the real property that Gasoil has leased is the landowner's right to drill for the oil or gas underneath his land. It is not a lease of the surface per se, and is not a lease of real property where human beings reside.

Accordingly, the court found the leases to be of nonresidential real property subject to Section 365(d)(4).

However, in *In re Frederick Petroleum Corporation*, 98 B.R. 762 (S.D. Ohio 1989), the court rejected the reasoning in *Gasoil*, holding instead that Section 365(d)(4) was inapplicable to oil and gas leases under Ohio law. The court examined several Ohio cases that alternatively described an oil and gas "lease" as: a lease, *Langmede v. Weaver*, 65 Ohio St. 17, 60 N.E. 992 (1901) (for purposes of Ohio's attestation requirements); a "chattel real or estate for years", *Acklin v. Waltermier*, 19 Ohio C.C. 872 (1899) (for recording and levy purposes); a license or lease at will, *Jones v. Wood*, 9 Ohio C.C. 560 (1895); a sale of the oil and gas with a corresponding license to enter real property, *Miller v. Vandergrift*, 12 Ohio C.C. (n.s.) 475 (1892); an incorporeal hereditament entitling the purported lessee "the right to enter upon the land, to sink its wells, and to take from underneath the soil such oil as it may find," *Hollister v. Vandergrift*, 12 Ohio C.C. (n.s.) 586, 590 (1892); "not strictly a lease, but a license coupled with a conditional grant, conveying the grantor's interest in the gas well, conditioned that gas or oil is found in paying quantities," *Herrington v. Wood*, 6 Ohio C.C. 326, 330 (1892); a right to possession that is "not an estate in the land," that, upon discovery of oil or gas vests into an estate, *Tucker v. Watts*, 1 Ohio C.C. (n.s.) 589, 592-593; a grant, demise, and let of land for the limited purpose and period named in the lease -- more than a mere license; it is a lease of the land for the purpose and period limited in the lease, *Harris v. Ohio Oil Co.*, 57 Ohio St. 118, 48 N.E. 502 (1897).

Finally, the court discussed the more recent case of *Back v. Ohio Fuel Gas Co.*, 160 Ohio St. 81, 113 N.E.2d 865 (1953), which it found most instructive. In *Back*, the Ohio Supreme Court held that an outright assignment of unextracted oil and gas was in the nature of a license rather than assignment of a fee interest. Noting that both the agreement at issue in *Harris* and the one before it purported to transfer unextracted oil and gas with the exclusive right to extract, the *Frederick Petroleum* court reasoned that its purported lease must also be a license. The court then noted that an Oklahoma court found an oil and gas lease to be a license and it, together with another Oklahoma case and an Illinois case, concluded that Section 365(d)(4) does not apply to such purported leases. Based on *Back* and these Oklahoma and Illinois cases, the court reasoned that:

[T]he Ohio courts appear to recognize that such leases create a license to enter upon the land for the purpose of exploring and drilling for oil and gas, and any oil and gas produced under the terms of the lease becomes the personal property of the lessee, with the exception of the one-eighth royalty reserved by the lessor. The court feels that the Ohio courts, if given the opportunity to do so, would characterize the property interest involved as being like or similar to the interest recognized under Oklahoma law.

As such, the court concludes that oil and gas leases are not leases for purposes of 11 U.S.C § 365(d)(4).

Neither *Gasoil* nor *Frederick Petroleum* have ever been cited by any subsequent court, so you might be tempted to believe that *Frederick Petroleum* --

being more recent, entered by a higher court, and engaging in a more robust examination of the relevant case law and legislative history (which we did not examine in this post), is the correct holding, but I have my doubts.

For starters, the facts of *Back v. Ohio Fuel Gas Co.* (the case holding the agreement at issue was in fact a license) are not as similar to the facts at issue in *Frederick Petroleum* as the *Frederick Petroleum* court would have you believe. Yes, the *Back* court did find it was dealing with a license, but it was not choosing between a license and a lease; it was choosing between a deed (which was to be filed with one set of real property records) and a lease or a license (which was required to be filed with a different set of property records). The agreement at issue purported to be an outright transfer of unextracted oil and gas, and in support of such an outright transfer, the agreement used granting language and purported to transfer such rights in perpetuity without the possibility of defeasment upon the happening of any condition. Furthermore, the *Back* agreement did not provide for the payment of any rent or royalty. As such, the oil company/purported lessee, who had recorded the agreement with the county's leases and licenses, was forced to acknowledge:

Admittedly, the instrument in question is not a 'lease' because it grants rights in perpetuity, reserves nothing in the nature of rent, and the rights granted are not subject to defeasment upon the happening of any conditions.

Given the oil company's acknowledgement that it was not dealing with a lease, the court had to choose between a deed, supported by the agreement's language purporting to be an outright transfer of oil and gas, and a license. The court apparently, though not explicitly, espoused the "nonownership" theory of oil and gas rights (see our prior post [here](#) and [here](#)), concluding the agreement's assignment language was illusory because the purported lessor did not have any ownership rights to the unextracted oil and gas to transfer in the first place. Thus, the agreement did not transfer any property right and was not a deed. As the court reasoned, the agreement fell squarely in those to be recorded with the leases and licenses, which by statute included "[a]ll leases and licenses ... given ... for, upon, or concerning lands or tenements in this state, whereby any right is given or granted to operate, or to sink or drill wells thereon for natural gas and petroleum or either, or pertaining thereto."

If the agreement at issue in *Back* did not grant rights in perpetuity without the possibility of defeasment or if the agreement provided for something in the nature of rent, the *Back* court might well have found it to be a lease rather than a license (although it probably would not have chosen between a lease or a license because both types of instruments were filed in the same set of county records). But, while the instrument in *Back* lacked these two features, the agreement in *Frederick Petroleum* (as with most modern Ohio oil and gas leases) would expire for lack of production and it provided for the "payment of royalties in the form of a one-eighth part of the oil and gas produced, plus a sum referred to as 'delayed rentals' ... payable each quarter until a well is constructed." Would this have been enough for the *Back* court to conclude that the agreement involved was a lease?

Ultimately, whether an Ohio oil and gas lease is a lease under the Bankruptcy Code may depend in large part on the language of the lease itself (individual leases vary widely) and the court considering the issue. See e.g., *Kramer v. PAC Drilling Oil & Gas, LLC*, 197 Ohio App. 3d 554, (Ohio Ct. App., Wayne County 2011) (relying principally on pre-*Back* cases and without discussing *Back*

and holding that the terms of the lease before it created fee-simple determinable in an oil and gas estate subject to the possibility of reverter and not a lease.)