WHITEPAPER

THE EFFECT OF MISSING PRODUCTION ON OHIO'S HELD BY PRODUCTION OIL AND GAS LEASES

BY: TIMOTHY M. MCKEEN AND KRISTEN L. ANDREWS WILSON

FURTHERMORE - THE OHIO STATE LAW

Timothy M. McKeen
Member

1233 Main Street, Suite 3000
Wheeling West Virginia 26003
(304) 231-0473
timothy.mckeen@steptoe-johnson.com

Kristen L. Andrews Wilson
Associate

1233 Main Street, Suite 3000
Wheeling West Virginia 26003
(304) 231-0444
kristen.andrews-wilson@steptoe-johnson.com

The Effect of Missing Production on Ohio's Held by Production Oil and Gas Leases

TIMOTHY M. MCKEEN* & KRISTEN L. ANDREWS†

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I. INTRODUCTION

Ohio is in the midst of a potential economic boom. The recent interest in developing the Utica and Marcellus shale formations has already caused millions of dollars to be invested in the state, and there is potential for even more. The discovery and utilization of the shale formations in Ohio could help ease our nation's energy dependence and initiate the state's ability to produce new revenue streams capable of developing multiple tiers of employment and wealth creation in one of the frailest economies in recent memory. This potential for growth is cast against the backdrop of Ohio's limited amount of oil and gas jurisprudence. Although Ohio has been home to oil and gas production for more than 150 years, its jurisprudence is relatively sparse compared to large oil and gas producing states such as Oklahoma and Texas. One area of particular concern to companies entering the Utica play is the validity of old leases that are held by production. This Article analyzes the limited Ohio law on the issue of gaps or "missing" production history of oil and gas leases that are outside of their primary term and considers the treatment of this issue in other states.

A typical lease for oil and gas has a primary term of one to ten years and a secondary term that perpetuates the lease "as long thereafter as"[1] oil or gas is produced in paying quantities. There are many leases in Ohio that are still valid and being operated under their secondary term. Most of these leases involve wells that are producing from the Clinton shale formation or other traditional shallow formations. Producers are now purchasing assignments of the deep gas rights associated with these leases with the intent of developing the Utica formation. Issues arise, however, when landowners or other interested parties contend that these old leases are no longer held by production due to missing or inconsistent production data during the secondary term.

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* Associate, Steptoe & Johnson PLLC, Wheeling, West Virginia.

† Associate, Steptoe & Johnson PLLC, Wheeling, West Virginia. The authors would also like to thank Matthew Barissi and Melissa Atkinson for their work on this Article.

[1] Tisdale v. Walla, No. 94-A-0008, 1994 WL 738744, at *4 (Ohio Ct. App. Dec. 23, 1994).

Ohio courts are already seeing an increase in litigation as landowners attempt to invalidate old leases in order to sign new leases for large bonus payments and increased royalties. Current operators vigorously defend these suits in order to continue production and to protect their ability to assign the Utica rights to large producers. The Supreme Court of Ohio has provided very limited guidance on a challenge of the validity of an oil and gas lease for lack of production. Thus, this area of Ohio law is left to the lower courts, which have provided conflicting guidance on the continued validity of various lease forms under different fact situations. A clearly defined rule is essential for Ohio's development of oil and gas and to provide comprehensible guidelines for not only producers, but also landowners.

II. OHIO LAW

As noted hereinabove, the Supreme Court of Ohio has not provided specific guidance on this issue, but it has held that Ohio law clearly abhors forfeiture.[2] It has also held that oil and gas leases are contracts and the terms of the contract will govern the rights and remedies of the parties.[3] The court has not ruled, however, on the exact nature of an oil and gas lease. Is it a fee simple determinable which would automatically revert to the lessor upon the violation of any condition in the lease, or is an oil and gas lease a fee simple subject to a condition subsequent which would not automatically terminate the lease but give the lessor the right to terminate it? Or is it some form of a mere mining lease? Whether the lease language creates a fee simple determinable, afee simple subject to condition subsequent or a true mining lease means the difference between a lease that is automatically terminated, and a lease that requires action.[4] Absent express terms in the oil and gas lease to address the specifics of the secondary term, the average producer and landowner are left to wonder about the validity of their lease and what action is necessary to terminate the lease.

Ohio's Eleventh Appellate District Court held that "[t]he terminology utilized in the *habendum* clause ("and as long thereafter as") is generally construed to create a determinable fee interest, such that the lessee's interest automatically terminates upon lessee's failure to satisfy any of the listed provisions which would serve to extend the term of the lease."[5] According to the court, no action by either the lessor or lessee was necessary to terminate the

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[2] Harris v. Ohio Oil Co., 48 N.E. 502, 506 (Ohio 1897).

[3] *Id.* at 505.

[4] Bruce M. Kramer, *The Temporary Cessation Doctrine: A Practical Response to an Ideological Dilemma*, 43 BAYLOR L. REV. 519, 521 (1991).

[5] *Tisdale*, 1994 WL 738744, at *4.

lease; it had expired on its own terms.[6] The Ninth Appellate District also views an oil and gas lease as a fee simple determinable.[7]

Other Ohio courts, however, have not based their reasoning on the nature of an oil and gas lease but have analyzed other factors in determining the validity of leases in their secondary term. In deciding whether to terminate a lease for cessation of operations resulting in zero production, courts generally consider the following key factors: (1) the duration of time over which there was no production; (2) the cause of the cessation; and (3) the lessee's diligence in restoring production.[8] Yet, Ohio courts have provided little certainty as to specifically how much missing production for which reasons and under what circumstances is required to find a lease terminable.

It is well established that a mere temporary cessation in production will not be enough to forfeit a lease.[9] The Fourth Appellate District has opined that courts should look at the length of time the well is out of production, and consider all attendant circumstances.[10] In *Wagner v. Smith*, the lease at issue was "held" by a well that had not produced for a period of more than two years.[11] The *Wagner* court noted that a two-year lapse of production was more than a temporary cessation and that the other defenses the operator raised were not sufficient to justify the cessation.[12] Thus, a court determining whether cessation was "temporary" to keep a lease active would likely look at all the circumstances, including the length of delay and reason for delay in determining under Ohio law whether the lease was forfeited.

Ohio courts have not adopted a clear-cut rule as to what is an acceptable cause of cessation. In *Wagner*, the court rejected the lessee's cause of cessation, which was that there were difficulties in repairing the problem of a leaking well and in determining the most efficient way to contact and obtain agreements from minority interest owners.[13] An Ohio court determining the cause of cessation would likely look at the obstacle that stands in the way of production and whether the cause is a reason to stop production.

Ohio has also required that the lessee operate with due diligence in restoring the production of the well when there has been a gap in activity. A totality of the circumstances approach was taken in *Wagner* to determine that the lessee did not exercise due diligence in restoring the production.[14] To arrive at its

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[6] *Id.* at *5.

[7] Kramer v. PAC Drilling Oil & Gas, L.L.C., No. 11CA0003, 2011 WL 6917588, at *3 (Ohio Ct. App. 2011).

[8] *See, e.g.*, Wagner v. Smith, 456 N.E.2d 523, 525–26 (Ohio Ct. App. 1982) (citing Barrett v. Dorr, 212 N.E.2d 29 (Ind. 1965)).

[9] *Id.* at 525.

[10] *Id.*

[11] *Id.* at 525.

[12] *Id.* at 527.

[13] *Id.* at 526–27.

[14] *Wagner*, 456 N.E.2d at 527.

decision, the court reviewed the "circumstances of the non-production, the cause of the non-production, and the length of time of non-production."[15] These guidelines analyze the cause of and total time of non-production as factors to determine whether there was due diligence in restoring the well to production status.

Arguments will likely be made that if a landowner is currently accepting royalty payments under a lease, the lease is ratified and still a valid lease. In *Litton v. Geisler*, the Fourth Appellate District Court noted that, "[i]t is rather universally held that acceptance of rents or royalties under an oil and gas lease such as the one here under consideration is a waiver of forfeiture for breach of any covenant or condition for which such rents or royalties are paid."[16] However, in *Bonner Farms Ltd. v. Fritz*, the United States Court of Appeals for the Sixth Circuit rejected this argument in its analysis of Ohio law.[17] In that case, it was argued that the landowners' acceptance of royalty payments ratified a lease that had not been producing. The court disagreed and held that the landowner was already entitled to payment from mineral interest that he owned and therefore his actions did not constitute ratification. The court stated that "before a party is estopped by the receipt of benefits from a transaction to deny the validity of the transaction it must initially appear that he is not otherwise entitled to those benefits."[18] If the landowner accepted free gas or rental payments under the lease, the estoppel claim would have been valid.

The issue of forfeiture of leases also must be viewed in light of implied covenants contained within oil and gas leases. Discussion of implied covenants is not the purpose of this article, but it should be noted that the Supreme Court of Ohio has two important cases on the issue of forfeiture. In *Harris v. Ohio Oil Co.*, the court held that the breach of an implied covenant in an oil and gas lease could not cause a forfeiture of the lease, but rather resulted in an action for damages.[19] Further, the court held with "[s]ome causes of forfeiture being expressly mentioned, none other can be implied."[20] In *Beer v. Griffith*, the Ohio Supreme Court cited *Harris*, but held in certain circumstances that parts of a lease could be forfeited for breach of an implied covenant.[21] In *Ionno v. Glen-Gery Corp.*, the Supreme Court of Ohio attempted to clarify *Beer* by noting the *Beer* decision does not stand for the proposition that forfeiture can never be

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[15] *See* Am. Energy Servs., Inc. v. Lekan, 598 N.E.2d 1315, 1321 (Ohio Ct. App. 1992) (citing *Wagner*, 456 N.E.2d 523).

[16] 76 N.E.2d 741, 743 (Ohio Ct. App. 1945).

[17] 355 F. App'x 10, 16 (6th Cir. 2009).

[18] *Id.* at 16 (quoting Stitzlein v. Willey, No. CA-318, 1979 WL 209691, at *2 (Ohio Ct. App. Dec. 12, 1979)).

[19] 48 N.E. 502, 506 (Ohio 1897).

[20] *Id.*

[21] 399 N.E.2d 1227, 1230 (Ohio 1980).

imposed, but that forfeiture can only be imposed when necessary to grant justice to both parties.[22] Forfeiture is also referred to as an "extreme measure."[23]

Thus, Ohio courts have not provided clear guidance to assist producers or landowners in determining whether their leases are still valid. As evidenced above, the lower courts are split as to exactly when a lease terminates for lack of production and exactly when, or if, forfeiture occurs.

III. OTHER STATES' LAWS

Other states, such as Texas and Oklahoma, have solidified these rules by addressing the issue of the nature of an oil and gas lease. In order to better understand what position Ohio should adopt, a brief background on Texas and Oklahoma oil and gas jurisprudence is necessary.

Texas law views oil and gas leases that contain a *habendum* clause that reads "operations shall continue for so long as oil and gas is produced in paying quantities" as creating a fee simple determinable estate.[24] Texas shares Ohio's jurisprudential abhorrence of forfeitures but refuses to class a termination of an oil and gas lease upon the happening of the trigger event for the determination of the leased estate as a "forfeiture." Texas bases its reasoning on the view that oil and gas leases are granted for a specific use of land, in this case the removing of hydrocarbons beneath the surface, and by the language of the lease indicating that it ends when it is no longer utilized for that specific use.[25] Essentially, Texas treats an oil and gas lease as a sale of the oil and gas underlying the property, which is subject to a reverter upon the happening of an event, usually the cessation of oil and gas production.[26] Texas views the termination of a lease when the trigger event specified in the *habendum* clause as the simple expiration of the lease in accord with its terms, not a forfeiture.

Oklahoma adheres to a completely different interpretation of the nature of an oil and gas lease.[27] Oklahoma rejects the Texas interpretation, reasoning that the grantee under a fee simple determinable conveyance stands in a dissimilar position from that of the lessee under an oil and gas lease.[28] The court in *Fransen v. Eckhardt* stated:

> Under a lease, development by the lessee is intended, and it is understood that the lessee will have the power to try to extend the lease by production, in a [fee simple determinable], the parties do not contemplate activity by the grantee to

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[22] 443 N.E.2d 504, 508 (Ohio 1983).
[23] *Id.*
[24] Stephens Cnty. v. Mid-Kan. Oil & Gas Co., 254 S.W. 290, 290 (Tex. 1923).
[25] *Id.* at 295.
[26] Natural Gas Pipeline Co. of Am. v. Pool, 124 S.W.3d 188, 192 (Tex. 2003).
[27] Kramer, *supra* note 3, at 521 n.5.
[28] Fransen v. Eckhardt, 711 P.2d 926, 930 (Okla. 1985).

> produce the minerals for the mutual benefit of the grantee and the reversioner.[29]

This means that the parties in an oil and gas lease intend to enter a mutually beneficial relationship. The lessor has an interest to see the lessee use all means in which to extract the oil and gas so that the lessor may receive a larger proportional share of the sale. Also, the lessee has an interest in selling as much oil and gas produced in order to generate income for itself. The Oklahoma Supreme Court has reasoned that the "grantor of a [fee simple determinable] interest does not think of any benefit but [its] own."[30] Therefore, forfeitures are not automatic under Oklahoma's interpretation.

IV. CONCLUSION

The law adopted in Oklahoma would best serve the interest of Ohio. Unlike Texas, Oklahoma avoids forfeiture of the lease when possible. "Forfeiture is a deprivation or destruction of a right in consequence of the nonperformance of some obligation or condition . . . [E]quity abhors a forfeiture."[31] Subsequently, Oklahoma has also ruled that not only equity, but "[t]he law abhors a forfeiture."[32] Unless the parties have contemplated an agreement that expressly provides conditions for forfeiture, the law should avoid this remedy at all cost. Forfeiture does not provide stability in the law. The Texas fee simple determinable approach to oil and gas leases adopted by some of Ohio's lower courts results in automatic forfeitures—a harsh outcome that the Supreme Court of Ohio should seek to avoid. To do so, the Supreme Court of Ohio must reject the fee simple determinable approach to oil and gas leases and only allow forfeitures in extreme circumstances.

The Supreme Court of Ohio will likely decide many cases in the near future on actions to invalidate held by production leases for gaps or missing production. The Court must adopt a bright-line rule to aid producers and landowners alike in their ability to determine the validity of oil and gas leases. A clear rule will provide much needed stability to Ohio's oil and gas jurisprudence and create an environment that fosters investment and development in the oil and gas industry. To establish a clear rule, the court must reject the interpretation that an oil and gas lease with a standard *habendum* clause is strictly a fee simple determinable that ends by its own terms and adopt the approach taken by Oklahoma that avoids automatic terminations (or forfeitures) of leases.

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[29] *Id.*

[30] *Id.*

[31] Barkacs v. Perkins, 847 N.E.2d 481, 483 (Ohio Ct. App. 2006) (citations omitted) (internal quotation marks omitted).

[32] City of Tulsa v. Air Tulsa, Inc., 851 P.2d 519, 521 (Okla. 1992).