

Publications

Oil and Gas Alert: Ohio Court Of Appeals Issues Decision on Effect of Pugh Clause, Expansion of Drilling Units, Equitable Tolling

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CLIENT ALERT | 3.22.2016

On March 4, 2016, the Ohio Seventh District Court of Appeals in *Summitcrest, Inc. v. Eric Petroleum Corp., et al.*, addressed several issues concerning oil and gas leases in Ohio. In its decision, the Court held that: (1) a Pugh clause in an oil and gas lease did not operate to terminate the lease prior to the expiration of its primary term; (2) defendant-lessee was entitled to equitable tolling of the lease during the pendency of the suit; and (3) an implied covenant of good faith and fair dealing could not be used to negate the express language of the lease, which authorized the lessee to expand an existing drilling unit. The Seventh District is one of the first Ohio appellate courts to address the interpretation and effect of a Pugh clause under Ohio law.

Click [here](#) to read the decision.

Background and claims

This case involves a declaratory judgment action in which plaintiff (landowner-lessor) sought a declaration from the court that its oil and gas lease covering 2,734 acres of land in Columbiana County, Ohio, had terminated because the subject well, known as the "1-35 well," was not producing in paying quantities. Alternatively, plaintiff sought a declaration that its lease had terminated with respect to lands located outside the boundaries of the well's unit by operation of a Pugh clause. The lease at issue provided for a primary term of five years, which could be extended for five additional years upon payment of an agreed-upon sum prior to the expiration date of the primary term. Defendant-lessee exercised the option to extend the primary term of the lease for an additional five years.

The well was completed in 2004 as a 40-acre unit and was the only well drilled on the property. In 2009, the lessee declared its intention to increase the size of the unit from 40 acres to 640 acres. In September 2010, plaintiff deemed the lease forfeited and recorded an Affidavit of Non-Compliance. After the lessee sought a drilling permit to drill additional wells on the property, plaintiff filed the declaratory judgment action. The lessee(s)^[i] filed an answer and counterclaim seeking,

among other things, an equitable tolling of the lease.

Plaintiff's first declaratory judgment claim was dismissed by the trial court on summary judgment after plaintiff offered no evidence to controvert defendant-lessee's position on the issue of paying quantities. This decision was not appealed, leaving only plaintiff's alternative declaratory judgment claim remaining.

Plaintiff's alternative claim concerned the interpretation and effect of a Pugh clause, attached as an Addendum to the lease, which contained the following language:

Continuous Development. **At the expiration of the primary term and any extension thereof** and at all times thereafter when oil and gas ceases to be produced in paying quantities (hereafter called "Termination Date"), this Lease shall terminate as to any portion of the Leased Premises located outside of the surface boundaries of any unit (hereinafter referred to as "outside lands") on which is located a well producing from a zone or zones included in such unit or on which is located a shut-in gas well completed in a zone or zones included in such unit. * * * Subject to the provisions of [Paragraph 5, the Operations Clause] if at any time Lessee allows a period in excess of one (1) year to elapse between the completion/abandonment of a well and the commencement of actual drilling operations on an additional well, this Lease shall terminate as to the outside lands. * * *

(emphasis added in opinion). Plaintiff argued that, pursuant to the one-year limitation with respect to additional wells in the Pugh clause, the lease terminated as to lands outside the original 40-acre unit because no additional wells were drilled during the primary term.

The trial court held that the acreage located outside the extended 640-acre drilling unit had expired under the terms of the Pugh clause and the lease, reasoning that the Pugh clause had two potential triggers: either 1) the Termination Date (defined as "the expiration of the primary term and any extension thereof and at all times thereafter when oil and gas ceases to be produced in paying quantities") or 2) "at any time," even during the primary term if additional wells were not drilled within the one-year period set forth in the clause. The trial court also entered a second judgment determining that the unit contained 640 acres as a matter of law and ordered the equitable tolling of the Lease as to the 640 acre unit.

The Seventh District Court of Appeals reversed the trial court's opinion with respect to its interpretation of the Pugh clause at issue. The Seventh District reasoned that the trial court's interpretation that the Pugh clause could be triggered "at any time"—even during the primary term—was incorrect because it: (1) failed to give consideration to the topical sentence of the paragraph, dictating its application only after the Termination Date; (2) "thwart[ed]" the maxim that every word in a contract should be given meaning; and (3) rendered the habendum clause of the lease meaningless, creating an absurd result. The Seventh District also held that the lease should be tolled as to the entire 2,734 acres, not just the 640 acre unit.

Finally, the Seventh District affirmed the trial court's decision concluding that the lessee's expansion of the well's unit size was valid under the terms of the lease. First, the Court noted that Paragraph 6 of the Pugh clause, and the ODNR's approval of the unit increase, showed that the unit increase was valid. Second, the Court declined to impose an implied covenant of good faith and fair dealing "controlling a unit size increase," because the plain language of the lease permitted the unitization and the imposition of an implied covenant cannot negate the express terms of the lease. In reaching its decision, the Court emphasized that "merely realizing the benefit of [the parties'] bargain . . . does not constitute 'bad faith.'"

If you have any questions about the Seventh District's decision, please contact: Gregory Russell (614.464.5468), Thomas Fusonie (614.464.8261), or Steven Chang (614.464.5484).

[i] Although three lessees/assignees were named in the Complaint, two settled with plaintiff prior to the Seventh District's decision.