

Publications

Oil and Gas Alert: Ohio Supreme Court Decides Perpetual Lease Issue

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Only one month after oral argument, the Supreme Court of Ohio has issued its decision in the consolidated cases of *Hupp v. Beck Energy Corporation* (renamed on appeal as *Hustack v. Beck Energy Corporation*) and *Claugus Family Farm L.P. v. Seventh District Court of Appeals*, affirming the holding of the Seventh District Court of Appeals that the leases at issue were not perpetual and thus void as against public policy. In doing so, it reaffirmed long-held Ohio law that delay rentals cannot extend a lease beyond its primary term and held that there is no implied obligation to develop the leased premises during the primary term.

BACKGROUND

The plaintiffs in *Hupp* were owners of property in Monroe County leased to Beck Energy Corporation (Beck) under form oil and gas leases containing fairly commonly used lease language. It contained a habendum clause stating that the lease will continue “for a term of ten years and so much longer thereafter as oil and gas or their constituents are produced or are capable of being produced on the premises in paying quantities, in the judgment of the Lessee, or as the premises shall be operated by the Lessee in the search for oil or gas ***.” It also contained a delay rental clause stating that the lease would terminate unless a well was commenced within twelve months of the lease date or a delay rental was paid on a quarterly basis until such commencement. Notably absent, however, was an express statement that the delay rental applied only during the lease’s primary term.

The landowners filed suit to terminate the leases, arguing that they were void as against public policy as “no-term” or “perpetual” leases because the combination of habendum clause and delay rental language allowed Beck to hold the leases indefinitely without production. The trial court agreed and certified a class action to void other leases based on the same form. It also tolled the term of the specific lease owned by the class representative. On appeal, the Seventh District reversed the trial court, concluding that Beck could not hold the leases forever, i.e., without production after the expiration of the primary term (and thus the leases were not “perpetual”), and

expanded the trial court's tolling order to include all the leases that were subject to the class action. The latter ruling prompted the petitioners in the *Claugus Family Farm* matter (Claugus) to file an original action with the Supreme Court contending that the tolling order prevented them from entering into a lease with another operator that would have paid a bonus in excess of \$400,000.

SUPREME COURT

The Court unanimously affirmed the Seventh District's decision that the contested lease form was valid and not void as against public policy as a perpetual lease. The Court held that delay rentals could be paid only during the lease's primary term and not beyond. Relying on long-standing Ohio oil and gas jurisprudence, the Court reasoned that the habendum clause in the oil and gas leases was a two-tiered clause with a definite primary term (of 10 years) and an indefinite secondary term that continued as long as certain conditions set forth in the lease were met (i.e., production in paying quantities). It was not therefore the open-ended or perpetual grant claimed by the landowners.

In reaching these conclusions, the Court rejected the landowners' argument that the phrases "capable of being produced" and "in the judgment of the lessee" allowed the lessee to unilaterally declare the undeveloped land capable of production to hold the lease into the secondary term. Rather, to apply at all, there had to be a well in existence from which there could be production. Similarly, the Court also rejected the landowners' claim that an implied covenant to develop applied during the primary term such that Beck's failure to drill constituted a breach terminating the lease. The Court found instead that such implied covenant could not be read into the lease since the lease specifically addressed when development should occur (pointing to the primary term) and specifically disclaimed any implied covenants. Thus, the Court found that the Seventh District correctly ruled that the lease precluded the imposition of an implied covenant to develop.

Finally, the Court held (5-2) that the appellate court had jurisdiction to toll the primary terms of the leases, including those of the unnamed class members. The Court explained that to be entitled to a writ of prohibition, a party must demonstrate each of the following: (i) judicial power has been or is about to be exercised, (ii) the exercise is unlawful, and (iii) injury would result from denying the writ for which there is no other remedy in the ordinary course of law. The Court found that Claugus had an adequate remedy in the ordinary course of law by moving to intervene in the appeal. The Court reasoned that because Claugus had actual notice of the tolling order issue eleven months before the Seventh District issued its decision, Claugus could have protected its interest by intervening in the action. Having failed to do so, the Court was not persuaded that a writ was appropriate.

This aspect of the decision gave rise to a dissenting opinion by Justice Pfeifer, who was troubled that the unnamed class members were prevented from entering into new leases as a result of the "specious argument" made by the counsel for the named class action members. Justice Pfeifer focused on the evident fact that the interests of class members were not necessarily aligned with the challenge to the leases and those same class members were not given notice and an opportunity to opt out of the action. Thus, Justice Pfeifer asserted that the due process rights of both Claugus and the unnamed class members had not been protected during the action.

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