

Client Alert: Ohio Seventh District Issues Important Ruling on Lease Validity

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On September 26, 2014, the Ohio Seventh District Court of Appeals in *Hupp et al. v. Beck Energy Corp. et al.* reaffirmed the ongoing viability of several typical oil and gas lease terms in Ohio, reversing a lower court decision that had held that commonly-used habendum clause and delay rental provisions created no-term leases that violated public policy and were therefore void from their very inception.

The Seventh District covers Belmont, Carroll, Columbiana, Harrison, Jefferson, Mahoning, Monroe and Noble counties.

Background:

Plaintiff-landowners leased property in Monroe County under form oil and gas leases with Beck Energy Corporation (Beck). The leases contained an habendum clause that stated that the leases 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 ***”. The leases also contained a delay rental clause providing for lease termination unless the lessee paid a specified delay rental.

The landowners challenged the leases alleging that the habendum clause rendered the leases “no-term” or “perpetual” leases that were contrary to public policy and, therefore, void *ab initio*. The landowners also argued that the leases allowed the lessee to hold the property indefinitely and without production through the payment of minimal delay rentals or by the lessee’s assertion that the land was capable of producing oil and gas. The trial court agreed with the landowners and granted summary judgment in their favor; Beck appealed.

The Appeal:

On appeal, the Seventh District Court of Appeals (Court) reversed the trial court, issuing five important rulings:

1. An oil and gas lease that contains an habendum clause with a primary and secondary term is not a “no-term” lease. Relying on 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 the conditions of the secondary term were met (i. e., production in paying quantities), and not the open-ended or perpetual grant that plaintiffs claimed.
2. Again relying on established oil and gas jurisprudence, the Court held that delay rental provisions only apply during the primary term of the oil and gas lease. Therefore, a lessee cannot extend a lease in perpetuity by tendering nominal delay rental payments beyond the primary term. Once the primary term of the lease expires, the delay rental provision is no longer applicable.
3. The phrase “capable of production” in the habendum clause requires that the *well*, and not merely the *land*, be capable of production. Simply because the land is capable of producing oil and gas does not satisfy the conditions of the secondary term. Instead, there must be an actual well capable of producing.
4. The phrase “are produced or are capable of being produced on the premises in paying quantities, *in the judgment of the lessee*” in the habendum clause does not permit the lease to continue in perpetuity at the lessee’s sole discretion. Rather, a good-faith standard is imposed upon the lessee regarding the paying quantities requirement, with or without the phrase “in the judgment of the lessee.” Accordingly, the lease would continue so long as there was an established oil or gas well that was actually producing or capable of producing in paying quantities.
5. Lastly, the Court reaffirmed the rule that implied covenants may be disclaimed by the contracting parties, including the implied covenant to develop. The Court found no ambiguity in the lease that required the lessor to notify the lessee of a breach, whether express or implied, when the lease expressly disclaimed implied covenants. The Court reasoned that the purpose of the notice of breach provision was to provide the lessee with notice and an opportunity to cure any alleged breaches as opposed to creating additional substantive obligations on the parties. Further, the Court held that the implied covenant to develop did not apply during the primary term of the habendum clause in light of the delay rental provision.

If you have any questions regarding the *Hupp* decision, please contact John Keller at 614.464.6389, Pete Lusenhop at 614.464.8263 or Greg Russell at 614.464.5468.