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What is This Thing Called LEASE?

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CONTENTS

PART ONE

Is It an Interest in Real Property?

If you are asking why you should care how an oil and gas lease is properly characterized—whether it is an interest in real property or in personal property, the nature and extent of the estate that it conveys, and how it should be construed contractually—you have fallen prey to the same misconception that has characterized the Ohio oil and gas industry for more than a century: the comforting and comfortable belief that everything will work out fine, because it always has. Such indifference may have been justified in the past, when such abstruse aspects of Ohio oil and gas law were, quite simply, not worth litigating. But the Utica Shale boom has altered the economics so profoundly that these issues are now the subject of a flood of lawsuits.

It would be safe to conclude that, thus far, the results have not been encouraging. The 2012 decision of the Monroe County Court of Common Pleas in *Hupp v. Beck Energy Corp*. [1] has confronted producers with the dire prospect of having their leases declared void, *ab initio*, as abhorrent to Ohio's purported public policy of encouraging timely development of the State's natural resources. Though the legal analysis set forth in *Hupp* is subject to challenge, the *Hupp* rationale for rendering oil and gas leases unenforceable—even when they are still within their primary terms and delay rentals are being paid, and even after a producing well has been drilled—has been seized upon and followed by other courts. We will present such a challenge beginning in Part 2 of this article. Unless these decisions are overturned, the consequences will ripen from discouraging to calamitous.

The intent of this article is to address the essential nature of the oil and gas lease and the estate granted thereby, clarifying how is can best be understood, and its effectiveness preserved, both as a contract and a conveyance. Before we get to that point, however, we must first address a yet more arcane issue, *i.e.*, whether an oil and gas lease is an interest in real property or in personal property.

A. Is it an interest in real property or a mere license to search for and to extract oil and natural gas?

There is a split of authority in Ohio over whether an oil and gas lease is an interest in real property or in personal property. Inconsistent decisions by the Ohio Supreme Court have left other courts floundering over what course the Ohio Supreme Court will follow when it decides this issue, which it ultimately must.

Why this is important is sometimes apparent only to a handful of oil and gas attorneys who practice in Ohio and must confront on a fairly regular basis the myriad issues involved in the construction of an instrument that experts and dilettantes alike refer to as an "oil and gas ***lease***" but that is remarkably dissimilar to the commercial and residential leases with respect to which most persons have a passing familiarity. The classification of an interest in oil and gas as realty or as personalty is a question that is of profound significance to the determination of the nature of the "lease" itself, *i.e.*, whether it creates a freehold, a tenancy in real property, or a mere license or contract right. Or, perhaps, it is the other way around. There is, in fact, a pronounced circularity to the analysis that is maddeningly confounding; nevertheless, the issue

begs for resolution [2].

The other primary significance of this classification is to determine the applicability of statutes that deal in some respect with interests in real estate but that, typically, do not specifically mention oil and gas interests. These include the Statute of Frauds, recordation statutes, various taxation statutes, and statutes that relate to such diverse issues as adverse possession, dormant mineral interests, dower, judgment liens, the licensing of real estate brokers, *lis pendens*, partition, probate, and quiet title actions.

The split of authority can only be understood with a (relatively) brief explanation of the history of the development of the law on the ownership of oil and gas before it is removed from the ground. Under the common law, according to the so-called *ad coelum* doctrine [3], the owner of real property maintained rights to the property as it extended from the heavens all the way to the earth's core, including any minerals found in between. The *ad coelum* doctrine worked well for—and, hence, still applies to—"hard" minerals (coal, limestone, gravel, sand, and the like), but it proved troublesome when applied to oil and gas, which are fugacious, *i.e.*, they can, potentially, migrate from one property to another. They are also fungible, which means it is difficult, if not impossible, to attribute them to a given property.

B. Oil and gas as real property or personal property—the "ownership-in-place" theory versus the "nonownership" theory

Two distinct theories have emerged to determine who owns subsurface oil and gas: the "ownership-in-place" theory; and the "nonownership" theory. Under the ownership-in-place theory, which is the rule in most states, ownership of oil and gas is the same as ownership of any other interest in real estate, and oil and gas, like hard minerals, may be the subject of absolute ownership in place. Under this theory, oil and gas are considered to be real estate, but, given their migratory nature, they are owned by a given surface or mineral estate owner only so long as they remain under that particular owner's tract of land; if they migrate to a neighboring property, they become part of that neighboring property and are then owned by that property's owner.

In this sense, the ownership of the fugacious substance can be viewed from a particular landowner's perspective as determinable [4]. Under this theory, a person has an estate in property—arguably an interest in fee simple "determinable"—*i.e.*, unless a stated condition occurs, resulting in the loss of that estate. In the case of oil and gas, the owner of the oil or gas is the person on whose land those substances are located; but, if the oil or gas migrates to another person's property, the original owner no longer owns it and the person to whose property it moved becomes the new owner. In jurisdictions that have adopted the ownership-in-place theory, the "owner" of the oil and gas *may* convey a fee interest in that oil and gas.

Under the "nonownership" theory (which is unequivocally followed in a minority of jurisdictions: Oklahoma; Louisiana; California; and Wyoming), oil and gas or other fugacious substances may not be the subject of ownership in place; instead, the surface or mineral estate owner has the exclusive right to reduce them to possession, at which time they become personal property and are subject to ownership as such. This right is sometimes viewed as a *profit à prendre*: a right to enter the land and to take some part of the land or

a product of the land [5]. Simply put, oil and gas are owned by the person who removes them from the land. What this means is that, in jurisdictions that have adopted the nonownership theory, the owner of a tract of land (or of the mineral estate underlying that tract) cannot convey a fee interest in the oil and gas underlying that person's property. The nature of the interest that such an owner may convey is the right to search for oil and gas on that person's land.

The so-called "rule of capture" modifies the *ad coelum* doctrine and is related to both theories of oil and gas ownership but focuses, however, not on ownership but on *use*. While often conflated with the nonownership theory, the rule of capture is apparently applied in all states, regardless of the particular ownership theory adopted, as a rule of nonliability: it provides that the owner of a tract of land acquires title to the oil and gas produced from wells drilled on that person's land even though it may be shown that part of the production migrated from adjoining lands. Under the rule of capture, there is no liability for "capturing" the oil and gas that drains from another person's land to a well on one's own land [6]. The rule of capture was created by the courts to encourage the development of oil and gas resources for the benefit of (American) society. Without it, the fear of liability would potentially curtail oil and gas exploration and production and deprive our society of these valuable resources.

The rule of capture is not absolute. A key limitation on the rule of capture is the doctrine of correlative rights, which effectively provides that a person's right to capture a neighbor's oil and gas does not apply when the removal of the hydrocarbons is done negligently or causes waste. The doctrine states that each owner has a right to a fair and equitable share of the oil and gas under his land, as well as the right to protection from negligent damage to the producing formation, giving each owner of minerals in a common source of supply the right to a fair chance to produce the oil and gas. Ohio statutorily defines "correlative rights" (for oil and gas purposes) as

> [t]he reasonable opportunity to every person entitled thereto to recover and receive the oil and gas in and under the person's tract or tracts, or the equivalent thereof, without having to drill unnecessary wells or incur other unnecessary expense [7].

The correlative-rights doctrine is a corollary to the rule of capture and is premised on the same ultimate purpose of encouraging oil and gas development. The correlative-rights doctrine confirms that activity inconsistent with that purpose is not protected by the rule of capture.

C. The split of authority in Ohio over whether an oil and gas lease is real property or personal property

— 1. Ohio cases saying that oil and gas leases are interests in real property —

Ohio courts have split over the treatment of a lessee's interest in oil and gas pursuant to a lease. In 1927, the Ohio Supreme Court, in *Pure Oil Co. v. Kindall* [8], clearly stated that "[i]t is well established that in Ohio oil and gas in place are the same as any part of the realty [9]." This is consistent with the ownership-in-place

theory. It is also consistent with the Court's 1897 decision in *Harris v. Ohio Oil Co.* [10], in which the Court construed an oil and gas lease as follows:

> *An instrument in such form is more than a mere license; it is a lease of the land* for the purpose and period limited therein, and the lessee has a vested right to the possession of the land to the extent reasonably necessary to perform the terms of the instrument on his part.
>
> In this case, possession was delivered to the lessee and operations commenced, wells drilled, and oil produced in paying quantities, and in such cases it cannot be doubted that the lessee has a vested, though limited, estate in the lands for the purposes named in the lease [11].

There is further support for the adoption of the ownership-in-place theory in Ohio in the 1903 decision in *Northwestern Ohio Natural Gas Co. v. Ullery* [12], where the Ohio Supreme Court stated:

> *Oil in the rock adheres to the real estate, and is a part thereof until brought to the surface, when it becomes personalty*, just as a tree, or stone coal or fire clay, is a part of the realty until severed, when it becomes personalty.
>
> That which is a part of the land before severance, belongs to the owner of the land after severance as well as before. *The fact that oil and gas are vagrant and transitory in their nature does not prevent them from adhering to and becoming part of the land while passing from one tract to another, and while so in one tract they are a part of that tract and belong to the owner thereof until they escape from such tract, and if brought to the surface before such escape, they become personal property belonging to the owner of the land* [13].

This language is consistent with both the ownership-in-place theory and the rule of capture. The Court in *Ullery* cited with approval its 1897 decision in *Kelley v. Ohio Oil Co.* [14], in which it had stated:

> *Petroleum oil is a mineral, and while in the earth it is part of the realty*, and should it move from place to place by percolation or otherwise, it forms part of that tract of land in which it tarries for the time being, and if it moves to the next adjoining tract, it becomes part and parcel of that tract; and *it forms part of some tract, until it reaches a well and is raised to the surface, and then for the first time it becomes the subject of distinct ownership separate from the realty, and becomes personal property*, the property of the person into whose well it came. And this is so whether the oil moves, percolates, or exists in pools or deposits. In either event, it is property of, and belongs to, the person who reaches it by means of a well, and severs it from the realty and converts it into personalty [15].

Both cases illustrate how the ownership and nonliability doctrines have become intertwined, a complication not always recognized and understood by other courts.

In 1989, Ohio's Fourth District Court of Appeals, in *Wiseman v. Cambria Products Co.* [16], held that an 1894 deed that transferred "all the coal, iron ore *and other minerals* in, on, and underlying" the land

included the right to oil and gas under the land [17]. In its decision, the Court of Appeals cited *Hardesty v. Harrison* [18], in which the Fifth District Court of Appeals had stated:

> We believe it is a well settled law that petroleum oil is a mineral and *is a part of the realty*, like coal, iron and copper. A grant without qualifying or limiting words of the minerals underlying certain real estate will include oil and gas [19].

In 2007, Ohio's Ninth District Court of Appeals, in *Maverick Oil & Gas, Inc. v. Bd. of Educ. of Barberton City School Dist*. [20], was presented with a dispute over the right of the owner of an oil and gas lease to have access to the land that was the subject of the lease. In holding that the lessee of the oil and gas lease did have that right of access, the Court of Appeals stated:

> An oil and gas lease also creates a limited property right, such that the lessee has the right to possess the land to the extent reasonably necessary to perform the terms of the lease on his part. *Harris*, supra at 129-30. It is well settled that *where a grantor transfers an interest in real estate* and the transfer is recorded, *the grantor may only convey his remaining interest* to a subsequent grantee and nothing more. *Shields v. Titus* (1889), 46 Ohio St. 528, 22 N.E. 717, paragraph one of the syllabus. Thus, where the grantor holds the property subject to a lease which has been previously recorded, the grantee likewise takes the property subject to the lease, and the subsequent transfer has no effect on the prior lease. See id [21].

This decision explicitly declares an oil and gas lease to be an "interest in real estate" that, once granted and recorded, limits that grantor thereafter to transferring only his "remaining interest" in the real estate "and nothing more [22]."

In 2012, the United States District Court for the Northern District of Ohio, in *Binder v. Trinity OG Land Dev. & Exploration, LLC* [23], expressly held that an oil and gas lease was an interest in real estate. In that case, Binder sued Trinity, claiming that he had an oral agreement with Trinity to identify landowners with whom Trinity could negotiate to obtain mineral rights. Binder claimed he was entitled to a fee of $500,000 for his services in identifying over 10,000 acres of land to Trinity, which resulted in Trinity acquiring the mineral rights to all that acreage. Trinity moved for judgment on the pleadings, contending that Ohio law does not allow a person without a real estate brokerage license to seek compensation for the procuring of prospects "calculated to result in the sale, exchange, leasing, or renting *of any real estate* [24]." Binder did not have a real estate broker's license. The Court granted Trinity's motion for judgment on the pleadings, stating:

> Under Ohio law, "[r]eal estate includes leaseholds as well as any and every interest or estate in land situated in this state, whether corporeal or incorporeal, whether freehold or nonfreehold." *Id.* at § 4735.01(B). *Real estate, under Ohio law, has been held to include mineral rights, specifically "rights to coal, oil and gas." Colucy v. D & H Coal Co.*, 1961 Ohio Misc. LEXIS 261, *2 (Ohio Ct. Of Common Pleas 1961) [25].

— 2. Ohio cases saying that oil and gas leases are not interests in real property —

Other Ohio cases, however, suggest that Ohio adheres to the nonownership theory, pursuant to which (a) oil or gas belongs to no one until reduced to possession and (b) the lessee's interest under an oil and gas lease is merely a license to explore, with *no* interest in the oil and gas until reduced to possession, at which time the lessee acquires an interest in the oil and gas as personalty, not realty. The authoritative treatise, Williams & Meyers, *Oil and Gas Law* [26], adds the following in its description of the nonownership theory:

> Of course one may not go upon the land of another to effect the capture, *so it is necessary to have such an interest in the land* upon which a well is drilled for the purpose of capturing the fugative [*sic*] minerals as will authorize the drilling of the well [27].

Thus, the question is whether case law applying the nonownership theory to oil and gas itself would also result in an oil and gas *lease* being held to be a real property interest or an interest in personal property. On this issue there is confusion in the Ohio case law.

A leading case that comes close to addressing the question is *Back v. Ohio Fuel Gas Co.* [28], decided by the Ohio Supreme Court in 1953. In *Back*, a landowner executed a *general warranty deed* conveying to Ohio Fuel Supply Company "all the oil and gas in and under" the specified land, along with the "the right and privilege of operating upon the said premises [and doing all other things necessary to extract and transport the oil and gas to pipelines]." Ohio Fuel Supply then assigned the gas rights granted by that deed to Ohio Fuel Gas Company. Both the deed to Ohio Fuel Supply and the assignment to Ohio Fuel Gas were duly recorded in the *lease records* of Ashland County. The landowner thereafter sold the property to Back, who brought a quiet title action against Ohio Fuel Gas claiming that he was a bona fide purchaser for value of the premises without actual or constructive notice of the claimed rights of the gas company under the deed. Back's argument was that "the instrument conveying the oil and gas to the Ohio Fuel Supply Company and its assignee, the gas company, should have been recorded *in the deed records* and *not in the lease records* of the county."

The Ohio Supreme Court in *Back* held that recording the general warranty deed in the Ashland county lease records was sufficient to constitute constructive notice of the existence, operation, and effect of the deed to a subsequent purchaser of the property in question. In explaining the distinction between the deed to Ohio Fuel Supply and an oil and gas lease, the Court stated:

> *The character of the instrument of conveyance reveals that it is other than a grant of real property. Possession of oil and gas, having as they do a migratory character, can be acquired only by severing them from the land under which they lie, and in effect the instrument of conveyance in the instant case is no more than a license to effect such a severance.* The very sale of oil and gas, separate and apart from the real estate surface, constitutes, in law, a constructive severance such as occurs in the case of sale of standing timber or growing crops.
>
> *The instrument of conveyance, as a whole, bears the earmarks of a license.* It grants operating privileges on the land surface, just as would be necessary to remove standing timber or growing

> crops in a sale thereof. In the habendum clause of the instrument here, which measures the estate granted, the interests granted or conveyed are designated as "the above granted and bargained oil and gas rights, with the appurtenances thereunto belonging," and are not characterized as oil and gas in place. Likewise, the covenant of seizin and warranty relates solely to "the oil and gas rights in, upon and under the said above described premises." It is significant, also, that when the parties chose to transfer an interest granted under the original instrument of conveyance they did so by a mere assignment of the instrument and not by a new and subsequent deed which would be necessary in case real property was being transferred.
>
> *As a matter of fact, many authorities hold that the owner of the land surface does not own any oil or gas which may be "in place" thereunder*. The position of such authorities is that the owner has the exclusive right to drill wells on his premises for these minerals and to take the products of such wells as his own personal property from whatever source they may come to such wells [29].

Based on this language, Williams & Meyers concluded that Ohio has adopted the nonownership theory [30].

In May of 2012, a federal bankruptcy court sitting in Ohio noted the split in authority in the Ohio cases but chose to accept the view that Ohio is in the nonownership camp because the nonownership theory "is the more sensible approach to the ownership of oil and gas rights *for the purposes of valuation in bankruptcy* [31]." The court's explanation suggests that its decision may have limited applicability:

> Given the migratory nature of oil and gas, it is premature to give value to the oil and gas before they are extracted from the land. The varying price of oil and gas affects the exploration of real property for their existence and, therefore, to value real property to include the value of oil and gas is near impossible. Therefore, the value of the oil and gas cannot be determined to any degree until the oil and gas are extracted from the land or at least until an offer is made to a debtor to purchase the oil and gas rights to specific real property [32].

A 1989 decision by another federal bankruptcy court sitting in Ohio, *In re Frederick Petrol. Corp*. [33], is not so circumscribed:

> Following a review of the Ohio cases, the court concludes that the oil and gas leases in this case are not leases as that term is traditionally used. These leases are more than a mere rental agreement for the use of real property. Rather, the 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. The court reaches this conclusion in part due to the similarities which are apparent in discussions of the rights of the oil and gas "lessee" under both Ohio and Oklahoma law, regardless of the label ultimately applied to those rights. The court also notes the Ohio Supreme Court's decision in *Back v. Ohio Fuel Gas Co., supra*, where the court followed the view of law common in most oil producing states, including Oklahoma. This

> provides an indication that Ohio courts would be more inclined to adopt a rule of law common to oil producing states [34].

Finally, in the recent case of *Wellington Resource Group LLC v. Beck Energy Corp.* [35], federal Judge Algenon L. Marbley expressly disagreed with the defendant's contention that an oil and gas lease is an interest in real estate. *Wellington*, which involved a broker's right to a commission for the sale of oil and gas leases, involved the same basic fact pattern as *Binder* [36]. Wellington Resource Group had entered into a contract with Beck Energy to provide prospective purchasers to Beck for oil and gas leases that Beck owned in Monroe, Belmont, and Noble Counties. Wellington then entered a co-brokerage agreement with Transact Partners to find those potential buyers. Transact succeeded: a company called XTO Energy, Inc., bought the oil and gas leases and related property for $85 million. Beck then refused to pay either Wellington or Transact. Wellington sued; Transact Partners intervened to assert its claim to compensation as well. Beck moved to dismiss Transact's Third Party Complaint.

Beck argued that Transact could not recover (a) because oil and gas leases fall under the meaning of "real estate" as defined in the Ohio Revised Code, and (b) because Transact was not a licensed Ohio real estate broker, it was prohibited as a matter of law from recovering a fee for its brokerage services in connection with such leases. This, of course, is the same argument that succeeded in the Northern District of Ohio in the *Binder* case. Judge Marbley was respectfully "unconvinced" by the decision in *Binder*. Though he recognized that the Northern District of Ohio had decided that the definition of "real estate" in Ohio "has been held to include mineral rights, specifically rights to coal, oil and gas [37]," he cited *Back* and *Frederick*, among other cases [38], in concluding as follows:

> In essence, this Court reaffirms its prior conclusion in Frederick, where it stated that "Ohio courts, if given the opportunity to do so, would characterize the property interests involved [here] as being like or similar to the interest recognized under Oklahoma law," and common to many oil-producing states, and hold that oil and gas leases are not a grant of real property. 98 B.R. at 766 [39].

With due respect, there is sound reasoning to support the conclusion that that that Williams & Meyers and Judge Marbley may be wrong or, at the very least, misguided. In addition to the long line of cases, including multiple Ohio Supreme Court decisions, that suggest that Ohio adheres to the ownership-in-place theory and that, consequently, oil and gas leases are interests in real property, there are a number of additional arguments that support the proposition that Ohio adheres to the ownership-in-place theory. These will be discussed more fully in Part 2 of this article.

D. It IS an interest in real property!

Notwithstanding the split of authority in Ohio over whether an oil and gas lease is real property or personal property and the inconsistent decisions on this issue by the Ohio Supreme Court and other courts construing Ohio law, there are a number of additional arguments that support our conclusion that, in Ohio, an oil and gas lease is most certainly an interest in real property. These are set forth below.

— 1. Ohio's Dormant Minerals Act —

Ohio's Dormant Minerals Act [40] sets forth the circumstances under which a mineral interest may be deemed abandoned and revested in the "owner of the surface of the *lands subject to the interest* [41]," clearly indicating that a mineral interest is an interest in real property. This conclusion is bolstered by the definition of the term "mineral interest" as "a *fee interest* in at least one mineral regardless of how the interest is created and of the form of the interest, which may be absolute or fractional or divided or undivided [42]." The term "minerals" includes oil, gas, and other gaseous, liquid, and solid hydrocarbons [43].

In adopting the Dormant Minerals Act, the Ohio General Assembly clearly recognized that minerals may be owned in fee and that a mineral interest may be severed from the ownership of the surface and held by another party [44]. Notwithstanding the cases discussed above that appear to hold that oil and gas are not susceptible to being owned in place, Ohio courts have long recognized that minerals may be separately owned [45]. Oil, gas, and other minerals may be owned *in fee* only if they are real property.

There are numerous events that can prevent a severed mineral interest from revesting in the surface owner. One is if, during the twenty (20) years immediately preceding the date on the statutorily prescribed notice of abandonment [46] is served or published,

> [t]here has been actual production or withdrawal of minerals by the holder from the lands, *from lands covered by a lease to which the mineral interest is subject*, from a mine a portion of which is located beneath the lands, or, in the case of oil or gas, from lands pooled, unitized, or included in unit operations . . . [47]

It seems axiomatic that, if the mineral interest is clearly defined as an interest in real property, a lease to which that mineral interest is subject must likewise be an interest in real property.

— 2. Ohio's recording statutes —

Ohio's recording statutes clearly treat oil and gas leases and other instruments relating to oil and gas leases as real property interests for recording purposes. ORC § 5301.09 requires that the following be filed for record and recorded:

> *[a]ll leases*, licenses, and assignments thereof, or of any interest therein, given or made *concerning lands or tenements in this state*, by which any right is granted to operate or to sink or drill wells thereon for natural gas and petroleum or either, or pertaining thereto . . . [48]

The place for filing is the Office of the Recorder of "the county in which *the land subject to any such lease* is located 49]." Similarly, the statutory provision relating to the forfeiture of such leases refers to them as "leases of natural gas and oil *lands* [50]." To be entitled to recordation, an oil and gas lease, license, assignment, or affidavit of forfeiture must be executed and acknowledged in the same manner as instruments for the conveyance or encumbrance of real property [51]. Oil and gas leases and licenses would therefore appear,

by definition, to be interests in real property.

— 3. Ohio's Arbitration Act and Ohio's quiet title action statute —

Ohio's Arbitration Act [52] mandates the enforcement of arbitration clauses in contracts as a method of settling disputes. However, the statute expressly does not apply to controversies involving the title to or the possession of real estate [53]. In a decision rendered in early 2014, *Riggs v. Patriot Energy Partners, LLC* [54], Ohio's Seventh District Court of Appeals held that the trial court had erred by permitting a quiet title claim challenging the validity of an oil and gas lease to go to arbitration since it is a controversy directly involving title to real estate and therefore exempt from arbitration pursuant to ORC § 2711.01(B)(1). The court stated:

> While Appellees do not address the quiet title claim specifically, Patriot asserts that oil and gas leases are purely contractual rights concerning personal property. However, we need not reach this issue in the narrow context presented by this case. R.C. 2711.01 exempts controversies involving title to or possession of real estate from going to arbitration, with certain exceptions that do not apply here. The purpose of a quiet title action is to resolve or remove any clouds on the title to real property. There is no need to predetermine the nature of the cloud to reach the conclusion that a quiet title action in this case will involve matters relating to the title to or possession of real estate, and is thus exempt from arbitration. Thus, the trial court erred by permitting the quiet title claim to go to arbitration since it is a controversy directly involving title to real estate and therefore exempt from arbitration pursuant to R.C. 2711.01(B)(1) [55].

While the court expressly declined to address the argument that oil and gas leases are purely contractual rights concerning personal property, it recognized that a quiet title action may be brought only "by a person in possession of *real property* [56]."

— 4. Ohio's partition statute —

In 1922, the Ohio Supreme Court, in *Black v. Sylvania Producing Co.* [57], held that,

> [u]nder statutory partition, a leasehold for oil and gas, with the right to the use of the fee for the purposes of producing oil or gas, or of drilling for or otherwise discovering the same, *in an estate of land such as contemplated by the statute*, may be the subject of partition [58].

This would appear to be a clear-cut endorsement of the ownership-in-place theory, since statutory partition is available only to "[t]enants in common, survivorship tenants, and coparceners, of *any estate in lands, tenements, or hereditaments* within the state" of Ohio [59].

— 5. The Uniform Commercial Code —

The Uniform Commercial Code ("UCC") has long wrestled with the thorny issue of classifying oil and gas interests. The current version of UCC Article 9, relating to secured transactions, has an entirely new category of collateral, which it calls "as-extracted collateral." The term is defined to include (a) oil, gas, or

other minerals that are subject to a security interest that is created by a debtor having an interest in the minerals *before extraction* and that attaches to the minerals *as extracted* and (b) accounts arising out of the sale at the wellhead or minehead of oil, gas, or other minerals in which the debtor had an interest *before extraction* [60]. The drafters of UCC Article 9 felt constrained to provide the following explanation:

> ***Under this article, oil, gas, and other minerals that have not been extracted from the ground are treated as real property****, to which this article does not apply. Upon extraction, minerals become personal property (goods) and eligible to be collateral under this article. See the definition of "goods," which excludes "oil, gas, and other minerals before extraction."* To take account of financing practices reflecting the shift from real to personal property, this article contains special rules for perfecting security interests in minerals which attach upon extraction and in accounts resulting from the sale of minerals at the wellhead or minehead. See, e.g., sections 9-301 (law governing perfection and priority), 9-501 (place of filing), 9-502 (contents of financing statement), and 9-519 (indexing of records). The new term, "as-extracted collateral," refers to the minerals and related accounts to which the special rules apply. The term "at the wellhead" encompasses arrangements based on a sale of the produce at the moment that it issues from the ground and is measured, without technical distinctions as to whether title passes at the "Christmas tree" of a well, the far side of a gathering tank, or at some other point. The term "at . . . the minehead" is comparable. [61]

The definition of the collateral category "goods" generally includes "all things that are movable when a security interest attaches," including fixtures [62], but, as noted in the Official Comment, it specifically excludes "oil, gas, or other minerals *before extraction* [63]."

A financing statement that covers as-extracted collateral must be filed in the office designated for filing a "mortgage on the related real property [64]." Such a financing statement must

> [p]rovide a description of the real property to which the collateral is related sufficient to give constructive notice of a mortgage under the laws of this state if the description were contained in a record of the mortgage of the real property. [65]

These provisions make a financing statement covering as-extracted collateral closely analogous to a mortgage, which is clearly an encumbrance on a real property interest.

> The current version of UCC Article 2, relating to sales of goods, provides in pertinent part:
>
> *A contract for the sale of minerals or the like, including oil and gas*, or a structure or its materials to be removed from realty *is a contract for the sale of goods* within [UCC Article 2], *if they are to be severed* ***by the seller*** but until severance a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell [66].

The drafters of UCC Article 2 have provided the following observation that seems particularly relevant to determining the nature of an oil and gas lease:

> Notice that this subsection applies only if the minerals or structures "are to be severed by the seller". *If the buyer is to sever, such transactions are considered contracts affecting land and all problems of the Statute of Frauds and of the recording of land rights apply to them*. Therefore, the Statute of Frauds section of this Article does not apply to such contracts though *they must conform to the Statute of Frauds affecting the transfer of interests in land* [67].

In other words, a contract involving minerals that the seller will sever and extract is a contract for the sale of goods, *i.e.*, personal property. But if the seller conveys the minerals to the buyer in situ, with the intent that the buyer sever them, such a contract involves the transfer of an interest in land, *i.e.*, real property.

— 6. The groundwater analogy —

The closest analogy to oil, gas, and other fugacious hydrocarbons is not a mineral at all; it is groundwater. In a 2006 decision, *McNamara v. City of Rittman* [68], the Ohio Supreme Court addressed a question of Ohio law that had been certified to it by the Sixth Circuit Court of Appeals, i.e., "Does an Ohio homeowner have a property interest in so much of the groundwater located beneath the land owner's property as is necessary to the use and enjoyment of the owner's home?" The cities of Rittman and Columbus argued that, although property owners have the right to the reasonable use of the groundwater beneath their property, they have no right of title, no ownership right, in the water itself. The Supreme Court, after reviewing its decisions in *Frazier v. Brown* [69] and *Cline v. American Aggregates* [70], disagreed:

> . . . The title to property *includes* the right to use the groundwater beneath that property. The "reasonable use" standard set forth in *Cline* greatly expanded water rights protection, reflecting the importance of water rights to every piece of property. *Cline* recognizes the essential relationship between water and property and confirms that groundwater rights are a separate right in property. The Restatement section cited in *Cline* "recognizes that the right to withdraw ground water is a property right that may be granted and sold to others." 4 Restatement of Law 2d, Torts, Section 858, Comment *b*. That right is one of the fundamental attributes of property ownership and an essential stick in the bundle of rights that is part of title to property [71].

The Court concluded:

> Groundwater rights are knowable and protectible [*sic*]. This court in Cline established the nature of the right, and Ohio has statutorily defined what constitutes reasonable use. R.C. 1521.17. The well-being of Ohio homeowners, the stability of Ohio's economy, and the reliability of real estate transfers require the protection of groundwater rights. We therefore hold that *Ohio landowners have a property interest in the groundwater underlying their land and that governmental interference with that right can constitute an unconstitutional taking* [72].

The Ohio Supreme Court's decision in *McNamara* was generally consistent with the Court's earlier decision in *Chance v. BP Chemicals, Inc.* [73] In *Chance*, the plaintiffs filed a suit on behalf of citizens of the City of Lima, Ohio, who owned an interest in property near BP Chemical's 200-acre chemical refinery.

Claiming that hazardous liquid waste from BP's deepwell disposal process migrated below their properties, the plaintiffs sought injunctive relief and general and punitive damages based upon theories of trespass, nuisance, negligence, strict liability and fraudulent concealment. The trial court bifurcated the litigation into separate liability and damage phases. At the close of the plaintiffs' case, the trial court issued a directed verdict to BP on the plaintiffs' claims for fraud, nuisance and ultrahazardous activity. The jury returned a verdict in favor of BP on the plaintiffs' trespass claim. The decision was affirmed by the court of appeals.

Chance dealt with the somewhat novel issue of whether the plaintiffs owned the native brine underlying their properties, such ownership being a necessary prerequisite to their trespass action. The Court began by disposing of the plaintiffs'/appellants' claim that this was resolved by the *ad coelum* doctrine:

> Appellants' argument implicates the ancient Latin maxim *cujus est solum, ejus est usque ad coelum et ad inferos*, defined in Black's Law Dictionary (6 Ed. 1990) 378, as "to whomsoever the soil belongs, he owns also to the sky and to the depths. The owner of a piece of land owns everything above and below it to an indefinite extent." In *Winton v. Cornish* (1832), 5 Ohio 477, 478, this court appeared to adopt the position illustrated by that maxim, stating, "The word *land* includes not only the face of the earth, but everything under it or over it. He who owns a piece of land, therefore, is the owner of everything underneath in a direct line to the center of the earth and everything above to the heavens."
>
> In *Willoughby Hills v. Corrigan* (1972), 29 Ohio St. 2d 39, 49, 58 Ohio Op. 2d 100, 105, 278 N.E.2d 658, 664, this court, citing the United States Supreme Court in *United States v. Causby* (1946), 328 U.S. 256, 66 S. Ct. 1062, 90 L. Ed. 1206, stated that "the doctrine of the common law, that the ownership of land extends to the periphery of the universe, has no place in the modern world." The court in *Willoughby Hills*, 29 Ohio St. 2d at 50, 58 Ohio Op. 2d at 106, 278 N.E.2d at 665, quoted from *Hinman v. Pacific Air Transp.* (C.A.9, 1936), 84 F.2d 755, 758: "'We own so much of the space above the ground as we can occupy or make use of, in connection with the enjoyment of our land. This right is not fixed. It varies with our varying needs and is coextensive with them. The owner of land owns as much of the space above him as he uses, but only so long as he uses it [74].'"

The Ohio Supreme Court went on to find that the appellants, given all the factors present in *Chase*, did *not*, as a matter of law, establish an unlawful entry on their properties by BP [75]. In so holding, the Court enunciated what could be described as a "less-than-absolute-ownership-but-ownership-nonetheless" doctrine:

> Consequently, we do not accept appellants' assertion of absolute ownership of everything below the surface of their properties. Just as a property owner must accept some limitations on the ownership rights extending above the surface of the property, we find that there are also limitations on property owners' subsurface rights. We therefore extend the reasoning of *Willoughby Hills*, that absolute ownership of air rights is a doctrine which "has no place in the modern world," to apply as well to ownership of subsurface rights. Furthermore, as we will discuss below regarding other considerations in this case, given the unique facts here we find that *appellants' subsurface rights in their properties include the right to exclude invasions of the subsurface property that actually*

interfere with appellants' reasonable and foreseeable use of the subsurface. [76]

The subsurface rights recognized by the Court are thus circumscribed but are clearly significantly more that would exist were the nonownership theory in effect.

Based upon our reading of *Chance* and *McNamara*, we believe it likely that the Ohio Supreme Court, if confronted with the issue of a landowner's interest in the oil and gas underlying his or her land, would conclude (a) that the landowner has a real property interest in that oil and gas and (b) that the landowner's ownership of that oil and gas is subject to the correlative rights of adjoining landowners. This would be consistent with the ownership-in-place theory.

E. Epilogue

While an epilogue typically connotes an ending, this is merely the end of Part 1. The balance of this article will be devoted to an issue of far greater concern to our readers than the rather academic discussion that we now conclude, *i.e.*, the resolution of the question that gives this article its title. As a result of the Utica Shale boom, Ohio is now experiencing a flood of cases involving oil and gas leases unlike anything it has witnessed in the past. Regrettably, many of these cases are being wrongly decided because of the woeful lack of understanding (and meaningful precedent) regarding the nature of an oil and gas lease as an instrument of conveyance. Determining what is this thing we call an oil and gas *lease* and what interest it conveys will test our predictive powers in a context of vital significance to the State of Ohio and, in particular, to the development of its natural resources.

ENDNOTES

1. *Hupp v. Beck Energy Corp.*, 2012 Ohio Misc. LEXIS 245 (Monroe County C.P. 2012) ("*Hupp*").

2. Many commentators have addressed, often in mystifying detail, the complex and occasionally unfathomable issues surrounding the theory of ownership embraced by a particular jurisdiction. The most digestible of these is John S. Lowe's admirable presentation in the eminently readable *Oil and Gas Law in a Nutshell* (5th Ed. 2009), Ch. 2.

3. This is short for *cujus est solum, ejus est usque ad coelum et ad inferos*, a Latin phrase meaning that ownership of land includes everything from the air space above to the center of the earth, *i.e.* from heaven to hell. J. Thomas Lane, "Ownership Determination and Resolving Ambiguities: What To Do When Confusing Deeds Stymie the Imagination," Energy & Mineral Law Foundation Special Institute on Title and Development Issues in the Utica Shale – Ohio (April 14-16, 2013), p. 2.

4. *Id.*, at pp. 3-4.

5. *Id.*, at p. 5.

6. *Id.*, at p. 6.

7. Ohio Revised Code ("ORC") § 1509.01(I). The correlative-rights doctrine also applies, with respect to groundwater, to limit the rights of landowners to a common source of groundwater (such as an aquifer) to a reasonable share, typically based on the amount of land owned by each on the surface above. This will be addressed in Part 2(F) of this article.

8. *Pure Oil Co. v. Kindall*, 116 Ohio St. 188, 156 N.E. 119 (1927).

9. *.Id.*, 116 Ohio St. at 201, 156 N.E. 119.

10. *Harris v. Ohio Oil Co.*, 57 Ohio St. 118, 48 N.E. 502 (1897) ("*Harris*").

11. *Id.*, 57 Ohio St. at 129-130, 48 N.E. at 506 (emphasis added).

12. *Northwestern Ohio Natural Gas Co. v. Ullery*, 68 Ohio St. 259, 67 N.E. 494 (1903) ("*Ullery*").

13. *Id.*, 68 Ohio St. at 271-272, 67 N.E. at 496 (emphasis added).

14. *Kelley v. Ohio Oil Co.*, 57 Ohio St. 317, 49 N.E. 399 (1897).

15. *Id*, 57 Ohio St. at 328, 49 N.E. at 401 (emphasis added).

16. *Wiseman v. Cambria Products Co.*, 61 Ohio App. 3d 294, 572 N.E.2d 759 (4th Dist. Ct. App. 1989).

17. *Id.*, 61 Ohio App. 3d at 299, 572 N.E.2d at 762.

18. *Hardesty v. Harrison*, 61 Ohio Law Abs. 445, 27 Ohio Law Rep. 282 (5th Dist. Ct. App. 1928).

19. *Id.*, 61 Ohio Law Abs. at 445 (emphasis added).

20. *Maverick Oil & Gas, Inc. v. Bd. of Educ. of Barberton City School Dist.*, 171 Ohio App. 3d 605, 872 N.E.2d 322 (9th Dist. Ct. App. 2007).

21. *Id.*, 171 Ohio App. 3d at 612, 872 N.E.2d at 327 (emphasis added).

22. *See also, Fourth & Central Trust Co. v. Woolley*, 31 Ohio App. 259, 261, 165 N.E. 742 (1st Dist. Ct. App. 1928) ("It is settled law that oil before its extraction is a mineral, and a part of the land"). These cases support the argument that an oil and gas lease is an interest in real estate.

23. *Binder v. Trinity OG Land Dev. & Exploration, LLC*, No. 4:11-CV-02621, 2012 U.S. Dist. LEXIS 76183, 2012 WL 1970239 (N.D. Ohio May 31, 2012) ("Binder").

24. *Id.* (emphasis added).

25. *Id.* at *9 (emphasis added).

26. Williams & Meyers, *Oil and Gas Law* (2013).

27. *Id. § 203.1* (emphasis added).

28. *Back v. Ohio Fuel Gas Co.*, 160 Ohio St. 81, 113 N.E.2d 865 (1953) ("*Back*").

29. *Id.*, 160 Ohio St. at 86-87, 113 N.E.2d at 867-868 (emphasis added).

30. Williams & Meyers, *Oil and Gas Law* § 203.1.

31. *In re Loveday*, 2012 Bankr. LEXIS 1937 (N.D. Ohio May 2, 2012) (emphasis added).

32. *Id*, at pp. 7-8.

33. *In re Frederick Petrol. Corp.*, 98 B.R. 762 (S.D. Ohio 1989) ("Frederick").

34. *Id.*, 98 B.R. at 766.

35. *Wellington Resource Group LLC v. Beck Energy Corp.*, Case No. 2:12-CC-104, 2013 U.S. Dist. LEXIS 134838 (S.D. Ohio Sept. 20, 2013) ("*Wellington*").

36. See above, text accompanying notes 24-25.

37. Judge Marbley also premised his decision on his interpretation of House Bill 493, then under consideration by the Ohio General Assembly, which, among other things, would have given the Chief of the Division of Oil and Gas Resources Management of the Ohio Department of Natural Resources authority to regulate designated "land professionals." That Bill, which was introduced on March 27, 2012, was never brought to a vote and has not been reintroduced in the current legislative session.

38. These included *Detlor v. Holland*, 57 Ohio St. 492, 505, 49 N.E. 690, 693 (1898) ("The contract between the parties in this case was not a lease of the lands, but only a grant of the sole right to produce petroleum and natural gas for and during the term of ninety days from that date, and as much longer as oil or gas should be found, operated and produced in paying quantities"); *Herrington v. Wood*, 3 Ohio C.D. 475, 6 Ohio C.C. 326, 330 (3rd Cir. Ct. App. 1892) (An oil and gas lease "is 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"); and *Ohio Oil Co. v. Toledo, Findlay & Springfield R.R. Co.*, 2 Ohio C.D. 505, 4 Ohio C.C. 210, 215-216 (6th Cir. Ct. App. 1889) ("We have arrived at the conclusion that the right of the plaintiff Company under these leases is in the nature of an incorporeal hereditament; that, strictly speaking, it is not a right in the land as such, but a right to enter upon the land, to sink its wells, and to take from underneath the soil such oil as it may find--to take it from the land and to render a portion of it to the land owner, the remainder to become its own to dispose of as it sees fit"). Judge Marbley also cited several decisions from other states that consider oil and gas leasehold interests to be personal property, without discussing the law in the many other oil-and-gas producing states that regard them as real property.

39. *Wellington, supra*, at pp. 26.

40. ORC § 5301.56.

41. ORC § 5301.56(B) (emphasis added).

42. ORC § 5301.56(A)(3) (emphasis added).

43. ORC § 5301.56(A)((4).

44. Such a severance may be accomplished by a conveyance of such rights by the surface owner or by a reservation of such rights in a transfer to the surface owner.

45. *See, e.g., Gill v. Fletcher*, 74 Ohio St. 295, 302, 78 N.E. 433, 435 (1906); *Moore v. Indian Camp Coal Co.*, 75 Ohio St. 493, 499, 80 N.E. 6, 7 (1907); *Chartiers Oil Co. v. Curtiss*, 14 Ohio C.C. (n.s.) 593, 594, 24 Ohio C.D. 106 (5th Cir. Ct. App. 1911), *aff'd*, 88 Ohio St. 594, 106 N.E. 1053 (1913); and *Bath Twp. v. Raymond C. Firestone, Co.*, 140 Ohio App. 3d 252, 256-267, 747 N.E.2d 262, 265 (9th Dist. Ct. App. 2000).

46. *See* ORC § 5301.56(E).

47. ORC § 5301.56(B)(3)(b) (emphasis added).

48. ORC § 5301.09 (emphasis added).

49. ORC § 5301.09 (emphasis added). It should be noted that "[n]o such lease or license is valid until it is filed for record, except as between the parties thereto, *unless the person claiming thereunder is in actual and open possession*." ORC § 5301.09 (emphasis added). Presumably, this does ***not*** mean that, under such circumstances, an oil and gas lease need not satisfy the Stature of Frauds, *i.e.*, be in writing and signed by the lessor. *See* ORC § 1335.04. We have found no reported decisions that address the applicability of the Statute of Frauds to oil and gas leases.

50. ORC § 5301.332 (emphasis added).

51. ORC § 5301.01.

52. ORC Chapter 2711.

53. ORC § 2711.01(B)(1).

54. *Riggs v. Patriot Energy Partners, LLC*, 2014-Ohio-558, 2014 Ohio App. LEXIS 541 (7th Dist. Ct. App.

2014).

55. *Id.*, at ¶ 25.

56. ORC § 5303.01 (emphasis added).

57. *Black v. Sylvania Producing Co.*, 105 Ohio St. 346, 137 N.E. 904 (1922).

58. *Id.*, 105 Ohio St. at 350, 137 N.E. at 905 (emphasis added).

59. ORC § 5307.01 (emphasis added).

60. ORC § 1309.102(A)(6).

61. Official Comment 4(c) to UCC § 9-102 [ORC § 1309.102] (emphasis added).

62. ORC § 1309.102(A)(44)(a).

63. ORC § 1309.102(A)(44)(c) (emphasis added).

64. ORC § 1309.501(A)(1)(a).

65. ORC § 1309.502(B)(3).

66. ORC § 1302.03(A) (emphasis added).

67. Official Comment 1 to UCC § 2-107 [ORC § 1302.03] (emphasis added).

68. *McNamara v. Rittman*, 107 Ohio St. 3d 243, 838 N.E.2d 640 (2005) ("*McNamara*"). *McNamara* consolidated two (2) cases, *Hensley v. Columbus*, 102 Ohio St. 3d 1420, 807 N.E.2d 365 (2004), and *McNamara v. Rittman*, 102 Ohio St. 3d 1420, 807 N.E.2d 365 (2004), in which the same question of Ohio law was at issue.

69. *Frazier v. Brown*, 12 Ohio St. 294 (1861).

70. *Cline v. American Aggregates Corp.*, 15 Ohio St. 3d 384, 474 N.E.2d 324 (1984), *appeal after remand*, 64 Ohio App. 3d 503, 582 N.E.2d 1 (10th Dist. Ct. App. 1989), dismissed, 48 Ohio St. 3d 708, 550 N.E.2d 479 (1990) ("*Cline*").

71. *McNamara, supra*, 107 Ohio St. 3d at 246-247, 838 N.E.2d at 644-645 (emphasis in original).

72. *Id.*, 107 Ohio St. 3d at 249, 838 N.E.2d at 646 (emphasis added). The *McNamara* holding became part of the Ohio Constitution as a result of a 2008 amendment. The Ohio Constitution now provides: "A property owner has a property interest in the reasonable use of the ground water underlying the property owner's land." Oh. Const. Art. I, § 19b(C). Ohio has statutorily defined what constitutes reasonable use of water. That determination "depends upon a consideration of the interests of the person making the use, of any person harmed by the use, and of society as a whole." ORC § 1521.17(A). All of the following factors must be considered in determining whether a particular use of water is reasonable: (a) the purpose of the use;(b) the suitability of the use to the watercourse, lake, or aquifer; (c) the economic value of the use; (d) the social value of the use; (e) the extent and amount of the harm it causes; (f) the practicality of avoiding the harm by

adjusting the use or method of use of one person or the other; (g) the practicality of adjusting the quantity of water used by each person; (h) the protection of existing values of water uses, land, investments, and enterprises; and (i) the justice of requiring the user causing harm to bear the loss. ORC § 1521.17(B).

73. *Chance v. BP Chemicals, Inc.*, 77 Ohio St. 3d 17, 670 N.E.2d 985 (1996) ("Chance").

74. *Id.*, 77 Ohio St. 3d at 24-25, 670 N.E.2d at 991-992.

75. *Id.*, 77 Ohio St. 3d at 27, 670 N.E.2d at 993.

76. *Id.*, 77 Ohio St. 3d at 26, 670 N.E.2d at 992 (emphasis added).