Hupp v. Beck Energy Corp. Decision Overturned

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In a long-awaited opinion[1], the 7th District Court of Appeals has reversed and remanded the Monroe County Court of Common Pleas decision in *Hupp v. Beck Energy Corp*.[2]

The Monroe County Common Pleas Court was the first of several to grant summary judgment to holders of mineral rights finding that the oil and gas leases at issue in the litigation were *void ab initio* as a matter of public policy. Since the *Hupp* trial court decision was rendered, trial courts in at least four other cases[3] have granted summary judgment in favor of lessors adopting the *Hupp* trial court's reasoning. Additionally, the Common Pleas Court's judgment has led lessors to routinely include "the public policy" argument in newly filed lease-busting litigation. If the trial court decision continues to be followed by Ohio courts, it will render untold amounts of leases employing similar habendum and delay rental provisions void from the date of their execution. It is to be hoped that the analysis in the 7th District's well-reasoned Opinion will be persuasive to other Ohio trial and appellate courts and, ultimately, the Ohio Supreme Court should the Court render an opinion on the matter.

The following is a summary of the key holdings from the 7th District Court of Appeal's Opinion:

I. ***The oil and gas lease is not a perpetual, no-term lease.*** The Common Pleas Court held that the oil and gas leases[4] at issue were perpetual, no-term leases. The trial court construed the habendum clause and delay rental provision as permitting the leases to be extended in perpetuity by either: (1) payment of nominal delay rentals, or (2) a determination by the Lessee, in its sole judgment, that the premises is capable of producing oil or gas in paying quantities.[5]

The 7th District found this reasoning problematic for four reasons.

1

The habendum clause specifies a primary and secondary term. The 7th District concluded:

[T]he lease is not a no-term lease. The habendum clause of the Lease contains a primary term and secondary term: "This lease shall continue in force *** for a term of ten years and as much longer thereafter as oil or gas or their constituents are produced or are capable of being produced in paying quantities, in the judgment of the Lessee****."

As stated in *Am. Energy Serv. v. Lekan*, 75 Ohio App. 3d 205, 598 N.E.2d 1315 (5th Dist. 1992), the habendum clause is "two tiered." *"The first tier, or primary term, is of definite duration***. The second tier is of indefinite duration and operates to extend the Lessee's rights under the lease so long as the conditions of the secondary term are met." Id*. at 212.[6]

Applying those principles to the *Hupp* form lease, the 7th District held, "[t]he Form G&T 83 Lease is not a no-term lease; it has two distinct terms."[7]

2

The delay rental provision applies solely to the primary term. The 7th District clarified the application of delay rentals, stating:

[T]he trial court incorrectly concluded that Beck could extend the Lease in perpetuity by making a nominal delay rental payment. Under established case law, *once the primary term of the Lease expires, the delay rental provision is no longer applicable*. In order for the Lease to continue into the secondary term, "oil or gas or their constituents [must be] produced or [must be] capable of being produced on the premises in paying quantities, in the judgment of the Lessee***."[8]

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The 7th District rejected the trial court's analysis of the Pennsylvania decision, *Hite v. Falcon Partners*,[9] which the trial court heavily relied upon in reaching its conclusion that the delay rental provision allowed the Lease to be extended in perpetuity. The 7th District distinguished *Hite* stating that, unlike the *Hupp* leases: (1) the *Hite* lease actually *expressly permitted* the lease to continue in perpetuity as long as delay rentals were paid, (2) when the lessors filed suit, the primary term had expired and no production had occurred, and (3) the lessees contended they were not required to drill as long as rentals were paid.[10] The *Hupp* leases, on the other hand, were still in their primary term at the time the trial court rendered its decision, and Beck did not contend it was entitled to indefinitely defer drilling as long as it paid delay rentals.[11]

3

"Capable of production" refers to the well(s) located on the land, not the land itself. The 7th District rejected the trial court's interpretation of "capable of production," stating:

Here, the secondary term of the habendum clause does not allow an extension merely because the *land* is capable of production. The Landowners are incorrect that the Leases require no development activity whatsoever, ever, and may be extended indefinitely. The trial court incorrectly concluded that Beck could extend the Lease in perpetuity by interpreting the phrase "capable of production," in the secondary term of the habendum clause to mean the *land* is capable of producing. Instead, case law has interpreted the phrase as referring to whether a *well* is capable of producing. This interpretation presupposes that *a well was drilled and began producing* during the primary term of the lease, and continued producing into the secondary term. The secondary term would then continue *until such time as the well was no longer capable of producing*.[12]

4

The "judgment of the Lessee" requires good faith. The *Hupp* trial court concluded that the phrase "in the judgment of the Lessee" enabled Beck to continue the Lease in perpetuity, at its sole discretion. The 7th District reasoned:

[T]he trial court over-parsed the phrase. The phrase does leave it to the judgment of the Lessee to determine whether a well is in fact or capable of production in paying quantities. It would be contrary to the joint economic interest of both a landowner and the lessee to continue drilling if it was no longer feasible. Under these conditions, the lease would end and the lessee's interest in the mineral rights would expire; it would not continue in perpetuity.[13]

Such phrases do not "necessarily allow the lessee to arbitrarily determine whether a well is capable of production."[14] "Rather, courts generally impose a good faith standard on the paying quantities requirement, with or without this lease language."[15]

II. ***A delay rental provision applicable to the primary term precludes implied covenants.*** The trial court had concluded that the *Hupp* leases were subject to implied covenants, including an implied covenant to reasonably develop, based upon its interpretation of the Ohio Supreme Court holding in *Ionno v. Glen-Gery Corp*.[16] The 7th District, however, summarily rejected this interpretation, and distinguished *Ionno*:

> The *Ionno* Court focused on contractual language stating that the rental was an offset in the case of production—"an annual advance payment which is credited against future royalties"—to show that there was an implied covenant to reasonably develop.*** By contrast, here the rental is *not an offset but rather a substitute for drilling*.[17]

Because the rental at issue in *Ionno* was an *offset*, the *Ionno* court found that "the contract manifestly contained an implied covenant on the part of the lessees that they will work the land with ordinary diligence so that lessors may secure the actual consideration for the lease being the payment of royalty on mined minerals."[18] The delay rentals in the *Hupp* leases, on the other hand, were "separate and independent consideration for the right to delay drilling during the primary term of the Lease."[19]

Further, the 7th District noted that the *Ionno* implied covenant to reasonably develop will only be inferred "where a lease fails to contain any specific reference to the timeliness of development."[20] Thus, implication of a reasonable development covenant was appropriate where, unlike the *Hupp* leases, the *Ionno* lease truly was a no-term lease with no stated primary term in which major actions such as production were required.[21] This was not the case in *Hupp*.

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III. A general disclaimer of implied covenants disclaims implied covenants. The 7th District rejected the trial court's conclusion that the notice provision contained in the *Hupp* leases created an ambiguity that nullified the disclaimer of implied covenants. To this effect, the 7th District opined:

> [T]he fact that paragraph 17 requires *notice* of the lessor's belief that the lessee has violated an expressed or implied obligation does not necessarily *create* implied obligations. The purpose of that clause is to provide notice to the lessee to ensure that is has time to cure any alleged breaches. And assuming arguendo that the clause at paragraph 17 somehow supersedes the express proscription against the creation of the implied covenants in paragraph 19, the fact that there is a delay rental provision during the primary term would preclude the reading of any implied covenants into the Lease...[22]

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The 7th District refrained from considering whether the trial court erred in failing to enforce the notice provision or whether the trial court erred in declaring the leases forfeit, because those issues were rendered moot by virtue of the resolution of the issues discussed above.

The 7th District Court's Opinion generally comports with the majority view expressed in other states where oil and gas jurisprudence is more completely developed than in Ohio.

1. *Hupp v. Beck Energy Corp.*, 7th Dist. Monroe Nos. 12 MO 6, 13 MO 2, 13 MO 3, 13 MO 11, 2014-Ohio-4255 (September 26, 2014).
2. Monroe C.P. No. 2011-345, 2012 Ohio Misc. LEXIS 245 (July 12, 2012).
3. *Bohlen v. Anadarko E&P Onshore LLC*, Washington C.P. No. 13-OT-167 (March 27, 2014); *Bentley v. Beck Energy Corporation*, Belmont C.P. No. 11-CV-513 (September 16, 2013); *Oxford Oil Company v. West*, Belmont C.P. No. 11-CV-435 (September 16, 2013); and *Belmont Hills Country Club v. Beck Energy Corporation*, Belmont C.P. No. 11-CV-290 (July 8, 2013).
4. The 7th District refers to the numerous *Hupp* leases in the singular, as each lease was derived from a form with generally applicable standard provisions.
5. *See Hupp*, 2012 Ohio Misc. LEXIS 245, *13.
6. *Hupp*, 2014-Ohio-4255, ¶86 (emphasis added).
7. *Id.* at ¶90.
8. *Id.*. at ¶99 (emphasis added).
9. 13 A.3D 942 (Pa. Super. 2011).
10. *Hupp* at ¶¶95-97.
11. *Id.*
12. *Id.* at ¶101 (emphasis added).
13. *Id.* at ¶102.
14. *Id.*
15. *Id.* at ¶103.
16. 2 Ohio St.3d 131, 443 N.E.2d 504 (1983).
17. *Hupp*, 2014-Ohio-245 at ¶¶113-114 (emphasis in original).
18. *Id.* at ¶112, citing *Ionno* at 133-134.
19. *Id.* at ¶115.
20. *Id.* citing *Ionno* at 133.
21. *Id.*
22. *Id.* at ¶120.