2013 Ohio Oil and Gas Law Review

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This past year proved active for Ohio's oil and gas industry. We saw exploration and drilling operations increase substantially and migrate further south (there are currently 44 rigs operating in Ohio, and some operations have extended further south into Washington County). We also saw the first quarterly production report issued by the Division of Oil and Gas Resources Management ("Division"), showing strong production results for the third quarter of the year (33.6 Bcf of natural gas and 1.33 MMbbls of oil). And we saw significant midstream infrastructure growth throughout the year, including the opening of the Momentum processing and fractionation plant and the opening – and temporary closing – of Dominion's Natrium processing and fractionation plant right across the Ohio River near Natrium, W.Va.

But the activity hasn't been only on the operational side – there have been several substantial developments on the legal side of Ohio's oil and gas industry as well. To assist our clients and friends, we have summarized a number of those developments

Legislative Developments

Substitute House Bill 59 ("HB 59")

On June 30, Governor Kasich signed the biennial budget bill, HB 59, into law. The bill provides for the offsite regulation of brine and drill cuttings through a permitting process managed by the Chief of the Division. It becomes effective January 1, 2014, and there is – naturally – a permit application fee ($2,500). HB 59 also requires the owner of a horizontal well to file production statements quarterly rather than annually. Further, the bill mandates coordination between the Ohio Environmental Protection Agency ("EPA") and Department of Health to address the monitoring, transportation, handling and disposal of technologically enhanced naturally occurring radioactive material ("TENORM") and other materials from horizontal wells. Notably, by statute, drill cuttings are characterized as naturally occurring radioactive material ("NORM"), not TENORM. The Ohio EPA published draft guidance documents on the regulation of TENORM and other

non-TENORM materials in October and November of this past year.

Substitute House Bill 72 ("HB 72")

Signed by the Governor on October 31, 2013, HB 72 becomes effective January 29, 2014. HB 72 updates various provisions of the Ohio Revised Code ("ORC") concerning the management and recordkeeping practices of county recorders' offices. In addition, HB 72 adds a requirement that a lessor and/or surface owner record a "notice of failure to file" in connection with the statutory procedures used to (1) forfeit an oil and gas lease under Ohio's Oil and Gas Lease Forfeiture Statute and (2) abandon mineral interests to a surface owner under Ohio's Dormant Mineral Act ("DMA"). This was done to clarify the process for Ohio's county recorders and put the burden for recording mistakes on the parties seeking forfeiture and abandonment.

House Bill 375 ("HB 375")

HB 375 was introduced on December 4, 2013, and is currently assigned to the Ways and Means Committee. As introduced, the bill levies a new severance tax on oil and gas severed through use of a horizontal well, to be paid by the owner's net proceeds upon sale. HB 375 proposes to reduce the existing severance tax rate applicable to non-horizontal wells, and creates a tax credit for working interest and royalty holders. The bill has a proposed effective date of April 1, 2014. We anticipate further amendments in the upcoming months.

Judicial Developments

Oil and gas litigation has become a mainstay for many plaintiff/landowner attorneys in Ohio since the Utica play started. We are starting to see decisions out of Ohio state and federal courts, and thought we would report on several of them that you might find of interest.

Administrative Review. In January, the Ohio Supreme Court decided *Chesapeake Exploration, L.L.C. v. Oil and Gas Commission*,[1] holding that the Chief's issuance of a well permit does not constitute an "order" and, therefore, cannot be appealed to the Ohio Oil and Gas Commission. Although ORC 1509.36 generally confers appellate jurisdiction on the Oil and Gas Commission over appeals from orders of the Chief by persons adversely affected, ORC 1509.06(F) divests the Commission of appellate jurisdiction over the Chief's decisions to issue permits for wells. The Court issued a writ of prohibition to the Commission preventing review.

Regulatory Authority. One of the most significant appellate decisions of 2013 was *State ex rel. Morrison v. Beck Energy Corp.*,[2] holding that the Division has sole and exclusive authority under ORC 1509.02 to regulate oil and gas production operations in Ohio. The court held that Munroe Falls' drilling and zoning ordinances were in direct conflict with ORC 1509.02 and were therefore preempted by state law. The city was permitted to enforce its road right of way ordinances but not in a way that discriminated against, unfairly impeded, or obstructed oil and gas operations. The Ohio Supreme Court has accepted an appeal of the case. We will be arguing the appeal, currently scheduled for February 26, 2014.

Arbitration. In *New Hope Community Church et al. v. Patriot Energy Partners, LLC*,[3] the Seventh Appellate District held that plaintiff-property owners failed to demonstrate that an arbitration clause in an oil and gas lease was procedurally unconscionable and, therefore, the arbitration clause was valid. Although there was some evidence of unequal bargaining power, there was no evidence of duress or coercion by the landmen who procured the signing of the leases.

Consent-to-Assign. In *Harding et al. v. Viking International Resources Co., Inc.*,[4] lessors challenged a lease on the basis that the lessee violated its "consent to assign clause," requiring "mutual agreement of the parties in writing" prior to assignment. The court held that the *assignment* was "invalid" for failure to obtain the lessors' consent, but that the lease itself remained in effect.

Notary Requirements. In *Bailey v. Reserve Energy Exploration Co.*,[5] the court held that a defectively notarized oil and gas lease is fully enforceable as between the parties in the absence of fraud and does not become a tenancy at will. The court reasoned that an oil and gas lease "is more like a deed than a typical lease in that it conveys a vested, though limited, estate in the lands for the purposes named in the lease." Several state and federal trial courts similarly held this past year that a defectively acknowledged, or non-acknowledged oil and gas lease is not "void" as a matter of law, and is still effective as between the parties. *See Tomko v. Cobra Leasing, LLC*[6] and *Cole v. EV Properties, LP.*[7]

Indefinite Secondary Term. In *Oxford Oil Company v. Barry M. West et al.*, which is now pending before the Seventh Appellate District Court of Appeals,[8] the trial court held a lease was "void ab initio as being a lease in perpetuity" for failing to specify the duration of the secondary term. The lease's habendum clause provided that production in paying quantities was to be determined "in [the] sole opinion of Lessee." The court found that this language vested the lessee with too much discretion and created "a no-term lease" in violation of public policy. The same appellate court will consider a similar issue in *Hupp v. Beck Energy Corp.*[9]

Production in Paying Quantities. In *Cox v. Doris J. Kimble, dba Red Hill Development, et al,*[10] lessors challenged their oil and gas lease on several grounds, including forfeiture of the lease for failure to produce. The court held as a matter of law that because there was a producing well on the premises, the affidavit of forfeiture filed by the lessors pursuant to ORC 5301.332 did not forfeit the lease. In *Gardner v. The Oxford Oil Co.*[11] Oxford, the lessee, had drilled only one well on the property, and later sold the well to plaintiff, reserving the deep rights. The plaintiff used the well to provide gas to three commercial buildings, but no other operations were underway. The appellate court rejected Oxford's argument that the assignment was a separate agreement, and held that the deep rights were subject to the lease. Because plaintiff's use was not "production in paying quantities," the lease expired, and Oxford's interest in the deep rights expired with it.

Implied Covenants. In *Bilbaran Farm, Inc. v. Bakerwell Inc.*,[12] the court held that the implied covenant to develop the leased property was disclaimed by the following provision: "This lease contains all of the agreements and understandings of the Lessor and Lessee respecting the subject matter hereof and no implied covenants or obligations…have been made or relied upon by the Lessor or Lessee supplementing or modifying this Lease…".

Lease Validity. In Leggitt v. Chesapeake Exploration, L.L.C. et al.,[13] lessors challenged their oil and gas lease because the lessors signed the lease in their individual/personal capacities when they actually owned the property subject to the lease as trustees. In holding that the lease was valid, the court relied on agency law and reasoned that when the lessors executed the lease, the lessors were acting as agents for an undisclosed principal, the trusts, which specifically gave the lessors authority to administer trust property.

Dormant Minerals. Ohio's trial courts have addressed the DMA regarding a number of issues this past year, including the constitutionality and self-executing nature of the 1989 version of the DMA; whether certain instruments operate to preserve a severed mineral interest against abandonment (e.g., a surface conveyance that makes mention of a previously reserved mineral interest and an oil and gas lease that covers a severed mineral interest); as well as the requirements for preserving a severed mineral interest under the 2006 version of the DMA. In total, there were at least a dozen decisions construing the effects of the DMA. On January 2, 2014, the federal district court in *Chesapeake Exploration, L.L.C. v. Buell*[14] certified two questions of law concerning the DMA: (1) "Is the recorded lease of a severed subsurface mineral estate a title transaction under the [DMA]?" and (2) "Is the expiration of a recorded lease and the reversion of rights granted under that lease a title transaction that restarts the twenty-year forfeiture clock . . . at the time of the reversion?" We anticipate a decision later this year.

Lease Extensions. In *Eastham v. Chesapeake Appalachia, LLC*,[15] a federal court considered whether the lessee was permitted to extend an oil and gas lease under identical terms based upon a provision that read: "Upon the expiration of this lease and within sixty (60) days thereinafter, Lessor grants to the Lessee an option to extend or renew under similar terms a like lease." The lessor argued that the lessee did not have the unilateral option to renew the lease and instead had to negotiate any extension or renewal of the original lease at the conclusion of the primary term. The lessee argued that it had the option to either extend the original terms of the lease upon identical terms or renew a like lease under similar terms. The court held for the lessee.

Nature of a Lease. In *Wellington Resources Group, LLC v. Beck Energy Corp.*,[16] the court held that Ohio's "real estate broker" laws did not apply to a broker of oil and gas leases. The court reasoned: "Oil and gas leases are not 'real estate' under Ohio law."

Equitable Tolling. In *Yoskey v. Eric Petroleum Corp.*,[17] the court held that the doctrine of "equitable tolling" applied, tolling the primary term of the lease for the pendency of the litigation. Several other courts this past year have held the same.

Regulatory Developments

This past year saw a significant increase in the number of applications filed by operators to statutorily unitize areas for unit operation under ORC 1509.28. To make the process more uniform, on May 23, 2013, the Division published guidelines governing the filing of unitization applications and the conduct of the hearings. The number of applications was significantly higher than in years past, as operators filed more than a dozen unitization applications during 2013, leading to 10 hearings and the issuance of four orders approving unit operations (there were no orders rejecting a filed application).

Midstream regulatory activity included the issuance of new pipeline safety rules by the Public Utilities Commission of Ohio for pipelines moving gas from horizontal wells producing from the Point Pleasant, Utica or Marcellus formations. These rules track the requirements of S.B. 315, under which operators gathering gas from horizontal wells must design, construct and install gathering lines in accordance with federal pipeline safety regulations, as well as give pre- and post-construction notice to the Commission.

What We Anticipate in 2014

We anticipate that 2014 will bring resolution to some of the issues that remain unsettled, including legislation on severance tax, a decision from the Ohio Supreme Court in *Morrison*, and decisions from the appellate courts in both *West* and *Hupp* (you will recall that the trial courts in both of these cases found, wrongly in our view, that fairly common lease provisions worked to create perpetual leases that violate public policy, making the leases void *ab initio*).

We are also likely to see additional case law on land and leasing issues, including more decisions on the DMA and what constitutes production in paying quantities sufficient to hold a lease in Ohio. Royalty litigation, as well as mechanics' lien litigation, is also likely as more production comes on line and more development activity takes place.

Additionally, in the latter part of 2013, the Division began to draft several rule packages that we anticipate will be finalized in 2014 (possibly by the summer). They include new rules addressing the construction of horizontal well surface locations (including freshwater impoundments) and the construction, operation and maintenance of off-site waste storage, treatment and disposal facilities. In the meantime, the Division is implementing its oversight authority through guidance and permitting documents.

Both the Division and the Technical Advisory Council are also considering changes to Ohio's spacing rules for horizontal wells that would reduce spacing at the toe and the heel of a lateral, as well as possibly along the lateral's length. Currently, the mechanism for this change is a topic of debate. We expect further developments later this year.

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[1] *135 Ohio St. 3d 204, 2013-Ohio-224*

[2] *2013-Ohio-356 (9th Dist.)*

[3] *2013-Ohio-5882 (7th Dist.)*

[4] *2013-Ohio-5236 (4th Dist.)*

[5] *No. 12 CV 213 (Belmont Ct. Com. Pl. Sept. 27)*

[6] *Trumbull C.P. No. 2012 CV 1066*

[7] *No. 4:12CV1923, 2013 U.S. Dist. LEXIS 53921(N.D. Ohio)*

[8] *Case No. 13 BE 0031*

[9] *2011-345 (Monroe Ct. Com. Pls. July 12, 2012)*

[10] *No. 12-OG-301 (Guernsey Ct. Com. Pls. Aug. 5)*

[11] *2013-Ohio-5885 (7th Dist.)*

[12] *2013-Ohio-2487 (5th Dist.)*

[13] *2013 U.S. Dist. LEXIS 147392 (S.D. Ohio)*

[14] *No. 12-cv-916 (S.D. Ohio)*

[15] *2013 U.S. Dist. LEXIS 133476 (S.D. Ohio)*

[16] *2013 U.S. Dist. LEXIS 134838 (S.D. Ohio)*

[17] *Columbiana Cty. CP No. 2012 CV 808*