Ohio Supreme Court affirms Fourth District Court of Appeals, holds that lease did not terminate after energy companies failed to pay minimum annual rental fees

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Recently, the Ohio Supreme Court issued a ruling that an oil and gas lease in Washington County did not terminate when the energy companies failed to pay the minimum annual rental fees set by the lease. The primary issue before the Court was whether the Bohlens (lessors) have the right to terminate an oil and gas lease when energy companies (lessees) fail to make the minimum annual rental payments provided for in the lease.

The lease at issue was executed in February 2006. The habendum clause of the lease provides for a primary term of one year and a secondary term that is to continue for so long as oil and gas is capable of being produced in paying quantities. During the first year of the lease, the lessee drilled and completed two wells on the Bohlen property. Neither well has produced oil, and only one well has produced gas (and it only produced gas in 2007).

In 2013, the Bohlens filed a declaratory judgment action in Washington County for an order declaring the forfeiture of the lease. The trial court ordered the forfeiture. However, the Fourth District Court of Appeals reversed the trial court's ruling.

On appeal to the Ohio Supreme Court, the Bohlens argued that the lease contains two provisions that, when read together, require the forfeiture of the lease. The Court, however, disagreed.

General contract principles guide the interpretation of oil and gas leases

The Ohio Supreme Court began its decision by reemphasizing its prior holdings regarding the interpretation of oil and gas leases. Importantly, the Court held that oil and gas leases are contracts and are to be interpreted under traditional principles of contract law. As such, the plain language of a lease governs the resolution of an oil and gas dispute.

The plain language of the Bohlen lease requires the delay rental clause and the minimum annual rental provision to be read separately

The Court's primary holding in Bohlen relates to two provisions in the lease: (1) the delay rental clause and (2) the minimum annual rental provision. Both provisions are common to oil and gas leases.

Typically, an oil and gas lease will contain a delay rental clause to allow lessees to defer drilling a well on the property. Such clauses require lessees to make annual payments to the lessor for the privilege of delaying drilling. It also is typical for oil and gas leases to contain a minimum annual rental provision. Minimum annual rental provisions guarantee lessors a certain sum of money payable each year in lieu of royalties from actual production.

To delay commencement of a well under the Bohlen lease, the delay rental clause requires the lessees to pay the Bohlens $5,500 per year. The Bohlen delay rental provision also contains a termination clause, whereby, the lease becomes null and void if the lessees defer commencement of a well and fail to pay the $5,500 delay payment.

Once drilling operations commence, the minimum annual rental provision in the Bohlen lease requires the lessees to pay the

Bohlens at least $5,500 per year in royalty payments. If the annual royalty payments are less than $5,500, then the lessees must pay the difference.

According to the Bohlens, the delay rental clause and the minimum annual rental provision should be read together. When read together, the lease requires the lessees to pay the Bohlens at least $5,500 per year. If the lessees fail to pay $5,500, then the lease terminates as provided in the delay rental clause. Since 2008, the Bohlens have consistently received less than $5,500 per year. Thus, the Bohlens argued that the lease has terminated.

The Ohio Supreme Court disagreed. Instead, the Court held that the provisions must be read separately. In this case, because two wells were drilled during the primary term of the lease, the delay rental clause has not been invoked. Since the delay rental clause contains the only termination provision in the lease, the lease is still in effect.

The Court then noted that the lessees have failed to make the minimum annual rental payments during the secondary term of the lease. The minimum annual rental provision, however, does not contain a termination clause, so underpayment does not automatically terminate the lease. Whether the lessees have to compensate the Bohlens for that underpayment had not been raised to the Court, and, therefore, was not discussed.

The Court then distinguished Bohlen from Ohio cases in which a court has declared the forfeiture of an oil and gas lease for failure to make royalty payments. In such cases, the lease at issue contained an express termination provision in the habendum clause. That termination provision clearly demonstrated the parties' intent for the lease to terminate upon failure to make royalty payments. By contrast, in Bohlen, the only termination provision in the lease is in the delay rental clause, and the delay rental clause does not apply because the lease is now in its secondary term.

The lease is not void as against public policy

Under Ohio precedent, no-term perpetual leases are void as against public policy, because they allow a lessee to encumber property in perpetuity without ever developing the underlying minerals. Reading the delay rental clause and the minimum annual rental provision together, the Bohlens argued that their lease was a no-term perpetual lease that should be declared void as against public policy.

The Court disagreed. Importantly, as already discussed, the Court determined that the delay rental clause and the minimum annual rental provision are distinct clauses that should be read separately. The Court also reiterated its prior decisions, holding that a lease that limits delay rental payments to the primary term of the lease is sufficiently constrained so as to avoid concerns associated with no-term perpetual leases.

Thus, the Court provided three central takeaways. First, oil and gas leases will be interpreted using traditional principles of contract law. Second, a termination clause will only be invoked if the lease clearly demonstrates the parties' intention to terminate the lease on those grounds. And, finally, leases with a limited habendum clause do not violate public policy for indefinitely delaying mineral development.

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