THE OHIO SUPREME COURT REFUSES TO IMPOSE AN INDEPENDENT DUTY ON OIL AND GAS OPERATORS TO DEVELOP DEEPER STRATA

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With the advent of hydraulic fracturing and horizontal drilling technology, many operators have been able to access "deeper" strata, such as the Marcellus and Utica formations, to extract large reserves of oil and gas. In many instances, however, extracting gas from these deeper formations may not be reasonably prudent, for example, because of the current market conditions, accessibility to pipelines to transport gas, and anticipated profits and costs of production. Disregarding these considerations, some landowners have argued that an operator has an implied duty to "explore further," and must develop all strata of gas without condition or else risk breaching and potentially forfeiting the leases.

Against this backdrop and in a matter of first impression, the Ohio Supreme Court recently held that such an implied covenant to explore further in oil and gas leases is not recognized in Ohio. [1] In Alford v. Collins-McGregor Operating Co., the Court found that the interests of both parties to a lease are sufficiently protected by the already recognized implied covenant of reasonable development, which simply imposes the traditional "prudent operator" standard. [2] Ohio law makes clear that there is no additional and independent duty to develop all strata of gas.

As further detailed below, Alford is significant for lease operators in the newfound era of deep strata production, as operators are not required to produce if development is not reasonable.

CASE BACKGROUND

The oil and gas lease in Alford was entered into in 1980 between certain landowners and an operator to permit oil and gas production on 74 acres of property in Washington County, Ohio. [3] Importantly, the lease did not disclaim any implied covenants and did not require a particular number of wells or production from a particular depth. [4] The operator drilled a well in 1981 and produced gas in paying quantities from the shallow Gordon Sand on an uninterrupted basis. [5] No oil and gas was produced from any of the formations below the Gordon Sand. [6]

Nearly 35 years later, in 2015, upon discovering that neighboring properties had been producing oil and gas from other strata, such as the Marcellus and Utica formations, [7] the landowners brought a claim against the operator seeking partial termination of the lease, alleging "horizontal forfeiture." [8] The landowners requested the Court to deem the lease forfeited as to all strata below the Gordon Sand formation, claiming that the operator had an

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obligation to explore further by drilling below the Gordon Sand formation into deeper, and potentially more profitable, strata. [9]

In response, the operator moved to dismiss the complaint for failure to state a claim, asserting that horizontal forfeiture is not recognized as a form of relief in Ohio. [10] The trial court agreed with the operator and dismissed the case. [11] On appeal, the Fourth District Court of Appeals affirmed and the landowners appealed to the Ohio Supreme Court. [12]

In a matter of first impression, the Ohio Supreme Court addressed "whether the [l]andowners' claim for breach of the implied covenant to explore further is cognizable in Ohio, and if so, the availability of partial horizontal forfeiture as a remedy." [13] The Court held that "there is no implied covenant to explore further separate and apart from the implied covenant of reasonable development." [14] Finding in favor of the operator, the Court relied heavily on a decision from the Oklahoma Supreme Court in holding that a "separate implied covenant to explore further would not support the overarching purpose of an oil and gas lease." [15] Rejecting the landowners' proposition that the implied covenant to explore further would "support the purpose of the lease" by exploring other strata for mutual party benefit, the Court explained that the implied covenant of reasonable development already protects the interests of both parties, because it accounts for the mutual interests of both the landowner and operator to maximize efficiency and profits. [16]

Notably, in holding that the implied covenant to explore further does not exist in Ohio, the Court declined to address the availability of horizontal forfeiture as a remedy for breach of any implied covenant. [17]

KEY TAKEAWAYS

The Ohio Supreme Court's decision in Alford is significant for three reasons.

First, the Court reaffirmed the longstanding proposition that oil and gas leases are contracts, and therefore, the terms of the lease agreement control. [18] As a result, a party is able to effectively disclaim all implied covenants, including the implied covenant of reasonable development, through a general disclaimer of all covenants. [19] The lease in Alford, however, failed to include any type of disclaimer, which subjected it to the implied covenant of reasonable development. [20]

Second, the Court declined to recognize the landowners' proposition that operators are bound to an implied covenant to explore further. [21] The holding of Alford is significant for oil and gas operators, considering the recent development of deep strata formations in the Appalachian Basin, such as the Marcellus and Utica. An implied covenant to explore further could have potentially placed an undue burden on operators to develop multiple strata of gas, even if such a development strategy was not prudent, timely, or profitable. [22]

Third, the Court declined to recognize an implied covenant to explore further because it found that the already recognized implied covenant of reasonable development sufficiently balances the interests of both parties to the lease. [23] The Court made clear that, as long as it is not disclaimed, the implied covenant of reasonable development requires an operator "to act as a reasonably prudent operator would as it develops the land under the lease." [24] Acting as a "reasonably prudent operator" includes taking into consideration "all facts and circumstances relevant to development, whether they relate to exploration…or some other aspect of development." [25] To that end, the Court noted "[w]hether the [operator] has breached the implied covenant of

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reasonable development should be determined by the facts and circumstances of each particular case." [26] Some of the factors a "reasonably prudent operator" should consider are:

[t]he depletion of the reservoir and the price for which the [operator] is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the [operator] is holding the lease merely for speculative purposes. [27]

The Court explained that "[r]ecognizing a separate implied covenant to explore further would prove unhelpful at best, as it would focus on just a small subset of factors relevant to the overall profitability of development." [28]

CONCLUSION

As a result of Alford, Ohio landowners cannot construe the terms of their lease to compel operators to drill strata if such development is not economically or practically feasible. If not disclaimed, the implied covenant of reasonable development sufficiently protects both parties by requiring the operator to act as any reasonably prudent operator would in determining what strata can or cannot be drilled for production. Therefore, a separate covenant to explore further is neither recognized nor necessary in Ohio.

Notes:

[1] Alford v. Collins-McGregor Operating Co., No. 2016–1281, 2018 WL 321611, at *4 (Ohio Jan. 3, 2018).
[2] Id.
[3] Id. at *1.
[4] Id.
[5] Id.
[6] Id.
[7] Id. at *1-2.
[8] Id. at *2.
[9] Id.
[10] Id. at *2.
[11] Id.
[12] Id.
[13] Id. at *1.
[14] Id. at *5.
[15] Id. at *4.
[16] Id. at *3.
[17] Id. at *1, *5.
[18] Id. at *2.
[19] Id. at *3.
[20] Id.
[21] Id. at *1, *5.
[22] Notably, the decision in Alford is consistent with what courts in Pennsylvania (another Appalachian Basin state) have concluded. See, e.g., Delmas Ray Burkett, II Revocable Trust ex rel. Burkett v. Exco Resources (PA),

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LLC, No. 2:11–cv–1394, 2014 WL 585884, at *7 (W.D. Pa. Feb. 14, 2014) ("declin[ing] to conclude that Pennsylvania law provides for an implied duty to economically exploit 'all strata' of gas."); Caldwell v. Kriebel Resources Co., LLC, 72 A.3d 611, 615 (Pa. Super. Ct. 2013) (finding that there is no implied covenant to economically exploit "all strata" of gas.).
[23] Alford, 2018 WL 321611, at *4.
[24] Id.
[25] Id.
[26] Id.
[27] See Heath v. Dellich, No. 239 WDA 2016, 2016 WL 7232426, at *15 (Pa. Super. Ct. Dec. 13, 2016) (quoting Clifton v. Koontz, 325 S.W.2d 684, 691 (Tex. 1959)).
[28] Alford, 2018 WL 321611, at *4.

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