Oil & Gas Operations & the Real Estate Title Industry

Description

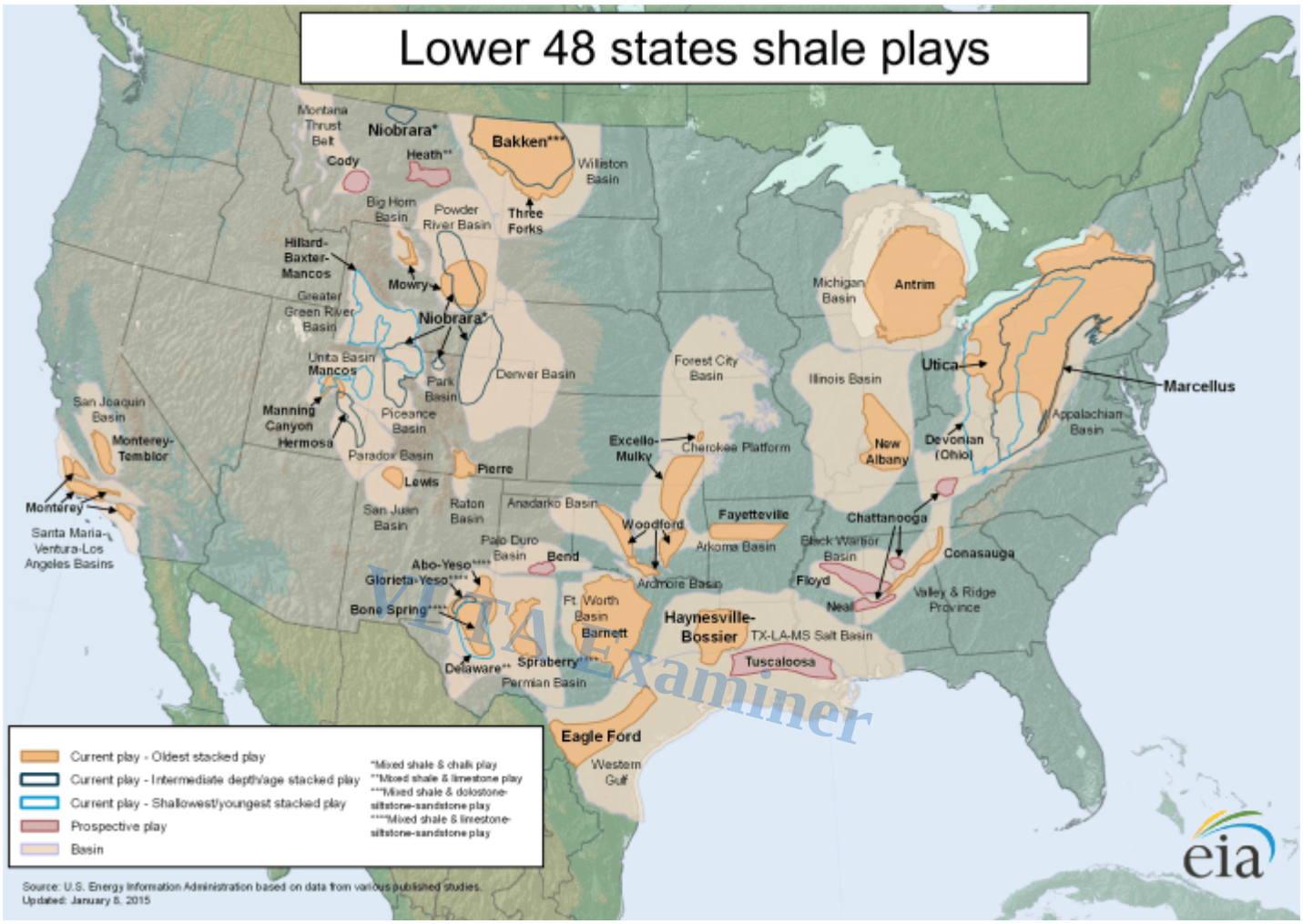
Market forces have driven down the price of fossil fuels and minerals; nowhere is this more evident than the price at the gas pump. However, the depressed prices permeate throughout business and industry, from power plants to airplane fuels to anything that uses energy. Oil and gas companies have suffered the most because lost or decreased profits have â??shutteredâ?• exploration and extraction. The industry has seen its share of bankruptcies, mergers, and takeovers.

Still, no one realistically expects the downturn to be indefinite. When prices begin to rise to a point that it becomes profitable for industry to go back below ground, the need for title work will also recur. Oil and gas titles resemble normal residential or commercial searches only to the extent that both examine the â??surfaceâ?• of the land; however, oil and gas titles go much farther back, and also include two other distinct chainsâ??the ownership of the subsurface minerals and the mineral leasehold. Following is a brief discussion of the oil and gas title industry.

Overview

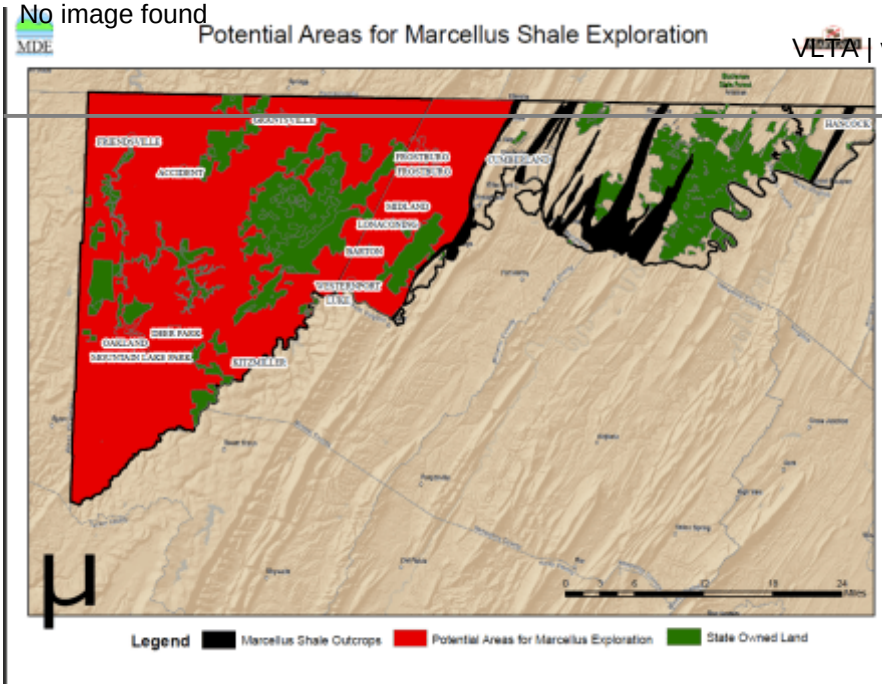
Oil and gas development in the United States dates back to the mid-19th century, although attempts to retrieve the minerals began much earlier. William Hart dug a well 27 feet deep in Fredonia, New York, to try to obtain a greater flow of gas from the stream in which he noticed gas bubbles rising to the surface. Then in 1859, Edwin Drake drilled the first commercially feasible well in Pennsylvania; â??Drakeâ??s wellâ?• is not only maintained as an historic site, but is generally considered to be the minimal starting point for title searches of oil and gas ownership.

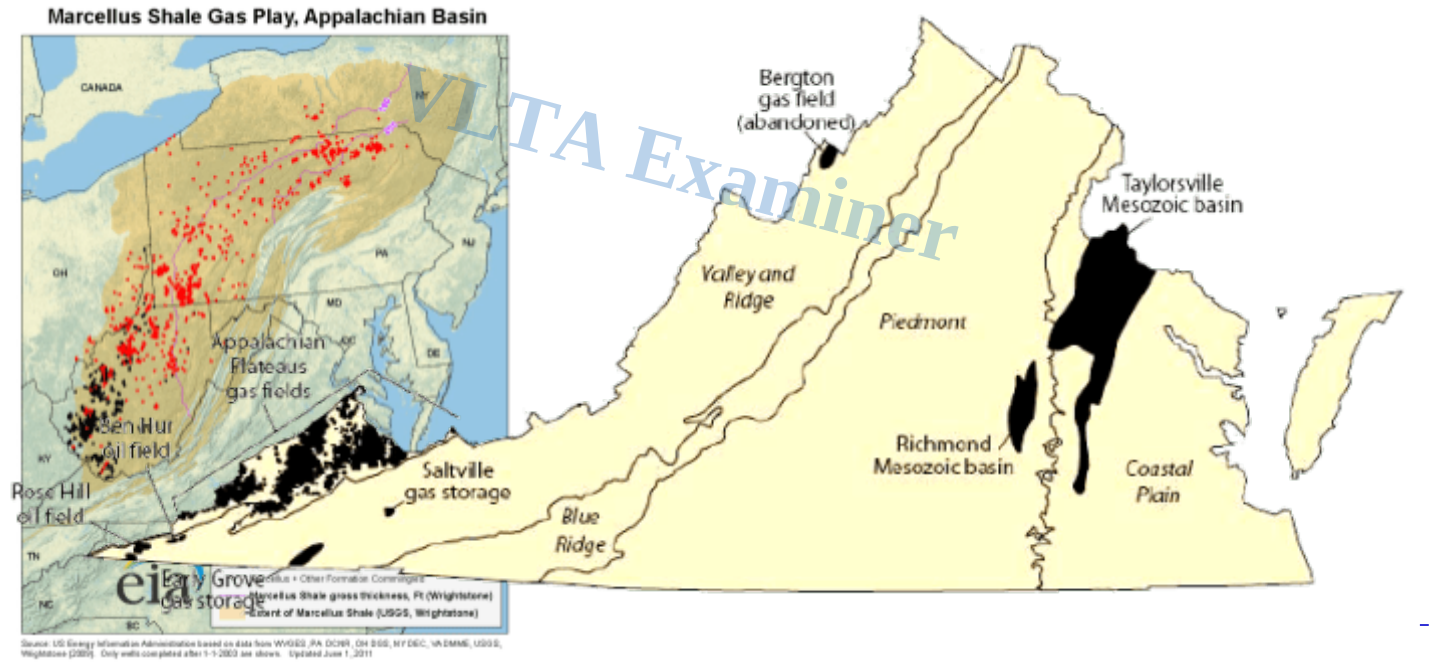
For over a century, oil and gas wells were drilled vertically from the pad site to extract whatever minerals could be reached by those methods using the equipment of the day. By the mid 1980s, technology had advanced to the point that horizontal drilling was not only possible, it became more efficient and less expensive than multiple vertical wells. Cement around steel casings allows deeper wells, providing access to natural gas trapped in shale formations. Well-known formations in the east include the Marcellus, Utica, and Huron; in addition, the Taylorsville formation in the Fredericksburg area holds some promise.



The Marcellus extends through Maryland, Virginia, and West Virginia, but the depths at which it is found varies with the terrain. (Average depth of the Marcellus is approximately 8,000 feet.)

A comprehensive history of the natural gas industry may be found at naturalgas.org.





Source: http://www.virginiaplaces.org/geology/naturalgasresources.html

Statutory provisions relevant to mineral lands

State statutes generally regulate the industry of gas and oil production, but for the most part, do not legislate the relationship between the mineral owner and the producer. One notable exception is West Virginia Code Â§22-6-8, prohibiting â??flat-rateâ?• leases and mandating a minimum royalty of 1/8 for all oil and gas production.

State statutes do address such topics as spacing of wells, pooling and/or unitization, permits and permitting, land use and remediation upon plugging and abandonment of wells.

Virginia

The Virginia Oil and Gas Act is codified in the Code of Virginia, 1950, as amended, in Title 45.1, Chapter 22.1 (Â§45.1-361.1, et seq.)

Maryland

The Maryland Gas and Oil statutes are in the Annotated Code of Maryland, Title 14, Gas and Oil (Â§14-101, et seq.)

West Virginia

West Virginia statutes on minerals (including coal) are found in the West Virginia Code, Chapter 22, Article 1, et seq. (Â§22-1-1, et seq.) Chapters 22-A, 22-B, and 22-C also address certain aspects of mineral production.

Native American Lands and Other Federal Lands

The topic of minerals underlying Native American lands is too extensive for a comprehensive treatment here. Reservations and individual allotments are held by the federal government in trust for the Native Americans who live on the reservations, and for the Native American individual allottees and their descendants.

Federal lands are either â??acquired landsâ?• (held in fee by the government, acquired by purchase, gift, exchange, or eminent domain), or â??public landsâ?• (held by the government in trust for the benefit of every citizen of the U.S.).

Title Issues

The ownership of subsurface minerals is a real property right separate and apart from the ownership of the surface. After the extraction of oil and gas began in the mid-19th century, property owners began to realize the value of the minerals, and would frequently sell the surface but keep the rights to whatever was below the surface. For this reason, an oil and gas search should carry the title back to at least 1859 (Drakeâ??s Well), if not to the patent. Title opinions should strictly define the scope of the search, including a disclaimer if the records are insufficient to cover a long enough time frame.

An oil and gas search starts like a residential or commercial search, but then it goes back much farther. The abstracter will begin with the current owner and create the chain back to the mid-19th century, and then bring the chain owners forward. If there is no reservation, sale, or lease of mineral rights, the title will have a familiar look; itâ??s the severance of minerals that makes an oil and gas title different.

â??The party of the first part hereby reserves a one-half interest in the oil, gas, coal, and other minerals within and underlying the property conveyed hereby.â?• [Note that fractional interests may be reserved.] This severance of the minerals from the surface begins a second chain of title that similarly must be brought forward to date. As has been stated, mineral ownership is an interest in real property, and may be sold or devised, or may pass by intestate succession. In Virginia and West Virginia, if the

minerals are owned separately from the surface, each interest is subject to taxation, and therefore subject to delinquency and sale for non-payment.

Itâ??s not uncommon that the chain of title of the mineral owner will end not long after its creation by reservation. Maybe a neighborâ??s land had sprouted a working oil well, and the owner of the subject tract had hopes of being next; when those hopes donâ??t materialize, the owner of the minerals forgets he has them. Generations later, the trail has gotten cold, and the heirs of the original owners are unknown by name and location. Solving this riddle will almost certainly require the intervention of the courts in a quiet title action.

Older deeds may have contained language purporting to reserve the royalty in the oil and gas: â??The party of the first part reserves unto itself one-half the royalty in the oil and gas underlying the property herein conveyed.â• In the West Virginia of a century ago, money from royalty was considered as, and used interchangeably with, ownership of the oil and gas in place. Thus, up until about the late 1920s or so, a reservation of royalty was deemed to be a reservation of the ownership of the oil and gas. That said, though, the language of reservation was crucial, and there have been numerous cases and analyses; for example, a reservation of â??one-half the royalty from the oil and gas *when produced* [emphasis added]â• has been considered a reservation of money only. However, a reservation of a 1/16 royalty in the first quarter of the 20th century has been determined to be a reservation of the ownership of Â½ the oil and gas, because the typical royalty was 1/8 (1/16 being Â½ of the 1/8 royalty).

Other aspects of reservations have been the subject of court cases in mineral states. In Pennsylvania, the â??Dunham Ruleâ?• states that a reservation of â??mineralsâ?• does not include oil and gas; oil and gas must be reserved specifically. Various states have decided their versions of a â??Duhig Rule,â?• that a reservation of Â½ the oil and gas, where the other Â½ is owned by others, may actually reserve nothing to the grantor.

The aspects of ownership may be further severed. For example, the owner of the oil and gas may grant the executive right to lease the minerals; this would, say, give the surface owner some control over the number and location of well sites on the land. (A holder of leasing rights may be liable to the mineral owner for waste if the leasing rights holder fails to enter into leases that would pay a royalty to the mineral owner.)

Oil and gas typically are leased together for development and extraction, but they, too, can be severed, with the oil being sold or leased to one entity and the gas to another. Other mineralsâ??coal, coalbed methane, etc.â??are beyond the subject of this material.

One issue that may cause complications to mineral owners is a mortgage of the surface that does not exclude the minerals from the lien. Even though â??you canâ??t transfer what you donâ??t own,â?• if a lender *thinks* it has a lien on the entire property, it may sell the property after foreclosure without exception for the oil and gas. (Keep in mind that the usual residential title searchâ??60 yearsâ??may not reveal the separate ownership.)

Federal lands: Title searches of federal lands must be done at the regional office of the Bureau of Land Management. The office for the Eastern States is located in Washington, D.C.
http://www.glorecords.blm.gov/default.aspx

Native American lands: Titles are searched at the local level, in the Land Titles and Records Office of the Division of Land Titles and Records of the BIA.

In areas where severance of minerals is common, title insurance for a typical residential or commercial transaction will cover only the surface. The legal description of the property to be insured will begin â??The surface ofâ?¦â?• Even if a special exception isnâ??t added to Schedule B, the insured will not have rights in the subsurface minerals (although a special exception is probably still a good idea, especially if an ALTA 9 is to be issued).

The ALTA 9 endorsement series contains a version that insures against loss or damage to an improvement located on the land resulting from the future exercise of the surface for the extraction of minerals. However, the endorsement does not cover damage from â??contamination, explosion, fire, fracturing, vibration, earthquake or subsidenceâ?¦â?• nor from the negligence of any person exercising the right of extraction.

The ALTA 35 endorsement series insures against loss resulting from the forced removal of any structure in order to exercise a right of mineral development.

Mineral Leases

Leases for the extraction of minerals are similar to leases of other real property; the essential elements remain the same. There must be a lessor, a lessee, specific property, consideration, and a term. (Older leases described the property by volume and the adjoining landowners; newer leases describe the property by tax parcel identification.)

In addition to a royalty for all minerals extracted, oil and gas leases will usually be â??paid up,â?• a fee per acre in advance for the lesseeâ??s operationsâ??even if the operations are unsuccessful. The actual royalty is, of course, negotiable, although the most common is 1/8. Higher royalties are common, whether based on negotiation or standard practice in the area.

The primary term of an oil and gas lease can be anything from a matter of months to years, but it is the secondary term that is most important to oil and gas operators. â??This lease shall be in effect for the primary term of 3 years, and as much longer thereafter as oil and gas is found in paying quantities or operations continue in the search for oil and gas.â?• Language such as this assures the operator that it may continue its profitable extraction as long as the minerals can be removed, and the lease is thus â??held by production.â?• The secondary term may also provide that the lease will continue if the land is used for the subsurface storage of gas. In oil- and gas-rich areas, leases from the late 19th century may still be valid, held by continuous production.

Other terms may be included in the lease as agreed, as with commercial leases of real property. The primary term may be preserved by the lessee by the payment of â??delay rentalsâ?• to the lessor, until such time as a producing well can be drilled. If a well in production fails to produce sufficient quantities, the lessor may â??shut inâ?• the well and pay fees to the lessor to continue the lease. The depth to which the lessee may drill may be specified: â??from the surface to a depth of 5,000 feet,â?• â??from the surface to the top of the Onondaga formation,â?• etc. Thus, it is possible that there may be 2 valid leases on the same property, distinguished by the depth to which each lessee may operate. A lease may also include a â??Pugh clauseâ?• which provides that at the end of the primary term, the lessee

may only hold a fraction of the leased property by productionâ??for example, 60 acres around any well drilled on the land.

With the advent of horizontal drilling (hydraulic fracturing), the right to pool and/or unitize tracts becomes an important term. Because a single well pad can extend drilling legs for miles beneath the surface, the joinder of adjacent tracts becomes economically and environmentally efficient. A lessee operating under an older lease will obtain a modification to include a pooling clause.

Most states allow mineral operations on property even if not all of the mineral owners execute a lease or leases. In such cases, the lessee is obligated to preserve and/or pay over the proportionate share of the royalties to all mineral owners. In West Virginia, however, all owners must have executed a lease before the lessee can begin operations.

Lessees can, and often do, assign all or part of the lease to other operators. (â?? Assignor hereby assigns to Assignee a 50% working interest in the lease of record in _____â?¦â?•) Consideration for an assignment may be a single flat payment, a reservation of a fractional royalty (an â??overriding royalty interest,â?• or â??ORRIâ?•), or both. A lessee with an unrestricted depth lease may assign all rights in a certain depth, retaining the rest. (â??Assignor hereby assigns to Assignee all right, title, and interest in the lease recorded in _____ from the surface of the Subject Property to a depth of 5,000 feetâ?¦â?•)

Although assignments should be recorded, state statutes do not require it.

Title opinions for oil and gas operators may take the form of a due diligence report, a preliminary drilling opinion, or a full drilling opinion, depending on the need at the time. Because of the risk involved, drilling opinions must be comprehensive and address not only ownership of the oil and gas (and surface, if requested), but also present leases, prior leases, easements, rights of way, liens, and taxes. The opinion should include a complete chain of title of not only the ownership, but also the leasehold. The opinion should also include appropriate limitations and disclaimers, and itemize specific defects, identifying those that require action and those that are for information only. Most oil and gas operators will proscribe a form and format they require for these opinions, which may run to over 100 pages. Once submitted, the opinion letter will be reviewed by the operatorâ??s landmen, which may result in requests for additional information.

Insuring Minerals and Mineral Rights (a wish list)

Title insurance companies have long been reluctant to insure oil and gas leases. In non-rating bureau states, the reason for not offering title insurance on oil and gas leases has traditionally been the risk associated with such a policy; still, as long as the policy doesnâ??t insure production, it is the opinion of the author that the risk is no greater than insuring any other lease, and may, in fact, be less. (Consider that a typical search for a commercial lease is only 60 years while an oil and gas search takes the title back to the mid-19th century.) One ancillary problem may be the amount of coverage; unlike a commercial lease, the value of the lease is difficult to determine. However, one should never confuse the unlikely with the impossible, as Wodehouseâ??s Psmith was wont to say. The amount of coverage may be determined by the assessment of the property, or even just by the request of the insured.

Because oil and gas searches donâ??t at present result in issuance of title insurance policies, the searches are usually delivered to attorneys to create opinion letters. The search itself is time-consuming and tedious, requiring some specialized training to complete. However, when the industry recovers, oil and gas title work can be lucrative.

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Steve Gregory provides underwriting support for WFG agents in West Virginia and serves as a secondary underwriting resource in Virginia. Over the course of his 35 year career, he has served with one of the nationâ??s largest underwriters for ten years in both a state manager and underwriting counsel role. He has also practiced law extensively in the private sector, including five years with Steptoe & Johnson in Charleston, West Virginia. Gregory works with the West Virginia Department of Transportation as well as Legal Aid of West Virginia. He earned his J.D. from George Mason University, and his bachelorâ??s degree from the University of Virginia.

Category

1. Underwriting

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