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A PRACTITIONER'S PERSPECTIVE ON EMERGING LEGAL TRENDS

# Potential Pitfalls for Lawyers Practicing in Fracking and Oil Rights

The Marcellus Shale is a sedimentary rock formation submerged thousands of feet beneath the Earth's surface through much of the Appalachian basin, although most prevalent in New York, Ohio, Pennsylvania and West Virginia.[1] The existence of vast deposits of natural gas underlying northern Appalachia has been known for over 100 years. In fact, since as early as the late 1800s, property owners in the Marcellus Shale region have been severing natural gas and related royalty rights from the surface of their properties in hopes of future exploration.

The recent development of horizontal drilling and hydro-fracking technology has allowed natural gas explorers to reach depths thousands of feet beneath the surface and economically extract vast amounts of natural gas in the Marcellus Shale region. Armed with these technological capabilities, oil and natural gas companies have aggressively pursued the acquisition of properties and natural gas rights in the Marcellus Shale region. The sudden interest in ownership of oil and gas rights is directly related to the rise of gas drilling companies' interests in drilling and extracting the natural gas found in the Marcellus Shale. Gas drilling companies obtain their rights to explore, drill and extract oil and natural gas by entering into oil and gas leases with the owners of such rights.

Unfortunately, this rapid proliferation of property transactions in the Marcellus Shale region has also brought about a rash of legal malpractice claims brought against attorneys accused of failing to adequately protect their clients' property interests in the acquisition, sale and lease of properties with potential natural gas production capabilities. Many of these claims have been brought against attorneys who did not have an understanding of oil and gas rights or the complexities involved in calculating fracking royalties. While many of these attorneys/defendants had extensive land use and real estate experience, they found themselves ill-equipped and overwhelmed when negotiating with the oil and natural gas drillers' team of savvy and dedicated land use attorneys.

An attorney must always be cognizant in any type of real estate transaction of potential legal malpractice exposure. An action for legal malpractice may be brought in either contract or tort. Generally, the elements of a legal malpractice action, based in negligence, include employment of the attorney which creates a duty of care; failure of the attorney to exercise ordinary skill and knowledge, thus causing a breach of the duty of care; and causally relating the failure or breach of duty to the plaintiff's harm. A legal malpractice case, based on a breach of contract claim, is created when the attorney accepts for a fee to represent a client with competent professional services consistent with those expected from his profession. In real estate transactions, the areas that may create legal pitfalls for attorneys are conflict of interest, inadequate/improper descriptions, inadequate title opinions, and, most recently, inadequate advice and assessment of ownership and benefits arising from the issue of subsurface rights to oil and gas deposits.

## Purchase and Sale of Oil and Gas Properties

In most cases, the owners of severed oil and gas (and related royalty) rights that were deeded decades ago either were not aware they owned them or did not appreciate their value. These long-forgotten oil and gas (and royalty) rights have been transferred by will or operation of law to each generation's heirs for decades. In some cases, a 50% reservation of oil and gas rights might be owned by hundreds of individuals who have no idea anyone in their family ever owned property in the Marcellus Shale region.

One of the most overlooked due diligence activities in real estate transactions involving oil and gas properties is performing an oil and gas title search. It is common practice for a real estate attorney to order a 60-year title search for a client who is buying property; however, when your client is buying or selling oil and gas rights, it is best practice to carefully review an oil and gas title search for these decades old reservations. An oil and gas title search is a search of the land records in the county where the property is located which searches title at least 150 years back. Although title insurance is not available to insure oil and gas rights, a careful review of all documents in the chain of title is imperative to determine if the seller actually owns the oil and gas rights they are proposing to sell.

1 Although this article concentrates on the Marcellus Shale Region, the information provided is applicable to various regions of the United States involved with drilling and fracking of oil and gas deposits.

When reviewing an oil and gas title search, it is essential to review each document in the chain of title for any severance of oil, natural gas, or monetary rights (the right to receive royalty monies) from the fee interest in the property. The majority of states interpret the express grant or reservation of "minerals" to include oil and natural gas rights. However, in Pennsylvania, the use of the word "minerals" is generally not sufficient to sever "oil and gas" rights from the surface of a property.[2] The specific words "oil" and/or "gas" must be used.[3]

For an attorney representing the seller of oil and gas rights, knowing what your seller owns and will be warranting in the deed cannot be underestimated. Most landowners have never reviewed title to their property and should not be 100% confident that they own the oil and gas rights they are selling. A seller that warrants title in a deed transferring oil and gas rights that he does not own is exposed to significant liability. As such, an oil and gas title search performed on behalf of a seller and buyer in preparation for a sale will protect not only the client's exposure to liability, but the attorney's exposure, as well.

## The Oil and Gas Lease

Landowners throughout the Marcellus Shale region have been inundated with offers from land companies hired by the oil and gas drillers to purchase leases for them. During one period, demand for leases in Northeastern Pennsylvania was so high that people were calling it "the Gold Rush".[4] Bonus money in excess of $6,000 per acre was paid by oil and gas companies in exchange for an oil and gas lease.

Many terms of an oil and gas lease may appear to resemble terms found in other land-use leases and contracts; however, attorneys must beware that these "lease" provisions are not always what they appear. The prime example of a deceiving provision of an oil and gas lease is the "term" provision. On its face, the term provision of an oil and gas lease may seem straightforward. For instance, a landowner may be presented with a lease with what appears to be a five-year term[5], after which time a typical lease would expire and all parties would be released from all lease obligations. This is not the case with an oil and gas lease. The date an oil and gas lease is executed is also the start of the "primary term" of the oil and gas lease. The primary term ends on the earlier of the end of the stated term (i.e. five years), or the date "operations" commence on the leased property. Each lease is a bit different in how it defines "operations" and some leases do not use this exact term. Generally "operations" includes activities such as inclusion of the property in a drilling unit and always includes the start of production of oil or gas from the leased property. If operations on the leased property commence, an oil and gas lease automatically enters what is known as the "secondary term." The secondary term of an oil and gas lease only ends when "operations" on the property end, which usually occurs when the well is plugged and the property's surface has been fully remediated. Marcellus Shale wells are anticipated to produce for over 50 years – meaning the terms negotiated in oil and gas leases today could survive for two generations.

The oil and gas lease provisions addressing the deduction of post-production costs from royalty payments has been the subject of much controversy and class-action litigation in both West Virginia and Pennsylvania. On its face, a deduction provision may appear to prohibit any deductions of post-production costs such as dehydration, compression, transportation and marketing from a landowner's royalty payments. However, a careful attorney will recognize that the concept of permitting deductions for "market enhancement"[6] activities can cause a significant reduction in royalty payments to a landowner.

## Wealth Preservation and Future Planning

The net result of many of these oil and gas leases has been a tremendous influx of new revenue for landowners. It is not uncommon for an individual who has a significant amount of land under an oil and gas lease to generate over $100,000.00 per month from royalty payments. For many people these monthly royalty payments are more money than they have ever previously earned from their daily jobs. As such, it is important to counsel your client on the best tax structure to ensure preservation of their new wealth (Family Limited Partnerships, Irrevocable Trusts and Limited Liability Companies). This may require a coordinated effort of tax professionals, financial planners and legal counsel working together to create alternative structures to maximize your client's earnings while also ensuring wealth preservation for generations to come.

Remember that your job as legal counsel does not end once your client has executed an oil and gas lease. There are many other factors and on-going considerations that must be taken into account when providing legal advice and representation to your clients. The failure to have a long-term plan for the use, maintenance and monetization of your client's property could result in significant financial losses and expose the practitioner to claims of legal malpractice.

2 It is important to note that this distinction between "minerals" and "oil and gas" is not only crucial to review of back title, but is relevant to current day deed drafting as well.
3 *Butler v. Charles Powers Estate*, 65 A.3d 885 (Pa. 2013).
4 In recent months, leasing activity has actually ebbed with the decline in petroleum prices and the abundance of natural gas reserves.
5 Generally, the primary term of an oil and gas lease is five (5) years although it could be more or less.
6 A typical "Market Enhancement Clause" can take several forms, however, the most common reads (emphasis added): "…all oil, gas or other proceeds accruing to the Lessor under this lease or by state law shall be without deduction, directly or indirectly, for the cost of producing, gathering, storing, separating, treating, dehydrating, compressing, processing, transporting, and marketing the oil, gas and other products produced hereunder to transform the product into marketable form; *however, any such costs which result in enhancing the value of the marketable oil, gas and other products to receive a better price may be deducted from Lessor's share of production so long as they are based on Lessee's actual cost of such enhancements.*"

## Recommendations

An attorney who intends on representing clients concerning the sale and/or purchase of property in the Marcellus Shale region must be cognizant of the legal pitfalls that exist, which could create potential legal malpractice claims. The following points should help attorneys avoid such pitfalls:

1. An attorney should do a thorough investigation of any potential conflict of interest. The client should be fully advised of any prior or present representation that could be perceived as a potential conflict of interest. If the attorney believes that there is no potential conflict of interest because of a prior representation, then he should inform his client in writing of the prior representation and the reason why he or she feels they can completely and fairly protect the interest of the current client. The attorney should request a signed informed consent from his client after identifying what the prior representation was, the role of the attorney in the prior representation, and why there is no risk, prejudice, or harm that will flow to the interest of the current client.
2. The attorney should always retain appropriate consultants with specialized knowledge of the Marcellus Shale region, including surveyors, title companies, tax advisors, and any other specialist who could be of assistance in providing full and complete guidance to the client concerning oil and gas deposits.

## Conclusion

The drilling and fracking of oil and gas deposits in the Marcellus Shale region has created business opportunities for lawyers. Unfortunately, these opportunities have led to an increase in legal malpractice claims. Hopefully, the attorney representing a client in the sale and/or lease of oil and gas properties will take all necessary steps to protect their client. If, however, a problem arises which creates a potential for a legal malpractice case, it is important that the attorney immediately notify his/her insurance company so that it can assist the attorney in assessing whether any of these potential pitfalls have created a basis for a legal malpractice claim.

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