Crude Awakening: Anticipated Oil and Gas Production in Ohio

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Oil and gas plays are not unusual in Ohio. The first reported Ohio well was drilled in 1814 (by accident) followed by more production in 1860. The Marathon Oil Company was founded near Findlay stemming from prolific production in the late 1800s and early 1900s. At the time, oil and gas also flowed freely in several areas of the state: from the northwestern to southeastern counties, northeastern counties and south central counties — wells were even drilled over Grand Lake St. Marys. Over time, most of Ohio has been involved in oil and gas exploration and development; wells have been drilled in76 of Ohio's 88 counties.

Many of the early oil and gas operations died off due to poor management, waste and lack of regulation. After the exploration of the late 1800s and early 1900s ran its course, there was a relative lull until the Morrow County Oil Boom in1963. This time the oil boom was accompanied by better laws that regulated the production and conservation of oil and gas and the placement of wells.

Today's excitement over oil and gas is accompanied not only by additional regulations that target protecting the public, the environment and the industry, but also by improved methods of production that make it possible to reach the oil and gas re-serves tucked in far reaches of underground rock and shale formations. Perfected in the shale formations in Texas, horizontal drilling involves drilling horizontal "legs" off a conventional vertical well. Even more, several horizontal wells can be drilled off the same well pad traversing horizontally a mile or more underground. As a result, fewer drilling rigs are needed on the ground's surface to produce the same resource volume.

The current focus in Ohio is on a formation known as the Utica Shale. Geologists believe that the Utica, which ranges from 6,000-9,000 feet in depth, may have served as the source of much of Ohio's historical production. Operators are looking at the Utica because of the possibility that it may contain not only natural gas but also crude oil and natural gas liquids(NGLs). The added value of crude oil and NGLs improves the overall economic value of the operations. These additional revenue streams are significant in today's environment of relatively low natural gas prices and the substantial costs involved in drilling a horizontal well — ranging from $2-$10 million a well.

As energy companies, geologists, petroleum engineers and landmen ready the landscape for operations in the Utica and begin tasks toward oil and gas production, lawyers need to be ready to service clients for countless legal issues relating to oil and gas production. More importantly, lawyers should under-stand the structure and laws by which oil and gas rights and interests are regulated, sold, purchased, transferred, proven and preserved.

Ohio's comprehensive regulatory structure

Unlike other states, Ohio provides a distinct, predictable and favorable regulatory structure for its oil and gas industry. Ohio Revised Code Chapter 1509 and the rules promulgated under it govern oil and gas activities in the state.[1] While the statute fulfills the primary goals of conservation and regulating health and safety aspects germane to oil and gas activities, a more important feature of R.C. 1509 is the General Assembly's fore-thought and understanding of the expertise required in regulating the oil and gas industry. Consequently it created the Di-vision of Mineral Resources Management(as an agency of Ohio's Department of Natural Resources).[2] It was given the

sole and exclusive authority to regulate the permitting, location and spacing of oil and gas wells and production operations within the state. The regulation of oil and gas activities is a matter of general statewide interest that requires uniform statewide regulation, and this chapter and the rules adopted under it constitute a comprehensive plan with respect to all aspects of the locating, drilling, and operating of oil and gas wells within this state … .[3]

The statute is of vital importance to Ohio producers due to the unique and technical aspects of oil and gas activities. It establishes a comprehensive statewide structure to govern the oil and gas industry in Ohio, assuring individuals and corporations in the industry that if they follow the set rules and regulations and obtain proper permits, they may conduct their business without undue interference from local authorities or otherwise. As such, local ordinances, laws and regulations of certain aspects of oil and gas activities — such as zoning laws — are pre-empted by the structure of R.C. 1509. This pre-emption of local regulations also supports the fundamental importance of a comprehensive plan to govern the oil and gas industry. Due to the comprehensive regulatory structure, state officials have acquired both the resources and the extensive scientific and technical expertise to regulate and to permit the oil and gas industry. Municipalities and other localities cannot be expected to have the expertise necessary to meet the two goals of encouraging oil and gas exploration and providing safe-guards to ensure the public welfare.

Accordingly the statute successfully pro-vides a complete and comprehensive structure for the protection of the public health, safety, welfare and the environment, while also providing for the effective and efficient development and use of Ohio's oil and gas reserves.

Obtaining and preserving oil and gas interests

Generally the first legal instrument related to the development and exploration of oil and gas is an oil and gas lease. Several articles and treatises address the nature, form and specific provisions of oil and gas leases (this article will not duplicate those efforts); however, the current excitement surrounding a new oil and gas play brings with it a scrutiny of both new oil and gas leases as well as established oil and gas leases, and the latter is garnering a great deal of attention. The current motivation for the increased scrutiny of established oil and gas leases is to determine if a lessor is in a position to terminate the current oil and gas lease(perhaps granted years ago) and enter into a new lease (which may include higher bonus payments given the anticipated return of the oil and gas play). The following discussion highlights a few bases for such scrutiny.

The validity, recordation and interpretation of oil and gas leases are governed by general statutes, industry specific statutes and case law. Still, challenges made in connection with oil and gas leases are commonly founded — and de-fended — on basic real estate grounds, some of which may sound familiar yet arcane to real estate practitioners. Challenges range from the effectiveness of a lease based on the date of recording in the public records, to the "termination" date of a particular oil and gas lease, to title issues and to disputes surrounding good title.

For example, Ohio is a "race state" with respect to oil and gas leases, licenses, assignments and other like instruments. Under R.C. 5301.09, oil and gas leases(or a memorandum of oil and gas lease)must be recorded to be effective as to third parties without notice or a reason to inquire (such instruments shall be "filed for record … without delay"). The statute states:

[N]o such lease or license shall be valid until it is filed for record, except as between the parties thereto, unless the person claiming thereunder is in actual and open possession.[4]

As such, an unscrupulous landowner could conceivably grant a lease to ABC Company, accept payment and turnaround and grant a lease on the same property to XYZ Company. If XYZ Company records its lease before ABC Company records its lease, XYZ Company holds the oil and gas rights in the property — and the landowner finds himself in a battle with ABC Company. ABC Company's unrecorded lease is not a valid lease unless ABC Company is in actual and open possession of the property — which is usually not the case with oil and gas leases at the beginning of a lease.

The term or duration of an oil and gas lease can be subject to challenge. Generally the term of an oil and gas lease is not set for a specific period of time, but the term is determined by the length of time in which oil and gas is produced from the leased property. That is, many leases provide for a *primary term* during which a lessee must drill a well and then a secondary term, which provides that the lease will continue as long thereafter as oil or gas is produced — in paying quantities — from the leased property. Arguments in connection with the term of a lease center on interpretation of the lease and may involve whether drilling has commenced; what constitutes paying quantities; the effect of a temporary cessation of activity; the effect of conditions of force majeure; the effect of nonpayment of amounts due under the lease; and whether other provisions of the lease or actions or inactions of the lessee negate the stated primary term or secondary term.

Title matters may also plague parties to an oil and gas lease and they may implicate “run of the mill” type matters (proper names of parties, marital status designations, proper legal descriptions, valid execution and acknowledgement and ownership or a gap in title). Complications also arise because oil and gas leases often involve severed mineral interests (those which have been split from the surface interests). Also the mineral interests may have been severed generations earlier, and raise title questions that extend to estate matters and myriad splits of the interests.

There may be two chains of title to be searched and a determination to be made to establish that the severed mineral interests have not merged back into the surface estate. Certain laws such as the forfeiture statute (R.C. 5301.332), the dormant mineral interest statute (see sidebar on pages 12-13) (R.C. 5301.56) and the marketable title statute (R.C. 5301.47 et seq) provide guidance and solutions to various title matters.

In the situation where a landowner desires to enter into an oil and gas lease, but an older oil and gas lease is of record — under certain conditions — the landowner can establish that the lease has expired and move forward to enter into a new lease. Given that most oil and gas leases do not have a definite term, landowners have incurred problems with old leases clouding their title to real estate. Revised Code 5301.332 provides potential relief for landowners by offering a method to remove oil and gas leases from the public record when such leases are no longer in effect. This statute is not intended to resolve disputes, and if the lessee asserts that the lease continues in effect and acts in accordance with the statutory procedure, the lease will be unaffected by the acts of the landowner under the statute. To use this statute a landowner must have a meritorious reason for the lease to be forfeited and two conditions must be met: no well exists on the leased property or none of the wells on the leased property are producing; and a specific provision in the leases has been broken or the term of the lease has expired. As long as the conditions are met, the landowner can proceed with the notice and affidavit procedure outlined in the statute. To protect a lessee’s interest and to avoid a lease from being forfeited, a lessee must respond to the landowner-lessor’s actions in accordance with the procedure outlined in the statute.

In the situation where a landowner owns the surface rights to the land and not the mineral interests underlying the surface, but the mineral interests have been “dormant” for a designated statutory period, under certain circumstances the dormant mineral interests may revert to the landowner.

A variety of title matters can also be addressed under Ohio’s Marketable Title Act (codified at R.C. 5301.47–5301.56); its purposes to simplify, to facilitate and to improve reliance on a record chain of title and to permit the extinguishing of outstanding claims on title due to a lapse of time. The Marketable Title Act works to eliminate “ancient interests” that operate to cloud title.

The act in its broadest sense requires that interests in land, including easements, mineral rights or other severed interests, be rerecorded every 40 years, or such interests will be automatically extinguished and reunited with the fee interest. However, many exceptions and exemptions exist in the Marketable Title Act which makes practical application of the statute difficult.

A claimant seeking record marketable title must complete the following steps:

- Determine the root of title and ensure that the claimant has an unbroken chain of title.[5]
- Review the root of title and later transactions in its chain, or an independent chain of title, to determine if any interests, claims or defects have been preserved or created.

- Ensure that (a) no record notice has been filed, (b) that there has been no continuous possession on the property for forty years or more and (c) no parties have preserved or gained interests in the property through adverse possession.
- Check the chain of title for any interests exempt from the Marketable Title Act, and thus not extinguishable by the Marketable Title Act.

On completion of these steps, a claimant may assert marketable record title as to his claimed interest, noting that the claimant's marketable record title may be subject to preserved interests, as set forth in the statute.

Interest holders, on the other hand, should be careful to protect their interests from extinguishment under the Marketable Title Act. The interest holder should file for record notice within the 40 year period (if his or her interest falls within the scope of the Marketable Title Act). When relying on references to the interest in the root of title or later transactions contained in the record title, the interest holder should ensure that these instruments specifically reference the interest that the holder wishes to protect. There are many aspects of the applicability of the Marketable Title Act that must be given close attention in order to protect or to assert the interests of the party claiming marketable record title or the interest holder.

In addition, title matters may be resolved by filing a quiet title action or a declaratory judgment action. The bases of these actions may include, among other matters, adverse possession claims, dormant mineral interests and marketable title issues. From a practice standpoint, quiet title actions require great detail and diligence in identifying all parties, especially when severed mineral interests are involved. Practitioners should be mindful of the nuances involved in filing of quiet title actions.

Going forward, Ohio will weave its own story about the current oil and gas play, an unlimited reality of lawyers, producers, geologists, petroleum engineers and landmen who are prepared to work and to participate in another chapter of Ohio's rich history.

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Endnotes

[1] R.C. 1509 was first enacted in 1965, and has been amended several times, most recently by S.B. 165 (2010).

[2] Effective Oct. 1, 2011, Ohio Department of Natural Resources has a Division of Oil and Gas Resources Management, which succeeds the authority of the Division of the Mineral Resources Management.

[3] R.C. 1509.02.

[4] R.C. 5301.09.

[5] The root of title is a conveyance or other title transaction which purports to create the interest being claimed and is the most recent title transaction recorded as of a date 40 years prior to the time which marketability is being determined.

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