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Gas Leasing & Development *update*

Oil and Gas Company Was a Couple Days Late and a Couple Dollars Short

Mark F. Himswoorth, Esquire

The Superior Court of Pennsylvania in the recent decision of *Hite v. Falcon Partners* considered whether the payment of \$2.00 per acre as “delayed rentals” had the effect of extending indefinitely the primary one-year term of an oil and gas lease which had otherwise expired, since there had been no attempt to drill oil and gas on the property at any time during that initial one-year term or, for that matter, at any time thereafter. The gas company, Falcon, argued that the payment of \$2.00 per acre as delayed rentals had the effect of extending the lease so long as the \$2.00 per acre was paid. The trial court rejected the argument, finding for the landowner and, on appeal, the Superior Court agreed.

The language considered by the Court is not uncommon in oil and gas leases. In this case, the leases at issue granted Falcon “all the oil, gas, surface and drilling rights in, on and under” the landowners’ land, with the term of each lease defined as follows:

3. Term. Lessee has the right to enter upon the Property to drill for oil and gas at any time within one (1) year from the date hereof and as long thereafter as oil or gas or either of them is produced from the Property, or as operations continue for the production of oil or gas, or as Lessee shall continue to pay Lessors two (\$2.00) dollars per acre as delayed rentals, or until all oil and gas has been removed from the Property, whichever shall last occur.

Despite the passage of years since the leases were signed, Falcon had not taken any action to drill on the landowners’ properties. Instead of receiving royalties had oil or gas been produced, the landowners merely received delayed rental payments of \$2.00 per acre per year. In light of Falcon’s inaction, the landowners were receptive to other offers from other gas companies to drill on their land. With those offers in hand, the landowners notified Falcon, in writing, of these other offers and whether Falcon wished to match the price, terms and conditions of those offers pursuant to a right of renewal clause in the lease. Falcon failed to respond and the landowners terminated the leases and demanded that Falcon record a release document to confirm the termination. Falcon refused, and the landowners consequently instituted suit.

Typically, in a modern oil and gas lease, the clause which provides for delay rental is known as the “drilling and rental clause,” which sets forth the requirements for keeping the lease in effect during the primary term. Pennsylvania courts have consistently interpreted delay rentals, therefore, to be “limited to the initial term of the lease.”

The Superior Court took Falcon to task, explaining that:

[T]he terms of paragraph 3, particularly to an unsophisticated landowner, indicate a one-year lease term within which time the lessor intended to accomplish certain things related to drilling, operating and producing oil or gas on a landowner’s property. It is not controverted that the properties have sat idle for six to seven years. If the lease could be extended in perpetuity through the payment of \$2.00 per acre per year, there would be little need for the parties to agree on a one-year lease term.

Accordingly, the Court held that once that one-year primary term expired, the mere payment of the delay rentals alone did not preserve Falcon’s drilling rights. Significantly, the Court found that if Falcon desired to enjoy the benefit of a longer period of permitted inaction, it should have drafted the leases to include a longer primary term. To find as Falcon urged, that it may pay delay rental indefinitely, would deny the landowners the opportunity to reap the financial benefits of actual production.

If you think that the term of your lease may have expired, call us at GLaD. ■



Gas Pipelines & Eminent Domain in Pennsylvania

Merle R. Ochrach, Esquire

Have you been approached to sign a pipeline agreement? Are you negotiating with the representative of the gas company? Have they suggested that if you don’t reach agreement the company will use the power of eminent domain to condemn the land they need?

Generally, in Pennsylvania intrastate pipelines do not entitle gas companies to utilize eminent domain. If the pipeline extends interstate the gas company has the power of eminent domain. The power of eminent domain allows the company to acquire land for fair market value without negotiating all of the fine points with the Landowner.

Late in 2010, an administrative law judge recommended that Laser Northeast Gathering Company, LLC not be given the status of a public utility with the power of eminent domain and further determined that gas gathering line companies are not public utilities because they do not serve the public. The decision will go before the Public Utility Commission for consideration before becoming final. If it is upheld it will mean that gas gathering lines will be subject to the Utility Commission’s standards or safety, usage costs and complaint procedures. Both the pipeline companies and Landowners are eagerly awaiting the final outcome of this proposed decision. ■



PADEP Issues Major New Gas Regulations and Establishes New Gas Databases

Kermit L. Rader, Esquire

During recent months the Pennsylvania Department of Environmental Protection ("DEP") has issued significant new regulations applicable to gas development and added new databases to its Marcellus Shale website. Together these actions should result in both better practices by gas companies and more information regarding those activities being more readily available to the public.

In late 2010, DEP issued two new sets of regulations applicable to gas development, one relating to well construction and the other setting limits for the discharge of total dissolved solids ("TDS"), the most significant pollutant found in wastewater generated by drilling. The well construction regulations require that state-of-the-art materials and methods be used so as to prevent leakage. They are intended to prevent the release of hydraulic fracturing fluids and flowback waters from wells, as occurred in DEP's view in the heavily publicized incident in Dimock, PA.

The water that flows back up a gas well following hydraulic fracturing contains large amounts of the rock that has been fractured. Those bits of rock are measured as TDS. While the regulations apply to discharges of TDS generally, many of its provisions are specific to the gas industry. Discharges of gas wastewater directly to surface water are prohibited; instead, such wastewater must be recycled or sent to a central treatment facility authorized to receive it. Moreover, while the regulations adopt a general limit of 2000 mg/L of TDS on a monthly average basis, a significantly lower limit of 500 mg/L is imposed on gas industry discharges. The justification given by DEP for imposing different standards is that the TDS concentration in, and the amount of TDS discharges by the gas industry is significantly higher.

In the same timeframe DEP has also added major new databases to its Marcellus Shale website relating to gas production and enforcement proceedings. Legislation passed in 2009 required that all gas companies submit semi-annual production reports on an aggregate and per-well basis to DEP and that those reports be publicly available. The first such reports were submitted in August of 2010 and posted on the website in November. These reports give property owners a means of verifying production information provided to them by gas companies in connection with royalty calculations. On its own initiative DEP also established an enforcement database that includes numbers of inspections, violations and enforcement action for each company on an annual and monthly basis, which provides an easy way to check on a company's compliance track record. ■

NEW ESTATE TAX LAW OFFERS PLANNING OPPORTUNITIES

Jonathan Samel, Esquire

An important goal of a wealth preservation plan which will allow you to successfully pass your property with Marcellus Shale onto your family, either during your lifetime or upon your death, may be to avoid or minimize federal estate and gift taxes. Recent tax law changes have made it easier to achieve this goal if you properly plan now.

As a result of a compromise between President Obama and Congressional Republicans regarding the "Bush Tax Cuts," the federal estate tax has returned for the years 2010 through 2012 with a new higher exemption amount and a new lower tax rate. In addition, the federal gift tax has been unified with the estate tax for the years 2011 and 2012 with the same exemption and same tax rate as the estate tax.

The federal estate tax is imposed on transfers at death, but a specified dollar amount has been exempted from the tax. This exemption amount continually increased in recent years up to \$3.5 million in 2009 (\$7 million for a married couple). The estate tax rate in 2009 was 45%.

The estate tax was temporarily repealed for calendar year 2010 under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

On the other hand, the federal gift tax which is imposed on lifetime transfers by gift continued in effect in 2010. The lifetime exemption for the gift tax remained fixed at \$1 million in 2010 (\$2 million for a married couple). The gift tax rate in 2010 was 35%.

Under the "sunset" provisions of EGTRRA, the estate tax was to have been reinstated automatically on January 1, 2011 at its 2001 levels, namely, a \$1 million exemption and a top tax rate of 55%.

However, the United States Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act"), which President Obama signed on December 17, 2010. The 2010 Act has reinstated the estate tax effective immediately at a new level, namely - an increased \$5 million exemption and a lower 35% maximum tax rate.

In addition, in a particularly unexpected and surprising development, the 2010 Act also extended the new generous estate tax shelter to lifetime gifts. Specifically, the 2010 Act unifies the estate and gift tax exemptions for 2011 and 2012, bringing them both up to \$5 million (\$10 million for a married couple). The gift tax rate is also 35% for 2011 and 2012.

Consistent with prior law, a taxpayer's use of his or her gift tax exemption during lifetime will correspondingly reduce the amount that he or she may pass at death free of estate tax. The exemption amount of \$5 million for both the estate tax and the gift tax will be indexed for inflation after 2011.

It is important to note that the provisions of the 2010 Act relating to estate and gift taxes are applicable for only two years. After that time, unless Congress acts to amend the tax law again, the sunset

provisions of EGTRRA will apply, and the a much reduced \$1 million exemption and a higher top estate tax rate of 55% will take effect in 2013. Therefore, a renewed discussion of the estate tax law prior to 2013 is virtually guaranteed.

The dramatic increase in the lifetime gift tax exemption from \$1 million to \$5 million (\$10 million for a married couple) creates enhanced opportunities for tax-efficient lifetime transfers to the younger generation. The 2010 Act creates an opportunity for taxpayers who previously used their \$1 million gift tax exemption to now make additional substantial gifts in 2011 and/or 2012 without any gift tax liability. However, it is important that before you consider making any gifts, you must first provide for your own ability to maintain your standard of living and to meet unexpected future needs.

Lifetime gifts can be particularly beneficial because they not only remove the gifted property from the taxpayer's taxable estate, but can also remove all future appreciation on that property from the taxable estate. A variety of wealth transfer techniques are currently available that can efficiently use a portion of the \$5 million gift tax exemption. You might consider transferring interests in your Marcellus Shale property to a "generational" trust which benefits your family members either during your lifetime or upon your death. In this manner, the future wealth generated from the property might be protected from being dissipated as a result of claims of creditors and marital problems of a family member. Such a trust can be designed to insure that assets which are not currently needed will pass to future generations of your family.

You should always periodically review your estate plan to make sure it is in line with your current objectives and personal goals. It is now particularly important that you implement this review. The 2010 Act creates significant immediate estate planning opportunities. However, there remains considerable uncertainty about the future of the estate tax. The time for planning is now.

If you have any questions about the 2010 tax law changes, or if you would like to review your estate plan, please contact our office and we will be happy to assist you. ■

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