OIL AND GAS TITLE EXAMINATION BASIC TERMS

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By Kraettli Q. Epperson

INTRODUCTION

The purpose of these materials is to present a brief explanation of the basic terms which need to be understood during the process of examining title to oil and gas interests. These brief materials do not describe the actual process of examining title and creating requirements. The level of complexity is aimed at the novice title attorney or landman. There has been an assumption that the reader understands land records generally and also has experience with surface real estate titles, but desires to make the transition to applying their general understanding of real property titles to the oil and gas title arena. Attendance at a longer course on this subject, or undertaking on-job training with proper supervision, is strongly suggested as the proper means to enable the reader to truly begin the examination of oil and gas titles.

Oil and gas titles are dealt with herein as if there is no difference in the development of oil versus gas, while in fact there are some instances where there are distinctions such as in the dimension of spacing units. There is no effort made in this article to address surface mining matters, although some of this material will certainly apply equally to such field. For simplicity of presenting these materials, oil and gas will usually be referred to as “minerals” herein, unless there is a specific reason to distinguish the application of the terms or concepts being discussed.

While the concepts and terms discussed herein are substantially in common use throughout the United States, the examples and authority are drawn primarily from Oklahoma sources.

These materials are divided into six main areas: **I. Overview of Title Conveyancing Process, II. Agreements and Conveyancing Documents, III. Types of Title Opinions, IV. Terminology Covering Oil and Gas Interests for Title Purposes, V. Units and Forced Pooling, and VI. Quality of Title: Defensible and Marketable Title.**

I. Overview of Title Conveyancing Process

The phrase "title to property" refers to ownership of the right to exclusively possess and use property for the benefit of the owner.[60 O.S. §1] The owner of land including the right to the surface, the air above the surface, and the subsurface region including the components therein (such as minerals, and water) has the fee simple title. [6 O.S. §64]

Surface parcels and the related surface title are not likely to migrate from their original location (in the absence of accretion or avulsion); however, some minerals, such as oil (as a liquid) and natural gas (in a gaseous state) have the ability to migrate within the porous rock in which they are located. Consequently, the various states have adopted either of two differing types of ownership rules pertaining to minerals. Under the first type the owner of the surface above a pool of oil or gas is deemed to own all of such minerals, even before the minerals have been extracted: meaning ownership in place. The second type uses the concept of the "rule of capture". The rule of capture follows the ancient concept applied to the taking possession of mobile wild animals and declares that until you have the animal (or oil and gas) in your physical control, you do not yet "own" it. So the owner of the minerals under the surface must reduce the minerals to possession before it can claim true practical ownership, and before it has in-hand any commodity to sell or otherwise transfer to a third party.

Oklahoma has adopted this rule of capture, while Texas on the other hand has adopted the opposite rule by declaring that oil and gas is owned by the owner of the parcel of land overlaying such minerals, even if the so-called owner has not yet "captured" such minerals. The difference between these two concepts impacts the enforcement of the rights of neighboring owners of minerals who may, in a manner of speaking, be appropriating a neighbor's minerals because the liquid or gaseous chemical substances are capable of flowing between the neighboring tracts.

The rule for Oklahoma is stated in Frost v. Ponca City, 1975 OK 141, 541 P.2d 1321, ¶8:

> *"The parties agree that under the 'law of capture' which obtains in Oklahoma, a landowner does not own migratory substances underlying his land, but has an exclusive right to drill for, produce, or otherwise gain possession of such substances, subject only to restrictions and regulations pursuant to police power. [cites omitted] A landowner does not acquire title, or absolute ownership of the migratory substances, until the substances are reduced to actual possession by being brought to the surface and then controlled. [cites omitted]"*

The rule in Texas is stated by the U.S. Supreme Court (Thompson v. Consol. Gas Utilities Corp., 57 S.Ct. 364 (1936 WL 64969)) as follows:

> *In the case of Brown v. Humble Oil & Refining Company, supra, the Supreme Court of Texas used this language:*
>
> *"The rule in Texas recognizes the ownership of oil and gas in place, and gives to the lessee a determinable fee therein. [cites omitted]*

The ownership concepts surrounding oil and gas are further complicated by the geological fact that such minerals usually are found at different levels under the ground within layers of specific porous rock, called formations or horizons. Therefore, you can have different owners of different type of minerals located under the same surface tract of land, because each type of mineral could be found at different levels. For instance, Owner A owns the minerals at or below the Mississippian formation, with Owner B owning the minerals located above the same formation. In addition, there are different types of materials that constitute minerals, such as iron ore versus aluminum bauxite, which can be separately owned, even if situated in the same formation under the same surface tract.

The owner of the surface tract may also be the owner of all of the minerals located beneath its lands, making him the owner of the fee. This means the mineral ownership has not been "severed" from the surface ownership. Such owner of both the surface and the minerals can either extract such minerals by its own efforts (or through a contractor) or can convey such right to a third party. Such conveyance can be permanent through the use of a "mineral deed", or for a temporary period through an instrument such as a "term mineral deed" or a "mineral lease". If the minerals are permanently conveyed away, it is said that the mineral rights have been "severed" from the surface rights. It is normal for the terms "mineral rights" or "mineral interest" to be shortened to simply the "minerals". Such abbreviated usage is not strictly correct, since the "minerals" themselves are still physically under the ground and are not being physically transferred.

When the right to search for and extract minerals is transferred to a third party on a temporary basis, such as through a mineral lease, such right is often referred to as a "profit a prendre", which in French means the right to produce income by searching for (and finding) something of value (i.e., producing a "profit"). Explained another way, until the minerals are found and extracted, under the rule of capture, all the mineral lease holder has is a "hunting license".

As explained by the Oklahoma Supreme Court in Rich v. Doneghey, 1918 OK 689, 177 P. 86, ¶7:

> *The right so granted or reserved, and held separate and apart from the possession of the land itself, is an incorporeal hereditament; or more specifically, as designated in the ancient French, a profit à prendre, analogous to a profit to hunt and fish on the land of another.*

The purpose of conducting a title examination relating to minerals is to pinpoint who holds the current rights including the authority to explore for and extract the minerals. Such rights may be held directly (e.g., by the surface owner before severance of the minerals, or by the mineral rights owner after severance), or may be derived (e.g., held by the lessee under a mineral lease given by the mineral owner). The "lessor" grants the right to the "lessee" to explore for and to extract the minerals.

The usual motivation to conduct such a title examination is because someone is somewhere in the process of beginning to look for ("explore") and extract ("drill for") such minerals, or is about to pay someone their share of the monetary proceeds from minerals that have been successfully extracted and sold ("division of proceeds"). It is foolhardy to expend money and effort, or pay out the resulting revenues, unless and until you are reasonably sure initially who can grant the rights necessary to explore for and extract such minerals, and ultimately, who is owed a share of the proceeds produced. It can be a financial disaster where someone drills a well without acquiring and holding the right to do so, because the true owner might receive a windfall in the form of a free well, and the drilling party is also potentially guilty of trespass.

As will be explained below, there are separate types of title opinions, depending on the current stage of the exploration and extraction process, and there is the possibility that the various components of the package of rights (the separate "sticks" in the proverbial "bundle of sticks") may be held by distinct persons. These rights might include the right to sign a lease to allow the exploration for and the extracting of minerals (the "executory right") may be held separate from the right to receive the proceeds from such extraction (the royalty right).   The title examination process is made substantially more tedious and detailed, and the opinion itself becomes much more voluminous (such as a typical surface title opinion being 10 pages versus a mineral title opinion being 200 pages), due to the mineral interests being subdivided and held in tiny fractional interests (measured out to 9 decimals) by large numbers of people, rather than being owned by just a single person or married couple, which is the typical ownership pattern for a surface tract.

II. Agreements and Conveyancing Documents

When the right to explore for and to develop a mineral prospect is granted to a third party, such grant usually takes the form of a lease. However, having the right to give such lease is held by the owner of the underlying minerals (unless the executory right has been assigned away). Hence, knowing the ownership of the underlying minerals is necessary to ensure that the lease is taken from the correct owner or fractional owners.

The documents transferring the ownership of the minerals may transfer the permanent right in the form of a mineral deed, or a temporary right in the form of a term mineral deed for a specified limited period. The compensation for such transfer is usually computed based on the value of the prospect per acre, multiplied times the number of acres. Where there is only a lease given, including the right to explore for and extract any minerals found, the document is a mineral lease, with payment to the lessor coming in a package broken down between (1) a bonus (for signing) per acre, plus (2) a royalty (as a fraction, such as 3/16) to be paid if and when there is oil or gas extracted and sold.

The owner of the minerals is usually known as the lessor or royalty owner while the lessee is known as the working interest owner or operator. The working interest owner is obligated to do the work necessary to produce the minerals. The deadline for the completion of the drilling of such well is usually expressed in terms of a primary term (such as one year from signing) with a possible extension of this deadline through the payment of an additional dollar amount by the lessee to the lessor before the primary term expires, known as a delay rental, again being computed and paid based on the number of acres involved.

The length of time that the lease will last can be a specific period, such as 10 years, but the uncertainty of what the net income would be for such a period of time usually discourages a lessee from expending substantial funds to locate and complete the drilling of a well, just to be forced to turn over the well and its flowing oil or gas at the end of the specified term. This uncertainty of the period of time it will take for the lessee to recover its initial drilling costs usually prompts the lessee to insist on a more flexible period of time for the term of the lease. The term of the lease is usually phrased as being for "so long as the well produces in paying quantities". There has been a court decision in Oklahoma confirming that this language does not violate the complicated real property rule against perpetuities, which rule prevents the granting of an interest in real property which will not vest in the grantee within the life of a person currently in being plus 21 years.

When a lessee fails to timely drill the required well, or when a well stops production after initially producing oil or gas in paying quantities, the lessor usually desires to be able to assert the right to lease the minerals to a different lessee in order to receive the expected royalty from the extraction and sale of the minerals. This attempt to terminate the lease runs into substantial fact questions which are not usually evident on the face of the public land records. Was the well completed and when? What was and is the level of production? Is it in paying quantities? Did the well stop production, and for how long, and why? Was such suspension period reasonable? Was the well being repaired (reworked) due to mechanical problems? Was an agreed to shut-in payment timely made to the lessor to extend the primary term or was the interruption due to unavoidable and excusable problems, such as the absence of a gas collection line?

A recent Oklahoma Court of Civil Appeals opinion suggests that the prior court-recognized rule that assumed that even if production ceased temporarily a lease continued and was not automatically terminated until a court said it was ended, has been replaced by the rule that upon the happening of the conditions needed to terminate the lease, it is terminated without court action. [Baytide Petroleum, Inc. v. Continental Resources, Inc., 2010 OK 6, 231 P.3d 1144] This decision is not likely to cause the usually cautious title examiner to unilaterally declare an unreleased lease as being terminated based on the assertions of a lessor, without court confirmation that the facts warrants such a determination.

When a lessee does not want to personally carry out its obligation under a lease to drill the needed well (due to, for instance, lack of equipment or insufficient funding to carry out the project), it can enter into a farmout agreement wherein it is agreed between the lessee and a third party that the third party will acquire a portion of the lessee's working interest upon the completion of the drilling of the well by the underlying lease's specified deadline.

When there is a mass sale of leasehold interests held by a lessee, in whole or in part, there is usually a purchase and sale agreement entered into which specifies which leases are being conveyed and the quality of title required, and the compensation for the transfer and how to handle any proceeds being held or received in the interim period before and immediately after closing. Usually the parties are looking for defensible title, rather than marketable title. [see this author's article on "'Defensible Title' when Examining Oil and Gas Interests: An Overview of the Law in Oklahoma," Article #222, found at www.eppersonlaw.com]

III. Types of Title Opinions

When the initial leases covering land in an area of interest are being acquired there may be a frenzy of acquisitions due to the competition between oil and gas drilling companies/lessees who usually simultaneously discover where the latest geological engineering studies or exploratory wells suggest the next "big" field is located.

This desire to "lease up" as much of the area as possible prevents the lessees from conducting full formal examinations of the record title to the land overlying the pool of oil and gas. Instead, the lease hounds and landmen make quick visits to the local county land records (or get digital copies to review) and make a cursory review of the ownership records covering the oil and gas, identifying who owns the severed minerals or the surface if the minerals remain unsevered. This examination of title usually results in a written title report and then the taking of leases from the apparent owners of record, and often times from the suspected heirs of the last visible owners who are dead but whose estate has not been probated. This practice assumes that there are no unrecorded conveyances of minerals or leases, and that therefore the heirs are the likely owners and targets.

In order to quickly but conditionally tie up mineral interests, the payment of the signing bonus is often in the form of a draft to the lessor in exchange for the signed lease, with the draft being a check payable to the lessor which is deposited with the lessor's bank but not honored until the lessee checks the title records.

Once the lessor completes additional work both to determine whether all owners in the area have been properly leased and to complete additional engineering work to increase their confidence that this location is likely to produce a productive well, then it will undertake a more formal title examination by an attorney. Such examination, in earlier times, was based on abstracts, but, due to the cost and delay associated with getting abstracts, the more recent practice is to rely on either an attorney's stand up examination of the public county land records or a semi-formal digital copy of excerpts from the public county land records tract index and the instruments listed on such index which are identified as relating to the subject mineral tract. Such imaging approach utilizes a non-attorney to review the records and to provide this booklet or digital copy to the attorney examiner. An Oklahoma Attorney General opinion confirms the public's right to make digital copies of the county's indexes and documents.

This "drilling opinion" is an attempt to ensure that all owners of minerals have been identified and have agreed both to allow the drilling and to the terms of compensation. This avoids the terribly costly situation of drilling a free well for an omitted owner.

If an owner is identified but refuses to accept the compensation offered by the proposed lessee, there is a statutory process in place to force such owner to allow the drilling to proceed, due to the public interest in developing the state's natural resources. This pooling proceeding before the Oklahoma Corporation Commission brings the parties in front of the Commission and results in the establishment of a reasonable figure for the signing bonus and the royalty fraction as reflected in a pooling order. The contents of such order is required to be reflected by filing an affidavit in the county land records, in lieu of a lease. [52 O.S. §87.4]

Once the well is drilled, it is time to distribute the net proceeds to the royalty interest holders and other recipients. In a recent Oklahoma Supreme Court case, it was decided that the duty of the lessee/operator was that of a fiduciary to ensure that proceeds are properly and timely distributed to all royalty and similar interest holders including holders of a net profit interest.   This is in spite of the contract for such payment only involving the lessor (not the lessee) and the net profit interest holder.   [see Hebble v. Shell Western E & P, Inc., 2009 OK CIV APP 61, ___ P.3d ___], wherein the lessee – Shell Oil—was hit with the largest punitive damage award in the history of the state, due to its failure to pay a net profit interest holder]

The lessee is obligated to promptly pay a lessor the proceeds due to such lessor from a successful well, and the lessor's failure to do so is subject to a statutory penalty of 12% per annum on the withheld proceeds, unless the title to the subject portion of the minerals is not marketable. If the title is unmarketable, the lessee only pays a 6% penalty, until the title is cleared up. The operator's use of the royalty owner's money is not free! Such marketability is measured by the Oklahoma Title Examination Standards adopted by the Oklahoma Bar Association ("OBA"). These standards are developed and approved initially by the Title Examination Standards Committee and the Real Property Law Section, followed by their adoption by the OBA House of Delegates. [see a series of annual articles concerning these Title Examination Standards and other title-related cases and statutes at www.eppersonlaw.com]

IV. Terminology Covering Oil and Gas Interests for Title Purposes.

As in any specialized area of professional activity, there are unique terms which have specific meanings in the context of mineral development. In particular, while the basic concepts familiar to the surface title examiner will also be found in mineral titles (such as contracts, deeds, leases, assignments, easements, term conveyances, probate matters, etc.), due to the financial emphasis of the oil and gas business (as a *profit a prendre*) the terms take on more of a transactional flavor (such as working interest, royalty, bonus payments, farmout agreement, net profit interest, etc.).

To be able to express or describe the type of document or interest involved in a transaction or title report, an expanded set of terms is needed. While this article does not seek to instruct the reader on how to specifically calculate a lessor's or lessee's interest, it will provide an overview of the jargon involved.

The initial quantum of interest held by a land owner encompasses all of the possible interests related to the possession and use of land, often referred to as the entire "bundle of sticks". Such interest is all inclusive, covering the period of ownership for the parcel of land from the present into the indefinite future, and encompassing not only the surface but the subsurface, and the air space above. Such rights to the exclusive possession and use of the land allow not just the aesthetic enjoyment of the view, but the construction of facilities (such as a home, parking lot, factory, underground pipeline, pump jack, tank battery, skyscraper, etc.) on the premises and the extraction of materials from the land (including but not limited to such items as water, coal, diamonds, methane gas, etc.). This all inclusive interest is known as a fee or fee simple, and covers both the time element (from now into the indefinite future) and the type of uses (farming, construction, gravel extraction, oil well, etc). If the interest is subject to termination due to the subsequent undertaking of impermissible uses (e.g., for so long as Blackacre is not used for the sale of alcoholic beverages) or the ending of a specific anticipated use (e.g., for so long as used for church purposes), the label is expanded to become, for instance, a fee simple determinable.

When dealing with the extraction of minerals (at the contract or title examination stage), it is important to ascertain whether this fee simple interest has been carved up. Such severance is permissible throughout the United States, although some of the related rules vary between states. For instance, some states have enacted laws merging separated mineral interests back into the surface owner's title when the minerals remain unused for an "unreasonable" time, known as a "lapse" statute. This concept echoes the rationale behind the concept of "adverse possession", enforcing the productive use of land by declaring "use it or lose it".

The severance could be limited to certain types of interests (e.g., coal rights), duration of interests (e.g., for a term of 10 years), or types of contracting rights or income streams (e.g., executory right to sign mineral leases, or a net profits interest).

At the most basic initial stage, when moving beyond the fee simple arrangement, the overly simplistic approach is to characterize all rights to possession and use as belonging to one category or the other, either surface or minerals. Practically speaking while these terms for these two categories are used in both laymen's conversations and, all too often, in professionals' contracts and conveyancing documents, the world is not that simple. For instance, the right to extract and use water from the land is a right held in varying degrees by both the surface and the mineral owner; the surface owner can either use the water for its purposes on the land or it can sell it off the premises, but the mineral owner can only use it for its own purposes on the land.

Each term or combination of terms produces a unique result. For instance, in an Oklahoma Supreme Court case interpreting certain terms, Allen v. Farmers Union Co-Operative Royalty Company, 1975 OK 102 ¶16, 538 P.2d 204, it was held:

It is our opinion that the Spears' reservation, 'all oil, gas & mineral rights' has essentially the same meaning as 'all oil, gas and other minerals' as set forth in the Panhandle case (495 P.2d 108, 113), *i.e., oil, gas and other minerals produced as a component or constituent thereof, whether hydrocarbon or nonhydrocarbon,* *and does not convey any other mineral or the right to produce any other mineral including copper, silver, gold or any other types of metallic ores or metallic minerals.*

The types of substances or materials included in the term minerals has changed over time because new technologies began to use chemicals and substances which had little or no recognizable value at the time of the original conveyance. For instance, aluminum bauxite or uranium ore were not significant substances in the early stages of mineral development. While the term "minerals" continues to be used as the most all-encompassing term, each transaction must seek to use terminology which accurately reflects the intent of the particular parties. The Oklahoma Supreme Court has held that the phrase "surface" is ambiguous. [Blythe v. Hines, 1977 OK 228, 577 P.2d 1268] So if you mean to include coal, say so!

The interpretation rule known as *ejustem generis* dictates that when there is a list which ends in a general term, such last general term is interpreted to include only such additional matters or items as would be in a common class with the initial part of the list. For instance, the word "minerals" in the phrase "oil, gas and other minerals" encompasses "other" hydrocarbons (similar to oil and gas), but not metallic ores. [Allen, supra]

When the owner of the fee simple interest desires to develop the minerals underlying their land they have three choices: (1) explore for and extract the minerals themselves, (2) convey the minerals in toto to another person, with the grantee deciding if and when to develop such minerals, or (3) leasing the minerals to a third party with the understanding that the grantee will develop such minerals within some specific time frame.

If an owner of the fee simple conveys away her minerals, thereafter the so-called surface owner has no further involvement in the transactions concerning the development of such minerals. Such conveyance can cover all mineral rights in perpetuity or for a specific term of years. This grant acts as a severance of the mineral rights from the fee simple (but under the Surface Damages Act, the operator is forced to offer the surface owner compensation for anticipated damages, even if the surface owner has no current interest in the minerals [52 O.S. §318.1 et seq.; Davis Oil Company v. Cloud, 1986 OK 73, 766 P.2d 1347]).

The leasing of minerals to a third party is the predominate method for the development of minerals, with a lease coming from either the fee owner or mineral owner, as appropriate to the facts. This right of a lessor to sign a lease agreement is usually referred to as the executory right, which is a severable right. This lease would be from the owner of the fee simple (including the minerals), or the owner of the minerals alone, with the lessor granting to a third party, the lessee, the exclusive right to explore for and to extract a particular mineral (or group of minerals).

The bundle of rights held by the lessee is often called the working interest or operating interest, because it is the lessee who undertakes the active efforts to work or operate a well.

The transaction surrounding the leasing of minerals involves several differing types of compensation.

As noted above, upon the signing of the lease the lessor is entitled to an immediate bonus based on the number of acres involved in the grant. The size of the bonus is dictated by the anticipated revenues to be derived from this prospect.

Upon the location, extraction and sale of the minerals, the lessor is entitled to a payment knows as a royalty, which can be delivered in kind (actual oil or gas) or by cash payment. Cash is usually sought and paid. Such interest is usually expressed in terms of a fraction, showing the allocation of the revenue, after costs, between the lessor and the lessee/operator, which is often 3/16 to the lessor and 13/16 to the lessee. Such a high percentage is held by the lessee to reflect the risk being undertaken by the lessee who all too often drills a "dry hole" which produces plenty of costs but no revenue. A lessor can choose, up front, to participate in paying for the drilling of the well taking on some the financial risks in return for a larger share of the hoped for revenue.

There is a public policy which leans towards the prompt development of minerals and against the holding of lands without development for speculation, awaiting possible successful drilling operation, by other lessees on nearby lands. To protect the mineral owner from the indefinite postponement of any income coming to the lessor from mineral development, and to allow the lessor to find another operator if the first one "drags its feet" too long, the leases usually include a "primary term', such as 2 years from lease signing. During such period the operator must complete the drilling of the well or lose the lease. Such loss means the operator cannot recover its upfront costs because it will never realize an income stream. After drilling the well successfully, which is usually measured by whether production results in "commercially paying quantities", the lease will usually continue for so long as it continues producing in such "paying quantities". Sometimes the drilling of the anticipated well is postponed, beyond the primary term, due to legitimate economic or other practical considerations, such as the unavailability of a natural gas pipeline to connect to. In such instances, if the operator desires to keep the lease alive, the mineral owner is entitled to a delay rental payment based, usually, on the number of acres, just as the initial signing bonus is computed. This compensates the mineral owner for the delay.

As mentioned above, the various subparts making up the property interests in the whole "bundle of sticks" are capable of being severed and held by other third parties. When an engineer or other professional provides drilling related services to a lessee, such worker is sometimes paid an interest in the anticipated well rather than in cash. Such interests might be called an overriding royalty interest, which is carved out of the lessee's (working) interest. It produces revenue but bears none of the risk of expense.

The property interest held by a fee simple interest owner in Blackacre is usually described, in part, by a legal description for the lands involved (either a governmental survey, or metes and bounds, or platted description). In addition, the fee owner might hold the entire interest (100%) or it may be held by one or more parties, as tenants in common or as joint tenants (with the right of survivorship). The quantum of ownership would often be stated as an undivided interest, if two or more people share the interest. If there are two co-tenants, each would hold an undivided one-half interest, or an undivided one-third interest for three people, etc. When dealing with a severed mineral interest, it is often the case that the mineral interest gets subdivided into tiny fractional interests, especially as deaths of the owners occur and the interests get split between multiple heirs or devisees, or when lands are kept with the surface interest as the lands are subdivided (platted) over time into lots and blocks.

The interest held by a mineral owner is often described as a net acres figure. For instance, if an owner holds a one-fourth undivided interest in a quarter section, and if the section contains 160 acres, then the mineral owner's interest is one-fourth of 160 acres or 40 net acres.

The quantum of interest held by the mineral owner/lessor, and its associated operator/lessee, in the net revenue derived from a successful well ("net" meaning after the operator deducts the costs of drilling and raising the oil or other minerals), is usually reported as a decimal carried out to several places (often 9 places). The owners of (a) the lessor's royalty, (b) the overriding royalty, if any, and (c) the lessee's working interest collectively hold 100% (expressed as 1.000000000) of the net revenues from the well (really from the unit related to the well). For instance, if the lessors altogether hold a 3/16 royalty, they collectively hold 0.187500000 of the well's net revenues; if the overriding royalty owners hold a 1/10 interest, they collectively hold 0.100000000 of the well; leaving the working interest holders/lessees/operators holding 0.812500000 of the well, for a total of 1.000000000 (meaning 100%). The parcel of land on which the well physically sits will usually be combined with other lands overlying the common source of supply producing the well's output. Such collection of parcels of lands are operated together and are called a unit. See the discussion of the creation of a unit immediately below.

V. Units and Forced Pooling.

The pool or collection of oil or natural gas or other underground liquid/gaseous mineral often underlies lands owned by more than one mineral owner. Public policy seeks to encourage an efficient extraction of oil and gas from the common pool, and to ensure that the revenues derived from extraction of oil or gas from such field is allocated equitably between the multiple owners. [52 O.S. §87.1 (e)] To achieve this goal, the Oklahoma Corporation Commission supervises the identification of the lands reasonably determined to overlay the pool being drained by a well. While expert technical testimony is solicited by the Commission and used in its decision making, such pools are usually assumed to be drained best by the use of a square or rectangular area, up to a 40 acre separate quarter quarter section for a vertical oil well unit (or up to 80 acres depending on the formation depth), and up to a 640 acre section for a vertical gas well unit, and up to 640 acres for a unit for a horizontal oil well. [52 O.S. §87.1 (c), (d), and (f)] Such separate spacing units are established by an order of the Commission after the conduct of a hearing on the technical aspects of where the pool is probably located. After the unit is established, then any well successfully drilled anywhere in the unit holds (past in its primary term) any and all leases covering any part of the unit.

If there are mineral owners holding acreage in the unit who have not yet been leased by an operator, the operator must negotiate a lease with the hold-outs before there can be any drilling conducted which will drain the land under such hold-out mineral owner's tract. If such parties cannot reach an agreement, then the operator can apply to the Oklahoma Corporation Commission for the purpose of forcing the non-leased mineral owners (i.e., known as forced pooling) to accept a set of terms, which terms have been approved by the Commission as being reasonable. Such action by the Commission is intended to ensure that the State's mineral resources are promptly and fully exploited, while ensuring that the interest holders receive fair compensation for the minerals being extracted.

After an order of the Commission is issued which force pools specific mineral owners' interests in specific tracts of land, an affidavit summarizing such order must be filed in the county land records. Such filing will give notice to the world that such mineral interest is no longer free to be conveyed or leased, but is now subject to the terms of the order. [52 O.S. §87.4]

VI. Quality of Title: Defensible and Marketable Title.

The title examiner who is responsible to prepare the acquisition report, drilling opinion or division order opinion will usually inquire of her client as to what quality of title is being sought. At the earlier stages, when the lease is being taken and the drilling is undertaken, a lower standard such as "defensible" title might be acceptable. Such quality of title allows for reliance on evidence, such as affidavits of heirship, which have some small risk of being incorrect, but which will usually will stand up to a court challenge, thereby making the title defensible.

However, if the drilling of the well produces oil or gas, and, consequently, there are revenues to be distributed among the various owners of the interests, then the proper recipients of the funds must be identified with more certainty in order to avoid the unpleasant result where the operator pays the wrong mineral owner and then has to pay twice when the true royalty owner appears. Such division order opinion and the related distribution of proceeds of production must, according to state statute, be based on "marketable title". [52 O.S. §570.10.D] Such legal and equitable title must be determinable based solely on the county land records, without the necessity to undertake an additional quiet title or probate action, and without being forced to take the risk associated with relying on an affidavit or other substitute for proper documents or court orders.

[The following detailed discussion of defensible and marketable title is excerpted from an earlier article written by the author of this paper. ["'Defensible Title' When Examining Oil and Gas Interests: An Overview of the Law in Oklahoma", Epp #222, found at www.eppersonlaw.com]

A. INTRODUCTION

According to Kuntz: "With respect to ordinary land transactions, it is well established that, in the absence of a specific provision on the subject, it is implied in every executory contract for the sale of land that the vendor must provide merchantable or marketable title. The same is true in the instance of contracts for the execution or assignment of an oil and gas lease. The vendor need not have such title at the time the contract is entered into, provided that he is able to perform at the proper time and place, or before trial."[1] The below discussion assumes that the parties have agreed to provide and to accept Defensible Title, rather than perfect, merchantable, or marketable title, and herein there is an attempt to explain, how the term, Defensible Title, is to be used in evaluating the adequacy of title to oil and gas properties being conveyed by a seller to a buyer. Principally, the focus is on the underlying title for oil and gas leases being sold and assigned by the lessee to a buyer.

The approach taken in this article is: (1) to discuss whether there is authority -- from statutes, case law, and treatises -- in the oil and gas industry, either inside or outside Oklahoma, defining the term "Defensible Title", standing alone, when determining whether title is adequate to enforce a sale between knowledgeable parties in the oil and gas industry, (2), because such definitive legal guidance does not appear to exist, to discuss what guidance the authorities do give us in at least a general sense, and (3) to explore what language can be found in typical asset purchase and sale agreements, which provide a definition for at least that particular transaction.

It should be noted that the assumption made herein is that the vendee rather than the vendor bears the risk associated with establishing the absence of Defensible Title. The determination as to who shall be the bearer of such risk is set

[1] Eugene Kuntz, *A Treatise on the Law of Oil and Gas,* Anderson Publication Company, 1989, §19.11 *Marketable title and abstracts of title.*

by the terms of the purchase and sale agreement ("PSA") utilized by the parties. Therefore, there may be instances where the PSA places the burden on the vendor.

B. WHAT DEFENSIBLE TITLE IS

A search of the court cases and statutes in Oklahoma failed to reveal any express definition of "Defensible Title" provided. Nationally, the search for a specific definition for "Defensible Title" was also fruitless.

As a recent professional article declared: *"There is no legally or commonly accepted meaning for 'defensible title', so it must be defined in each asset purchase agreement."*[2]

Defensible title has generally been defined as: *"…[S]omething less than marketable; it is imperfect on the record but is possible to defend."*[3] So, it is generally understood: "Defensible Title" is a lower standard than "perfect or marketable title."

This lack of specific objective guidance concerning "defensible title" creates the requirement that one must look to any agreement of the parties (i.e., the PSA between the seller and buyer) for guidance.

C. WHAT DEFENSIBLE TITLE IS NOT

[2] Allen D. Cummings, Randy Browne *Meeting of the Minds on Title Defects,* 48 Rocky Mtn. Min. L. Inst. 27, 27.07 (2002).

[3] *See* Thomas P. Schroedter, *Oil and Gas Title Examination and Title Curative: Marketable v. Defensible Title*, COMPREHENSIVE LAND PRACTICES, AN AAPL PUBLICATION at III-48 (1st ed. 1984), note 5.

It is generally understood that “perfect title” and “marketable title” are higher standards than “Defensible Title”. To help understand how they are different, it is beneficial to view Defensible Title as that which “perfect title” and “marketable title” are not.

“If the term ‘free from defects’ means free from all flaws or defects, both of record and in fact, we are speaking of the perfect title, and long ago Lord Chancellor Hardwick stated that ‘it is impossible in the nature of things that there should be a mathematical certainty of a good title.’”[4]

In other words, practically speaking, there is no such thing as a truly “perfect” title. In addition, “merchantable title” and “marketable title” are usually used interchangeably, and such terms will be treated in this article as covering the same quality of title.[5]

Under Oklahoma’s Production Revenue Standards Act[6] the Title Examination Standards adopted by the Oklahoma Bar Association (“Standards”) are the official gauge used to determine whether a producer will have to pay 6% or 12% interest on proceeds from sales of production not timely tendered to a royalty owner. If title is “marketable” under such Standards, then the higher rate of

[4] *Standards of Mineral Title Examination—Marketable Title vs. Defensible Title,* G.D. Ashabranner, 9 Mineral Law Institute 95 (Rocky Mountain Mineral Law Institute, 1964).
[5] The Oklahoma Supreme Court views the terms “merchantable title” and “marketable title” as synonyms. *See* Knowles v. Freeman, 649 P.2d 532, 535 (Okla. 1982), 1982 OK 89**.** ¶16
[6] 52 O.S. §§ 570.1 to 570.15.

interest must be paid. In other words, the producer is penalized when the title is really marketable, but proceeds are held up. 52 O.S. § 570.10.D. provides:

D. 1. Except as otherwise provided in paragraph 2 of this subsection, where proceeds from the sale of oil or gas production or some portion of such proceeds are not paid prior to the end of the applicable time periods provided in this section, that portion not timely paid shall earn interest at the rate of twelve percent (12%) per annum to be compounded annually, calculated from the end of the month in which such production is sold until the day paid.

2. a. Where such proceeds are not paid because the title thereto is not marketable, such proceeds shall earn interest at the rate of six percent (6%) per annum to be compounded annually, calculated from the end of the month in which such production was sold until such time as the title to such interest becomes marketable. <u>Marketability of title shall be determined in accordance with the then current title examination standards of the Oklahoma Bar Association.</u>

b. Where marketability has remained uncured for a period of one hundred twenty (120) days from the date payment is due under this section, any person claiming to own the right to receive proceeds which have not been paid because of unmarketable title may require the holder of such proceeds to interplead the proceeds and all accrued interest into court for a determination of the persons legally entitled thereto. Upon payment into court the holder of such proceeds shall be relieved of any further liability for the proper payment of such proceeds and interest thereon.

(underlining added)[7]

In Oklahoma, the Standards define marketable title as: "[Title] free from apparent defects, grave doubts and litigious uncertainty, [consisting] of both legal and equitable title fairly deducible of record."[8] Marketable title has also been

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[7] *See also* <u>Hull, et al. v. Sun Refining</u>, 789 P.2d 1272 (Okla. 1990), 1989 OK 168, ¶9 ("Marketable title is determined under §540 [now §570.10] pursuant to the Oklahoma Bar Association's title examination standards.").

[8] 16 O.S. App. § 1.1.

defined as title that is saleable (i.e., that which a purchaser can be required to accept) as opposed to being perfect.[9]

The Standards are not only made applicable to oil and gas matters by such Statute, but, in general, are deemed by the Oklahoma Supreme Court as being "persuasive", which makes them the equivalent of an opinion from the Oklahoma Court of Civil Appeals.[10]

If a PSA required "marketable title", then, according to Oklahoma case law:

"'A purchaser under such a contract is not required to resort to evidence dehors [outside] the record. It is not sufficient that the title is good in fact; that is, capable of being made good by the production of affidavits or other oral testimony. It must be good of record…the court said: 'The title may be good; but one to whom an abstract showing a good title has been promised as a condition precedent is not bound to accept any evidence thereof, except that contained in the abstract. The vendee in such a case is not required to accept or rely upon parole evidence of title, or information dehors the record, or the word of the vendor.' It was therefore held that the purchaser was not obliged to accept the title, which was bad of record, although capable of being made good by evidence showing adverse possession for the statutory period of time… 'A title is not marketable where it depends necessarily upon matter in pais [without legal proceedings], which is in itself a doubtful fact, and never can be determined or established, except by bringing every party into court.…"[11]

Hence, assuming a PSA only requires a defensible title the title being provided by a seller does **<u>not</u>** have to be:

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[9] *See* Thomas P. Schroedter, *Oil and Gas Title Examination and Title Curative: Marketable v. Defensible Title,* COMPREHENSIVE LAND PRACTICES, AN AAPL PUBLICATION at III-48 (1st ed. 1984).

[10] *See* **<u>Knowles v. Freeman</u>**, *supra* note 5 (The title examination standards are persuasive in authority); *see also* OK AG Opin. 79-230.

[11] <u>Campbell v. Harsh</u>, 122 P. 127, 129 (Okla. 1912), 1912 OK 165, ¶10 (summarizing numerous authorities, citations omitted, ancient terms explained).

1. Perfect, meaning without even minor defects;
2. Marketable;
3. Of record;
4. Free from the need to rely on parole evidence;
5. Free from the need to rely on affidavits; nor
6. Free from the need for litigation to prove the title is valid.

CONCLUSION

Due to the on-going operational and financial aspects of the development of minerals, a whole set of unique terms have been created to decipher such property interests, conveying documents, and contractual terms.

It is only by studying forms widely used in this industry and by reviewing applicable state statutes and cases that a would-be title examiner can become competent.