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# Gas Leasing & Development

*update*

## Are You Held by Production?

By Kermit Rader, Esquire

Landowners tend to view their leases as having a term, typically 5 years, and believe that when the term expires they will be free to negotiate a new lease with the same or a different gas company. As both the going rates for the signing bonuses and royalties and the landowner's knowledge regarding leases and gas development generally are likely to have increased significantly during the intervening 5 years, the landowner is often looking forward to a much more favorable new lease and receiving a large bonus check. That is, at least, until the landowner approaches the gas company about negotiating a new lease.

What landowners often are unaware of until that point in time is the impact of the provision in their lease known as the continuation clause and the aggressive way that many gas companies have been interpreting it. The continuation clause usually immediately follows the term provision in the lease. It typically provides that the lease shall continue past the expiration of the lease's primary term for as long thereafter as one of conditions exist, either on the leasehold or in a unit including the leasehold. The primary conditions for continuation are:

1. *Production of gas and paying quantities;* and
2. *Conducting operations in search of gas.*

It is relatively easy to determine whether gas has been produced from a well and when it hasn't, to prove that it hasn't. Either the landowner will have received royalties or not and metering by the gas company would establish whether gas has been produced from a well. Moreover, Pennsylvania law now requires that production figures be reported to PADEP and those figures are publicly available on PADEP's

website. Thus, if production is the only condition for continuation provided in the lease, it should be clear-cut whether the lease has continued or expired.

Determining whether operations have been conducted in search of gas is more problematic, however. This is particularly true because it is common when the lease's term is about to expire for the gas company to establish a production unit including leases on the verge of expiration and to install a vertical well within the unit. Typically the vertical well will not be capable of actually producing gas as the gas company's goal at that stage is not to produce gas; rather, it is merely to avoid losing

the leases that would otherwise expire. There may be no further activity with respect to the vertical well until the gas company plans to actually develop a producing well in that unit, which may be a considerable period of time.

According to the gas company, the vertical well, even if it is not capable of producing gas, is an operation in search of gas that continues the lease or hold by production. This is particularly true for some companies, such as Shell, that have a large backlog of leased, but undeveloped properties. In contrast to the relative ease of proving that production has not occurred, proving that a vertical well is not capable of producing gas or that these operations were not diligently pursued requires the gathering of many facts that are not readily available.

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## GAS PRODUCTION SOMETIMES COMES WITH OBNOXIOUS GAS EQUIPMENT

By Merle R. Ochrach, Esquire

The Pennsylvania Commonwealth Court has ruled in favor of New Century Pipeline in finding that its compressor station falls within the definition of "gas production" as used in Bradford Township's Zoning Ordinance. The Court held that compressor stations cannot be banned by the Township in areas where they permit gas production.

Neighbors complained of the odor and noise that the compressor station caused. The dispute between the Township and the gas companies centered around whether the compressor station was "necessary to drilling or pumping operations". The Court determined that the operation of the compressor station is "gas production" and therefore a permitted use.



While this case was based on a specific township ordinance, the determination of the compressor station as being part of "gas production" could have wider implications and could be applied to other contexts such as lease interpretation and perhaps determination of costs to be passed on to land owners, in the future. Land owners and governmental officials should take heed and use care in defining "gas production" and specifically exclude or define certain equipment related to oil and gas production if it is intended that the specific use of equipment shall be restricted or limited in some way.

# Hunting Clubs in the Marcellus Shale Region Face Unique Planning Challenges

By Jonathan Samel

Many landowners in the Marcellus Shale region are nonprofit hunting clubs. The potential for revenue associated with gas exploration and drilling activities has produced great interest among these organizations. However, it is critical that transactions by hunting clubs relating to these activities are carefully structured to avoid unintended adverse income tax consequences, and to provide for effective future ownership succession and governance.

A "social club" is defined by Section 501(c)(7) of the Internal Revenue Code as an organization whose main purpose is to provide social and recreational activities for its members. A social club is generally exempt from income tax, and hunting clubs fall into this category. However, the exemption from income tax only applies to revenue generated from "exempt function income sources" which includes membership fees, dues and assessments, and certain limited investment income.

If a nonprofit hunting club receives rent (including an upfront lease bonus) under the provisions of a gas lease or any gas royalty payments, the following income tax issues will arise without additional planning:

**1** Rent from gas leases and gas royalty payments will be taxable income to the hunting club.

**2** A Section 501(c)(7) social club is only permitted to receive up to 35% of its revenue from non-member sources to avoid losing its tax exempt status (the gross receipts test). However, if a rental payment under a gas lease is a one-time "unusual event," such payment may be excluded from the 35% gross receipts test. Therefore, receipt of a one-time lease bonus payment, although taxable, will not necessarily jeopardize a hunting club's tax exempt status. On the other hand, payment of royalties under a gas lease are not a one-time "unusual event," and therefore such royalty payments will not be excluded from the 35% gross receipts test. As a result, a hunting club will lose its tax-exempt status when the amount of annual royalty payments exceeds 35% of the club's annual gross receipts.

**3** Section 501(c)(7) also prohibits the assets of a social club from being used for the private interests of the members.

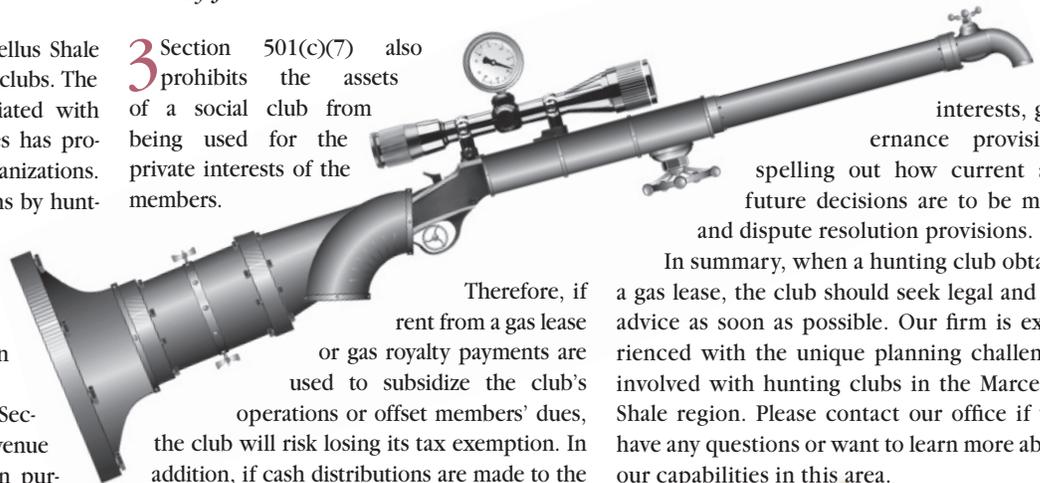
Therefore, if rent from a gas lease or gas royalty payments are used to subsidize the club's operations or offset members' dues, the club will risk losing its tax exemption. In addition, if cash distributions are made to the club's members, the club will also lose its tax exempt status.

To solve these income tax issues, the members of a hunting club should consider forming a new limited liability business entity such as a limited liability company (LLC) or a limited partnership (LP). Then the right to receive future royalty payments under a gas lease could be moved from the Section 501(c)(7) tax exempt club to a newly formed LP or LLC. To accomplish this, the club might sell the future royalty rights to the new entity for a purchase price determined by a professional appraiser experienced in valuing gas rights. The future royalty payments would then be made to the LLC or LP, and the royalty income would flow through the LP or LLC to the individual members. The hunting club could continue to own the surface of the property and operate the activities of the club relating on the surface.

The use of limited liability business entities such as limited liability companies and limited partnerships is a common wealth preservation planning technique. The business entity should be structured to avoid exposing the gas royalty rights to any future liabilities arising from the operation of the hunting club on the surface of the property and to any future personal creditors of the members of the club. It is important that the owners of the new business entity owning the royalty rights enter into well written partnership agreement with protective asset protection provisions. Such an agreement among the members should also contain, among other things, restrictions on the subsequent transfer of ownership

interests, governance provisions spelling out how current and future decisions are to be made and dispute resolution provisions.

In summary, when a hunting club obtains a gas lease, the club should seek legal and tax advice as soon as possible. Our firm is experienced with the unique planning challenges involved with hunting clubs in the Marcellus Shale region. Please contact our office if you have any questions or want to learn more about our capabilities in this area.



## Are You Held by Production?

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If the gas company's view is upheld, until the gas company pursues actual production, the landowner would receive no benefit from their gas rights, notwithstanding having a gas lease, neither receiving royalties nor being able to pursue a more favorable lease. To avoid this situation the landowner may want to consider pursuing a lease expiration claim.

We would be happy to review the relevant language of your lease and let you know whether you have a basis for a lease expiration claim.

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