

(Where Have All the Landmen Gone? Continued)

dramatically closer to the Metro-New York region than the Gulf Coast wells which are the source of significant portions of existing supply; and (4) realistically, New York needs and wants the significant tax revenues that will flow to both the State and involved localities from gas production.

As evidence of the energy companies' confidence in the long term viability of the Marcellus Shale gas supply, a Norwegian energy company with significant North Sea oil production (StatoilHydro), closed a \$3.37 billion deal with Chesapeake Energy in November to acquire a significant minority interest in Chesapeake's lease rights in the Marcellus Shale. That deal also obligates StatoilHydro to fund 75% of the drilling and production costs associated with those leases in the next several years.

The reasonable expectation is that DEC will complete its environmental review process, adopt new regulations, and start reviewing drilling applications by sometime in early 2010. Once it appears the new regulations will be in place, and depending on the general economic conditions in the U.S. and around the world, the landmen will be back. Do you know all your rights and options in negotiating a gas drilling lease? Are you ready to answer the knock at the door?

Tax Implications of Oil and Gas Leases: "What You Wish For"

By: Gary M. Schuster, Esq.

The old saying goes, "Be careful what you wish for." If your dream comes true and gas is pumped from your land for years to come, you will be very handsomely paid. However, right behind those royalty checks will come the tax men, from the federal and state governments. It is never too early to start planning for legal ways to preserve wealth and reduce tax liability for yourself and your family. The best time to structure how your assets are held is before the real cash - the royalty money - starts coming in.

Tax planning must encompass your entire financial situation. The gas earnings cannot be considered apart from your employment, business, savings, investments and other assets and liabilities. Also, tax planning almost always involves designing ways to pass wealth from you to your heirs, so it is intertwined with estate planning. Tax planning helps determine how much taxes are paid, when they are paid, and who will receive the remainder of your property.

Why start early, before the money arrives? Estate planning involves not just making gifts in a Will, but also making lifetime gifts. Federal tax law currently permits \$1 million of lifetime gifting tax free. Therefore, if you have assets that might appreciate over time, it is better to gift them sooner, while their value is relatively low. That way, more of your assets can be passed to heirs without triggering tax liabilities.

Not only is lifetime gifting an attractive option, but it is also not necessary to make a gift of the entire asset. Assets can often be "fractionalized," meaning that smaller portions of the assets can be transferred, while the remainder is retained. Real estate, in particular, is often referred to as a "bundle" of rights, with mineral rights (including the right to drill and recover natural gas) being one of those rights. Imagine a tract of several hundred wooded acres co-owned by several people as a hunting preserve. One or more co-owners could transfer just their mineral rights (including natural gas rights) while retaining essentially all the surface rights to the property - rights to enter, use and enjoy, and other rights. The most potentially valuable property rights (the stream of future royalties if gas is found in commercially recoverable quantities) can be transferred while their value is low (before signing the lease), without adversely impacting the use of the land by the transferor or the other co-owners.

The foregoing is just one among many possibilities. However, it illustrates why someone involved in gas leasing should consult with qualified tax and estate planning counsel before the money starts rolling in.

Mr. Schuster is an attorney on our Business and Estates Team and participates in the Gas Leasing Working Group. You can reach him at gms@jacobowitz.com or by calling 845-778-2121 ext. 230.



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158 Orange Avenue
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540 Broadway
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Phone: 845-778-2121
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Where Have All the Landmen Gone?

By: Gerald A. Lennon, Esq. and Gary M. Schuster, Esq.

For months and even years, local landowners were visited and called by "landmen," trying to get them to sign leases for gas drilling on their properties. And yet, suddenly, the landmen seem to have vanished. Where have they gone? Will they return? When?

Landmen generally do not work for a particular gas company, but are free-lancers who are commonly paid on a per diem basis by whomever engages them. They are experienced in soliciting and negotiating gas and oil drilling leases with landowners. At the direction of the energy companies they travel around the country to wherever the leasing activity is "hot."

Leasing activity in New York State, particularly in the Marcellus Shale Formation, has come to a standstill primarily because the NYSDEC has halted the issuance of drilling permits. The DEC has undertaken a substantial environmental review of the statewide well drilling permit process which it last reviewed in 1992. The 60 page outline for completion of the environmental review document was adopted on February 6, 2009. The entire process, including public hearings, is expected to run through the end of 2009.

However, it is reasonable to expect that the landmen will return, in due course, for a variety of reasons: (1) more recent estimates of the amount of gas available in the Marcellus Shale formation are much larger than stated in the original evaluation report - the one that set off the initial gas leasing rush; (2) companies, particularly Chesapeake Energy, have paid millions of dollars to acquire leases - which expire within 5 to 10 years if drilling activity is not started; (3) natural gas pricing, while significantly down from its peak, will surely rise as and when the national economy rebounds; (4) the Marcellus Shale formation is

(Continued inside on page 3)



The Marcellus Shale:

Natural Gas Leasing



Provided by Jacobowitz & Gubits, LLP

First Quarter 2009

Compulsory Integration Q&A

By: Gerald A. Lennon, Esq.

Q: Can a Gas Company Take Gas From Under My Property Without My Permission?

A: While it may surprise you, under the Compulsory Integration provisions of current New York State Law the answer is a resoundingmaybe!

Under current New York State law, a gas company is required to obtain a drilling permit from the Department of Environmental Conservation (NYSDEC) prior to commencement of any drilling activities. The program is administered by the Division of Mineral Resources. As part of the drilling permit application the gas company must designate and define the area of land ("Unit") in which it desires to drill. It must not only identify the lands to be included in such Unit, but also its proposed drilling plans (including well and pipeline locations) and the rationale for the size, location and tracts of land to be included in the proposed Unit.

Drilling permits are granted for Units of relatively limited sizes based on the believed likelihood of recovery of oil and/or gas resources, the associated geology and the perceived "interconnectedness" of the geology of the lands within the proposed Unit. Natural gas Units vary in size (in other areas of the country) based on a variety of factors, but frequently are in the 500-1000 acre range. It is not currently (publicly) known how wide the size range of Units might be in the Marcellus Shale exploration area. In the event that oil and/or gas is discovered in economically recoverable quantities in a Unit, all the owners of the oil and/or gas rights in that Unit MUST share in the value of the resources actually recovered.

Q: Don't I Have to Sign a Lease for the Gas Company to Have the Right to Take Gas from My Property?

A: Not necessarily, but the gas companies do prefer to get a signed lease from landowners for any lands they intend to include within a proposed Unit.

Gas exploration companies try to get all of the mineral rights owners in a proposed Unit to sign leases before they submit an application for a drilling permit. Obviously, they don't want to find large quantities of recoverable oil and/or gas resources and then have to go "hat in hand" to any property owners whose oil and/or gas interests they have not already leased. (Continued on page 2)

This newsletter is intended only to provide general information and does not constitute legal advice. Legal advice must be tailored to particular circumstances and the needs and intent unique to the individuals involved. Nothing in this newsletter should be used as a substitute for the advice of competent legal counsel.

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What is the Marcellus Shale?



The Marcellus Shale is a black shale of Middle Devonian age that underlies much of Pennsylvania, New York, Ohio, West Virginia and adjacent states.

Geologists have long known that the Marcellus contains natural gas. However, the depth of the rock unit and its low permeability made the Marcellus an unconventional exploration target. Within the past few years two technologies, hydraulic fracturing and horizontal drilling, have been tested in the Marcellus resulting in some of the most productive wells in the eastern United States. These developments triggered an explosion of drilling and leasing activity. Leasing activity is on hold pending environmental review by the NYSDEC.

[Source: www.geology.com/articles/marcellus-shale]

(Compulsory Integration Q&A Continued)

It is a misconception, however, that an individual owner of a parcel of land (or the owner of the oil and gas rights if owned separately) within a proposed Unit can refuse to sign a lease and thus block the exploration company from drilling in the proposed Unit. While the exploration company can't force you to actually sign a lease there is a procedure whereby your lands (oil and gas rights) can be included within an approved drilling Unit without your express permission.

Q: How does the gas company force me to include my lands in one of their proposed drilling Units?

A: The NYS Environmental Conservation Law (ECL Article 23) provides a process that allows gas companies to obtain a drilling permit even when they have not obtained leases from all those owning the oil and/or gas rights in the proposed Unit for which the drilling permit is sought.

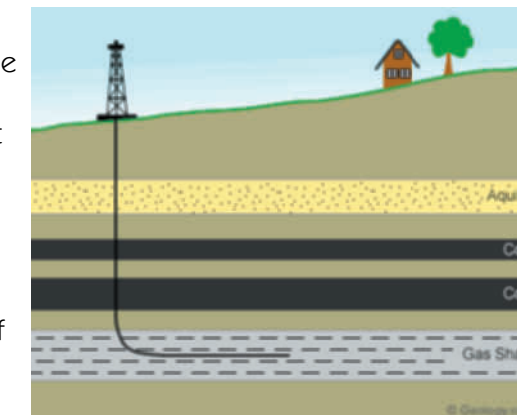
If the owners of at least sixty (60%) percent of the lands (oil and gas rights) within the proposed Unit have consented to drilling, then the company can initiate a Compulsory Integration proceeding under the applicable ECL Article 23 law and regulations to obtain a drilling permit for the proposed Unit without the consent of the "uncontrolled" landowners. The law provides that upon application by the gas company to include lands in a proposed Unit for which they do not have signed leases the DEC "...shall schedule an integration hearing."

The gas company applies to NYSDEC for compulsory integration of uncontrolled mineral rights interests (owners who have either not signed a lease nor otherwise agreed to the drilling) in the proposed Unit. Section 23-0901 provides that the department (DEC) "... shall make an order integrating all tracts or interests {emphasis applied} in the spacing unit for development and operation...." after it finds, "...after detailed study and analysis, notice and hearing..." that such integration is "...necessary to carry out the policy provisions..." of ECL 23-0301. The relevant law is clearly structured to allow the Unit to be formed and the drilling permit to be issued despite the lack of cooperation of some owners of oil and gas rights.

The fact that the DEC can effectively force participation of a mineral rights interest owner in a Unit in which a drilling permit will be issued does not eliminate the obligation of the gas company to pay for those mineral rights. Any integration order shall be issued only "...upon terms and conditions that are just and reasonable..." The integration hearing is held by DEC upon at least 30 days notice to all the mineral rights owners affected. [NOTE: It appears from the applicable law that the drilling permit can not be issued until the conclusion of the hearing process and issuance of the integration order].

Upon adoption of the integration order all uncontrolled mineral interest owners are given notice of their rights and options to be compensated for their mineral rights interests that were included in the Unit resulting from the compulsory integration process. The (previously) uncontrolled owners are given, by state statute, three (3) options on how to receive their unit compensation.

They may elect to participate as an "Integrated non-participating owner," "Integrated participating owner," or "Integrated royalty owner." It is not necessary to review these options in detail at this time. However, should the (previously) uncontrolled owner not sign the state election form and choose an option within the specified time frame, the owner is deemed to have elected the default option - "Integrated royalty owner." As a default "integrated royalty owner" the owner would receive a royalty payment equal to the LOWEST royalty rate of those who have signed leases in the Unit - but with a minimum royalty rate of 12.5%. As you can see, an "uncontrolled" property owner in this leasing area risks not only being compelled to participate in a Unit but also may receive a royalty payment for such participation at a rate less than could have been effectively negotiated.



Mr. Lennon is a senior partner on our Real Estate team and leads our Gas Leasing Working Group. He can be reached at gal@jacobowitz.com or 845-778-2121 ext. 251.

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Do you own forest land? Ever wonder if you can still sign a lease for gas drilling? Check out the forestry management article in our next newsletter to see what your options are!

DEAR NEW YORKER:

In the first decade of the 21st Century, gas exploration has evolved from a predominately regional operation into a large-scale business, attracting national and global companies. As a result, production of natural gas has significantly increased.



This evolution is a direct result of higher natural gas prices coupled with improvements in both gas exploration and extraction technologies.

These advancements have furthered the exploration and extraction of natural gas from two formations that had been previously difficult to tap - the Trenton-Black River and Marcellus Shale.

If done properly, and with proper environmental safeguards, the increased production of natural gas can be a benefit to the landowners, economy, and all New Yorkers. It has already generated significant revenue for energy companies, and some landowners. The companies and the government must be vigilant to protect our environment throughout the process.

In addition to raising environmental concerns, some landowners have complained to my office about abusive, misleading, and/or fraudulent tactics used by certain exploration and development companies, or their agents, in an effort to obtain a lease. If you believe that you have been defrauded by an unscrupulous landman or gas exploration company, or if you have environmental concerns, please contact my office at 1-800-771-7755.

I want to share with you some general information in the event you or someone you know is approached and asked to sign a lease. I hope you find the information contained in this pamphlet useful.

Sincerely,

Andrew M. Cuomo
Attorney General

HOW TO ENTER INTO AN OIL AND GAS LEASE

Most landowners who have entered into an oil and gas lease have been approached by a person directly or indirectly representing a gas operator.

This person is commonly referred to as a **landman**. The landman's main purpose is to secure leases on as large an area as possible.

Landmen may approach landowners at their homes or businesses, or may contact landowners preliminarily by telephone before meeting with them in person.

WHAT IS AN OIL AND GAS LEASE?

In very general terms and in the context of mineral rights and exploration, a lease is a written instrument where the landowner (the "lessor") grants to a business (the "lessee") the right to extract oil and natural gas from beneath a landowner's property.

Like many other types of leases, the rights and obligations of the lessor and the lessee are detailed in the lease and, in most cases, landowners will be bound for the duration of the lease to those terms and conditions.

In addition, the lessee will record either the lease or a memorandum of lease at the local county clerk's office.

Thereafter, if you want to sell your property, the buyer will have to accept that lease along with it. In other words, the rights and obligations set forth in the lease are connected to your land.

For this reason, and because of the complexity of oil and gas leases, **the Attorney General strongly recommends that before signing a lease you contact an attorney to secure professional, personalized advice in this important transaction.**

LANDOWNER'S TIPS

If you are thinking about signing an oil and gas lease, consider the following:

- 1. CONSULT AN ATTORNEY**
before you sign a lease, and review each term and condition of the lease with your attorney.
- 2. ASK ALL NECESSARY QUESTIONS**
to ensure that you understand all terms and conditions on the lease.
- 3. OBTAIN IN WRITING**
all promises and conditions, and make sure those written promises are part of the lease.
- 4. NEGOTIATE**
as you may get better terms than those initially offered to you.
- 5. SEARCH FOR**
and negotiate with more than one gas operator.
- 6. THERE IS STRENGTH IN NUMBERS**
so consider negotiating your lease together with a group of neighbors or interested parties.
- 7. OBTAIN COPIES**
of the lease you sign and a copy of the lease signed by both you and the gas operator to make sure that the lease reflects the agreement reached with the landman.
- 8. THE RIGHT TO CANCEL**
is yours for 3 business days after signing the lease, but to cancel, you must comply strictly with all requirements (consult your attorney).

The New York State
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1-800-771-7755
www.oag.state.ny.us

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**OIL & GAS
LEASES:
LANDOWNERS' RIGHTS**

NEW YORK STATE
OFFICE OF THE ATTORNEY GENERAL

ANDREW M. CUOMO
ATTORNEY GENERAL

Here you can find out what the gas companies are saying:

<http://www.iogany.org/>

Want to learn more about where the industry insiders get their information?

<http://www.petroleumeducation.com/>

Did you know? Approximately 22 percent of the energy consumption of the U.S. comes from natural gas. Slightly more than half of the homes in the U.S. use natural gas as their main heating fuel. (Source: Energy Information Administration - http://www.eia.doe.gov/oil_gas/natural_gas/info_glance/natural_gas.html)

Want more information on the Marcellus Shale?
<http://geology.com/articles/marcellus-shale.shtml>

NEW YORK STATE OFFICE OF THE ATTORNEY GENERAL
ANDREW M. CUOMO, ATTORNEY GENERAL

OIL & GAS LEASES

FOUR KEY TERMS IN OIL AND GAS LEASES

THE LEASING CLAUSE

This clause describes in general terms what rights the lessor is granting the lessee, such as "the right to access and extract oil, gas and their constituents" and "all exclusive rights needed to explore, develop, produce, measure and market production." This includes the right to conduct exploratory tests, drill wells, and use or install roads on a landowner's property.

THE LEASING TERM CLAUSE

The leasing term usually consists of a primary term and a secondary term. Generally, the primary term is explicitly stated as a number of years. The secondary term, however, can extend the duration of the lease indefinitely into the future if gas production is ongoing or if one or more specific events occur, like continued rental payments.

THE BONUS PAYMENT CLAUSE

The bonus payment is the amount of money landowners receive as consideration for signing the lease. It may be a fixed amount or it may be a dollar-per-acre amount.

THE ROYALTY PAYMENT CLAUSE

A royalty is the landowners share of the proceeds from the sale of oil, gas, and other constituents. This clause will determine what percentage a landowner will receive and what deductions, if any, will be made from the sale price before the landowner receives his or her royalties.

PROBLEMS WITH LANDMEN

MISLEADING OR MISUNDERSTOOD STATEMENTS

TOP 5

1. "Your property will [or won't] be in the unit"

Neither the landman nor the gas operator can guarantee that any property will be part of a spacing unit because the New York State Department of Environmental Conservation (NYSDEC) makes this determination.

A landman could let you know whether an operator has proposed a spacing unit containing or excluding a specific property, but any statement purporting to guarantee the inclusion of a property in a spacing unit is misleading.

2. "This is the standard lease, and it's not negotiable"

There is no such thing as a standard lease in the oil and gas leasing business. All leases and all terms in the lease - except for those terms required by law - are negotiable.

3. "All your neighbors have signed, and you're the sole person holding everything up"

It is highly unlikely that you are holding up the transaction. While it might not be misleading to state that all the neighbors have signed (if, indeed, they have signed leases), it is rarely the case that a landowner's reluctance to sign a lease alone is holding everything up.

The NYSDEC requires gas operators to control a minimum of 60% of the property with the proposed spacing unit and 100% of the property through which the well would be drilled. If the size of one property within the proposed unit is such that the gas operator cannot reach that minimum percentage without that property, or cannot drill the well-bore without traversing through that property, than the statement would be accurate.

4. "Don't you want to receive \$X every month"

The amount of money a landowner receives in royalties is a function of several different factors that change from one day to the next. Therefore, no landman can give you a reasonable estimate of how much money you will receive in royalties. A landman, however, may use examples to show you how your royalties will be calculated.

5. "If you don't sign, we'll take the gas from your property without paying you"

The law in the State of New York does not allow this to happen. If a landowner is located within a unit, she will share in the royalties generated within that unit in the proportion allocated to her property.

PRESSURE TACTICS

Remember, it is your property, and you have the right to decide who can come on it, or contact you.

FEELING UNDER PRESSURE? CONSIDER THE FOLLOWING:

1. Obtain the full name, address, and telephone number of both the landman and the business they represent.
2. Direct the landman to leave the property and to not return or contact you again.
3. Write a letter to the landmen and the business they represent, restating the above request.
4. Consider contacting local law enforcement to determine if additional action is necessary.

VERBAL PROMISES VS. WRITTEN DOCUMENTS

Verbal promises should be put in writing. It is essential that every single promise and agreement be in writing and included in the lease.

FAILURE TO PROVIDE A COPY OF THE LEASE

Landowners should demand a copy of the lease within a reasonable time after they sign it. In addition, landowners should request the landman leave them a copy of the lease before it is signed by the gas operator.

PROBLEMS WITH THE LEASE

As noted previously, the leasing clause grants the lessee many rights beyond the right to extract oil and gas. Before deciding whether to sign a lease, landowners should pause to consider what type of uses they want to allow on their properties. For example, while one landowner would not object to allowing gathering pipelines to be installed on his property, another may find such intrusion to be unacceptable.

LEASE DURATION

Landowners should also be mindful of those conditions that will extend the duration of the lease beyond its primary term. Before signing a lease, the landowner should understand how the lease will operate, including whether it will trigger a secondary term, and, if so, when.

ROYALTIES

Landowners should understand exactly what they are receiving in royalties. For instance, if the lease calls for an 18% royalty payment, know how will it be calculated and how to independently verify that you are receiving the correct amount of royalties.

DISPUTES

Another issue that landowners must consider is how would a dispute between the lessor and the lessee be resolved. The so-called "standard leases" contain a provision requiring the use of arbitration, typically involving a panel of three arbitrators. The lessee and lessor each pay the fee for an arbitrator and they split the fee for the third arbitrator. This can result in a significant outlay of money just to have your grievance heard.

Ever wonder how natural gas gets from "Well Head to Burner Top"?
<http://www.naturalgas.org/naturalgas/naturalgas.asp>

Check out the NYSDEC website to find out the latest on the environmental review process:

<http://www.dec.ny.gov/energy/45912.html>