The Good, The Bad, and The Ugly Title, Is Good Title Marketable?

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I. Introduction

The exploration, drilling and development of oil and gas has always been noted as a risky endeavor. It was often said decades ago that one needs to anticipate drilling nine dry holes before drilling the one well that makes the whole effort worthwhile. Technology and information gleaned from prior exploration efforts have reduced many of these risks. The reduced risks are limited to geology and the presence of hydrocarbons within a formation. Market risks, competition from other energy sources, and, in the United States, ownership of land and mineral rights create risks that must be quantified, understood, and possibly addressed before expending tremendous capital in the quest to produce these valuable commodities. In fact, title risks may be greater today than ever before as the resurgence of oil shale development has created a boom in basins once thought to have played out or were certainly beyond the presumed "prime" production. In our area, the Permian Basin is a great example as title is more complicated today than at any time in the past 100 years of operations in this basin. This paper focuses on the risks associated with title. A common question and term utilized in assessing the risk is whether the title is "marketable." We endeavor to define this amorphous term, discuss

the reality of title risks, risk tolerance, statutory marketable title acts, and how to make unmarketable title marketable. As stated before and as will be seen below, "mineral title examination is, and will probably always be, more art that science." [1] We believe this holds true for both landmen and lawyers.

II.
Definitions

The concept of marketable title is amorphous. However, there are a number of court cases that have attempted to define the term "marketable title" and other terms dealing with the quality of title. Several of the terms have been defined in Black's Law Dictionary. We provide these general definitions as follows:

> **Marketable Title:** "A title which is free from encumbrances and any reasonable doubt as to its validity, and such as a reasonably intelligent person, who is well informed as to facts and their legal bearings, and ready and willing to perform his contract, would be willing to accept in the exercise of ordinary business prudence. . . . Marketable title is one which is free from reasonable doubt and will not expose a party who holds it to hazards of litigation. . . . It is said to be not merely a defensible title, but a title which is free from plausible or reasonable objections." [2]
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> **Merchantable Title:** "A good and marketable title in fee simple,

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[1] Robert P. Hill and Richard H. Bate, *Curing Title Defects*, Mineral Title Examination III 10A-38 (Rocky Mt. Min. L. Fdn. 1992).

[2] Black's Law Dictionary "Marketable title" (West 5th ed.).

free from litigation, palpable defects, and grave doubts, a title which will enable the owner not only to hold it in peace but to sell it to a person of reasonable prudence . . . One that can be held without reasonable apprehension of being assailed and readily transferable in market. [3]

Good Title: "One free from reasonable doubt, that is, not only a valid title in fact, but one that can again be sold to a reasonable purchaser or mortgaged to a person of reasonable prudence . . . A title free from litigation, palpable defects and grave doubts. See also Marketable Title." [4]

Defensible Title: Something less than marketable; it is imperfect on the record but is possible to defend.[5]

Unmarketable Title: "Exists when for vendee to accept title proffered such would lay him open to fair probability of vexatious litigation with possibility of serious loss. It being sufficient to render it so if ordinarily prudent man with knowledge of the facts and aware of legal questions involved would not accept it in the ordinary course of business but title need not be bad in fact . . .

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[3] *Id.* "Merchantable title."

[4] *Id.* "Good title."

[5] Kraettetli Epperson, "Defensible Title" When Examining Oil and Gas Interests: An Overview of the Law in Oklahoma, 8 (November 4, 2009), that may be found at the following website: https://eppersonlaw.com/wp-content/uploads/2013/07/222DefensibleTitleOBA.pdf
citing 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.

> Title is 'unmarketable' where it is of such a character as to expose the purchaser to the hazards of litigation and where there are outstanding possible interests in third persons." [6]
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> **Bad Title:** This term does not appear in Black's Law Dictionary, nor does it necessarily go to the issue of marketability. In certain instances, bad title may be referred to by title examiners, landmen, and other title professionals as unmarketable title. However, it may also just be indicative of a complex chain of title involving numerous issues requiring substantial research to determine the marketability thereof. Therefore, as with other uses of the term "bad," bad title may be bad or it may be good.
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> **Ugly Title:** This term does not appear in Black's Law Dictionary and the term does not go to the issue of marketability. Generally when this term is employed it is a reflection of the chain of title, the issues raised and the number and types of transactions involved in the chain of title. Most fee titles in areas with long established oil and gas production tend to be ugly due to the numerous depth severances, unique participation agreements, contractual interests and other events that substantially complicate the title to a tract of land.

Marketable title, merchantable title and good title are used interchangeably. We treat

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[6] Black's *supra* n. 1 "Unmarketable title."

these terms as evidencing the same quality of title. Marketable title does not mean perfect title. While everyone would like "perfect title," the ability to attain perfection can be prohibitive, and in many instances may not be possible. Therefore, when dealing with the issue of marketability, the issue of risk must be assessed, weighed, understood, and dealt with for transactions to proceed to closing.

III.
Business Risks

A. <u>Due Diligence Review</u>: Why is the issue of marketable title a concern? In this consumer oriented society goods, commodities, stocks, bonds and even some real property are bought and sold quickly, efficiently, and without much fanfare. So why are title lawyers and landmen so concerned about the quality of title with respect to oil, gas and mineral properties? The answer may lie with history, third party demands, the risks encountered, the value of the property at stake, and the liability that may be incurred as a result of a mistake. "For an operator, risk may threaten its investment capital, it may expose the operator to liability for nonpayment or trespass, or it may threaten its reputation for doing business responsibly or honorably." [7] Banks may require confirmation of title, upper management may need to know that the company has a sufficient quality of title that provides reasonable comfort that the company can pursue drilling and exploration operations, and the potential for tremendous liability in the event drilling operations are in trespass all drive the need for some title review and to ensure that the quality of the title is satisfactory for the client's or company's purpose. Therefore, it is common for the purchaser of mineral properties to insist upon an agreement that

[7] Angela L. Franklin and Amy M. Mowry, *Balancing Risk in Title Opinions*, Advanced Mineral Title Examination 15-3 (Rocky Mt. Min. L. Fdn. 2014).

allows an examination of the records and files to validate the title represented and assess the risks associated with the properties to be acquired. This is often described as "due diligence" and the purpose "is for the review to provide suitable assurances that the buyer is going to receive the deal upon which it based its offer."[8] The due diligence review process is the method by which the purchaser examines the seller's files and county, state and federal records to, among other things, determine if the title to the property meets the standard in terms of quality that the purchaser bargained for. "[A]ssuring these expectations will be met becomes the primary goal."[9]

B. <u>Risk Tolerance</u>: What does the client or your boss really want? Phrased another way, what is the goal in acquiring the title to a tract of land or an interest therein? Based on the answers to these questions one may largely determine how much risk is reasonable under the circumstances. Is the interest being acquired merely to be held for speculation with the intent to ultimately reconvey the interest to a third party? Does your client or your company desire to hold the interest as a tangible asset with potential future economic value? Does your client or company desire the asset so it can possess, use, extract, sever, or otherwise utilize the asset for some economic benefit? If title to the property is being acquired for the purpose of a future sale to a third party, consideration of the marketability of the interest must be made not only on the front end but, likewise, on the back end as a third party acquiring the interest may have a different risk profile or risk tolerance and may demand a higher level of comfort on the issue of marketability than what you are willing to accept at the front end. After all, title is simply legal evidence of a person's ownership rights in property. Attempting to quantify the

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[8] Milam Randolph Pharo, *Due Diligence Review in Oil and Gas Acquisitions or "I Don't Care - Did I Get the Deal I Bid On?",* 39 Rocky Mt. Min. L. Inst. B-1 (1993).

[9] *Id.*

potential for damage, injury, liability or loss that may be occasioned due to a title failure can be difficult. Some of the difficulty is due to a lack of knowledge of the potential value. This is particularly true in the case of mineral properties, where value may be greatly enhanced as a result of the very actions of the acquiring party. Title defects that are seen as having little value and risk might rise to the level of a great threat if a very prolific oil well is completed on the property. Understanding these issues is a key to assessing your client's or boss' risk tolerance as well as assessing when and if title curative should be secured. It is often said that a dry hole cures many title defects.

The cost of either avoiding a title failure or the impact of the title failure on the ultimate objective must be appropriately considered. Each person's risk tolerance differs and the ability to find that appropriate level of comfort will vary among persons, transactions, and events. Lawyers and landmen must endeavor to recognize their client or their boss' apparent risk tolerance and understand that it may change from transaction to transaction or from time to time based upon extrinsic factors.

C. <u>Assessment of Risks</u>:

1. <u>Acquisition</u>: Assessing risk during an acquisition phase requires an understanding of the nature of the interest to be acquired and the threats to title on that interest and the ability of the assignor to convey the quality of title bargained for to the assignee. If the interest being acquired is a leasehold interest, an assessment needs to be made to determine if the lease is within its primary term or an extended term, has the lease been perpetuated by all necessary conditions and has the lessee preformed all its covenants. In addition, title to the underlying mineral interest on which the lease is based must likewise be examined. If the interest being acquired is a mineral interest, then title to the leasehold estate may not be

applicable but evidence of whether the lease is in force should be presented or determined. If an entire prospect is being acquired, then there may be numerous mineral interests and/or leasehold interests that are being acquired as part of the prospect. If the acquisition involves the borrowing of money and the acquired interests are to be subject to a mortgage, then the lender will have a vested interest in not only the soundness of the marketability of the underlying assets to be acquired, but also the creation of and the potential future enforcement of the terms and provisions of the mortgage and the borrower's ability to place a mortgage lien on the acquired interests. The amount of capital to be expended in the acquisition will be an important factor in determining the risk tolerance. If the acquisition involves an interest of a nominal size, there may not be any further investigation to determine marketability other than a quick review of the records or reliance upon prior title work that may be somewhat dated. On the other hand, if the acquisition involves a large mineral interest or leasehold position and the purchase price is significant, then the acquiring party will likely insist upon evidence of greater certainty that the title to be conveyed is marketable or at a minimum, defensible. Elaborate purchase and sale agreements are negotiated for the purpose of assessing risk, providing mechanisms for dealing with tracts or leases that are deemed unmarketable and the procedures by which the parties can cure defects or adjust the purchase price due to the title defects encountered.

2. <u>Drilling</u>: Since drilling costs involve an outlay of substantial capital, most oil and gas companies require a drilling title opinion prior to commencing drilling operations. However, if there is an existing opinion that covers the spacing unit or area to be drilled by the new well, then there may not be a need to obtain a new title opinion for that specific well. The operator may rely upon prior title work on prior wells drilled on the same leases. Drilling opinions are focused on the issue of trespass. Do the parties drilling the well have the legal right

to commence operations on the land of the proposed well and have they secured leases, agreements, or other rights from all the owners of interests in the lands subject to the well? If there are small interests that are not subject to a lease, contract, or other mechanism such as a forced pooling order, are the drilling parties willing to carry that interest and incur the risk that they may never receive compensation for the drilling costs attributable to that interest.

3. Division Orders: A division order title opinion is one that allocates the proceeds of production from a well that is producing oil and gas. The production purchaser and the operator want to ensure that the parties entitled to the proceeds of production are timely and properly paid. Many oil and gas producing states have statutes that require payment within a certain time period. The drilling opinion should have detailed any defects attendant to the working interests. The division order opinion also focuses on any defects in title that affect the royalty interests, overriding royalty interests and other burdens on production as well as any defects in title that would pose a potential claim or be a lien on the proceeds of production. Many title defects can be waived for drilling purposes but will raise their ugly head in a division order title opinion. A common defect is a mortgage or lien on a drilling party's interest. Such a lien would not impact its ability to drill the well but may impact who receives the proceeds of production upon the sale of oil and gas from the well. Most oil and gas mortgages have an assignment of production provision entitling the mortgagee to the proceeds.

4. Purchase and Sale Agreements: The quality of title to be delivered at closing is often addressed in a purchase and sale agreement ("PSA"). Care should be taken in drafting the PSA so the issue of title, and specifically the quality of title, is fully fleshed out and clearly defined. Most PSAs will have mechanisms in place to deal with tracts or interests where

title does not meet the standard bargained for in the PSA. Very few large transactions close where all title meets the standard set forth in the PSA. The parties generally make accommodation to allow the transaction to proceed to closing even when there are unmarketable tracts by adjusting the purchase price or providing for a period of time for curing the title defects.

The PSA likely has a due diligence period where title defects must be raised by the potential purchaser, thereby triggering a series of actions for curative or adjustment of the purchase price. "Given that a purchaser's title protections are generally limited to the interim period and is clearly defined in the PSA, it is important that both parties fully analyze and understand the title provisions set forth therein. The starting point when reviewing the PSA is the statement of an acceptable title standard as this standard will define what constitutes a title defect." [10] Some commentators have warned that unless the parties actually intend for the standard to be "Marketable Title" that term should not appear in the PSA. [11] If the intention is to deliver "Defensible Title" that term should not be used by itself, but the PSA should fully explain what the parties intend by the use of the term. It has been noted that common law standards of marketable or merchantable title are difficult to achieve for oil and gas interests and should not be used in a PSA. [12] Therefore, the parties "will want to ensure that the definition of defensible title used in the PSA is a clearly defined and achievable standard." [13]

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10 Christopher Heasley and David Wildes, *Applying Title Defects Under a Typical Purchase Agreement*, Due Diligence in Oil & Gas and Mining Transactions Ch. 9 (Foundation for Natural Resources and Environmental Law, Sept. 2018).

11 Allen Cummings and Randy Browne, *Meeting of the Minds on Title Defects*, 48 Rocky Mt. Min. L. Fdn. 27-3 (2002).

12 *Id.* at § 27.02.

13 *Heasley & Wildes, supra* n. 10. at 9-8.

IV.
Marketable Title Acts:

A. <u>Model Marketable Title Act and State Acts</u>: Marketable Title Acts were created to clean up title defects after a certain passage of time. The Model Marketable Title Act was promulgated in 1990 but was withdrawn in 2015 as obsolete. [14] Twenty states have marketable title statutes some of which include provisions from the original Model Marketable Title Act. [15] State marketable title acts range from twenty to forty years of an unbroken title chain. [16]

B. <u>Model Dormant Mineral Interests Act</u>: The Model Dormant Mineral Interests Act, formerly the Uniform Dormant Mineral Interests Act is specific to mineral interests. Under the Model Dormant Mineral Interests Act, a mineral interest is dormant if there is no actual use of the mineral interest for twenty years or more. [17] Only Washington and Connecticut have enacted the Model Dormant Mineral Interests Act. [18] However, other states have enacted dormant mineral interest statutes.

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14 *Uniform Law Commission*, https://www.uniformlaws.org/committees/community-home?CommunityKey=4d753f31-17c0-4fdd-b231-7042943d364f

15 *Id.* States with marketable title statutes include: California, Connecticut, Florida, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Nebraska, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Utah, Vermont, Wisconsin, and Wyoming.

16 David B. Hatch & Angela L. Franklin, "Curative Documents and Tools: You Have a Defect Now What Do You Do?" Oil & Gas Mineral Title Examination 10-1 (Rocky Mt. Min. L. Fdn. 2019).

17 *Id.*at https://www.uniformlaws.org/committees/community-home?communitykey=50d74964-c806-4cbf-9c7a-8f6a83f5be9c

18 *Id.* States with Dormant Mineral Acts include California, Connecticut, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Nebraska, New York, North Carolina, North Dakota, Ohio, Oregon, South Dakota, Tennessee, Virginia, Washington, West Virginia, and Wisconsin.

C. Title Standards: Some states bar associations have adopted certain title standards. While these standards do not bind a court of law, courts have considered them when ruling. [19]

V.
Title Not Meeting Expectations

A. Curative Instruments: Many defects in title can be cured through obtaining of an appropriate curative instrument. [20] Curative instruments can range from a court decree, a correction instrument that takes the place of a defective instrument, to a note or memorandum in a lease file.

Correction instruments should be executed by all parties thereto, reference the prior instrument, and describe the defect being corrected. If the defect in title is very old, it may be difficult to track down one or more of the original parties to the instrument which may preclude this type of correction action.

If there is some doubt or uncertainty as to the quantum of interest held by various parties, the parties can enter into a stipulation of interest setting forth their respective interests. The agreeing parties must execute the stipulation. The stipulation should contain present words of grant and cross conveyance to effectuate its terms.

Disclaimers of interest are often utilized to evidence of record that a particular party does not claim any interest in a property or does not claim an interest adverse to another party's

19 Hatch & Franklin, *supra* n. 16. States with title standards include: Texas, Oklahoma, North Dakota, Michigan, Louisiana, Arkansas, Colorado, New York.

20 For a discussion of curative instruments in greater depth *see* Robert P. Hill and Richard H. Bate, *Curing Title Defects*, Mineral Title Examination III 10A (Rocky Mt. Min. L. Fdn. 1992); and Franklin and Mowry, *supra* n. 7.

interest. It is not uncommon for a party to "disclaim" an interest but will not execute a document that is in recordable form. If you obtain a letter or other written disclaimer that is not in recordable form, you should keep the document in your lease file for future reference. Likewise, if a telephone conversation occurs where a person states that he or she does not claim an interest but does not wish to place the same in writing, you should detail the conversation and pertinent facts in a memorandum. Place the memorandum in the lease file for future reference.

Affidavits are often utilized to provide evidence of facts that do not appear of record. Affidavits may be used to reflect a person's marital history, age of majority, heirship, change of name, mergers and corporate restructuring, and other matters that help explain breaks in a chain of title or other facts that are necessary to explain title issues appearing in the chain of title or provide facts that are missing from the record. Affidavits are sworn statements and should be executed by an unbiased third party not related to the parties who receive the benefits from the facts set forth in the affidavit. Self-serving affidavits have diminished value. While affidavits may help explain a title defect and supply information, it does not make it so. For example, an affidavit of heirship may supply appropriate heirship information, but it is not a substitute for a probate proceeding in many states and certainly does not cut off rights of other persons who can prove their heirship to the deceased individual. It is evidence and can assist the client or your boss in assessing the risk.

Less formal memoranda or letters may also reveal pertinent facts but are not generally sworn to under oath and may not be formal statements of fact. Information in memoranda or letters may be utilized not only to establish facts but may involve agreements by and among parties. Included within letters may be farmout letter agreements. Memoranda and letters are not generally in recordable form, and, therefore, do not appear of record.

B. **Court Actions:** Many defects in title may require court action to ultimately resolve the title issue. Common court actions include probating an estate, securing a declaratory judgment, and quite title. The ultimate proceeding to clear defects in title is a quite title action. Any action filed only operates against the named defendants who are properly served with notice under the laws of the state in which the land is located, and the action is filed. Defendants classified as "All Unknown Persons Who Claim and Interest in the Premises Adverse to the Plaintiff" does not capture persons "whose identity is known to the plaintiff, shown of record, or discoverable with reasonable diligence." [21] If the person's identity is reasonably ascertainable, the plaintiff has a duty on due process grounds to find it and serve notice on that person. If the person's whereabouts is not known and cannot be ascertained through reasonable efforts, then service of the notice may be made by publication under the laws of the state in which the land is located. The burden is on the plaintiff to prove its title.

C. **Sleeping Dogs:** Time heals all wounds, unless the wound kills you first! On occasion, the client or your boss needs to be advised of the potential pitfalls of pursuing curative documents or filing a court action and the impact of a potential adverse outcome. The ultimate business decision after being presented with all of the facts is to determine whether it may be better to leave a particular title defect in place, without action and without drawing attention to it. If the effort of securing a curative instrument or filing a court action is likely to result in an adverse finding against your client or your company, it may be best to leave it alone, at least for a time. A decision may be made to withhold curative for a period of time, possibly the period of the statute of limitations of a particular action or beyond the period of time necessary to secure

21 Richard H. Bate, *Use of Curative Statutes, Statutes of Limitation, Marketable Title Acts and Absent Mineral Owner Statutes*, Mineral Title Examination II at 8-37 (Rocky Mt. Min. L. Fdn. 1982).

title by adverse possession. The landman and attorney should be extremely careful in making such a recommendation. They must fully document the efforts to explain the issues as well as the client's or company's response not to cure the defect.

D. <u>Expectations of Title</u>: The attorney and landmen dealing with title issues on a transaction should have a clear understanding of the expectations of the client or company with respect to the title it is attempting to secure. Reasonable efforts should be made to ensure that the title to be received meets those expectations and where it does not, that the client or company is fully informed of the risks, costs, and time it takes to resolve the particular defects. An expectation of perfect title is generally not reasonable. It is the role of the landmen and attorneys to properly advise the client or company of the risks and, in turn, the client or company must evaluate its tolerance for risk so that all efforts can be made to address any title impediments to the extent necessary to bring them in line with the client's or company's expectations. Whether the title is defensible, merchantable, good or marketable, however such terms are defined in the state where the land is located, should be fully understood. The parties intentions as to the quality of title must be thoughtfully and carefully set forth in any purchase and sale agreement with attendant provisions to deal with the likely event that one or more of the tracts intended to be acquired will not rise to that standard. If the expectations of the purchaser cannot be met, then the ultimate recourse should be to terminate the agreement and walk away. There should be provisions that likewise address that potential outcome such as forfeiture of escrow money or other limited compensation to be paid by one party to the other.

VI.
Conclusion

Yes, Good Title is Marketable. But the real question is whether the title to be delivered by a purchaser meets the quality standard bargained for and if silent, whether state law requires the delivery of "marketable" title or some lesser standard. Perfect title is rarely achievable and in large oil and gas transactions, marketable title may not be achievable for each of the properties intended to be acquired. It is imperative that lawyers and landmen communicate the title risks involved and the effort and time that will be required to bring title to a marketable standard. Parties to oil and gas transactions should have reasonable expectations with respect to the issue of title quality and the agreement should reflect the standard as well as the available recourse that will be taken if one or more properties do not rise to the appropriate title quality level. The agreement should also detail the pursuit of obtaining curative material, as well as the time frame that such curative must be secured.