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| TO: | PLANO |
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| RE: | **PLANO Legal Update**<br>**November 2015** |

## A. Supreme Court refuses to expand lessee's duties under Mineral Code art. 122 (reasonably prudent operator) to include the obligation to disclose information to the lessor when the lessee is purchasing its lessor's mineral rights

In *McCarthy v. Evolution Petroleum Corp.*, 2014-2607 (La. 10/14/15), 2015 WL 5972515, the Louisiana Supreme Court struck down an admitted "novel and untested" cause of action asserted under Mineral Code article 122 ("Art. 122"). Plaintiffs, as lessors who owned a 1/8 lease royalty interest, attempted to expand the obligations of the prudent operator beyond good faith conduct in operations. Specifically, the plaintiffs pleaded that Art. 122 contemplates the duty of transparency when the lessee negotiates the purchase of its lessor's mineral rights. The Court disagreed with plaintiffs and held that a lessee owes its lessor no additional duty to disclose information in the purchase of the lessor's royalty interest than the lessee would owe to any other seller.

As background, plaintiffs relied on error and fraud to seek damages and rescission of the sale of their royalty interest in mineral leases within Delhi Field Unit, located in Richland Parish. The mineral rights were leased more than 60 years ago, with the lessors retaining a mineral interest of 1/8 for royalty payments. Production in paying quantities maintained the leases at issue.

The current lessee, Evolution Petroleum Corp., decided to it would sell the Delhi Field Unit leases to a specific kind of purchaser—one that would use "CO2 enhanced oil recovery technology" in order to dramatically increase mineral production. Denbury Resources, LLC agreed to purchase the leases for $50 million in cash plus other compensation.

While the sale to Denbury was pending, Evolution approached the plaintiffs in an effort to buy plaintiffs' 1/8 royalty interest in the leases. Evolution did not disclose the pending deal with Denbury and offered plaintiffs the equivalent of royalties paid to plaintiffs over the previous 16 years in exchange for plaintiffs' future rights. Plaintiffs agreed to sell their 1/8 mineral interest for approximately $25,000.

Once plaintiffs discovered Evolution's deal with Denbury, plaintiffs filed suit against Evolution for rescission of sale and damages. Plaintiffs relied on Art. 122 to allege (1) fraud by silence and (2) fraud by affirmative misrepresentation. Because no jurisprudence has recognized plaintiffs' theory of recovery, Evolution objected to the petition by filing an exception of no cause of action.

The district court sustained Evolution's peremptory exceptions of no cause of action and dismissed the petitions. The Second Circuit Court of Appeal agreed that plaintiffs failed to plead a cause of action but remanded the case to allow plaintiffs the opportunity to amend their pleading. Evolution filed similar exceptions to the Supplemental and Amended Petition. The trial court again sustained the exceptions. But the Second Circuit reversed the trial court, holding that a cause of action against the lessee for fraud was sufficiently pleaded.

On review, the Supreme Court noted that the parties agreed on one central point: plaintiffs' suit depended on whether Art. 122 could be construed to include the causes of action for fraud as pleaded by plaintiffs. Therefore, the Court conducted an in depth analysis of the duties contained in Art. 122.

*Fraud by Silence*

In order for plaintiffs to plead a cause of action for fraud by silence, a fiduciary relationship must have existed between them and the lessee. The Court held that plaintiffs failed to plead such a relationship because (1) the petitions contain no allegation of any relationship of confidence between the lessors and the lessee, (2) Art. 122 expressly states that a "mineral lessee is not under a fiduciary obligation to his lessor," and (3) while the parties can contract to include additional duties, the default duties under Art. 122 pertain to "mineral development operations, not to buying and selling mineral rights."

The Court assessed the duties established by Art. 122 and held that "disclosure of information [such as the sale to Denbury] is nowhere mentioned among these duties." The Supreme Court further recognized that the "[p]arties may stipulate what shall constitute reasonably prudent conduct," such as requiring the disclosure of information at issue, but the petitions contain no allegation that the parties entered such an agreement.

In concluding its analysis on fraud by silence, the Supreme Court quoted Patrick Martin's treatise on mineral law: Thus he (the lessee) is not required to place the interests of the lessor ahead of his own, nor is he bound by the traditional fiduciary restraints of full disclosure, lack of self-dealing, or prohibition against profiting from the affairs of one's principal.

*Fraud by Affirmative Misrepresentation*

After the Supreme Court held that the lessee did not have an affirmative duty to disclose particular information during the purchase of plaintiffs' mineral rights, it assessed the legal significance (if any) of the affirmative statements made by the lessee to plaintiffs. Simply, did any statements made by Evolution to plaintiffs create a cause of action?

The Second Circuit relied on Civil Code art. 1870 to hold that plaintiffs had a cause of action due to allegations that the lessee falsely asserted the value of the object. But the Supreme Court rejected this application based on Mineral Code art. 17 ("Art. 17"). By focusing on the future value of the minerals, plaintiffs essentially attempt a cause of action for lesion beyond moiety—a cause of action which is strictly prohibited under Art. 17. In cases dating back as far as 90 years ago, the Supreme Court held "that an allegation of inadequate price paid for a mineral interest is the essence of a lesion claim, but is not actionable." The Supreme Court found that the speculative value of mineral rights invalidated lesion beyond moiety claims. Based on the codification of the jurisprudential rule against lesion causes of action in the context of mineral sales, the Court relied on Art. 17 to bar claims of insufficient price and denied plaintiffs' cause of action for fraud by affirmative misrepresentation.

Under the instant facts, plaintiffs failed to plead a cause of action for fraud under Art. 122; thus plaintiffs' petitions for rescission of sale or fraud were dismissed. The Supreme Court recognized that Art. 122 focuses on the lessee's conduct in extracting minerals, while plaintiffs' claims rely on the purchase of mineral rights.

Most simply, the Court held that "courts recognize that mineral exploration is costly for operators and inherently speculative for all parties involved. By relieving mineral lessees of fiduciary duties to lessors and by exempting mineral transactions from lesion, the Mineral Code appears to promote each party keeping their own counsel on issues related to value, and the law will not step in to relieve a mineral rights seller from a transaction if the seller later regrets the price."

The Court does note that, under Art. 122, parties to mineral leases may contractually impose a duty for a lessee to disclose information. So be sure to read your lease provisions applicable to your situation to confirm whether or not the duty to disclose information is contractually included.

### B. Fifth Circuit slaps down another oil and gas insurer for denying coverage

This has not been a good summer in the Fifth Circuit for oil and gas insurers denying claims. In *Cox Operating, L.L.C. v. St. Paul Surplus Lines Insurance Co.*, 795 F.3d 496 (July 30, 2015), the Fifth Circuit upheld a jury award of over $9 million in damages and over $13 million in penalties. Then, in *Weiser-Brown Operating Co. v. St. Paul Surplus Lines Insurance Co.*, Docket No. 13-20442 (Sep. 16, 2015), the Fifth Circuit upheld a jury award of over $2 million in damages and a judge's award of over $1.2 million in penalties.

The *Cox* decision relates to Cox's efforts to collect from its insurer for millions of dollars Cox spent in cleaning up pollution and debris after Hurricane Katrina damaged its oil and gas facilities in Eloi Bay and Quarantine Bay in Plaquemines Parish, Louisiana. St. Paul provided both a $1 million primary commercial general liability policy and a $20 million umbrella policy. Both policies provided coverage for pollution clean-up costs that result from a sudden and accidental pollution incident. Although St. Paul paid just under $1.5 million of the over $10.9 million in claims submitted by Cox for its clean-up, St. Paul refused to pay the difference. The jury awarded Cox the full difference plus another $13,064,948.28 in penalty interest because St. Paul had not, within 30 days after Cox's claim notice, "commence[d] an investigation of Cox['s] claim" or "request[ed] from Cox … all items, statements, and forms that St. Paul reasonably believed, at that time, would be required from Cox."

Like the jury, the Fifth Circuit had no sympathy for St. Paul. Even though Cox had submitted over $2 million in claims after the one-year reporting period specified in the policies, the Fifth Circuit held that St. Paul's denial of Cox's claim constituted a waiver of this reporting requirement. Cox had reported the pollution event within a year; that it took over a year to complete the clean-up would not prejudice Cox. The Fifth Circuit also rejected St. Paul's argument that it should get a credit for the $5 million that Cox was paid by other insurers for its separate ROWD (removal of wreckage and debris) policy; the Fifth Circuit agreed with Cox that the $9 million jury award was for an amount "over and above" what Cox had already recovered. Finally, the Fifth Circuit rejected St. Paul's numerous efforts to set aside the $13 million penalty award. Because St. Paul delayed in responding to Cox, the Fifth Circuit had no hesitation in upholding the 18% interest penalty under the Texas Prompt Payment of Claims Act, Tex. Ins. Code § 542.054. Although St. Paul was able to convince the Texas Association of Defense Counsel to file an amicus brief supporting its petition for rehearing on the penalty issue, the Fifth Circuit had just one follow-up word to say: denied.

The *Weiser-Brown* decision tells a similar tale. Weiser-Brown spent millions associated with the "loss of control" of an oil well it operated in Lavaca County, Texas and made a claim to St. Paul under its control-of-well insurance policy. A jury awarded $2,290,457.03 in damages to Weiser-Brown, and the district court awarded another $1,232,328.14 under the Texas Prompt Payment of Claims Statute.

On appeal, St. Paul just attacked the penalty award. But again, St. Paul's arguments fell short. Even though St. Paul had promptly acknowledged Weiser-Brown's claim with a request for further information, it never indicated in its various follow-up letters that any request for information remained unfulfilled or that determination of coverage was contingent on receiving more information. Because St. Paul did not accept or reject Weiser-Brown's claims within 15 days after Weiser-Brown's last submission of documentation (the applicable time-period under the version of the statute in effect at the time), the district court imposed the 18% penalty interest from that date, and the Fifth Circuit affirmed.

The bottom line for insurers is that they should not be cavalier in dealing with their oil and gas insureds. The bottom line for oil and gas companies is that they should give prompt notice to their insurers and respond to timely requests for information, but that they should not surrender whenever an insurer pushes back: courts and juries in the Fifth Circuit have shown little pity for insurers who do not honor their contracts.