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Oil and Gas Acquisitions

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Unique Louisiana Issues in Due Diligence

When reviewing title to properties located in the State of Louisiana, you should be aware of three particular issues that are somewhat different from a review of properties in other states - Mineral Servitude, Forced Pooling, and Legacy Lawsuits.

1. Mineral Servitude

Every state provides for the sale or assignment of mineral rights, to be owned separate and apart from title to the land. Unlike other states, Louisiana law provides that a mineral right can only be maintained separate and apart from the land if operations or production are conducted. The conveyance of a mineral right that includes the right to drill and explore is called a "Mineral Servitude." (*See LA Mineral Code Art. 21)* The Mineral Servitude will generally terminate unless operations or production occur without a lapse of 10 consecutive years (*Mineral Code Art. 27).* This "use it or lose it" period is called "prescription of non-use." There are few exceptions where a servitude can be maintained perpetually (i.e., not subject to prescription of non-use), including the situation where mineral rights are reserved in a sale of land to a government *(Mineral Code Art. 149).*

Many other special rules apply to the maintenance of a Mineral Servitude. For example, if a navigable body of water or a government owned highway traverses the servitude lands, the servitude will be divided into parts. In order to be fully maintained in effect, a divided servitude will generally require operations or production to be conducted on *both sides* of the water or highway.

If you are reviewing properties located in Louisiana, the due diligence review should confirm, among other things, that any mineral servitude has not been divided, and has been maintained in force and effect by continuous operations or production, without a lapse of more than 10 years. Additionally, you need to understand the effect of unit operations and the effect of a producing unit well located on or off the servitude lands.

2. Forced Pooling and Unitization

Your Due Diligence review should take into consideration any special rules in Louisiana applicable to each type of Unit.

Four types of pooling and unitization apply in Louisiana: (i) a Unit established under the terms of your Mineral Lease (called a “Declared Unit”), (ii) a Voluntary Unit Agreement (“VUA”) established by contract or agreement of the parties, (iii) a Unit established by governmental Order of the Louisiana Commissioner of Conservation (called a “Forced Pooled Unit” or “Commissioner’s Unit”) and (iv) Communitization Agreements, if Federal lands are involved. In addition to verifying the seller’s title and ownership percentages, your due diligence review should take into consideration any special rules in Louisiana applicable to each type of Unit.

A. <u>Declared Unit</u>. Similar to Texas, a Declared Unit is established by filing a declaration in the public records in accordance with the terms of a mineral lease. This unit becomes effective upon filing in the public records where the lands are located. In most cases, only the Working Interest (WI) owners need to sign the declaration. Generally, the mineral lease and ORI Assignment grant the WI owner the right to file a Declared Unit without further consent. Consequently, an owner of overriding royalty interest (ORI) or lessor’s royalty will not need to sign unless required by an unusual contract. If a Declared Unit is established, it will be limited in size to the smallest area allowed by the terms of the applicable Mineral Leases, etc. Typically, leases allow units equaling 40 acres for an oil well and 160 acres for a gas well. In addition to the small unit sizes allowed, one particular issue with Declared Units is if any part of the unitized lands are unleased (possibly resulting from a title bust), then the Declared Unit may be subject to attack.

One drawback to a VAU is that it becomes void if a Commissioner's Unit is established for the same depths or formations.

B. **<u>Voluntary Unit (VUA)</u>** A VUA is simply a contract between all mineral owners (Royalty, ORI and WI) within the unit boundaries. The ORI owner typically gives the WI owner authority to establish a VUA without its signature. However, the mineral lease does not grant this authority to the WI owner. The VUA is formed by written agreement between the WI and royalty interests, and is effective when recorded in the Conveyance records of the Parish. You should note that the State Mineral Board has a form of VUA that is mandated to be used if State owned lands or water bottoms are located within the VUA. One drawback to a VUA is that it becomes void if a Commissioner’s Unit is established for the same

depths or formations.

C. <u>Commissioner's Unit</u>

The Commissioner's Unit is the most common type of unit in Louisiana. These units are established by governmental Order. Many out of state landmen or lawyers are not familiar with the special rules applicable to these governmental units. One of the special rules is known as the "Risk Fee" penalty, which allows an operator to force non-operators to either participate in the drilling or be subject to a non-consent penalty (similar to non-consent in a Joint Operating Agreement). Note that the Risk Fee penalty does not apply to lands that are unleased. If a Commissioner's Unit is established, the due diligence team must confirm that (i) the interests being acquired are not subject to suspension of revenues under a Risk Fee penalty and (ii) the seller is not currently receiving an undisclosed non-consent interest that will later revert to another party once the Risk Fee or other non-consent penalty is recouped. The Risk Fee penalty does <u>not</u> apply to a Declared Unit or a VUA.

As in all other units, your due diligence review should confirm proper payment of lessor's royalty and ORI's on tracts included in a Commissioner's Unit. Prior to August 1, 2012, the unit operator was not obligated to pay lessor's royalties or ORI's on third party leases where the lessee was subject to a Risk Fee penalty. <u>*Gulf Explorer vs. Clayton Williams Energy, Inc.*</u> Effective August 1, 2012, LRS 30:10(A)(2) was revised to now provide that during recovery of the "risk fee penalty" the operator is required to pay the non-participating lessee (1) for the benefit of the lessor, all royalty due under the non-participating owners leases, (2) overriding royalty interests carved out of its leases. These payments are generally limited by the average unit net revenue of the operator. Proper payment and the lack of royalty demands should be confirmed during your due diligence review.

D. <u>Issues with Federal Lands/Minerals (Communitization Agreements)</u>

If the area to be acquired is located, all or part, on Federal lands or waters, then unitization may be accomplished by a contract often referred to as a Communitization Agreement ("CA"). Just as needed for review of any other type of Unit, you should confirm (i) the seller's ownership percentage in the CA, (ii) that the CA has been properly approved, and (iii) the unit area has been maintained in force and effect.

One special rule is the "Risk Fee" penalty, which allows an operator to force some non-operators to either participate in the drilling or be subject to a non-consent penalty.

Effective 8/1/12, revisions to LRS 30:10(A)(2), now provide that during recovery of the "risk fee penalty" the operator is usually required to pay the royalty and ORI attributable to the non-participating leasee.

Proper payment and the lack of royalty demands should be confirmed during your Due Diligence review.

3. Legacy Lawsuits

Corbello v. Iowa Production, (La. 2/25/03), 850 So. 2d 686

These suits became prominent after the Louisiana Supreme Court's 2003 decision in *Corbello v. Iowa Production*. These actions are known as "legacy suits" because they often arise from operations conducted many decades ago, leaving an unwanted "legacy" in the form of damages from actual or alleged contamination. In *Corbello*, the court held that damages for breach of a contract were not limited to the value of the land, and therefore extremely high awards of damages were justified. These suits typically name every operator and non-operator who ever owned a leasehold interest, even if the operations occurred decades ago. For due diligence purposes, it is important to recognize that the current buyer may have liability for damages caused by past operations, even if the acquisition deed provides that the buyer only assumes liability for future operations occurring after the effective date of the sale.

A "Legacy Lawsuit" refers to a suit filed by a landowner claiming that oil and gas operations, often occurring many years ago, caused his property to become polluted or contaminated, above or below the surface.

Generally the buyer will have an environmental study done to confirm or deny the existence of pollution or contamination. If a lease is still in force and effect, the oil company is generally not required to restore the surface until its operations are completed, *unless* its use of the land is found to be unreasonable or excessive. In the case of *Terrebonne Parish School Board vs. Castex Energy, Inc.*, the Louisiana Supreme Court held that our Mineral Code does not impose an implied duty to restore the surface to its *original pre-lease condition* absent proof that the operations were excessive or unreasonable. In *Castex,* the court held that dredging of canals in marsh areas was a normal use, and the company did not have to fill in the canals, even though they were causing coastal erosion. However, this rule can be modified by specific terms of a lease, and a lessor can specifically require that restoration obligations be conducted even before expiration of the lease. The due diligence review should include a review of onerous lease provisions that may require, among other things, specific surface restoration liabilities.

Terrebonne Parish School Board vs. Castex Energy, Inc., (No. 2004-C-0968, 1/19/2005)

In an apparent attempt to reign in the numerous Legacy lawsuits that continued to be filed, the Louisiana Supreme Court more recently issued a 42-page decision in *Marin vs. Exxon*. In the *Marin* case, Exxon installed and operated oil and gas facilities, along with a landing/dock terminal, on plaintiffs' properties. Exxon also built separators, oil gathering systems, and pits used for skimming oil from saltwater and other fluids produced with oil and gas. The Supreme Court in *Marin* held that once the landowner has notice that there is apparent damage to land (for example where crops don't grow in old pit areas), the landowner is

Marin vs Exxon, 48 So. 3d 234 (La. 2010)

required to investigate the site and to file suit within one (1) year after being put on notice of possible contamination. The fact that chemicals remained in the ground from operations conducted more than one-year prior, did not result in tolling or interrupting the running of the one-year prescription.

We strongly suggest that if there is any suspicion of surface contamination (possibly from old drilling or production pits) or subsurface contamination (possibly from salt water injection), then it is imperative that you have an attorney, along with an environmental expert, guide your review of these areas. This applies even if the seller indicates that the sites were properly remediated, in accordance with governmental standards or if obvious signs of contamination no longer exist.

You cannot simply take a "clean" report generated by a prior operator as being conclusive. An independent evaluation should be conducted in areas where there is any evidence to suggest prior contamination, surface or subsurface.

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