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# Does Market Volatility in the Oil Patch Breed New Litigation?

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## I. . We Have Entered Another Era Of Market Volatility.

There is certainly no need to elaborate on the significant swings in market prices that have occurred over the past year. Oil prices reached a record high in July of 2008 (at somewhere around $147 a barrel) and dropped to approximately $40 a barrel in early December of 2008. Clearly, a fall in market prices has an impact on upstream activities, especially on exploration expenditures. The oil and gas industry has often coped with periods of market volatility in the past. What may make the present era different is the view of many that the recent dramatic decline in prices is intrinsically linked to the global financial crisis.[2]

## II. Past Eras of Market Volatility Have Led to Significant Litigation.

### A. The Market Value Cases

Prior to the 1970s, natural gas was considered virtually a waste product of crude oil production, since crude oil was much more valuable and there was a lack of adequate markets for gas. Indeed, unless a pipeline was available in the field to purchase gas as it came out of the ground, the gas was often flared (burned at the well) in order to maintain oil production. To entice a pipeline to build the facilities necessary to take and purchase the gas, a producer needed to make a long-term commitment of sufficient reserves to justify the pipeline's investment. In fact, even into the 1960s, the gas market remained poor; prices were low, and, generally, there was a surplus of gas available. Thus, most producers sold natural gas to pipelines under long-term contracts that obligated the pipeline to take or pay for a certain minimum amount of production.

In the 1970s, unexpected changes in the gas market occurred that reduced the attractiveness of a producer's long-term gas contracts as compared with new gas sales contracts. A gas shortage developed in the early 1970s and was made worse by the Arab Oil Embargo in 1973, resulting in dramatic increases in gas prices, especially in the intrastate market where prices were not regulated. However, many producers were obligated to sell their gas under pre-existing long-term contracts, pre-

1 The author is grateful for the assistance of Kelly Brechtel Becker of Liskow & Lewis.

2 Energy Economist, Issue 327, January 1, 2009, "Upstream Barometers."

venting them from entering new gas sales contracts at higher prices. The disparity in prices under the old versus new contracts spawned a series of litigation throughout producing States regarding the meaning of "market value" in the lease royalty clause when the lessee was obligated under a long-term contract price that was considerably lower than the current market price.

Many courts, including the Texas Supreme Court in *Exxon Corp. v. Middleton*, 613 S.W. 2d 240 (Tex. 1981), interpreted the market value clause to mean that royalties were owed on the current market value even when the gas was dedicated to a long-term contract at a lower price. Louisiana, however, took the opposite approach. In *Henry v. Ballard & Cordell Corp.*, 418 So. 2d 1334, 1338 (La. 1982), the Louisiana Supreme Court held that if the lessee makes a prudent sale of the gas consistent with its duty to market, then the lessor should be paid royalty based on the lessee's sales price, not on some higher, fluctuating, day-to-day measure of market value. *Henry*, 418 So. 2d at 1338-40. Commentators have described the courts following the Texas approach as adhering to the "view that 'market value' is a 'plain term' that must be given its usual meaning – the price a willing buyer and seller would agree upon at the time of production," whereas courts following Louisiana's rationale interpret "market value" as a "term of art in the oil and gas industry [such that] courts must ... look beyond the four corners of the lease to the parties' intent, to implied covenants, or to fundamental fairness." John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. Rev. 223, 234 (1996).

**B. Take-or Pay Litigation**

In the 1960s and 1970s, producers of natural gas typically entered into high priced "take-or-pay" natural gas sales contracts with their pipeline purchasers. These contracts provided proportionately high take obligations for the pipeline with guarantees of payment to the producer. The term "take-or-pay" refers to a provision in a natural gas sales contract pursuant to which the pipeline purchaser committed to take a certain specified volume of gas and pay for it, or pay for it regardless of whether the gas was taken or not. The purpose of "take-or-pay" provisions was to assure producers a steady flow of income necessary to allow them to conduct their business. When natural gas market conditions changed beginning in approximately 1983, pipelines greatly reduced or stopped taking gas, and as a result they incurred enormous take-or-pay liabilities, *i.e.*, the pipeline companies owed billions of dollars to producers under their natural gas sales contracts for natural gas volumes not taken. This led to efforts by pipeline companies to settle their take or pay liability and to amend contracts to get out of their high-priced, high-take gas obligations. In both instances, producers often filed suits, and the vast majority of the disputes, including those where litigation was filed, were

compromised. Many of the settlements involved a payment to the producer, as well as either amendments to the contract, especially the pricing and take provisions, or a termination of the contract. Years of litigation ensued involving these "take-or-pay" claims, which raised several different issues.

For example, in *Pogo Producing Co. v. Sea Robin Pipeline Co.*, 493 So. 2d 909 (La. App. 3 Cir. 1986), a Louisiana appellate court held that a producer was entitled to a preliminary injunction forcing a pipeline company either to take or pay under the gas contract once it had made a prima facie showing of likelihood of success on the merits. Additionally, in *Hanover Petroleum Corp. v. Tenneco, Inc.*, 521 So. 2d 1234, 1240 (La. App. 3 Cir. 1988), another Louisiana appellate court rejected the pipeline's defense of force majeure, holding that "adverse economic conditions and modifications in governmental regulations and policy which tend to render performance burdensome and unprofitable do not constitute force majeure."

Another line of cases revolved around the question of damages, specifically whether the pay alternative in the contract constituted a liquidated damages clause – mandating the remedy by having the pay alternative written into the contract. The majority of courts addressing this issue have held that the take-or-pay clause provides for alternative performance and that the pay clause is not a mandated remedy for breach or a liquidated damages clause. *Roye Realty & Developing v. Arkla, Inc.*, 863 P.2d 1150 (Okla. 1993); *Prenalta Corp. v. Colorado Interstate Gas Co.*, 944 F.2d 677 (10th Cir. 1991); *Resources Inv. Corp. v. Enron Corp.*, 669 F. Supp. 1038 (D. Colo. 1987). The *Roye* case has been cited for "easing the troubles of natural gas pipelines committed to take-or-pay contracts" for its holding that "'the measure of damages for anticipatory repudiation of both the take and the pay obligations in a take-or-pay gas purchase contract is the difference between the market price at the time when the aggrieved party learned of the repudiation and the unpaid contract price.'" Ryan Griffitts, *Roye Realty & Developing v. Arkla, Inc.: Two Steps Forward and Two Steps Back in the Take-or-Pay Saga*, 20 Okla. City U.L.Rev. 219 (1995) (citing *Roye*, 863 P.2d at 1154-55).

**C. Royalty on Take-or Pay Litigation**

Because of the enormous payments (totaling billions of dollars industry-wide) that producers received from pipelines pursuant to the numerous gas contract settlements that were entered into across the industry in the take-or-pay litigation, widespread litigation ensued between royalty owners and producers over whether the producers owed royalty on such gas contract settlement payments. This litigation involved claims by private royalty owners in all of the gas producing states (*e.g.*, Louisiana, Texas, Oklahoma, New Mexico, *etc.*) as well as claims by the MMS for royalties under leases affecting federal lands onshore and offshore, pri-

marily in the Gulf of Mexico. That litigation produced a variety of results throughout the various jurisdictions, and the split in decisions largely revolved around two competing views: (i) the royalty obligation cannot be triggered absent "production," versus (ii) the lessee's entitlement to share proportionately in all benefits of production.

For example, the United States Fifth Circuit Court of Appeals ruled federal lessees did not owe royalties on unrecouped take-or-pay payments, because such payments were for gas *not taken*, and "royalties are not owed unless and until actual production, the severance of minerals from the formation, occurs," 853 F.2d at 1165. *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988). A similar result was adopted by the Texas courts in *Killiam Oil Co. v. Bruni*, 806 S.W. 2d 264 (Tex-App. San Antonio 1991), where the court held that royalties were not owed on a take-or-pay settlement because the lease at issue only provided for royalties on "gas ... produced from said land" and thus "'production' ... means the actual physical extraction of minerals from the soil." 806 S.W.2d at 267.

The Louisiana Supreme Court, on the other hand, focused not on the strict language of the royalty clause, but rather on the implied covenants between the lessor and the lessee and the doctrine of fundamental fairness. *Frey v. Amoco Production Co.*, 603 So. 2d 166, 170-74 (La. 1992). In finding that royalties were, indeed, owed on amounts received under take-or-pay settlements, the *Frey* court held that that a mineral lessee must share with its lessor the "economic benefits generated by the lease." 603 So. 2d at 173-74. In other words, the *Frey* decision stands for the proposition that all proceeds from a wellhead sales contract, including a settlement or payment under a take-or-pay contract for production from the wellhead, were royalty bearing because the lease expressly provided for royalty on "amount realized at the well from such sales." Moreover, the Louisiana Supreme Court in *Frey* explicitly acknowledged that its decision differed from other jurisprudence on that same point.[3]

**D. Posted Price Litigation**

Historically, oil companies posted a price at which they were willing to purchase oil from a particular well or lease. Eventually, postings evolved into field or location postings, which companies publish and which set a price they are willing to pay for oil of a certain type at a given field or location during a stated time period. Yet, not all companies actually bought oil at their posted prices, and some companies that posted prices may have paid more or less than their posting, depending upon the contract negotiated between the producer and the buyer and upon other factors including quality, location, quantity, and available transpor-

[3] *Frey*, 603 So. 2d at 182 ("We are aware of the federal and state court jurisprudence holding contrary to the position we assert herein.").

tation facilities. Until 1992, most companies posted prices in a fairly narrow range. Beginning in 1992, postings diverged into what are often referred to as tiers. One tier of posted prices is made up of the active buyers of lease crude and contains most of the postings. Another tier of posters generally includes integrated major oil companies that have their own refineries to supply, such as Exxon, Shell, Chevron, and Amoco.

Beginning in the 1980s, off-lease market centers (such as the Empire and St. James market centers) began to develop. Crude oil was transported to market centers, where it was aggregated, processed, further blended, and sold at enhanced market center prices, which were reported publicly. Market center prices reflect, in part, the costs incurred in transporting, aggregating, processing, and blending the crude and, thus, are typically higher than the value of the oil on the leased premises, *i.e.*, the posted price. In the late 1980s and early 1990s, the use of the posted price in purchases and sales of crude oil between affiliated companies began to come under increasing scrutiny. Eventually, disputes arose between producers and royalty owners, who recognized that market center prices were typically higher than posted prices and thus questioned the use of posted prices to value crude oil for royalty purposes.

MDL 1206 was a nationwide class action raising federal antitrust claims and state-law oil royalty claims against numerous large national oil companies. The crux of the plaintiffs' claims was that "the differential between the market price at the trading center and the posted price at the lease was too low because the defendants consistently set their posted prices below the actual market value," and thus defendants underpaid royalties by basing the royalty payment on the posted price instead of the higher market center price. The MDL 1206 case resulted in a nationwide settlement of the antitrust claims. In approving a settlement class, the Texas district court noted that "the problem of differences in state remedies [for royalty claims] (including lease cancellation in Louisiana, for example) and defenses to those remedies has been overcome where the plaintiffs all share common federal antitrust claims." *In re Lease Oil Antitrust Litigation (No. II),* 186 F.R.D. 403, 421 n.27 (S.D. Tex. 1999). Following MDL 1206, numerous state court cases were filed asserting both royalty and severance tax claims based on the notion that crude oil was not properly valued when the posted price was used. In these cases royalty owners and the tax department have contended that the "value" of crude oil for royalty or severance tax purposes should be based upon "spot market" prices obtained in transactions at a market center, with adjustments for "backing out" transportation costs between the lease and the market center. This valuation method is often referred to as the "market center netback methodology." There have been no reported Louisiana decisions on these state-law posted price and severance tax claims, as the vast majority of disputes have settled.

## III. The Present Market Volatility Is Equally Likely To Result In Litigation.

No one can predict with any amount of certainty what kinds of disputes, and what kind of litigation, will come out of the present market volatility. However, our experience with similar market conditions in the past can give us some indication of what kinds of claims might be on our "radar screens" over the next several years.

Certainly, any type of long-term, fixed price contract can be put at risk in an era of great market volatility. As the past demonstrates, long-term contracts with fixed purchase prices are often attacked when it is perceived by the royalty owner, or the working interest owner, that the long-term fixed price is too low with respect to current market values. Conversely, purchasers may seek ways to get out from under long-term contracts where the fixed prices are inordinately high with respect to falling market prices. Fortunately, because there is already some case law on basic issues such as "market value" and the royalty obligation with respect to settlements, a significant repeat of those same kinds of claims may not materialize.

In addition to a repeat of the kinds of claims that have been seen in the past, there are a number of other areas where great market volatility can give rise to litigation.

### A. "*Frey* Claims" in the New Era.

Historically, the law has been slow to catch up to the realities of the market. The posted price severance tax litigation, for example, was based largely on the fact that the severance tax law referenced "posted price" as a measure of value for crude oil, and the law was not changed to reflect changing marketing practices. While posted price may have been, at one point in time, an accurate reflection of market value in the field, the allegation was that, by the 1990s, new marketing models had rendered posted prices to be irrelevant in most fields. That extensive posted price litigation was, in large measure, an attempt to find an accurate way to measure value in a new marketing era of sales to affiliates, buy-sell arrangements, exchanges, market-center transactions, *etc.*

In much the same way, the vehicles for financial trading of commodities have evolved since many of the oil and gas instruments in effect today were written. Commodity trading, hedging, "swaps," short selling, trading at market centers or pooling points – these were not widely known when many of the oil and gas leases and contracts were written. There has been very little litigation applying the traditional oil and gas claims, and traditional oil and gas principles of duties to royalty owners, market value, etc., in this era of sophisticated commodity trading, where a producer/lessee may also engage in a certain amount of trading activity as a way to hedge against price fluctuations.

Louisiana, in particular, is in a unique situation when it comes to the application of royalty concepts to commodity trading. Because of the Louisiana Supreme Court decision in *Frey v. Amoco*, it is the law of this State that royalties are owed on the "economic benefits generated by the lease." *Frey*, 603 So. 2d at 173-74. No court, as yet, has attempted to apply the concept of "economic benefits" to the revenue generated by the trading of the oil or gas produced from the lease or to the trading activity used as a hedge against fluctuating prices.

**B. Attempts to Reject Lease Terms.**

As the recent experiences in the Haynesville Shale demonstrate, amounts paid to lessors or royalty owners in conjunction with exploration and drilling rights can also fluctuate greatly, both because of volatile oil and gas prices and for reasons unrelated to those prices. These fluctuations potentially can give rise to two distinct kinds of litigation.

First, of course, when landowners "sign on" to leases for certain amounts and then the price increases significantly, the result is often what is euphemistically referred to as "lease busting" claims, where landowners, lessors, or royalty owners try to negate the terms of the lease, often in the hope of obtaining a higher bonus payment, royalty, *etc.* The significant spike in bonus payments for the Haynesville shale properties has resulted in a number of "lease-busting" claims. In fact, a simple Google search of the words "Haynesville shale" turns up a number of lawyers offering to review leases for landowners and to evaluate for those landowners whether the terms of the lease are fair. The drop in the value of Haynesville shale leases that occurred in the late summer and fall has put a damper on those claims. None of those claims has reached the stage of a reported decision.

Second, the volatile pricing in areas like the Haynesville shale can result in the exact opposite kind of claims: lessees may attempt to revoke the terms of leases. The local press in the Haynesville shale areas have reported on instances where lessees purportedly have concluded that, for whatever reason, the lessee is not bound by the terms of a lease, or an anticipated lease, although few of these kinds of situations have, as yet, resulted in litigation, and there are no reported decisions.

**C. "Price-Fixing" Claims.**

Whenever there are significant swings in market prices, there is also a risk that price-fixing claims will result. These claims sometimes focus on a specific markets or market centers and make allegations that certain entities were or are able to control or fix the published or indexed prices at that market center. Some of those kinds of allegations were brought in conjunction with the "posted price" litigation. In "posted price" cases, the allegation was sometimes made that a certain market price was "artificially low" because one entity, or a handful of entities, controlled that market, or because there were few options for producers that wanted to

sell their production, resulting in a "captive market." As the vast majority of those claims were settled, there is no reported decision on those issues.

While we have not seen significant accusations of "price fixing" or litigation over price fixing at Louisiana market centers, such claims recently have been made with respect to the market at the Houston Ship Channel. There, the Commodity Futures Trading Commission, the entity charged with promoting the integrity of the energy markets, has conducted certain non-public investigations in conjunction with alleged attempts to manipulate the price of natural gas at delivery locations in Texas. *See, e.g., In re Application to Enforce Administrative Subpoena of the U.S. Commodities Futures Trading Commission v. the McGraw-Hill Companies*, 507 F. Supp. 45 (D. D.C. 2007). According to accounts published in the press, the accusations arose when Platts reported that some natural gas traders believed that a company or companies drove down prices for gas flowing through a pipeline hub at the Houston Ship Channel.[4] The accusation is that these companies would wait until the last thirty minutes of the end-of-month trading day and, at that time, sell significant quantities of gas well below market prices with the intent of manipulating futures prices, while at the same time taking "short" positions or engaging in "swaps," where they would realize their profits. The allegation is that the traders would submit the sale information to Platts knowing Platts would reply on the price reports. Certain of those matters have settled without any admission of liability.

"Price-fixing" claims also have implications for royalty owners and for non-operating working interest owners. If, for example, it is determined that production was sold at "artificially low" prices, that may give rise to claims by royalty owners or working interest owners that they were paid based on prices that were artificially low, as well. There is also the possibility that private royalty owners may begin to bring claims similar to those articulated by the CFTC, alleging that significant players in a specific market engaged in activities that might be construed as "price fixing."

**D. Development Claims.**

Ordinarily a mineral lease provides that drilling operations or production on any part of the lease will maintain the entirety of the lease. However, courts have always recognized an "implied obligation" or "implied covenant" to develop the lease. Today, the implied obligation to develop is expressed in Mineral Code article 122 as follows:

> A mineral lessee is not under a fiduciary obligation to his lessor, but he is bound to perform the contract in good faith and to develop and operate the property leased as a reasonably prudent operator for the

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[4] Houston Chronicle, 12/27/2006, page 1; Houston Chronicle, 7/27/2007, page 3.

> mutual benefit of himself and his lessor. Parties may stipulate what shall constitute reasonably prudent conduct on the part of the lessee.

The official comments to Mineral Code article 122 contain an extended discussion of the obligation to develop. Although the annotation under Article 122 of the Mineral Code suggests that the implied obligations of reasonable development and further exploration are considered to be two separate covenants, which is true in many common law jurisdictions, Louisiana courts have tended to blur the distinction between the two covenants. Our courts have sometimes discussed the two covenants as though they were individual branches of a single obligation to develop and explore for the mutual benefit of lessor and lessee.

Disputes over the development obligation are often contentious because in many state and federal Louisiana cases in which a court has found a breach of the development obligation, lease cancellation was the remedy. The ultimate question in a development dispute is always whether the lessee has acted as a reasonably prudent operator. *Carter v. Arkansas Louisiana Gas Co.*, 213 La. 1028, 36 So. 2d 26 (1949). As the law stands today, the prudent operator standard is fairly flexible, taking into account "similar circumstances and conditions, having due regard for the interest of both contracting parties." *Carter, supra.* In considering whether development has been "reasonable" for the benefit of both lessor and lessee, the jurisprudence has generally considered the following factors:

> geological data;
>
> the number and location of the wells drilled both on leased lands and adjoining property;
>
> productive capacity of producing wells;
>
> costs of drilling operations as compared with profits;
>
> time interval between completion of the last well and the demand for additional operations; and
>
> acreage involved in the disputed lease.
>
> *Vetter v. Morrow*, 361 So. 2d 898 (La. App. 2 Cir. 1978).

The ultimate question is whether or not the lessee has met the reasonably prudent operator standard. This standard, as is relates to the development obligation, has been described in *Carter v. Arkansas Louisiana Gas Co.*, 36 So. 2d 26 (La. 1948) as follows:

> The law of this state is well settled that the main consideration of a mineral lease is the development of the leased premises for minerals, and that the lessee must develop with reasonable diligence or give up the contract; further, that as to what constitutes development and reasonable diligence on the part of the lessee must conform to, and be governed by, what is expected of persons of ordinary pru-

dence under similar circumstances and conditions, having due regard for the interest of both contracting parties. *Id.* at 28.

The reasonably prudent operator standard is an objective one. In early cases, courts stated that neither party is made "the arbiter of the extent to which, or the diligence with which, the operations shall proceed." *Brewster*, 140 F. at 814. And in cases where significant development activities have been conducted, a mere difference of opinion as to the amount of operations necessary to constitute reasonableness was held insufficient to merit lease cancellation. *Fontenot v. Austral Oil Exploration Co.*, 168 F. Supp. 36, 40 (W.D. La. 1958).

The comments to Mineral Code article 122 also discuss an "offshoot" of the reasonable obligation to develop – obligation of further exploration. As part of his development obligation, a lessee has the obligation to explore and test all portions of the leased premises after discovery of minerals in paying quantities. Mineral Code article 122, comment; *Taussig v. Goldking Properties Co.*, 495 So. 2d 1008 (La. App. 3 Cir. 1986). Whether the lessee has sufficiently tested and explored the leased premises is "a question of fact which must be resolved by a consideration of the facts and circumstances shown in the particular case." *Carter v. Arkansas Louisiana Gas Co.*, 36 So. 2d 26, 28 (La. 1948). However, it is evident that a lessee is not obligated to continuously or periodically drill wells upon the premises. *See Middleton v. California Co.*, 112 So. 2d 704 (La. 1959). In cases where the court has found the lessee in compliance with his obligations to develop, the lessee has demonstrated that it has made diligent efforts to determine what reservoirs might exist under the property and exhibited a willingness to develop potentially profitable reservoirs.

There is some uncertainty in the law as to the reach and extent of this obligation. In *LeJeune v. Superior Oil Co.*, 315 So. 2d 415 (La. App. 3 Cir. 1975), for example, the lessor contended that the lessee had breached the lease because it had not drilled a "good prospect" in a specific sand outside of the unit being produced. The Court, however, ultimately concluded that, because this specific sand was "not a 'known mineral producing formation,' within the meaning of the obligation of the lessee to develop," there was no violation either of the obligation to develop or of the obligation to explore. On the other hand, in *Rathborne Land Company, L.L.C. v. Ascent Energy, Inc.*, No. 05-2452 (E.D. La. 12/31/2008), the Court found that a lessee had breached its obligation to reasonably explore and develop by failing to obtain 2D seismic data, failing to pursue farmouts, "failing to participate in a 3D study that might have disclosed the presence of potentially profitable oil and gas deposits," and failing to release retained acreage.

Articles 136 and 137 require that written notice be given to the lessee before suit is filed for breaches of the obligations set forth under the

article 122 of the Mineral Code. *Rivers v. Sun Exploration and Production Co.*, 559 So.2d 963, 969 (La. App. 2d Cir. 1990) (recognizing that the notice requirement set forth in Article 137 is an indispensable prerequisite to a judicial demand). The written notice required by these articles operates without exception. See *Wilson v. Palmer Petroleum, Inc.*, 97-2386 (La. App. 1 Cir. 11/26/97), 706 So.2d 142, 146 (holding that rules applicable to active/passive breach are no longer applicable to the written notice requirement of Article 137).

It takes little imagination to predict the kinds of exploration and development claims that can arise as a result of widely fluctuating prices. When prices are low, lessees may chose to limit production or to shut in certain wells. Such decisions may give rise to claims by lessors that the lessee has breached the implied obligation to reasonably develop the property. In those instances, lessors must be prepared to demonstrate that further development will not be profitable for the lessee and that its actions are in accordance with the "reasonably prudent operator" standard. When prices are high, lessors may bring claims regarding the obligation to explore the property, arguing that "a reasonably prudent operator" would seek out and explore over and above what is already being produced. Again, lessees must be prepared to argue that their decisions were reasonably prudent, given the *Vetter* factors.

**E. Production in Paying Quantities**

Not all production will maintain a mineral lease in effect. Whether or not the lease specifically requires production in paying quantities, that requirement is implied in the lease. Louisiana Mineral Code Article 124 provides that production is in paying quantities when production applicable to the total of the original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss. Louisiana Mineral Code Article 125 provides that, in applying Article 124, the amount of the royalties being paid may be considered only insofar as it may show the reasonableness of the lessee's expectation in continuing production. The amount need not be a serious or adequate equivalent for continuance of the lease as compared with the amount of the bonus, rentals, or other sums paid to the lessor.

How this requirement could be interpreted in an era of quickly falling prices is unclear. The comments to the Louisiana Mineral Article 124 seem to provide that (1) the lease must be producing in such a manner as to yield a profit to the working interest owner over current operating expenses; and (2) the amount of the royalties being paid to the lessor must be sufficient to dispel any notion that the lessee has been holding the lease for speculative purposes and is doing all that might be reasonably expected to maximize his profit on his total investment or minimize any loss thereon. It is clear that, over some period of time, proceeds of

production need to be sufficient to satisfy operating expenses plus derive some small profit. Unfortunately, the period of time during which the lessee must demonstrate this small profit is not certain. Another difficulty in determining if the lease is producing in paying quantities, particularly for an outside party, is quantifying the expenses. Even internally a company may not be attempting to match up revenues from the lease with lease expenses on a periodic basis.

As with many topics, the issues involved in determining whether a lease is producing in paying quantities can be complicated, especially if the lessee operates several wells in the field and some type of allocation must be made for expenses. For example, should the expenses be allocated based on units of production, by well, or in some other manner? It is also important to remember that it is the lease that must be producing in paying quantities, not a well on the lease. Thus, there is no problem with operating a marginal well in conjunction with a better well on the same lease.

When prices have been low, but are starting to see a significant increase, this issue can arise when additional production has been obtained and the lessor or a potential top lessee is arguing that the base lease has expired and the leased premises is now either unleased or subject to the top lease. As a practical matter, if there is no other new, better production and no third party attempting to lease the property for a substantial bonus and better lease terms, the lessor normally does not care whether or not the lessee is making money, as long as the lessor is paid royalty.

There is no requirement that the lessor put the lessee in default in this situation, nor is there any opportunity for the lessee to cure the default after some period of time lapses the court determines reasonable. This is because the language found in standard leases provides that the lease will be maintained in effect as long, but only so long, as production is obtained in paying quantities and for 90 days thereafter.

**F. Lien Claims.**

Lien claims can arise especially in instances where prices take an unexpected downturn. The "classic" lien situation is when a contractor on a well site finds itself unable to make payments to its subcontractors, and the subcontractors file liens under the Louisiana Oil Well Lien Act. The risk of this can rise dramatically if a contractor is thinly capitalized and finds itself over-extended in a period of decreased cash flow. Great market volatility also puts at risk long-term contracts that lock in drilling rigs at high day rates. Those high day rates, which may have been justified when prices were high and drilling rigs were in great demand, may look less attractive in an era of falling prices when drilling is down. Jack-up rigs in the Gulf of Mexico may be particularly at risk, as there are concerns in certain areas that there may be over capacity.

The Louisiana Oil Well Lien Act, La. R.S. 9:4861 *et seq.*, establishes a right of certain claimants to a privilege on, among other things, the proceeds from oil or gas production. A "claimant" is defined as "a person who is owed an obligation secured by the privilege established." La. R.S. 9:4861(1). The privilege is limited to operations essentially associated with oil or gas wells. La. R.S. 9:4861(3). After the revisions of the mid-1990's, it is clear that "operations" no longer include the transportation and handling of production beyond the well site. The statute now makes clear that its intent is to provide a privilege to those who provide work associated with the drilling and production of the well itself. The privilege attaches to the entire "operating interest under which the operations" are being conducted, to certain facilities at the well site, and to related tracts, servitudes, and leases. The act also specifically provides for the establishment of a privilege over proceeds. La. R.S. 9:4863(4).

The law also provides for an operator's lien at La. R.S. 9:4881, *et seq*. An operator is defined as "a lessee who is conducting operations with respect to a well." La. R.S. 9:4881. A "lessee" is defined as "a person who owns an operating interest." La. R.S. 9:4861. The operator's lien extends to the following property:

> the operating interests under which the operations are conducted; a well, building, tank, etc. on the well site; certain movables on the well site; a tract of land covering the well site of the operating interest; the hydrocarbons produced from the well site; and the proceeds received by, and the obligations owed to, the operator from the disposition of hydrocarbons subject to the privilege.

*See* La. R.S. 9:4883(A). Importantly, this privilege does not affect "[t]he hydrocarbons produced from the well site that are owned by the lessor, sublessor or overriding royalty owner." *See* La. R.S. 9:4883(B).

The operator's privilege is established and effective as to third parties when "the obligation it secures is incurred." The operator's privilege ranks equally with other privileges granted under LOWLA, and are superior in rank to all other privileges, except for privileges for ad valorem taxes, privileges given under Part A of LOWLA, and mortgages or security interests effective as to third parties *before* the operator's privilege is established. *See* La. R.S. 9:4888.

Both types of liens may be enforced by writ of sequestration, without the necessity of furnishing security. La. R.S. 9:4871. Both types of liens must be preserved by the filing of a lawsuit within the specified period of time.

In difficult times, it is easy to imagine a number of different scenarios under which someone who provides labor, goods, or services in conjunction with the drilling and production of a well goes unpaid, or when an operator is not paid all that may be due to him. Parties whose property

could be subject to liens should take steps, including requesting lien waivers, to protect their property from the risk of liens.

## IV. Summary – What Will The Future Bring?