

A Sigh of Relief: Oil and Gas Lender not Liable, as Mortgagee, for Failure to Release Expired Leases

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In the latest ruling from the contentious Gloria's Ranch case (*Gloria's Ranch, L.L.C. v. Tauren Exploration, Inc.*, 2018 La. LEXIS 1694), the Supreme Court of Louisiana reversed the lower courts' decisions that held Wells Fargo Energy Capital, Inc. ("Wells Fargo"), as the mortgagee of a mortgage granted by a mineral lessee, solidarily liable with the mineral lessee mortgagor for the lessee's failure to release an expired oil and gas lease covered by the mortgage. The Supreme Court also held that Wells Fargo was not responsible for a lessee's failure to release a lease in which Wells Fargo held a net profits interests and overriding royalty interest granted by the lessee. This decision will calm concerns of energy lenders, who feared a chilling effect on secured oil and gas financing in Louisiana if solidary liability was upheld.

The Supreme Court of Louisiana granted a writ application to determine whether Wells Fargo was properly held solidarily liable as an "owner" of the oil and gas lease under La. Mineral Code art. 207 and a "lessee" under La. Mineral Code art. 140. These statutes require that a former owner or lessee release the expired mineral lease and holds lessees liable for failure to pay royalties that are due. In its June 27, 2018, opinion denying solidary liability, the court articulated that Wells Fargo was not an "owner" or a "lessee" for purposes of the La. Mineral Code.¹

Background

In 2004, Gloria's Ranch, the landowner, entered into a mineral lease in which Tauren Exploration ("Tauren") was the lessee. Tauren later assigned Cubic Energy ("Cubic") a 49 percent interest in the lease. Both Tauren and Cubic entered into separate credit agreements with Wells Fargo in which each mortgaged its interest in the Gloria's Ranch lease as collateral. The mortgages included a customary collateral assignment of proceeds from the lease in favor of Wells Fargo (*i.e.*, an assignment of production). Tauren later reached an agreement with Wells Fargo to release its mortgage in exchange for Tauren assigning a 10 percent net profits interest in the lease and a portion of an overriding royalty interest in its deep rights to Wells Fargo. At the time the Gloria's Ranch litigation arose, Wells Fargo held a mortgage covering Cubic's leasehold interest and a net profits interest and overriding royalty interest covering Tauren's leasehold interest.

In 2010, Gloria's Ranch, asserting the lease terminated due to failure to produce in paying quantities, filed suit against Tauren, Cubic, and Wells Fargo for failure to release the lease. Gloria's Ranch sought damages for its inability to lease its minerals to third parties due to the cloud created by the unreleased lease, lost rentals, and lost royalties.

Wells Fargo's Mortgage Covering Cubic's Leasehold Interest

The intermediate court of appeal held Wells Fargo solidarily liable with its mortgagor, Cubic, finding that Wells Fargo, as a mortgagee, became an owner of the lease because it "controlled the bundle of rights that make up ownership, *i.e.*, the rights to use, enjoy, and dispose of the lease."² The intermediate court found that Wells Fargo's right to control Cubic's conduct of oil and gas

operations under the lease through the mortgage and credit agreement amounted to ownership because these financial instruments gave Wells Fargo the rights of “usus,” “fructus,” and “abusus.” Specifically, the court of appeal pointed to: (1) language in the credit agreement that directed Cubic where to spend the loan proceeds; (2) Wells Fargo’s ability to approve the location and depth of wells; (3) Wells Fargo’s right to specify which workovers and completions to perform; (4) the requirement that Cubic provide Wells Fargo with financial statements; (5) Wells Fargo’s ability to access the leased mineral property; (6) Wells Fargo’s overriding royalty interest and net profits interest in the lease; and, (7) the requirement that Cubic obtain Wells Fargo’s written consent to release the lease.

In overturning the court of appeal, the Supreme Court of Louisiana expressed that none of the provisions within the mortgage or credit agreement gave Wells Fargo the right to explore for and produce minerals on the leased land, which is “the primary right granted in a mineral lease and the stamp of ownership thereof.”³ The court stated that the “bundle of rights” controlled by Wells Fargo were traits of security rights related to safeguarding the collateral, rather than ownership rights of “usus,” “abusus,” and “fructus.”

The Supreme Court’s opinion noted that “it is customary in the oil and gas industry for a lender to (1) include restrictions on how the debtor/borrower will use the leased property, (2) require full financial information with regard to the status of the collateral encumbered by the mortgage, (3) require that the borrower maintain the encumbered mineral leases in force and effect, and (4) allow inspection of the premises.”⁴

Louisiana’s high court emphasized that Cubic’s assignment of production in favor of Wells Fargo was “merely a security device – not an assignment of the *fructus* (civil fruits) of the mortgaged property for purposes of creating ownership or holding a mortgagee liable for the obligations of its debtor.”⁵ The court added that the mere existence of a security interest does not subject a mortgagee to liability for its mortgagor’s breach of the lease contract.

Regarding the court of appeal’s determination that Wells Fargo held *usus* (physical use) over the lease because of its right to enter the property, oversight rights, and its right to direct the use of proceeds, the Supreme Court of Louisiana stated that these provisions were also typical rights of a secured creditor. The opinion specified that these rights did not convey any ownership rights and existed to keep Wells Fargo informed about the condition of the collateral as well as Cubic’s ability to pay back the loan.

In its analysis of Wells Fargo’s alleged right of *abusus* (alienation) over the lease, the Supreme Court discussed the provision in Cubic’s mortgage that required Wells Fargo’s consent before Cubic could release its oil and gas lease. The court determined that this provision was simply a protection over Wells Fargo’s collateral, not an element of ownership. The Supreme Court’s opinion stated that, though Cubic did not abide by its obligation to release the lease with Gloria’s Ranch when the wells on the property failed to produce in paying quantities, Wells Fargo should not be held solidarily liable merely because it held a security interest in that lease.

Wells Fargo’s Net Profits Interest and Overriding Royalty Interest Covering Tauren’s Leasehold Interest

Although Wells Fargo acquired an overriding royalty interest and net profits interest in Tauren’s interest in the lease, the Supreme Court determined this did not amount to ownership in the lease as these financial interests were passive, derivative rights that were given to Wells Fargo in

exchange for the release of Tauren's mortgage. Citing La. Mineral Code art. 81, the court explained that "the owner of a mineral royalty has no executive rights; nor does he have the right to conduct operations to explore for or produce minerals."⁶ As these financial interests did not allow Wells Fargo to perpetuate the oil and gas lease, it was not an owner and did not possess obligations of ownership like the maintenance of production in paying quantities, payment of royalties, or release of the lease upon demand by the lessor.

** 2018 Summer Associate Brent Wagner contributed to this alert.*

¹ *Gloria's Ranch, L.L.C. v. Tauren Exploration, Inc.*, 2018 La. LEXIS 1694, *23-24

² *Gloria's Ranch, L.L.C. v. Tauren Exploration, Inc.*, 223 So. 3d 1202, 1222

³ *Gloria's Ranch, L.L.C. v. Tauren Exploration, Inc.*, 2018 La. LEXIS 1694, *16-17

⁴ *Gloria's Ranch, L.L.C. v. Tauren Exploration, Inc.*, 2018 La. LEXIS 1694, *17

⁵ *Gloria's Ranch, L.L.C. v. Tauren Exploration, Inc.*, 2018 La. LEXIS 1694, *18

⁶ La. R.S. § 31:81