Are the OCC's Reserve-Based Lending Guidelines Enforceable'

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Two years ago, right after crude oil prices hit rock bottom in the middle of the worst downturn for U.S. producers since the 1980s, the Office of the Comptroller of the Currency ("OCC") revised its Handbook for Examination of Oil and Gas Exploration and Production Lending ("E&P Handbook"). The updated E&P Handbook introduced new metrics by which bank examiners were intended to evaluate the repayment risks on banks' loans secured by oil and gas reserves, or reserve-based loans. The unexpected changes announced by the OCC—in the midst of an already stressful commodity price downturn—added to angst and consternation among energy lenders and their oil and gas borrowers. Importantly, the OCC mad these changes to the E&P Handbook without first submitting them to Congress for review and approval under the Congressional Review Act ("CRA").

A few years before the revised E&P Handbook was issued, the OCC, along with other agencies responsible for oversight of national banks, issued a similar update to guidance for the evaluation of "leveraged loans" under the Interagency Guidance on Leveraged Lending (leveraged lending guidance). Similar to the updates to the E&P Handbook, the agencies issued their updated guidance without first submitting it to Congress for review and approval under the CRA.

In 2017, following an inquiry by Senator Pat Toomey, the Government Accountability Office ("GAO") reviewed whether the OCC and other agencies' action with respect to the updated leverage lending guidance complied with the CRA and concluded that it did not. Following the GAO's decision, officials at the OCC and Federal Reserve have publicly stepped back from enforcing the updated leverage lending guidance.

Although the GAO's decision related to the leveraged lending guidance, the same determination should be made with respect to the updated E&P Handbook because it is similar to the leveraged lending guidance when it comes to scope, purpose and effect on banks. For further reading and analysis, please refer to our article "Enforceability of OCC Reserve Based Lending Guidelines."

Energy Lender's Liability Clarified under Louisiana Law

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 an 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. For further reading and analysis, please refer to our article “A Sigh of Relief: Oil and Gas Lender not Liable, as Mortgagee, for Failure to Release Expired Leases.”

Retained Acreage Clauses in Texas Leases

In April 2018, the Supreme Court of Texas rendered decisions in two cases involving disputed “retained-acreage” clauses found in oil and gas instruments. Broadly, these “retained-acreage” clauses vary widely and prescribe the portion of the lease that remains upon expiration of the applicable primary term, or in certain cases, the cessation of continuous drilling operations. Although the Court applied the same principles to these companion cases, the Court reached different conclusions, with each turning upon the specific language in each instrument’s retained-acreage clause (Endeavor a lease, XOG an assignment).

In Endeavor Energy Resources, L.P. v. Discovery Operating, Inc., --- S.W.3d ---, No. 15-0155, 2018 WL 1770290 (Tex. Apr. 13, 2018), the dispute centered around whether Endeavor (as operator and lessee) was entitled to 81 acres per well (the number of acres allocated by Endeavor (as operator and lessee) to each well in the proration unit plats for each well), or whether Endeavor was entitled to 160 acres per well (the maximum number of acres permitted to be allocated by an operator to a well according to Texas Railroad Commission guidelines). Endeavor maintained that an operator’s allocation of a lesser number of acres to a well (whether mistaken, in error or otherwise) did not control over the express lease language entitling the lessee to a “proration unit to contain the number of acres required to comply with applicable rules and regulations…for *obtaining the maximum producing allowable* for the particular well.” However, the Court determined the prior language in the sentence to be dispositive, which provided that the lease terminated except as to “those lands and depths located within a governmental proration unit assigned to a well…” Ultimately Endeavor was only entitled to the specific acreage that “Endeavor ‘assigned to’ each well” in its proration unit plats.

In XOG Operating, LLC v. Chesapeake Exploration Limited Partnership, --- S.W.3d ----, No. 15-0935, 2018 WL 1770506 (Tex. Apr. 13, 2018), the issue was whether the surviving acreage after giving effect to a retained-acreage provision in an assignment from XOG to Chesapeake was governed by the operator’s (here, Chesapeake’s) acreage designation or by the applicable field rules. If the applicable field rules controlled, then Chesapeake would retain more acreage (320 acres per well) than it designated in the proration plats filed with the Railroad Commission (200 acres per well). XOG contended that Chesapeake’s designation determines the acreage it continues to hold under the retained-acreage provision because only an operator, not the Railroad Commission, can include acreage within a proration unit, and only by filing a Form P-15 and plat for a well. However, the retained-acreage clause in the assignment defined the acreage included within the proration unit of each well to mean “the area within the surface boundaries of the proration unit then . . . *prescribed* by field rules . . . .” Focusing on the reference to a *prescribed* proration unit, the Court held that the retained-acreage provision was not limited to Chesapeake’s designation but was controlled instead by the applicable field rules.

Each of these cases turned upon the specific language in the instrument and that language’s interaction with underlying statutory and regulatory requirements. Unlike the retained acreage clauses in the Endeavor leases that required the operator to assign acreage to a proration unit to retain such acreage upon termination of the lease, the clause in the XOG assignment allowed for

the operator to retain acreage by reference to the field rules, which prescribed the size of the proration unit. While the field rules in Endeavor referred to assignments by operators claiming acreage, the field rules in XOG prescribe proration units.

These two cases are an important reminder to operators, lessees and lessors to particularly focus on retained-acreage clauses, both in terms of avoiding ambiguity in the provision itself and their interaction with applicable field rules and the proration designation (whether or not a plat is required) for each well. As the Court cautioned in its XOG decision, these two cases "apply the same principles and ascribe the words the parties chose their plain meaning."