ALL'S WELL THAT ENDS WELL:

The *Gloria's Ranch* Decision, And its Impact on Credit Documentation

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I. Introduction*

Energy lenders to the upstream sector of the oil and gas industry released a collective sigh of relief on June 27, 2018, thanks to the Louisiana Supreme Court. In a highly anticipated ruling, the Supreme Court reversed the controversial decision of the Second Circuit, Court of Appeal, in *Gloria's Ranch v. Tauren Exploration*.[1]

* Portions of this paper are taken from PATRICK S. OTTINGER, *Louisiana Mineral Leases: A Treatise* (Claitor's Law Books & Publishing Division, Inc., 2016), §§ 12-03-06 (hereinafter cited as "Ottinger, *Mineral Lease Treatise*"), principally by way of adaptation, reorganization and supplementation. Chapter Twelve of this Treatise is entitled "Secured Interests in the Mineral Lease, and in the Parties' Rights and Interests Thereunder." Also utilized herein are portions of the *amici curiae* brief filed by this author, as described in footnote 1.

[1] 252 So. 3d 431 (La. 2018). In the interest of full disclosure, your presenter represented the American Bankers Association and the Texas Bankers Association as *Amici Curiae* in support of Wells Fargo's writ application to the Louisiana Supreme Court, and on the merits. The LBA participated in this brief through our capable general counsel, David Boneno. A copy of our *amici* brief is available on the website of the LBA at https://lba.org/LBA/Communications/Legal_Bulletin/LBA/CommunicationLayouts/Legal_Bulletin.aspx?hkey=2f5f82cf-a718-4627-a18b-59761a6f0c99&WebsiteKey=6d74d428-c265-4f6a-bb3c-6819a7da2fcf. (URL broken for formatting purposes.)

The *Gloria's Ranch* case is particularly unique in that certain aspects of the decision would be of great interest to an audience of oil and gas lawyers, while other phases of the case are equally important to today's audience—bank counsel concerned with its implications on secured transactions involving mineral leases (as well as, to be hereafter noted, other commercial leasehold interests) as collateral for the indebtedness of the lessee-borrower. It is certainly conceivable that *vice versa* does not apply here.

II. The *Gloria's Ranch* Decision

A. Pertinent Facts:

The underlying operative facts in the case are not particularly controversial or unusual for a case arising out of Haynesville Shale formation,[2] but the ruling of the trial court, as modified and affirmed by the appellate court, was both extreme and unprecedented in Louisiana law. The decisions in the lower courts certainly were problematic, and a cause for significant concern to the energy lending industry.

The basic facts are that three companies held the mineral lease granted by a land owner, Gloria's Ranch: Cubic, Tauren and Exco. Cubic borrowed money from a Wells Fargo affiliate,[3] which debt was secured by a mortgage containing, among other customary provisions, an assignment of production proceeds. The mortgage and the credit agreement were typical of most documentation in a reserve-based loan transaction, commonly called an "RBL."[4] More about that in a bit.

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[2] The importance of the Haynesville Shale was explained by the court in *Ferrara v. Questar Exploration and Production Co.*, 70 So. 3d 974, 978 (La. App. Ct. 2d), *writ den'd* 75 So. 3d 943 (La. 2011), thusly:

"In March 2008, however, things changed when Chesapeake Energy publicly announced the discovery of the Haynesville Shale formation as a large and potentially profitable natural gas play. On August 18, 2008, the Commissioner of Conservation issued a memorandum recognizing that the Haynesville Shale zone 'has been shown to be both laterally continuous and productive over an extensive area' and dispensing with the production test requirement for proposed units in the Haynesville Shale."

[3] Wells Fargo Energy Capital, Inc. is a wholly owned subsidiary of Wells Fargo & Company, a bank holding company ("BHC"). The BHC Act of 1956, as amended (28 U.S.C. §1841, *et seq.*), provides for all BHCs to be supervised on a consolidated basis by the Federal Reserve.

[4] "At its core, the traditional reserve-based loan is little more than an asset-backed loan, a mortgage secured by oilfield reserves rather than a home." Michael P. Marek & Robert A. Wilson, *A Future for Reserve-Based Lending in Emerging Markets? Limitations on the Traditional Model*, 10 TEX. OIL & GAS L.J. 150 (2014). *See* Part III.E hereof.

The lands covered and affected by the mineral lease from Gloria's Ranch participated in production from the Cotton Valley and Haynesville formations, but production diminished to the point that the lessor asserted that the lease had lapsed due to lack of production in "paying quantities."[5]

Gloria's Ranch issued a demand to the defendants for a release of the allegedly expired lease.[6] The defendants resisted, contending that the mineral lease had not lapsed. Additionally, the lessees were alleged to have failed to pay lease royalties to Gloria's Ranch from a certain well completed in the Haynesville zone.

B. The Trial Court's Ruling:

Suit was filed by Gloria's Ranch against the three companies,[7] and Wells Fargo, mortgagee of Cubic, to declare the mineral lease to have expired by its own terms;[8] for damages for failure to release the expired lease,[9] and for unpaid royalties from a well in Section 15, including "damages double the amount of royalties due."[10]

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[5] "When a mineral lease is being maintained by production of oil or gas, the production must be in paying quantities. It is considered to be in paying quantities when production allocable to the total 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." LA. REV. STAT. ANN. § 31:124. *See* Patrick S. Ottinger, *Production in "Paying Quantities"–A Fresh Look*, 51 ANN. INST. ON MIN. LAW 24 (2004). Also published at 65 LA. L.REV. 635 (Winter 2005). *See also* Ottinger, *Mineral Lease Treatise*, § 3-15.

[6] LA. REV. STAT. ANN. § 31:206. Under article 206 of the Louisiana Mineral Code, "when a mineral [lease] is extinguished by . . . expiration of its term, . . ., the former owner shall, within thirty days after written demand by the person in whose favor the right has been . . . terminated, furnish him with a recordable act evidencing the extinction or expiration of the [mineral lease]."

[7] Exco settled with the plaintiff prior to trial, leaving only Tauren, Cubic, and its mortgagee, Wells Fargo, as defendants.

[8] *Id*. at § 31:133. Article 133 of the Louisiana Mineral Code announces that a "mineral lease terminates at the expiration of the agreed term or upon the occurrence of an express resolutory condition."

[9] *Id*. at § 31:207. Under article 207 of the Louisiana Mineral Code, if the "former owner of the . . . expired mineral [lease] fails to furnish the required act [evidencing the termination of the mineral lease] within thirty days of receipt of the demand . . ., he is liable to the person in whose favor the . . . lease has been . . . expired for *all damages resulting therefrom* and for a reasonable attorney's fee incurred in bringing suit."

[10] *Id*. at § 31:139.

The trial court found that the mineral lease had lapsed due to the failure to produce in "paying quantities," and awarded damages to Gloria's Ranch for lost-leasing opportunities at $18,000 per acre ($22,806,000) due to the lessees' failure to release the expired lease.[11] It further awarded $726,087 for unpaid royalties for the well in Section 15 pursuant to article 140 of the Louisiana Mineral Code ($242,029 in royalties due plus $484,058 in "double royalties" as damages). Attorney's fees in the amount of $936,803 were also awarded. This judgment was rendered against all three remaining defendants (including Wells Fargo), *in solido*.

Whatever can be said about the propriety of the court's ruling as to lease termination, and the basis of damages "resulting from" the failure to release the expired lease, and the assessment of "damages double the amount of royalties due,"[12] the most radical and controversial aspect of the decision is that Wells Fargo, the mortgagee-lender of one of the lessees (Cubic), was held co-extensively liable along with the defaulting lessees for monetary damages awarded by the court for violations of the lease and applicable statutes.

Of particular relevance to this topic, with regard to Wells Fargo, the trial court held that the mortgage granted to it by Cubic contained an "assignment," sufficient to make Wells Fargo some sort of "owner" of the expired lease and, thus, liable as an "owner" for the failure to release the expired mineral lease, and for unpaid royalties and codal damages.

C. The Appellate Decision:

On appeal,[13] the appellate court disagreed with that specific ruling, finding that the language of the mortgage on which the trial court relied was not an assignment of an interest in the Gloria's Ranch lease, but, rather, an assignment or pledge of production, in the nature of a security interest.[14]

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[11] *See* Ottinger, *Mineral Lease Treatise*, § 1-25(e), for a discussion of volatility in bonus prices in the Haynesville Shale in Northwest Louisiana in the year 2008, documenting per acre bonus payments ranging from $150 (February 2008) to $25,000 (July and August 2008).

[12] While not particularly relevant to this audience, the Supreme Court's decision also resolved a long-standing debate on the maximum award of damages that a court might award for non-payment of royalties. *See* Ottinger, *Mineral Lease Treatise*, § 13-30(c).

[13] 223 So. 3d 1202 (La. App. Ct. 2d 2017).

[14] This typical mortgage provision is set forth in Part V hereof, on Pages 41-42 *infra*.

Nevertheless, the appellate court found that the various covenants and provisions in the recorded mortgage (as well as the unrecorded credit agreement) constituted some indicia of "control," sufficient to justify a finding that Wells Fargo "owned" an interest in the lease, supporting its solidary liability along with its borrower, Cubic.

Most important to the appellate court seemed to be a mortgage provision that required the bank's consent to the release by the lessee of an item of collateral, in this case, the Gloria's Ranch mineral lease. As to this common mortgage clause, the court noted, as follows:

> Wells Fargo exercised control over Cubic's oil and gas operations on the lease, and controlled Cubic's ability to release the lease for failure to produce in paying quantities. As such, Wells Fargo shared co-extensive liability with Cubic to provide a recordable act evidencing the release of its interest in the lease, and we discern no manifest error in the trial court finding Wells Fargo solidarily liable with the remaining defendants.[15]

In its analysis leading to the determination that Wells Fargo "exercised control over Cubic's oil and gas operations on the lease, and controlled Cubic's ability to release the lease for failure to produce in paying quantities," the appellate court evaluated this novel and unprecedented theory under the definition of "ownership" in the civil law as being composed of the rights of *usus, fructus* and *abusus*.[16]

That the appellate panel seemed to recognize that it was entering uncharted legal territory, with significant implications to the sanctity and utility of a mortgage, is evidenced by its attempt to limit its ruling with the following admonition in the Conclusion portion of the opinion, to-wit:

> We note this case is highly fact-intensive and should not be construed as governing other cases that may follow unless the same facts exist.[17]

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[15] 223 So. 3d at 1224.

[16] "Ownership is the right that confers on a person direct, immediate, and exclusive authority over a thing. The owner of a thing may use, enjoy, and dispose of it within the limits and under the conditions established by law." LA. CIV. CODE ANN. art. 477A.

[17] 223 So. 3d at 1225.

After affirming the trial court's award of damages, and awarding an additional $125,000 as attorney's fee for the appeal, the defendants applied to the appellate court for rehearing, which was denied.[18] However, two of the five judges[19] dissented vigorously from the denial of rehearing, stating, as follows:

> Devastating economic repercussions might possibly develop throughout the lending industry if the original opinion of this court is maintained. Serious and harmful impact on the oil and gas industry is foreseeable. At a minimum, confusion will develop inside the legal community, as well as to other advisors to the respective companies within those industries if the original pronouncement of this court is maintained. Notwithstanding a generally well written and analyzed original opinion and the instructive language therein that this is a somewhat isolated fact setting, cautious managers and decision makers within those industries will incur a most chilling effect on their businesses. All of these developments can be potentially harmful in a broader sense; e.g. the potential impact on the financial condition of this state resulting from lost revenue.
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> * * *
>
> The majority opinion has far-reaching implications on the banking industry as well as the oil and gas industry. It is wholly reasonable for a lender to impose certain safeguards to ensure that its collateral is protected, and the responsibilities of an owner should not be imposed on a lender for taking such measures. Solidary liability between a lender and its borrower/owner for its actions will have a calamitous effect in Louisiana on banking and the relationship between creditors and debtors. I agree with Wells Fargo's assertion that the opinion will have a most chilling effect on the financing of oil and gas operations, which in turn will have an

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[18] Rehearing was denied on August 7, 2017.

[19] A panel of an appellate court is composed of three judges, but in order to consider an application for rehearing, two additional judges are randomly assigned. LA. CONST. art. V, § 8(B).

> adverse economic effect on government and business in our state.[20]

While a dissent from a denial of rehearing at the court of appeal level is not particularly unusual, this extraordinary and powerful dissent from denial of rehearing was quite compelling, written by Judge *Pro Tempore* Bleich, with whom Chief Judge Brown stated that he "strongly agrees." This author cannot remember ever seeing a dissent from a denial of rehearing so cogently and strongly stated. It actually served as somewhat of a "roadmap" for the writ application that followed, and of the *amici* filings in support of Wells Fargo.

D. The Supreme Court's Opinion:

The defendants next sought writs of *certiorari* and review from the Louisiana Supreme Court, supported by significant *amici curiae* briefing.[21] Writs were granted,[22] the case was briefed, and oral argument was held on March 13, 2018.

The court issued its unanimous opinion on June 27, 2018, and unanimously reversed the Second Circuit's decision as it relates to the liability of a mortgagee for the faults or inactions of its borrower-lessee.[23]

Associate Justice Marcus Clark, writing for the court, noted that the mortgagee was not an "owner" for purposes of article 207 of the Mineral Code and, therefore, was not liable to the plaintiff for damages "resulting" from the lessee's failure to release the expired mineral lease. Additionally, it found the mortgagee was not a "lessee" for purposes of article 140 of the Louisiana Mineral Code and, was not liable for failure to pay royalties that were due.

The court rejected the propriety of any analysis of the relationship created by the mortgage under the provisions in the Louisiana Civil Code pertaining to the intrinsic attributes of ownership. Noting that the mortgage at issue was created in accordance with article 203 of the Louisiana Mineral Code, the court found no basis to go outside of the Mineral Code to determine the effect

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[20] 223 So. 3d at 1225-26.

[21] As noted previously, your presenter filed an *amici curiae* brief on behalf of American Bankers Association and Texas Bankers Association. An *amici* brief was also filed on behalf of the Louisiana Oil and Gas Association and the Louisiana Mid-continent Oil and Gas Association.

[22] 231 So. 3d 639-42 (La. 2017).

[23] *Supra* note 1. While the decision on the liability of the bank was unanimous, one justice dissented on an unrelated issue pertaining to the appropriate damages for nonpayment of royalties.

or consequences of this mortgage.[24] It reached this conclusion in reliance on article 2 of the Mineral Code that provides, as follows:

> **Art. 2. Relation to Civil Code**
>
> The provisions of this Code are supplementary to those of the Louisiana Civil Code and are applicable specifically to the subject matter of mineral law. In the event of conflict between the provisions of this Code and those of the Civil Code or other laws the provisions of this Code shall prevail. If this Code does not expressly or impliedly provide for a particular situation, the Civil Code or other laws are applicable.[25]

For this and other reasons, the court determined that it found no basis "where the La. Mineral Code addresses or sanctions ownership of a lessee's interest via a theory of control of rights."[26] Rather, the court noted that "[o]wnership of the mineral lease can be transferred by assignment or sublease," citing to the relevant articles of the Mineral Code.[27]

Finding that a mortgage of mineral leases was expressly authorized by articles 203 and 204 of the Louisiana Mineral Code, the court concluded, as follows:

> Based on the foregoing, we find no authority for the court of appeal's holding that a mortgage and a credit agreement, which are both legally provided for in the La. Mineral Code, can be methods by which ownership of a mineral lease are conveyed simply because they assert some control over the collateral described therein. We find the "bundle of rights" controlled by Wells Fargo are not traits of ownership, but of security rights. The mortgage and

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[24] "First, on a legal basis, we find no authority for superseding the ownership principles set forth in the La. Mineral Code with those of the La. Civil Code." 252 So. 3d at 438.

[25] LA. REV. STAT. ANN. § 31:2.

[26] 252 So. 3d at 438.

[27] LA. REV. STAT. ANN. § 31:127. *See also* Patrick S. Ottinger, *What's in a Name? Assignments and Subleases of Mineral Leases Under Louisiana Law*, 58 ANN. INST. ON MIN. LAW 283 (2011).

> credit agreement contain provisions typical of security contracts, all designed to protect the collateral.[28]

The RBL transaction involved in *Gloria's Ranch* might also be viewed as a mezzanine facility inasmuch as Wells Fargo was assigned an overriding royalty interest, and a net profits interest in the collateralized mineral leases. On this basis, among others, Gloria's Ranch contended that these interests—despite being passive in nature—constituted further indicia that Wells Fargo "controlled" Cubic's interest in the collateralized mineral lease. The Louisiana Supreme Court dismissed this contention, as follows:

> Additionally, we find no merit to the argument that because Wells Fargo acquired an overriding royalty interest and net profits interest from Tauren's interest in the lease, it somehow became an owner of the lease. These financial interests are merely passive, derivative rights given in exchange for the cancellation of Tauren's mortgage.[29]

Gloria's Ranch filed for a rehearing, which was denied by the Supreme Court on September 7, 2018.[30]

III. The Law of Mortgage

A. Basic Principles and Features of the Louisiana Mortgage:[31]

1. Definition and Essential Features of Mortgage.

"Mortgage" is defined in article 3278, Louisiana Civil Code, as "a nonpossessory right created over property to secure the performance of an obligation."[32]

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[28] 252 So. 3d at 439. Among other authority, the court cited Ottinger, *Mineral Lease Treatise*, § 12-10, for the proposition that it is "customary in the oil and gas industry" to include covenants and provisions of the type as found in the Wells Fargo mortgage.

[29] *Id*. at 440-41.

[30] 251 So. 3d 392 (Mem). However, "Tauren's rehearing application [was] granted for the limited purpose of remanding the matter for the trial court to consider the effect the reversal of Wells Fargo's liability has on the award, particularly as it relates to the virile share accounted for in the EXCO settlement." *Id*.

[31] *See* §§ 12-03 through 12-06 of Ottinger, *Louisiana Mineral Leases*.

[32] LA. CIV. CODE ANN. art. 3278.

The Louisiana Supreme Court has characterized the effects and consequences of a mortgage on immovable property, as follows:

> Perfect ownership becomes imperfect when the property is mortgaged, by the alienation of that real right; but the title and the possession still remain in the owner.[33]

"Mortgage may be established only as authorized by legislation."[34] Consequently, "[a] mortgage is *stricti juris*, since '[t]he mortgage only takes place in such instances as are authorized by law.' LSA-C.C. Art. 3283 [now 3281]."[35]

At an early date, our Supreme Court succinctly announced this principle when it stated,[36] as follows:

> Our lawgivers have thought it wise to restrain the power of hypothecating property, which is one of the rights of dominion, by the following general and sweeping rule:
>
> > 'The mortgage only takes place in such instances as are authorized by law.' C.C. 3250.
>
> The mortgage right then is to be measured, in every case, by the express grant of power in our Codes and other statute books.[37]

Further guidance as to the character and consequences of mortgage is provided by the following articles of the Louisiana Civil Code, to-wit:

> **Art. 3279. Rights created by mortgage**
>
> Mortgage gives the mortgagee, upon failure of the obligor to perform the obligation that the mortgage secures, the right to cause the property to be seized and sold in the manner provided by law and to have

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33 *Duclaud v. Rousseau*, 2 La. Ann. 168, 173 (La. 1847).

34 LA. CIV. CODE ANN. art. 3281.

35 *Guillory v. Desormeaux*, 179 So. 2d 456, 457 (La. App. Ct. 3d 1965).

36 *Voorhies v. deBlanc*, 12 La. Ann. 864 (La. 1857).

37 *Id*. at 865.

> the proceeds applied toward the satisfaction of the obligation in preference to claims of others.[38]

Art. 3280. Mortgage is an indivisible real right

> Mortgage is an indivisible real right that burdens the entirety of the mortgaged property and that follows the property into whatever hands the property may pass.[39]

Once established on an immovable, the mortgage encumbers the entirety of the property affected by it, as security for the secured debt, and the mortgagee has the right to enforce the mortgage against all of the property, notwithstanding that the mortgagor might have alienated a portion or portions of the encumbered land to a third person. Enforcement may be by ordinary proceeding or executory process.[40]

This important feature of mortgage is fully explained in revision comment (a)--1991 to article 3280 of the Louisiana Civil Code, which provides, in part, as follows:

> The concept of indivisibility is central to the understanding of mortgage. In essence "indivisibility" expresses the notion that each portion of the mortgaged property secures every part of the mortgaged debt. "It is well settled . . . that a mortgage is in its nature indivisible and prevails over all the immovables subjected to it, and over each and every portion." Lawton v. Smith, 146 So. 361, 363 (La.App. 2nd Cir. 1933). Correlatively, each part of the obligation is secured by all of the mortgage over all of the property. "Each and every portion of the property mortgaged, is liable for each and every portion of the debt." Bagley v. Tate, 10 Rob. 45 (La. 1845). The concept of indivisibility does not prevent the parties from agreeing to the partial release or division of the right to enforce the mortgage, or otherwise modifying its effect within the

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[38] LA. CIV. CODE ANN. art. 3279.

[39] *Id*. at art. 3280.

[40] *See* Patrick S. Ottinger, *The Enforcement of Real Mortgages by Executory Process*, 51 LA. L.REV. 87, 111 (Fall 1990).

> limits permitted by law, and subject to the rights of third possessors under the laws of registry.[41]
>
> **Art. 3282. Accessory nature**
>
> Mortgage is accessory to the obligation that it secures. Consequently, except as provided by law, the mortgagee may enforce the mortgage only to the extent that he may enforce any obligation it secures.[42]

As noted by reference to the last cited article, a mortgage is an accessorial obligation. Its existence necessarily depends upon the continued existence of a principal debt for which the mortgage serves as security. Hence, if the principal debt fails or becomes unenforceable, the mortgage also fails.[43] Defenses that defeat the enforceability of the principal obligation would also mean that the mortgage cannot be enforced.[44]

2. Types of Mortgage.

There are three types of mortgage contemplated by Louisiana law, *viz*., conventional, legal and judicial.[45] This paper considers only the conventional mortgage as only that type of mortgage was involved in our case under study.

There are three kinds of conventional mortgage recognized under Louisiana law. These are the following, to-wit:

> (1) The special mortgage, wherein a mortgagor secures the payment of a specific, existing debt.[46]

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[41] LA. CIV. CODE ANN. art. 3280, cmt. (a)--1991.

[42] *Id*. at art. 3282.

[43] *Lacoste v. Hickey*, 14 So. 2d 639, 641 (La. 1943) ("Hence it happens, that in all cases where the principal debt is extinguished, the mortgage disappears with it.").

[44] LA. CIV. CODE ANN. art. 3296 ("Neither the mortgagor nor a third person may claim that the mortgage is extinguished or is unenforceable because the obligation the mortgage secures is extinguished or is unenforceable unless the obligor may assert against the mortgagee the extinction or unenforceability of the obligation that the mortgage secures.").

[45] *Id*. at arts. 3283-84.

[46] *Id*. at art. 3288.

(2) The "collateral mortgage" in which the mortgagor executes a collateral mortgage note (secured by the collateral mortgage), which note is given in pledge as security for the payment of one or more debts, represented by "hand notes."[47]

(3) Mortgage securing future obligations under which the mortgagor creates a present mortgage securing an obligation to arise in the future.[48]

In the practice, the multi-indebtedness mortgage has become the most popular kind of conventional mortgage, due to its ease of use and flexibility.[49]

"A conventional mortgage may be established to secure performance of any lawful obligation, even one for the performance of an act. The obligation may have a term and be subject to a condition."[50]

3. Essential Requirements for the Validity of the Conventional Mortgage.

"No special words are necessary to establish a conventional mortgage."[51] However, the Civil Code dictates certain essential requirements for the confection of a valid conventional mortgage.

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[47] *Id*. at art. 3158; *Thrift Funds Canal, Inc. v. Foy*, 260 So. 2d 628, 630 (La. 1972) ("A collateral mortgage is a mortgage designed, not to directly secure an existing debt, but to secure a mortgage note pledged as collateral security for a debt or a succession of debts."), and *First Guaranty Bank v. Alford*, 366 So. 2d 1299, 1302 (La. 1979) ("Unlike the other two forms of conventional mortgages, a collateral mortgage is not a 'pure' mortgage; rather, it is the result of judicial recognition that one can pledge a note secured by a mortgage and use this pledge to secure yet another debt.").

[48] LA. CIV. CODE ANN. art. 3298.

[49] *See* David S. Willenzik, *Future Advance Priority Rights of Louisiana Collateral Mortgages: Legislative Revisions, New Rules, and a Modern Alternative,* 55 LA. L.REV. 1 (September 1994).

[50] LA. CIV. CODE ANN. art. 3293.

[51] *Id*. at art. 3287.

"A conventional mortgage may be established only by written contract."[52] Consequently, parol evidence is not admissible to prove the existence of a mortgage.[53]

"A contract of mortgage must state precisely the nature and situation of each of the immovables or other property over which it is granted; state the amount of the obligation, or the maximum amount of the obligations that may be outstanding at any time and from time to time that the mortgage secures; and be signed by the mortgagor."[54]

Notably, there is no requirement that the mortgage be signed by the mortgagee, "whose consent is presumed and whose acceptance may be tacit."[55]

One court has noted that "Article 3289 did not require a mortgage to be signed by the mortgagee because it was simply codifying a 'widely accepted commercial practice.'"[56]

In addition to these essential requirements for the validity of a mortgage, as imposed by the Civil Code, a further requirement is specified in article 3352A(5), which requires the instrument to contain the "last four digits of the social security number or the taxpayer identification number of the mortgagor, whichever is applicable."[57] However, the failure to include this prescribed information does not invalidate a mortgage that otherwise complies with applicable law.[58]

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52 *Id*.

53 "In the absence of allegations that execution of an authentic act of sale of immovable property was induced by fraud or mistake, parol evidence to show that a mortgage was intended is properly excluded." *Breaux v. Royer*, 57 So. 16 (La. 1912).

54 LA. CIV. CODE ANN. art. 3288.

55 *Id*. at art. 3289.

56 *KeyBank Nat. Ass'n v. Perkins Rowe Associates, LLC*, 823 F. Supp. 2d 399, 406 (M.D. La. 2011), *aff'd* 502 Fed. Appx. 407 (5th Cir. 2012) (unpublished).

57 LA. CIV. CODE ANN. art. 3352A(5).

58 *Id*. at art. 3352B.

B. Leasehold Mortgages:[59]

The types of "things" that might be made subject to a mortgage are enumerated in article 3286 of the Louisiana Civil Code, reading, in pertinent part, as follows:

> **Art. 3286. Property susceptible of mortgage**
>
> The only things susceptible of mortgage are:
>
> * * *
>
> (4) The lessee's rights in a lease of an immovable with his rights in the buildings and other constructions on the immovable.
>
> (5) Property made susceptible of conventional mortgage by special law.[60]

The mortgage involved in *Gloria's Ranch* would principally emanate from (5) above, by way of articles 203-04 of the Louisiana Mineral Code.

In *Rivet v. Regions Bank of La., F.S.B*,[61] the court noted the following with respect to the term "leasehold estate" under Louisiana law, to-wit:

> "Leasehold estate" is a term unknown to the Civil Law, which does not recognize estates in land. *See* A.N. Yiannopoulos, 2 Louisiana Civil Law Treatise § 226 at 422-23 (3d ed. 1991). In Louisiana, a lease of immovable (real) property is a personal (in personam) contract which does not create rights in rem; however, under provisions of various statutes, both predial (real estate) and mineral leases are afforded some of the attributes of rights *in rem,* notably the protection of the public records doctrine, including the susceptibility of the rights of the lessee to conventional (real estate) mortgages and the ranking of such encumbrances among them-

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[59] For a comprehensive discussion of the role of leasehold mortgages, *see* Michael H. Rubin and S. Jess Sperry, *Lease Financing in Louisiana*, 59 LA. L.REV. 845 (Spring 1999).

[60] LA. CIV. CODE ANN. art. 3286.

[61] 108 F. 3d 576 (5th Cir. 1997).

> selves based on time of recordation. *See id.,* at 424-25, *and also* La.Rev.Stat. Ann. (sic--Title 9) §§ 2721 & 2754-56[62] (West 1991).[63]

"A lessee's leasehold interest, particularly with respect to a long-term lease, is also an important form of collateral to a lender to secure the obligations of the lessee. Leasehold mortgages are particularly used to finance the lessee's construction or renovation of improvements under a long-term ground lease."[64]

Due to the unique nature of the collateral in a leasehold mortgage, significant issues are presented. These include (a) the nature of the interests acquired by a purchaser at a judicial sale;[65] (b) the potential of confusion resulting in the extinguishment of the mortgage occurring when the lessee acquires the leased premises,[66] and (c) the need to secure a subordination and attornment agreement from the prime lessor in relation to security granted by the lessee.[67] While of great significance, these are beyond the scope of this presentation.

Moreover, a commercial lease is not a real right,[68] while a mineral lease is a "real right,"[69] and an "incorporeal immovable."[70]

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[62] LA. REV. STAT. ANN. §§ 9:2754-56 were repealed by Act No. 169, 2005 La. Acts 1383.

[63] 108 F. 3d at 580, n. 2.

[64] Peter S. Title, *Leasehold Mortgage*, 2 LA. PRAC. REAL EST. § 18:93 (2d ed.)

[65] *See Carriere v. Bank of La.*, 702 So. 2d 648 (La. 1997).

[66] *Id*.

[67] *See* Ottinger, *Mineral Lease Treatise*, § 12-11(b). The necessity for securing a subordination and attornment agreement from the prime lessor is also discussed (albeit in a different commercial context) in Patrick S. Ottinger, *Is There a Future for Wind Energy in the Bayou State? The Answer, My Friend, is Blowin' in the Wind*, 7 LSU JOURNAL OF ENERGY LAW AND RESOURCES 38-39 (Fall 2018).

[68] "In Louisiana, a lease of immovable (real) property is a hybrid, a personal contract which nonetheless enjoys a number of attributes of a real contract, including public records protection, the right to peaceable possession, the right to evict, and the like." *Matter of Dibert, Bancroft & Ross Co., Ltd.*, 117 F. 3d 160, 164, n. 2 (5th Cir. 1997) (internal citations omitted).

[69] LA. REV. STAT. ANN. § 31:16.

[70] *Id*. at § 31:18.

A leasehold mortgage involving collateral composed of commercial leases differs from a leasehold mortgage in which mineral leases constitute the collateral in the further respect that, unlike a mineral lease, the failure on the part of the lessee-mortgagor to timely pay rent under a commercial lease does not result in the *ipso facto* termination of the lease, unless the lease provides otherwise.[71]

In contrast, the failure to pay delay rentals under a mineral lease results in the *ipso facto* termination of the lease,[72] and there exists the potential for dissolution of the mineral lease for non-payment of royalties,[73] or a breach of an implied covenant.[74]

C. Interrelationship Between the Louisiana Civil Code and the Louisiana Mineral Code as to the Lease and the Mortgage:

In order to create a bridge from a leasehold mortgage to its important subset, the Mineral Lease Mortgage, it is instructive to recognize the relevant law with respect to the lease (the collateral in each type of mortgage) and to the mortgage itself.

Three decades after the adoption and implementation of the Louisiana Mineral Code, the law of lease was comprehensively amended and reenacted, effective January 1, 2005.[75]

As reenacted, article 2668 of the Louisiana Civil Code now defines the "lease," as follows:

> **Art. 2668. Contract of lease defined**
>
> Lease is a synallagmatic contract by which one party, the lessor, binds himself to give to the other party, the lessee, the use and enjoyment *of a thing* for a term in exchange for a rent that the lessee binds himself to pay.[76]

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[71] Rather, the doctrine of judicial control permits the court to decline to terminate the lease if such remedy is deemed inappropriate under the circumstances. *See Sieward v. Denechaud*, 45 So. 561 (La. 1908). *See also* Ottinger, *Mineral Lease Treatise*, § 13-34(g).

[72] *See* Ottinger, *Mineral Lease Treatise*, § 4-08(d)(4).

[73] LA. REV. STAT. ANN. §§ 31:140-41.

[74] *Id*. at § 31:136.

[75] Act No. 821, 2004 La. Acts 2556.

[76] LA. CIV. CODE ANN. art. 2668. (Emphasis added.).

Article 2671 of the Louisiana Civil Code now characterizes a lease according to the "agreed use of the leased thing," thusly:

> **Art. 2671. Types of leases**
>
> Depending on the agreed use of the leased thing, a lease is characterized as: . . . mineral, when the thing is to be used for the production of minerals; . . ..[77]

Concordant with that statement, article 2672 of the Louisiana Civil Code provides that a "mineral lease is governed by the Mineral Code." This referral gives primacy to the Louisiana Mineral Code in matters pertaining to the mineral lease, a consideration of great significance to the Supreme Court in the *Gloria's Ranch* case.

Having thusly been referred to Title 31 of the Louisiana Revised Statutes, the codal instruction of article 2 of the Louisiana Mineral Code, set forth previously,[78] directs one to resolve the dispute involving a mineral lease within the framework of the Mineral Code, rather than the "Civil Code or other laws," if the Mineral Code addresses the matter at hand.

If the Mineral Code "does not expressly or impliedly provide for a particular situation, the Civil Code or other laws are applicable."[79] In this sense, the Civil Code and the Revised Statutes are said to be "suppletive" to the Mineral Code in that those sources will "fill in the gap," in case the Mineral Code does not provide an answer or guidance with regard to a particular issue under the mineral law of this state. Contrarily, the Louisiana Mineral Code operates to the exclusion of the Civil Code or other laws if it addresses the situation presented.

Within the Louisiana Mineral Code, we find articles 203 and 204B relative to authority for the granting of a mortgage on a mineral lease. These articles provide, as follows:

> **Art. 203. Mineral rights susceptible of mortgage; effect of mortgage**
>
> A mineral [lease] is susceptible of mortgage to the same extent and with the same effect, and subject to the same provisions of rank, inscription, reinscrip-

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77 *Id*. at art. 2671.

78 *Supra* note 25.

79 *Id*.

> tion, extinguishment, transfer, and enforcement as is prescribed by law for mortgages of immovables under Article 3286 of the Civil Code.[80]
>
> **Art. 204. Mortgage may include pledge; effect of pledge**
>
> * * *
>
> B. Pledges of minerals produced or the proceeds from the sale or other disposition thereof entered into after Chapter 9 of the Louisiana Commercial Laws (R.S. 10:9-101, et seq.) becomes effective are effective between the parties and as to third parties as provided in Chapter 9.[81]

Thus, the clear instruction of both codes is to resolve issues pertaining to mineral leases (and other mineral rights) within the text and strictures of the Louisiana Mineral Code, to the extent that it can be done. Indeed, the Supreme Court in *Gloria's Ranch* articulated that, "on a legal basis, we find no authority for superseding the ownership principles set forth in the La. Mineral Code with those of the La. Civil Code."[82]

D. Mortgage of Mineral Leases:

1. Preface.

With the adoption of the Louisiana Mineral Code, effective January 1, 1975,[83] express authority is now provided for the creation and establishment of a mortgage on mineral leases by the lessee (herein, a "Mineral Lease Mortgage"), and the inclusion in such mortgage of a security agreement.[84] The relevant provisions of the Louisiana Mineral Code are articles 203 and 204, set forth above.[85]

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80 LA. REV. STAT. ANN. § 31:203.

81 *Id*. at § 31:204B.

82 252 So. 3d at 438.

83 Act No. 50, 1974 La. Acts Vol. III, effective January 1, 1975.

84 LA. REV. STAT. ANN. §§ 31:16, :18.

85 *Supra* notes 80 and 81.

"A mineral lease is a contract by which the lessee is granted the right to explore for and produce minerals."[86]

Mineral leases, as well as interests in those contracts, fall under the broad category of "mineral rights."[87] As such, these rights are classified as "incorporeal immovables" to which the laws relative to immovables in general apply.[88] Hence, the lessee's "working interest" is immovable in nature, and is susceptible of being mortgaged.

"No special words are necessary to establish a conventional mortgage."[89] Because of this important pronouncement, it is difficult to fail to confect a valid Mineral Lease Mortgage.

In reference to the Mineral Lease Mortgage granted by Cubic to Wells Fargo at issue in *Gloria's Ranch*, the following explanation is provided in commentary:

> Cubic was able to secure an impressively-sized credit facility of twenty million dollars in 2007, a feat that likely would not have been possible just a year later. By late 2008, a credit crunch had begun to squeeze the oil and gas industry, one that followed the doldrums of the wider U.S. economy after the subprime crisis. Commodity prices fell, the stock market plummeted, and many small operators were left with little to no access to capital for their operations. These conditions led to a shift of financing arrangements in favor of lenders. . . .. Lastly, a lender will almost always cover the borrower's interests with a dedicated security device to obtain direct control over these interests upon a default of the borrower's obligations. Conventionally, the execution of a mortgage covers all, or a portion of, the borrower's leasehold interests. Loui-

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86 *Id*. at § 31:114.

87 *Id*. at § 31:16.

88 "Mineral rights, including mineral leases, are classified under the Mineral Code as incorporeal immovables and are subject to the Civil Code articles respecting immovable property." *Guy Scroggins, Inc. v. Emerald Exploration*, 401 So. 2d 680, 684 (La. App. Ct. 3d), *writ den'd* 404 So. 2d 1257 (La. 1981). In the interest of full disclosure, your author represented the defendant in this suit.

89 *Id*. at art. 3287.

siana law expressly makes mineral leases susceptible to mortgage.[90]

2. Types of Property That May be Encumbered by a Mineral Lease Mortgage.[91]

By definition, a mortgage encumbers immovable property.[92] In the context of a Mineral Lease Mortgage, immovable property includes, most importantly, the mineral leases, and other rights that constitute "real rights" or "incorporeal immovables."[93]

Typically, a Mineral Lease Mortgage also includes a security agreement that establishes a security interest in property that would be classified at law as movable. Under Section 102(d)(15) of the Louisiana U.C.C., "'[p]ersonal property' means movable property."

This security agreement would encompass hydrocarbons attributable to the lessee's interest, and produced pursuant to the mineral lease, and equipment placed on the leased premises by the lessee (unless they become a component part of the immovable).[94]

3. The Lessee's Interest in the Mineral Lease.

As previously noted, article 3286(4) of the Louisiana Civil Code provides that "[t]he only things susceptible of mortgage are . . . [t]he lessee's rights in a lease of an immovable with his rights in the buildings and other constructions on the immovable."[95]

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[90] Andrew D. Martin, *Mineral Code Article 206 Liability After Gloria's Ranch: Rights, Remedies, Revolution*, 6 JOURNAL OF ENERGY LAW AND RESOURCES 377, 385–86 (Spring 2018).

[91] *See* Patrick S. Ottinger, *The Enforcement of Real Mortgages by Executory Process*, *supra* note 40, at 111.

[92] LA. CIV. CODE ANN. art. 3286.

[93] LA. REV. STAT. ANN. § 10:9-102(d)(14) and (d)(16).

[94] *Id*. at § 10:9-102(a)(6). In UCC jargon, these are called "as-extracted collateral."

[95] LA. CIV. CODE ANN. art. 3286(4).

The "lessee's rights in a [mineral] lease," being "a lease of an immovable," is the "working interest" under the lease.[96] As concerns the lessee, a mineral lease is a "thing" in the contemplation of the Civil Code--it is "property" owned by the lessee.[97] The lessee's interest under the mineral lease is intrinsically immovable in nature.[98]

"A conventional mortgage of a . . . lease . . . includes the things made susceptible of mortgage with them by Article 3286, unless the parties expressly agree to the contrary."[99]

The foregoing statement merely codifies early jurisprudence to the same import.

For example, in an early case,[100] the Louisiana Supreme Court considered a lessee's contention that, after a judicial sale foreclosing on a mortgage, "the mortgage foreclosed covered the leases alone, and did not include the oil wells, equipment for operating same, including tanks, gas engines, pumping rigs, and other improvements on said leases . . .."[101] The court rejected that contention in the following words, to-wit:

> However, we are convinced that at least a part of the items covered by the alternative demand, such as the wells, casing, pumps, etc., are a part of the leases and necessary to their full operation; but since the proof in the record is not sufficient to enable us to determine whether all of those items have become immovables by destination covered by

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96 "The term 'working interest' is synonymous with the extent of a lessee's 'leasehold interest' in a tract or subsurface geological strata thereunder." *Pinnacle Operating Co., Inc. v. ETTCO Enterprises, Inc.*, 914 So. 2d 1144, 1145, n. 1 (La. App. Ct. 2d 2005).

97 While admittedly a case dealing with the heritability of a mineral servitude, the comments of the Louisiana Supreme Court in *Ford v. Williams*, 179 So. 298, 301 (La. 1938) are both instructive and pertinent, wherein the court noted that a "right acquired under a mineral servitude is property, and all property which a person leaves at his death is transmitted by mere operation of law to his nearest heir, if there is no testament or institution of heir." *See also Roberts v. United Carbon Co.*, 78 F. 2d 39, 42 (5th Cir. 1935) ("Irrespective of divergent ideas of the ownership of oil and gas underground, in Louisiana . . . oil and gas leases and royalties are property and their value depends on the prospect of recovery of oil and gas.").

98 *See* LA. REV. STAT. ANN. § 31:18.

99 LA. CIV. CODE ANN. art. 3291.

100 *Choate Oil Co v. Glassell*, 96 So. 543 (La. 1922).

101 *Id*. at 544.

> the mortgage, we think that justice can best be done by remanding the case for further evidence and adjudication upon the alternative demand. If such property had been attached to the leases and was necessary to their operation and development, they were immovables by destination and covered by the mortgage of said leases.[102]

Concerning the ancient statutory provisions, the court, on rehearing, commented, as follows:

> Act 232 of 1910, p. 393, was passed, as its preamble recites, to encourage the development of oil, gas and mineral lands, by lessees and other grantees of mineral rights; and to that end the act provided that such lessees and other grantees should have the right "to mortgage such leases or contracts, together with all buildings, constructions and improvements placed and erected on such lands or to be placed and erected thereon. * * *"
>
> It is clear that an act intended to encourage and promote the welfare of an industry, especially a new one, ought to be interpreted as liberally as possible, so as to carry out, rather than hinder, the plain legislative intent.
>
> But it is manifest that an oil, gas or mineral field cannot be developed by the lessee thereof without certain "buildings, constructions and improvements," necessary to reach said minerals (by drilling, boring or digging) and to extract and store or distribute the same. Hence such "buildings, constructions and improvements" become accessories and dependencies of the lease "without which it would be of no value or service"; and therefore form part of the thing alienated or mortgaged.[103]

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102 *Id*. at 545.

103 *Id*. at 545-46.

Numerous papers have been presented at the Institute on Mineral Law on the important topic of security in connection with oil and gas financing.[104] While the comprehensive revision on the law of mortgage in 1991,[105] and the enactment of Chapter 9 of the Uniform Commercial Code in 2001,[106] and the adoption of significant legislation in 2014,[107] have arguably rendered certain of these presentations somewhat outdated, they do remain as excellent historical references, and conceivably remain relevant to kinds of security that remain in effect under prior regimes of law.

E. Reserve-based Loans:

When making a loan, a financial institution takes on the risk of repayment, and wants to ensure that it is repaid. In order to increase the likelihood of repayment, a lender will take a mortgage on the borrower's property. In connection therewith, the lender has an interest in making sure that the borrower maintains its rights in the collateral throughout the life of the loan to prevent the loan from becoming unsecured or undersecured. A loss of the collateral would increase the lender's risk of not being repaid. While the interests of the borrower and lender may be somewhat aligned in that both parties want to see the borrower's business succeed, the lender's primary focus is always having its loan repaid.

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[104] *See*, *e.g.*, A. E. Alexander, *Financing of Oil and Gas Interests*, 5 ANN. INST. ON MIN. LAW 3 (1957); Thomas A. Harrell, *The Mortgage of Mineral Rights and Contracts in Louisiana*, 13 ANN. INST. ON MIN. LAW 14 (1966); Edward C. Stanton, III, *Current Developments in Oil and Gas Financing*, 20 ANN. INST. ON MIN. LAW 187 (1973); Richard W. Simmons, *Mortgages and Other Financing Devices for Oil and Gas Loans*, 29 ANN. INST. ON MIN. LAW _ (1982); Marilyn C. Maloney, *Secured Transactions Affecting the Federal Outer Continental Shelf*, 34 ANN. INST. ON MIN. LAW 47 (1987); Thomas A. Harrell, *Financing Oil and Gas Interests in Louisiana--What Hath the U.C.C. and the Legislature Wrought?*, 36 ANN. INST. ON MIN. LAW 205 (1989); James A. Stuckey, *Mineral Financing Under the Louisiana Version of Chapter 9 of the Uniform Commercial Code*, 37 ANN. INST. ON MIN. LAW _ (1990); Thomas A. Harrell, *The Effect of Louisiana's New Mortgage Provisions and Article 9 on Oil and Gas Financing*, 40 ANN. INST. ON MIN. LAW 271 (1993); Craig W. Murray, *The Oil and Gas Lawyer's Role in the New Financing Techniques*, 42 ANN. INST. ON MIN. LAW 44 (1995), and Leon J. Reymond, Jr., *Representing a Borrower in an Energy Financing*, 48 ANN. INST. ON MIN. LAW 184 (2001).

[105] Act No. 652, 1991 La. Acts 2068.

[106] Act No. 128, 2001 La. Acts 206, effective July 1, 2001, at 12:01 o'clock A.M.

[107] Act No. 281 of 2014, effective January 1, 2015, more fully discussed *infra* notes 172 and 180.

1. Statutory and Regulatory Modification of "Rule of Capture."

At its core, a reserve-based loan is predicated upon the lender's evaluation of the quantity of oil and gas under the control of the lessee, based upon reserve reports, pricing of commodity, the net revenue interest accruing to the lessee, and the anticipated costs to obtain the production, among other factors. Among other covenants in the Cubic credit documents is the requirement to provide "reserve reports" from time to time, setting forth an analysis of the estimate of the quantity of reserves that might be produced and thereby generate revenue to repay the loan. Typically, the lender will have these reports analyzed by a consulting geologist or reservoir engineer as a part of its due diligence. Periodically, a borrowing base determination is made to stay current as to the limits of the line of credit available to the borrower.

It is appropriate to pause for a brief moment to consider how the adoption of conservation laws has made possible the use of mineral leases as collateral.

In Louisiana (as well as all other producing states), the "rule of capture" has historically applied.[108] The "rule of capture" stands for the proposition that a land owner is privileged to use reasonable methods to produce migratory hydrocarbon minerals from under his property, and to thereby become the owner of such minerals when they are brought to the surface, and are "reduced to possession,"[109] without any liability to adjacent property owners, even though the minerals so produced have in fact been drawn from under the adjacent owner's property.

"The owner of a tract of land acquires title to the oil or gas which he produces from wells drilled thereon, though it may be proved that part of such oil or gas migrated from adjoining lands."[110]

Louisiana Revised Statutes section 31:14 now codifies the "rule of capture" by providing that a "landowner has no right against another who causes drainage of liquid or gaseous minerals from beneath his property if the drainage results from drilling . . . operations on other lands."[111]

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[108] *Louisiana Gas & Fuel Co. v. White Bros.*, 103 So. 23 (La. 1925); *McCoy v. Arkansas Natural Gas Co.*, 143 So. 383 (La. 1932). The "rule of capture" is now codified in three articles of the Louisiana Mineral Code, *viz.*, LA. REV. STAT. ANN. §§ 31:8, :13, and :14.

[109] "Minerals are reduced to possession when they are under physical control that permits delivery to another." *Id*. at § 31:7.

[110] Robert E. Hardwicke, *The Rule of Capture and Its Implications as Applied to Oil and Gas*, 13 TEX. L.REV. 391, 393 (1935).

[111] LA. REV. STAT. ANN. § 31:14.

The necessary corollary of the "rule of capture" is that the adjacent land owner's remedy is to "go and do likewise."[112] The wasteful consequences of the unfettered application of the "rule of capture" were among the numerous factors motivating the conservation movement of the 1930s and 1940s.[113] The principal objectives of conservation legislation are the prevention of waste,[114] the avoidance of the drilling of unnecessary wells, and affording each owner the opportunity to recover its just and equitable share of the common "pool."[115]

The conservation laws continue the "rule of capture," but regulate it by imposing reasonable restrictions in the exercise of the state's police power. One of the devices which regulates the "rule of capture" is the notion of well spacing, that is, the governmental regulation of the placement of wells in such a way as to promote the goals of conservation legislation.[116]

Also, the legislation authorized the Commissioner of Conservation to impose a regime of proration by adopting rules and regulations to "limit and prorate the production of oil or gas or both from any pool or field for the prevention of waste."[117]

Finally, and importantly, the Commissioner of Conservation was authorized to create units for the exploration and production of oil and gas. In *Davis Oil Co. v. Steamboat Petroleum Corp.*,[118] the Louisiana Supreme Court recognized the importance of unitization, as follows:

> The general concept behind the establishment of drilling units is to prevent adjoining landowners or leaseholders from having to drill protective offset

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[112] *Barnard v. Monongahela Natural Gas Co.*, 65 A. 801, 802 (Pa. 1907); *see also* Kramer & Martin, *The Law of Pooling and Unitization* § 2.01 (LexisNexis Matthew Bender 2018) (stating that the interest holder's protection "is the right to drill offset wells that would intercept the hydrocarbons otherwise being drawn to the neighboring wells.").

[113] Louisiana's Conservation Act was enacted by Act No. 157 of 1940, and is now embodied in Title 30 of the Louisiana Revised Statutes.

[114] "'Waste', in addition to its ordinary meaning, means 'physical waste' as that term is generally understood in the oil and gas industry." LA. REV. STAT. ANN. § 30:3(16).

[115] *Id*. at § 30:9A.

[116] *Id*. at § 30:4C(13). *See* Statewide Order No. 29-E, LA. ADMIN. CODE 43:XIX § 1901.

[117] LA. REV. STAT. ANN. § 30:4C(11).

[118] 583 So. 2d 1139 (La. 1991).

> wells on their premises by permitting them to share production proportionately to the area of their acreage drained by the unit well.[119]

The imposition of a limit on the quantity of oil and gas that might be produced from a particular well constituted a drastic restriction on the exercise of rights under the "rule of capture." By modifying the "rule of capture," it resulted in a predictable amount of oil or gas which a bank's borrower might be able to produce. This, in turn, enabled a lender to have confidence in extending credit to be collateralized by the oil and gas that its borrower would be able to produce, unfettered by the ability of the neighboring land owner to lawfully remove such oil and gas in accordance with the "rule of capture."

In his excellent book chronicling the history of oil and gas financing,[120] Buddy Clark of Haynes & Boone in Houston, Texas, made the following observations with respect to the favorable or advantageous consequences that resulted from the imposition of conservation laws, including allowables and proration, to-wit:

> Without the introduction and subsequent court enforcement of conservation laws, the stability of the economic factors necessary for successful financing of oil may never have been achieved. Proration rules slowed the initial rate of well production and had the side effect of slowing the pace at which the producer was able to recover his investment. This created demand for longer-term credit. Fortunately, slower production also led to more disciplined commodity markets, which, in turn, created the crucial element: a predictable cash flow that bankers needed to lend with confidence.[121]

So, while the national movement towards conservation was a positive and important one, an unintended consequence of the adoption of rules pertaining to the spacing of wells, the institution of rules of proration, the assignment of allowables, and unitization, was that certainty came to a chaotic industry, resulting in capital markets embracing the oil and gas industry by extending credit, resulting in one of the most important sectors of the American economy.

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[119] *Id*. at 1142.

[120] Bernard F. Clark, Jr., *Oil Capital: The History of American Oil, Wildcatters, Independents and Their Bankers* (June 2016).

[121] *Id*. at 96.

2. The Precarious Nature of Mineral Leases as the Source of Collateral for Loan Security.

In the "upstream" sector of the oil and gas industry,[122] the participants are so-called "E&P" companies.[123] The principal form of collateral for an oil and gas loan are the mineral leases held by such a borrower. As previously stated, a loan of this type is called a "reserved-based" loan.[124]

When mineral leases constitute the collateral to secure a loan in an RBL transaction, it is important to recognize the unique issues thereby presented. This might best be illustrated when one considers two different loans—one secured by raw land to be developed for a commercial purpose, and the other secured by mineral leases. The principal indebtedness of each borrower is $10 million.

In the former case, the collateral is essentially "dirt" or "land," the classic immovable.[125] That secured lender can actually see and walk on the collateral securing its loan via a mortgage. That collateral "is not going anywhere." There is absolutely no fear or concern that lender's collateral will disappear.

In contrast, in the instance where the collateral is composed of mineral leases, the lender can see and hold the written contract evidencing the lessee-borrower's rights under the mineral lease, but, by its very nature, such collateral is "perishable" or "precarious" in the sense that the collateralized mineral leases must be maintained in force and effect by the lessee-borrower

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[122] "Upstream companies—also known as E&P companies—find, develop, and produce oil, natural gas, and natural gas liquids (NGL). The upstream business model is analogous to mining for raw materials. Upstream companies manage their development and production costs and emphasize production volume to generate profit margins, which are sensitive to commodities market prices. This price risk can cause volatility in company cash flow and the value of O&G reserves." Comptroller's Handbook on Safety and Soundness, Oil and Gas Exploration and Production Lending, issued by the Office of the Comptroller of the Currency (March 2016), pp. 1-2 ("OCC Lending Manual"). *See infra* note 137 for the URL for this Manual.

[123] "E&P" means "exploration and production." These are companies that drill and produce oil and gas.

[124] An excellent series of four articles on the topic of reserve-based lending were presented in the Oil and Gas Financial Journal by Jason Fox, Dewey Gonsoulin & Kevin Price, *Reserve Based Finance: A Tale of Two Markets—Part 1* (Jan. 1, 2014); *Part 2* (Feb. 1, 2014); *Part 3* (March. 1, 2014), and *Part 4* (April. 1, 2014).

[125] *See* LA. CIV. CODE ANN. art. 462 ("Tracts of land, . . ., are immovables.").

taking certain actions prescribed therein.[126] In other words, mineral leases serving as collateral for this secured loan have—in contrast to the land itself—the potential to expire and terminate,[127] in which case, the collateral ceases to exist, and the lender becomes unsecured or undersecured.[128]

Both loans for $10 million will be documented by a credit agreement and an array of security interests, principally a mortgage describing the collateral, coupled with a security interest in the revenue generated by any lease on the land or in the oil and gas produced by the mortgagor.

However, the loan to the E&P borrower will typically have significantly more and different clauses, conditions, requirements and covenants, in contrast to the loan secured by the raw land. Again, this is in order that the RBL lender might have the highest level of comfort and assurance that its collateral will not "perish," or become extinguished, essentially leaving that bank unsecured or undersecured.

Additionally, even when the mineral leases are being properly maintained in force and effect, the volatility in commodity prices can quickly exacerbate the status of the loan, in comparison to the raw land.[129] So clearly, the terms and provisions pursuant to which a bank might be willing to loan money to the E&P company are carefully negotiated so as to ensure that the unique collateral on which the bank relies for repayment, continues to exist for the life of the loan. Given the precarious nature of mineral leases, it is both reasonable and understandable that a bank would want to have additional safeguards in place in order to protect against the lapse or extinction of such leases, and accordingly, the loss of its collateral.

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[126] *See* Ottinger, *Mineral Lease Treatise*, § 4-03. ("A mineral lease is 'perishable.' Unless it is properly and timely maintained in force and effect, it will come to an end at some determinable date. This occurrence of the 'perishing' of the mineral lease is called 'lease expiration,' or 'lease termination,' and it is avoided by 'lease maintenance.'").

[127] LA. REV. STAT. ANN. § 31:133 ("A mineral lease terminates at the expiration of the agreed term or upon the occurrence of an express resolutory condition.").

[128] "A mortgage is extinguished: By the extinction or destruction of the thing mortgaged." LA. CIV. CODE ANN. art. 3319(1).

[129] For example, a sharp decline in oil prices could cause the value of the reserves to decline below the value of the loan, causing the lender to be undersecured. Conversely, land typically has a more stable basis of valuation. Indeed, this has been a major concern of Federal regulators. *See* Gillian Tan, Ryan Tracy and Ryan Dezember, *Regulators Warn Banks on Loans to Oil, Gas Producers*, The Wall Street Journal (July 2015) ("U.S. regulators are sounding the alarm about banks' exposure to oil-and-gas producers, a move that could limit their ability to lend to companies battered by a yearlong slump in prices."

3. The Absolute Necessity of Mortgage Lenders to Safeguard the Collateral Securing Their Loans in Order to Manage Their Risk and Protect Against Loss.

It is a foundational principle of banking that a lender should be able to rely upon the existence of the collateral throughout the life of a loan. The continued existence and availability of collateral during the life of a proposed loan is a risk factor considered at the time a loan is made. When a lender makes a secured loan, it is vital that the collateral is safeguarded so as to manage the risk of loss by mortgage lenders.

To this end, it is customary for a credit agreement or the mortgage (or both) to include an array of unique covenants to allow the lender to monitor the activities of the borrower, and to inform itself as to the operations, plans and projections of the borrower. These types of safeguards are widely used in both commercial and residential mortgage loans, and are intended to protect and preserve the property mortgaged, including requiring the perpetuation of the mineral leases by the mortgagor debtor.[130]

Commentators have recognized the propriety of including an array of covenants in a credit agreement or mortgage executed by a company such as Cubic in the *Gloria's Ranch* case. For example, in an article entitled "Some Aspects of Oil and Gas Financing," the author explained, as follows:

> The instrument creating the pledge of an oil and gas property to secure payment of a loan is customarily in the form of a . . . mortgage which, together with the note, is the most important document to the banker. . . . In a few brief words, the special provisions we like are as follows:
>
> (1) That the mortgagor will comply with all State and Federal Regulations regarding the production of oil and gas.
>
> (2) That he will keep his leases and mineral rights in full force and effect.
>
> (3) That he will comply with and fulfill all his obligations under the leases.

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[130] Protections widely included in mortgage loan documentation include the following requirements of the borrower: to maintain property insurance, repair any damage, maintain the property to prevent it from deteriorating or decreasing in value due to its condition, refrain from any major alterations to the property without the lender's knowledge, and pay taxes promptly to prevent loss of property at tax sale.

(4) That he will operate his leases in a good and workmanlike manner and in accordance with best engineering practices.

(5) That he will permit the mortgagee or its consultants to inspect the properties at all reasonable times.

(6) That he will furnish the mortgagee with a monthly report of his operations, if requested.

(7) That the mortgage not only secures the note described therein, but also any and all renewals, extensions and rearrangements of the debt.

(8) That the mortgage secures the payment of all future advances and loans as well as other obligations to the bank, whether fixed or contingent, primary or secondary, express or implied, or past, present or future, and whether created or not under the terms and provisions of the mortgage.[131]

4. The Sole Purpose of Covenants is to Ensure the Collateral Continues to Exist for the Life of the Loan, and to Protect Against the Loan Becoming Unsecured or Undersecured.

Neither the mortgage nor credit agreement entered into between Cubic and Wells Fargo were unique or extraordinary. Rather, both are typical of transactions of this type—an RBL loan to an E&P company. Unfortunately, however, the Second Circuit misinterpreted the special provisions contained therein as a way for Wells Fargo to somehow "control" or "dictate" the operations of Cubic's business, and failed to recognize their principal purpose of protecting not only Cubic's collateral as a source of repayment, but also minimizing Wells Fargo's risk of loss on the Cubic loan.

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[131] John R. Scott, *Some Aspects of Oil and Gas Financing*, 5 INST. ON OIL AND GAS LAW AND TAX'N 325, at 330-31 (1954). *See also* Hubert Dee Johnson, *Legal Aspects of Oil and Gas Financing*, 9 INST. ON OIL AND GAS LAW AND TAX'N 141, at 157 (1958), for a similar list of typical covenants often encountered in an RBL.

The Second Circuit seemed to have placed particular emphasis on a typical clause that requires the mortgagor-lessee to obtain the bank's consent to release an item of collateral.[132] Given the nature of the collateral securing the loan—mineral leases (the status of which becomes much more tenuous and precarious), this clause is nothing more than a provision to ensure that the loan remains secured at all times. It does not preempt or displace the obligations of the lessee *vis-à-vis* its lessor.

With respect to this clause, a particular argument made by Gloria's Ranch can only be characterized as facially insupportable, and that is that the failure of Wells Fargo to release its mortgage on the expired lease in some manner constituted a "cloud on the title." Incredibly, as cited by the Second Circuit, expert testimony on this point was offered by which the expert "asserted Wells Fargo's interests in the lease would create red flags for potential lessees."[133]

The Supreme Court easily disposed of this argument by noting that a "mortgage is extinguished by the extinction or destruction of the thing mortgaged."[134] Thus, the extinction of the mineral lease obviously brings the mortgage to an end as to that expired item of collateral, and the unreleased mortgage cannot conceivably be a "cloud on the title" of the land owner, who was never a party to the mortgage in the first place. No property owned by Gloria's Ranch was affected by the Mineral Lease Mortgage granted by Cubic.

The necessity of this "need consent to release" clause is obvious in an RBL mortgage. Unlike a mortgage in which raw land, for example, is the collateral (remember, the land will always be there), the unilateral release of a mineral lease by the lessee-borrower results in turning the secured loan into an unsecured or undersecured loan.[135] Consequently, this would greatly impair a bank's ability to rely upon such type of collateral due to its increased risk of loss on the loan.

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[132] "Notably, Wells Fargo controlled Cubic's ability to alienate its interest in the lease by requiring Cubic to obtain its written consent to release the lease." 223 So. 3d at 1223.

[133] *Id*. at 1224.

[134] *See* LA. CIV. CODE ANN. art. 3319(1)

[135] The sale by the mortgagor of the mortgaged land does not diminish the rights of the secured lender as the mortgagor's vendee takes the land subject to the recorded mortgage. *See* LA. CIV. CODE ANN. art. 3280. However, if the mortgagor *releases* (and thereby terminates) a mortgaged mineral lease, the lender is, to that extent, unsecured as to its loan.

5. Federal Law Encourages the Use of Covenants in RBL Financing Structures.

Not only are clauses of the type contained in the Cubic mortgage and credit agreement, customary and typical as a matter of affording security to the lender, they are actually encouraged by Federal law.[136]

In March of 2016, the Office of the Comptroller of the Currency issued its OCC Lending Manual.[137] As explained in the preamble to this Manual:

> This booklet addresses only E&P lending to up-stream companies because their financing structures are more specialized than financing structures used by midstream, down-stream, and service companies. Loan policies and underwriting standards applied to midstream, downstream, and service companies are similar to traditional commercial and industrial loans.[138]

The OCC Lending Manual noted the following with respect to the management of risk in an RBL transaction, to-wit:

> Underwriting standards and approval requirements that are specific to lending to the E&P industry and provide appropriate lender controls, including measurement of O&G reserve and production history; financial analysis expectations; realistic repayment terms consistent with the use of proceeds; advance rates and risk adjustments on various reserve types; pricing parameters; stress or sensitivity analysis of cash flow; covenant and structure expectations; *approval authority*; and policy exception authority.[139]

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[136] These guidelines are suggested, not mandated, by the OCC Lending Manual, in the nature of "best practices." A search of this manual discloses that the word "shall" does not appear therein.

[137] *Supra* note 122, and available for review: https://www.occ.treas.gov/publications/publications-by-type/ comptrollers- handbook/pub-ch-og.pdf. (URL broken for formatting purposes.)

[138] *Id*., at p. 3.

[139] *Id*., at p. 18. (Emphasis added.).

Thus, had it not been rectified by the Louisiana Supreme Court, the Second Circuit's decision, finding liability on the part of a lending bank that utilizes these unique and vital covenants, would necessarily have meant that compliance with the OCC Lending Manual (Federal law) will lead to a new species of financial exposure and, hence, risk to a bank—precisely the state of affairs sought to be avoided by this regulatory Manual.[140]

Instead, the covenants were a set of provisions that Cubic agreed to follow in order to remain in good standing with its mortgage loan. Regardless of the covenants, Cubic always retained the power and ability to terminate its mineral lease, and this right was in no manner ceded to its mortgagee, Wells Fargo. However, by releasing an item of collateral, and without making some other financial accommodation with Wells Fargo, Cubic would have been in default of the terms of its mortgage loan. This, however, was a matter strictly between Wells Fargo and Cubic.

If a bank is unable to rely upon the continued existence of its collateral, then a lender will not be able to make certain loans where the collateral is subject to such a risk of loss. This would have devastating effects on banks and other lenders as well as all Louisiana industries that borrow money, a consequence anticipated by the judges who dissented from denial of rehearing at the Second Circuit.[141]

Consequently, it is an absolute necessity for Louisiana lenders to contractually safeguard and protect against their collateral being alienated, extinguished, diminished or destroyed, thereby finding itself either unsecured or undersecured. Lenders must know that their borrowers will not terminate, damage, sell, transfer, or otherwise alienate their collateral without their knowledge, and without first making other accommodations to protect the lender from loss.

Protective contractual provisions requiring the borrower to communicate with the lender and to address the outstanding loan, before it alienates or terminates the lender's collateral, are important protections to the lender. Such protections, however, should neither cause the nature of a debtor-creditor relation-

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[140] Issues have been raised as to the enforceability of the OCC Lending Manual since it was not submitted for congressional review pursuant to the Congressional Review Act, 5 U.S.C.§ 801(a)(1)(A). *See* Buddy Clark, *Next Stop: The Twilight Zone. Enforceability of OCC Reserve-Based Lending Guidelines*, available at http://www.haynesboone.com/-/media/files/alert-pdfs/2018/enforceability_of_occ_reserve_based_lending_guidelines.ashx?la=en&hash =B4B4CEC 49268A92 B63063BED61580B C5F70575D9. (URL broken for formatting purposes). Last visited November 20, 2018.

[141] *See* text associated with *supra* note 20.

ship to change; impose upon lenders the underlying obligations of an owner of mortgaged assets; nor be misconstrued as "control" over the borrower to give rise to any sort of liability upon the lender *vis-à-vis* third persons such as Gloria's Ranch.

Unfortunately, the Second Circuit seemingly placed great significance on the notion that Wells Fargo exercised "control" over Cubic, its borrower. This far-reaching decision, had it not been rectified, would have stood for the proposition that a mortgagee can be held liable for the actions or inactions of its borrower if the secured creditor retains the right to monitor and to be informed as to its borrower's activities and operations. Such a ruling would be extreme and catastrophic to the lending industry in a variety of industries (certainly not limited to the upstream E&P space).

IV. Typical Documentation in a Mineral Lease Mortgage

A. Credit Agreement:

While there is no statute mandating that the parties to a loan transaction enter into a credit or loan agreement, it is obviously advantageous to the lender to do so. This is because Louisiana law disallows a cause of action by a debtor against a lender unless the credit agreement is in writing. Thus, Louisiana Revised Statutes section 6:1122 provides, as follows:

> **La. Rev. Stat. Ann. § 6:1122. Credit agreements to be in writing**
>
> A debtor shall not maintain an action on a credit agreement unless the agreement is in writing, expresses consideration, sets forth the relevant terms and conditions, and is signed by the creditor and the debtor.[142]

This statutory provision, sometimes called the Louisiana Credit Agreement Statute, has been interpreted and enforced by our courts on numerous occasions.

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[142] LA. REV. STAT. ANN. § 6:1122. *But see Citizens National Bank v. Coates*, 563 So. 2d 1265 (La. App. Ct. 1st), *writ den'd* 563 So. 2d 1058 (Mem.) (La. 1990), and the discussion of this case as being contrary to the prohibitions of the Louisiana Credit Agreement Statute in David S. Willenzik, *Future Advance Priority Rights of Louisiana Collateral Mortgages: Legislative Revisions, New Rules, and a Modern Alternative*, *supra* note 49, at 29, n. 116.

For example, in *Jesco Const. Co. v. NationsBank Corp.*,[143] the Louisiana Supreme Court took up a question certified to it by the United States Court of Appeal, Fifth Circuit, being "whether the Louisiana Credit Agreement Statute precludes all actions for damages arising from oral credit agreements, regardless of the legal theory of recovery."[144]

The court examined the history of the cited statute, and its prior precedent on the topic,[145] and concluded, as follows:

> We answer the question certified to us in the affirmative. The Louisiana Credit Agreement Statute precludes all actions for damages arising from oral credit agreements, regardless of the legal theory of recovery asserted.[146]

The Supreme Court reaffirmed this decision with respect to actions against lenders based on alleged "oral credit agreements," and added additional commentary on the statute in *King v. Parish National Bank*,[147] in which the court stated, as follows:

> . . . that the Louisiana credit agreement statute precludes all claims, including bad faith breach and bad faith acts, when predicated on the existence and enforceability of oral credit agreements and implied agreements based on the creditor's and debtor's previous relationship. Furthermore, we find that the provisions of La. R.S. 6:1121 *et seq.,* extend to bar claims based on oral credit agreements against a creditor's employees when the employees are acting within the course and scope of employment.[148]

However, the court then noted that the Louisiana Credit Agreement Statute "is inapplicable to the bad faith claims against the appraisers and appraisal company since these claims are outside the parameters of the statute."[149]

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143 830 So. 2d 989 (La. 2002).

144 *Id*. at 990.

145 *Whitney National Bank v. Rockwell*, 661 So. 2d 1325 (La. 1995).

146 830 So. 2d at 992.

147 885 So. 2d 540 (La. 2004).

148 *Id*. at 542.

149 *Id*.

Certainly, depending upon the magnitude and nature of the secured debt, prudence and policy dictate that a written credit agreement be executed between the lender and its borrower.

B. Documentation Typically Contained in a Mineral Lease Mortgage:

1. Mortgage.

Due to the nature of the mineral lease (and of the oil and gas produced therefrom) as an item of collateral, a mortgage or security agreement customarily contains certain unique covenants or conditions appropriate to the operation or maintenance of oil and gas interests or mineral leases.

By way of illustration, a Mineral Lease Mortgage (or security agreement contained therein) will typically include provisions regulating the following matters (in addition to the customary mortgage provisions), to-wit:

- *Warranty of Title*--The mortgagor typically provides a representation as to the sufficiency of the title to the mineral leases, stating the working interest and net revenue interest, subject to Permitted Liens or Permitted Encumbrances.

- *Agreement of Mortgagor Relative to Operation of Mortgaged Property*--The lender will often include provisions which restrict the manner in which the borrower will operate the property in order to ensure compliance with applicable laws and the maintenance in force and effect of the collateral.

- *Prohibition of Advance Payment Contracts*—While arguably less important in contemporary marketing circumstances, this provision is often included as a representation or warranty on the part of the borrower that no portion of the borrower's future revenue stream is committed to any obligation such as "take-or-pay," or other arrangement whereby future revenue will be diverted to another party in order to "make

up" a production imbalance, thereby diminishing the mortgagee's collateral position.[150]

- *Procurement and Maintenance of Insurance*--The mortgagee will require that the borrower will, at its expense, procure and maintain such policies of insurance in such amounts as are ordinarily or customarily maintained with respect to the Mortgaged Property.

- *Furnishing of Information*--The borrower will be required to furnish the lender with full information as to the status of collateral encumbered by the mortgage.

- *Compliance with Environmental Laws; Indemnity*--Because of the nature of oil and gas exploration, and the concomitant opportunity to become exposed to environmental liability, a lender will often require that its borrower conduct its operations in a specified manner, and certainly in a manner that complies with applicable environmental regulations. Some comfort might be afforded to secured lenders by reason of Louisiana Revised Statutes section 9:5395.[151]

- *Qualification to Hold State or Federal Leases*--The mortgagee will require that the borrower take all actions necessary to be qualified to own or operate mineral leases

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[150] A "take-or-pay" provision in a gas purchase contract is one whereby the pipeline-purchaser commits to take or, failing to take, to pay for a minimum annual contract volume of natural gas that the producer has available for delivery. Where gas is paid for but not taken, the contract normally permits the purchaser to "make-up" the deficiency by taking an excess amount of gas ("make-up gas") over a specific term and, in turn, to receive a refund or credit. *See*, *e.g.*, *Frey v. Amoco Production Co.*, 603 So. 2d 166 (La. 1992).

[151] Enacted by Section 3 of Act No. 1087, 1995 La. Acts 2941, this statute extends to lenders the same immunities from liability for environmental conditions or events as are extended under Federal law.

granted by the State[152] or Federal[153] government.

- *Maintenance of Encumbered Mineral Leases*--The mortgagee will require that the borrower maintain the encumbered mineral leases in force and effect, unless the borrower, in good faith, determines that a lease is no longer economic.

- *Transactions with Affiliates*--Borrower will covenant that it will not, directly or indirectly, enter into any sale, lease or exchange of any property or any contract for the rendering of goods or services with respect to any of the mortgaged property with any of its affiliates unless on fair and reasonable terms no less favorable than could be obtained in an arm's length transaction with a non-affiliate.

- *Uneconomic Wells*--Borrower will be required to give mortgagee notice of any circumstance in which a producing well becomes uneconomic.

- *Incorporeal Rights Incidental or Accessory to Mortgaged Property*--Louisiana Revised Statutes section 9:5386 permits parties to collaterally assign certain incorporeal rights, including insurance proceeds representing the damages recovered out of the loss of mortgaged property.

If the borrower is not the operator,[154] the relevant covenant or requirement is usually modified to obligate the borrower to "use its best efforts to," or "to cause," the designated operator to take the actions described.

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152 LA. REV. STAT. ANN. § 30:123.1.

153 43 U.S.C.A. § 1337, and 30 C.F.R. § 256.35.

154 The "operator" may be designated by contract, such as by a joint operating agreement, or by the Commissioner of Conservation. *See Hunt Oil Co. v. Batchelor*, 644 So. 2d 191, 196 (La. 1994) ("The Commissioner has the power to establish compulsory units and designate unit operators therefor.").

2. Security Agreement.[155]

The Mineral Lease Mortgage typically includes a security agreement in order to encumber the movable property owned by the lessee. Importantly, this includes the lessee's interest in minerals, as well as movable (personal) property placed on the leased premises.[156]

3. UCC-1 Financing Statement.[157]

In order to perfect the security interest granted in the Mineral Lease Mortgage with respect to movable (personal) property, it is necessary to file a UCC-1 Financing Statement. The original UCC-1 may be filed in any parish, but any amendments, supplements or terminations of that original document must be filed in the same parish in which the original is filed. This topic is beyond the scope of this presentation.

C. The Notion of "Control" Inherent in Credit Documentation:

The theory of "control" as proffered by Gloria's Ranch, as a means of establishing that Cubic's lender was an "owner" of the mineral lease, was dedicated to the objective of imposing liability on such lender for damages resulting from its failure to release an expired lease of which it was to be deemed an "owner." That theory had no support in any reported decision of a Louisiana court.

At its core, the proposition relied on various covenants or provisions in credit documentation, including the mortgage (recorded, of course) and the unrecorded credit or loan agreement.

The role of recordation *vel non* of the document evidencing the requisites of "control" is worthy of commentary. As to the credit agreement, the fact that it was not recorded certainly means that the theory's proponent, plaintiff-Gloria's Ranch, would never have seen it until after suit was filed, and it was obtained in discovery. It is difficult to discern how the unknown provisions in this unrecorded contract could contribute to the analysis of "control" from the view point of the land owner-lessor of Cubic, and certainly could in no sense constitute a "cloud of title" as contended by Gloria's Ranch.

With regard to the various provisions in each of these documents typical in an RBL transaction, no testimony at trial was presented to establish that the various covenants were ever exercised by Wells Fargo, with the possible

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155 *See* Ottinger, *Mineral Lease Treatise*, § 12-09.

156 LA. REV. STAT. ANN. § 10:9-102(a)(12).

157 *See* Ottinger, *Mineral Lease Treatise*, § 12-09(b)(5).

exception of a requirement that various reports of operations, activities or expenditures were apparently sent (as required) to the lender.

These observations mean that the "control" theory was predicated on the *mere* existence of certain mortgage clauses, not on actual activity taken by the lender pursuant thereto. Had it been embraced by the Supreme Court, this circumstance—that the mere inclusion, without more, in credit documents of the right of a bank to monitor the activities of its borrower—should be of immense concern to any prudent lender.

For the draftsman who is not willing to leave his or her comfort zone by making any, or, certainly, any drastic, modifications or revisions to the mortgage forms that have served their purpose for years or decades, there might be reluctance to make a change such as adding to the "assignment of proceeds" paragraph, as a point of clarification, a sentence such as, "It is not the intention of the parties to assign any interest in and to any item of collateral to Mortgagee," or words to such effect. Such a clause would unquestionably negate any intention to permit the credit documents to be interpreted in any manner as rendering the mortgagee an "owner" of a mineral lease.

Yet, it is noteworthy that the Supreme Court did not reach its ultimate conclusion based upon traditional principles of contractual interpretation. As any first year law student knows, "[i[nterpretation of a contract is the determination of the common intent of the parties."[158] Rather, the court merely evaluated the import of the relationship created by the credit documentation as evincing a regime of "control."

The Second Circuit particularly noted the following provisions in the Cubic mortgage as being indicia of the "control" by Wells Fargo giving rise to its responsibility:

> **2.03 Assignment**.[159] To further secure the full and punctual payment and performance of all present and future Indebtedness, up to the maximum amount outstanding at any time . . ., Mortgagor does hereby absolutely, irrevocably and unconditionally pledge, pawn, assign, transfer and assign to Mortgagee all monies which accrue after 7:00 a.m. Central

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[158] LA. CIV. CODE ANN. art. 2045. *See also* Patrick S. Ottinger, *Principles of Contractual Interpretation*, 60 LA. L.REV. 765 (Spring 2000).

[159] A clause of this type is sometimes called an "assignment of runs." *See, e.g.*, *F.D.I.C. v. McFarland*, 243 F. 3d 876, 881 (5th Cir. 2001) ("McFarland secured this note with a mineral lease mortgage and assignment, an 'assignment of runs,' of his interest in the oil, gas, and minerals produced from the mortgaged leasehold and mineral interests.").

> Time . . . to Mortgagor's interest in the Mineral Properties[160] and all present and future rents therefrom . . . and all proceeds of the Hydrocarbons . . . and of the products obtained, produced or processed from or attributable to the Mineral Properties now or hereafter (which monies, rents and proceeds are referred herein as the "Proceeds of Runs"). Mortgagor hereby authorizes and directs all obligors of any Proceeds of Runs to pay and deliver to Mortgagee, upon request therefor by Mortgagee, all of the Proceeds of Runs . . . accruing to Mortgagor's interest[.][161]

The OCC Lending Manual says the following about the propriety to obtain from the borrower an "assignment of proceeds," to-wit:

> **Collateral Documentation** E&P lending involves unique documentation and perfection of security interests in collateral. The ownership of O&G is real property while it is still in the ground, but it changes to personal property when it is extracted from the well. Following is a short synopsis of the documentation that banks should use for E&P lending:
>
> **Deed of trust or real estate mortgage:** The deed of trust or real estate mortgage (depending on the state in which the property is located)[162] should provide for the assignment of O&G proceeds, which allows the bank to request that payments from the reserve purchaser be distributed directly to the bank. A bank may or may not perfect its assignment of the lease proceeds, but this clause in the document is necessary if the bank ever desires to do so.[163]

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160 "Mineral Properties" is defined in the mortgage as "all of Mortgagor's right, title and interests in the oil, gas, and mineral leases, mineral servitudes, sublease, farmouts, royalties, overriding royalties, net profits interests, production payments, operating rights and similar mineral interests and subleases and assignments of such mineral interest[s]."

161 252 So. 3d at 437.

162 Of course, Louisiana does not recognize the "deed of trust." *Ricks v. Goodrich*, 3 La. Ann. 212 (La. 1848).

163 OCC Lending Manual, p. 29.

The Second Circuit next took cognizance of the "Hypothecation Clause" in the Cubic mortgage, particularly the reference therein to "assign," as follows:

> **2.01 <u>Hypothecation.</u>** (a) In order to secure the full and punctual payment and performance of all present future Indebtedness, the Mortgagor does by these presents specially mortgage, affect, hypothecate, pledge, and ***assign*** unto and in favor of Mortgagee, to inure to the use and benefit of Mortgagee, the following described property, to-wit:
>
> (1) The Mineral Properties, together with all rents, profits, products and proceeds, whether now or hereafter existing or arising, from the Mineral Properties.[164]

In reference to the Hypothecation Clause, the court observed that, "[a]t trial, Gloria's Ranch stressed that the use of the word 'assign' in the 'Hypothecation' clause proves the mortgage included an assignment of the lease."[165] The Second Circuit did not accept this contention, stating that the "use of the words 'assign' and 'assignment' in an instrument does not mandate a finding that the instrument included an assignment."[166]

Finally, the Second Circuit found no basis to conclude that the Cubic mortgage resulted in an *assignment* of the lease to Wells Fargo, notwithstanding the inclusion of the following clauses in the mortgage, to-wit:

> **2.02 <u>The Security Interests.</u>** In order to secure the full and punctual payment and performance of all present and future Indebtedness, Mortgagor hereby grants to Mortgagee a continuing security interest in and to all right, title and interest of Mortgagor in, to and under the following property, whether now owned or existing or hereafter acquired or arising and regardless of where located:
>
> (1) The Mineral Properties.[167]

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164 252 So. 3d at 436-37. (Emphasis added.).

165 223 So. 3d at 1221.

166 *Id*.

167 252 So. 3d at 437.

> **5.02 Remedies.**
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> * * *
>
> (b) Upon the occurrence of any Event of Default, Mortgagee may take such action, without notice or demand, as it deems advisable to protect and enforce its rights against Mortgagor and in and to the Collateral.[168]
>
> * * *
>
> **5.05 Sale.** Upon the occurrence of an Event of Default, Mortgagee may exercise all rights of a secured party under the UCC and other applicable law . . . and, in addition, Mortgagee may, without being required to give any notice, except as herein provided or as may be required by mandatory provisions of law, sell the Collateral or any part thereof at public or private sale, for cash, upon credit or future delivery, and at such price or prices as Mortgagee may deem satisfactory. Mortgagee may be the purchaser of any or all of the Collateral so sold at any public sale . . . Upon such sale, Mortgagee shall have the right to deliver, assign and transfer to the purchaser thereof the Collateral so sold[.][169]

With respect to these typical mortgage provisions, the Second Circuit stated, as follows:

> In the event Cubic defaulted on its loans, the mortgage gave Wells Fargo the right to seize and sell the lease to satisfy the debt. As such, we find the use of the word "assign" in the Hypothecation clause does not deprive the mortgage of its character, which is "to secure the full and punctual payment and performance of the Indebtedness."[170]

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168 *Id*.

169 *Id*.

170 223 So. 3d at 1222.

V. Is There a Need to Revise our Credit Documents?

The unanimous opinion of the Louisiana Supreme Court in reversing the decision of the Second Circuit as it pertains to the liability of the bank-mortgagee, so completely repudiated the rationale embraced by the appellate court that it seems inconceivable that any court would interpret a mortgage and associated credit documentation in the extreme manner as originally embraced by the trial and appellate courts in *Gloria's Ranch*.

Indeed, the "collective sigh of relief" noted in the first sentence of this paper is justified because the utility and functionality of the mortgage has been restored to its proper place in our law. For this reason, this author does not feel that any particular need exists to modify in a comprehensive way the traditional documentation used in secured financing such as in an RBL transaction.

Nevertheless, as a means of adding an additional level of protection to the lender (think, "belt and suspenders"), the author suggests that a clause such as the following be included in the credit agreement, to-wit:

> This Agreement shall be binding upon and inure to the benefit of the parties hereto, their respective successors and assigns. Except as otherwise expressly provided, no other Person not a party hereto shall have any rights under this Agreement, nor shall any third Person be a third party beneficiary of any duty, covenant, obligation or right of any party hereunder, or enjoy any rights to seek relief for any alleged breach or default hereunder, the parties expressly negating any intent to confer any rights on any third Person. For avoidance of doubt, no third Person (particularly to include a lessor or other Person owning rights under any Lease constituting any part of the Collateral or Mortgaged Property hereunder) shall have any right to pursue or assert any claim against Lender hereunder. The performance or non-performance, or the exercise or non-exercise, of any duty, covenant, obligation or right hereunder may not be availed by any third Person in any suit for damages, specific performance or any other legal remedy. Borrower expressly recognizes and acknowledges that the various clauses, covenants and provisions contained herein and in the Mortgage are reasonable and necessary, and are contained and set forth so as to assure to Lender that the Collateral is maintained and established as security to Lender for the repayment of the Loan, and the full and prompt performance of all obliga-

> tions of Borrower to Lender, and are not to be construed as any indicia or evidence of control on the part of Lender with respect to such Collateral. No provision in this Agreement or in the Mortgage shall ever be construed as making Lender an owner of any mineral lease constituting Collateral for the Loan.

Beyond this clause, it would be appropriate to review existing credit documents, particularly the mortgage instrument, to see if it employs, as a title or heading to any paragraph that grants a security interest in minerals accruing to the lessee under the mineral lease, the word "assign" or "assignment," and change the heading to some other appropriate section title. Although titles to sections are included for convenience only,[171] this did not prevent the trial court in *Gloria's Ranch* from placing significant emphasis on the title ("Assignment"), and concluding that, as a consequence thereof, the lender-mortgagee had been "assigned" an interest in the mineral lease sufficient to make the bank an "owner."

Prior to its amendment in 2014,[172] Louisiana Revised Statutes section 9:4401A read as follows:

> **La. Rev. Stat. Ann. § 9:4401. Conditional or collateral assignment of leases or rents**
>
> A. Any obligation may be secured by an assignment by a lessor or sublessor of leases or rents, or both leases and rents, pertaining to immovable property. Such assignment may be expressed as a conditional or collateral assignment, and may be effected in an act of mortgage, by a separate written instrument of assignment, or by a separate written instrument of pledge, ***and may be referred to,***

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[171] Section 6.06 of the Cubic mortgage provided, as follows:

Titles of Articles, Sections and Subsections. All titles or headings to articles, sections, subsections or other divisions of this Mortgage or the exhibits hereto are only for the convenience of the parties and shall not be construed to have any effect or meaning with respect to the other content of such articles, sections, subsections or other divisions, such other content being controlling as to the agreement between the parties hereto.

[172] Act No. 281 of 2014, effective January 1, 2015. For a discussion of this significant legislation in the area of security interests in movable property (including hydrocarbons), *see* Ottinger, *Mineral Lease Treatise*, § 12-08(b).

> ***denominated, or described as a pledge or an assignment, or both***."[173]

While, in practice, one encounters instruments intended to impart a security interest that use, interchangeably, the terms "assignment" and "pledge," the two terms are fundamentally different and, in deed, quite the opposite of each other. This was recognized by the Louisiana Supreme Court in the case of *Scott v. Corkern*,[174] to-wit:

> The contracts of pledge and assignment are entirely different and produce varied legal results. Assignment or transfer of credits and other incorporeal rights is a species of sale and is treated as such in our Civil Code, being found in Chapter 12 of Title VII ('Of Sale').[175] Article 2642 of the Civil Code[176] provides that delivery of an assignment takes place as between transferrer and transferee by the giving of title. Accordingly, a vesting of title in the transferee is essential to an assignment. See Strudwick Funeral Home v. Liberty Ind. Life Ins. Co., La. App., 176 So. 679 and authorities there cited.
>
> On the other hand, a pledge is another sort of contract, having characteristics completely diverse to those of an assignment. It is dealt with under a separate title (Title XX)[177] of our Code and is essentially a contract of security, being defined in Article 3133[178] as 'a contract by which one debtor gives something to his creditor as a security for his debt'. This is the antithesis of an assignment (in which title passes) for, in the contract of pledge, the debtor retains the title of the thing which he places, either actually or constructively, in the hands of his creditor as security for the payment of the debt. See Article 3166 of the Civil Code. Hence, it is

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[173] LA. REV. STAT. ANN. § 9:4401A, prior to its repeal and amendment in 2014 (emphasis added).

[174] 91 So. 2d 569 (La. 1956).

[175] Now, Chapter 15 of Title VII of the Louisiana Civil Code.

[176] Now, articles 2642-43 of the Louisiana Civil Code.

[177] Now, Chapter 1 of Title XX-A of the Louisiana Civil Code.

[178] Now, article 3141 of the Louisiana Civil Code.

> impossible to have an assignment and a pledge of the same thing at the same time.[179]

Thus, the jargon of the commercial lending industry often uses the terms "pledge" or "assignment" interchangeably, when referring to the commitment or dedication of a revenue stream from a lease put forth as collateral for a loan. The use of the term "assignment" even resulted in the filing by practitioners of a Mineral Lease Mortgage in the conveyance records under the articulated theory that it contained an "assignment" of proceeds.[180]

Because the trial court in *Gloria's Ranch* seized upon the word "assignment" as a basis of finding that Wells Fargo was an "owner" of the mineral lease (despite the fact that the text of the relevant section clearly contemplated a *pledge* of production), it is advisable to avoid that term in the credit documentation except in the appropriate context. It must be admitted that, to some practitioners, there is comfort in using the same forms as used for years, perhaps decades, but a slight, surgical tweak in this regard makes sense, as demonstrated by our case under study.

VI. Conclusion

The decision of the Supreme Court in *Gloria's Ranch* was both authoritative and comprehensive in rejecting the novel theory embraced by both the trial and appellate courts. Had the court not reversed the decision of the Second Circuit, the implications to lending practices in the upstream sector of the E&P industry would be far reaching and potentially problematic. If there were merit to the theory embraced by the appellate court (and the Supreme Court correctly held there was not), there would be no reason why a lending bank could not be held co-responsible with its borrower for other faults or inactions of the latter, including personal injury or death on the rig floor, unpaid vendors, "legacy lawsuits,"[181] and other claims encountered by the mineral lessee.

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[179] 91 So. 2d at 571.

[180] Act No. 281 of 2014 comprehensively revised this older statute, and now envisions a pledge, rather than an assignment, "of the rights of a lessor or sublessor in the lease or sublease of an immovable and its rents." *See* §§ 12-08 and 12-09 of Ottinger, *Mineral Lease Treatise*, for a discussion of this significant legislation, which, as noted, pertains to the creation of a security interest by a lessor, but not by a lessee, under a lease.

[181] "'Legacy litigation' refers to hundreds of cases filed by landowners seeking damages from oil and gas exploration companies for alleged environmental damage in the wake of this Court's decision in *Corbello v. Iowa Production,* 02-0826 (La.2/25/03), 850 So.2d 686. These types of actions are known as 'legacy litigation' because they often arise from operations conducted many decades ago, leaving an unwanted 'legacy' in the form of actual or alleged contamination. Loulan Pitre, Jr., '*Legacy Litigation' and Act 312 of 2006,* 20 TUL. ENVT. L.J. 347, 34 (Summer 2007)." *Marin v. Exxon Mobil Corp.*, 48 So. 3d 234, 239, n. 1 (La. 2010).

Additionally, notwithstanding the Second Circuit's attempt to limit its decision,[182] the ruling, while arising in the oil and gas context, would certainly be argued by future litigants as being applicable in other commercial contexts in which the loan documentation imposed covenants that could be assimilated to "control." Certainly, commercial leases are a common form of collateral in real estate development, and the lender appropriately insists on reasonable safeguards by way of covenants in the credit documents. These covenants are not unique to an RBL transaction, and could give rise to the same assimilation to factors of "control" sufficient to diminish the traditional understanding of the mortgage.

The arguments advanced by the plaintiff in *Gloria's Ranch* with respect to the notions of "control," and its contentions invoking an analysis under the elements of ownership--*usus*, *fructus*, and *abusus*--are reminiscent of the art of Rube Goldberg.[183] While the Supreme Court cogently dissected and disposed of these arguments, it is suggested that further support might have been found under the notion of the classification of contracts as being nominate or innominate.

The following articles of the Louisiana Civil Code distinguish contracts as being either nominate or innominate, to-wit:

> **Art. 1914. Nominate and innominate contracts**
>
> Nominate contracts are those given a special designation such as sale, lease, loan, or insurance.
>
> Innominate contracts are those with no special designation.[184]
>
> **Art. 1915. Rules applicable to all contracts**
>
> All contracts, nominate and innominate, are subject to the rules of this title.[185]

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182 *See* text associated with *supra* note 17.

183 "RUBE GOLDBERG (1883-1970) was a cartoonist, an inventor, and the only person ever to be listed in Merriam-Webster's Dictionary as an adjective. Of the nearly 50,000 cartoons he drew in his lifetime, Rube is best known for the zany contraptions of Professor Butts. These inventions, also known as Rube Goldberg Machines, solved a simple task in the most overcomplicated, inefficient, and hilarious way possible." https://www.rubegoldberg.com/rube-the-artist/. Last visited November 20, 2018.

184 LA. CIV. CODE ANN. art. 1914.

185 *Id*. at 1915.

> **Art. 1916. Rules applicable to nominate contracts**
>
> Nominate contracts are subject to the special rules of the respective titles when those rules modify, complement, or depart from the rules of this title.[186]

The enumeration of nominate contracts in article 1914 is clearly illustrative, as the enumeration is preceded by "such as."[187] Since mortgage is defined and recognized by Title XXII of Book III of our Civil Code,[188] it is clearly a "nominate" contract.

As such, the import and efficacy of a mortgage is regulated by the precepts in the Civil Code, subject to notions of "freedom of contract." The mortgage is a recognized institution that should not be dramatically redefined by the lawful inclusion of provisions for the protection of the lender.

Indeed, one of the intrinsic attributes of the nominate contract of mortgage is that it is "nonpossessory" in nature.[189] To find some irregular species of ownership in a mortgage under a theory of "control" turns the notion of a nominate contract on its head.

The Supreme Court has noted the following with respect to a mortgage,[190] to-wit:

> It is to be noted that '* * * A mortgage is the alienation of a right in the property, not the alienation of the property itself. Perfect ownership becomes imperfect when the property is mortgaged, by the alienation of that real right; but the title and the possession still remain in the owner. * * *' Duclaud v.

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186 *Id*. at 1916.

187 Prior to its repeal by Act 503 of 1999, article 3556(29) of the Louisiana Civil Code defined "such as," as "words employed to give some example of a rule, and are never exclusive of other cases which that rule is made to embrace." I really miss that definition.

188 Composed of articles 3278 through 3337 of the Louisiana Civil Code. Supplemental provisions are contained in Code Title XXII of Title 9 of the Louisiana Revised Statutes.

189 LA. CIV. CODE ANN. art. 3278.

190 *Fid. Credit Co. v. Winkle*, 202 So. 2d 280 (La. 1967). It is to be noted that the internal citations to articles of the Louisiana Civil Code are references to articles prior to the comprehensive revision to the law of mortgage by Act No. 652, 1991 La. Acts 2068.

> Rousseau, 2 La.Ann. 168. '* * * in the case of a mortgage the title remains in the debtor, whereas in the case of a sale it does not; but what difference does this make when the mortgage empties the title of all value so far as the recourse of the plaintiff against the property is concerned, * * *. While mortgage does not transfer the title, nor even a dismemberment of it, it nevertheless creates a real right upon the property. C.C. art. 3282. And to that extent it is an alienation of it. And that is why the legal capacity to mortgage must be the same as that to alienate. C.C. art. 3300. Mortgage is just as efficacious as sale for putting property beyond the reach of a creditor. * * *' Thompson v. Calcasieu Trust & Savings Bank, 140 La. 264, 72 So. 958.[191]

The Supreme Court's decision in *Gloria's Ranch* was cogent and precise in rejecting the rationale of the courts below, restoring the mortgage to its historic role of being merely a security device with great commercial efficacy. The various covenants and provisions contained in the mortgage granted by the mineral lessee to its lender are matters between the parties to the mortgage only, and are designed to allow the lender to be advised as to the operations and activities of its borrower in order to be fully informed as to the borrower's ability to repay the loan.[192] There is no basis in the law to allow a third party, such as a mineral lessor, to avail the various provisions contained in the mortgage.

As we have said, "all's well that ends well." In fact, so serious and controversial was the state of affairs as the case exited the Second Circuit, I am confident that this audience would concur that we might wish to rename the final iteration in this case, "Glorious Tranche."

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[191] *Id*. at 286.

[192] As noted earlier, covenants of this type are typically contained in a mortgage in an RBL transaction, and are encouraged by Federal regulators.