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State of Louisiana
DEPARTMENT OF NATURAL RESOURCES
OFFICE OF MINERAL RESOURCES
STATE MINERAL AND ENERGY BOARD

MEMORANDUM

TO: State Mineral and Energy Board
FROM: OMR Staff
DATE: April 25, 2016
RE: Proposed New Oil and Gas Lease Form

At the March 9, 2016 State Mineral and Energy Board meeting of the Legal & Title Controversy Committee, Staff identified four remaining issues with the Proposed New Lease Form that were of concern to Interested Parties. Those issues were:

- Assignments (Article 4)
- Notices (Article 20)
- Audit Rights and Records Retention (Article 10)
- Signature Page

In accordance with SMEB Resolution # 16-03-008, Staff revised the Proposed New Lease Form and posted it on the Department of Natural Resource's website on March 16, 2016. The revised form satisfactorily resolved two of the issues—Notices and the Signature Page.

Seventy-one Interested Parties submitted comments to Staff regarding the revised Proposed New Lease Form. Staff has carefully reviewed and considered all comments received. Staff's recommendations regarding the two unresolved issues (Assignments and Audit Rights and Records Retention) follow.

Assignments

Article 4, entitled Assignments, as proposed to the Board on March 9, 2016, reads as follows:

“ARTICLE 4 – TRANSFERS AND ASSIGNMENTS

In accordance with La. R.S. 30:128, the parties hereto understand and agree to the following:

- (A) No assignment, sublease or other transfer (collectively “Assignment”), in whole or in part, of any rights or interests granted to Lessee under this Lease shall be valid unless approved by Lessor.
- (B) Lessor’s approval is not required for the granting of a mortgage in, collateral assignment of production from, or other security interest in a mineral lease or sublease or the transfer of an overriding royalty interest, production, payment, net profits interest, or similar interest in a mineral lease or sublease.
- (C) Prior or subsequent to any Assignment, but in no event later than sixty (60) days from the date of execution of the Assignment, the assignor shall present to OMR a request for approval of the Assignment by Lessor. Failure to do so shall subject the assignor to the required statutory penalty beginning on the sixty-first (61st) day following the date of execution of the Assignment.

Additionally, upon the Lessor’s approval of an Assignment of any undivided interest of less than 100% granted under this Lease in the Leased Premises (or any portion thereof), the assignor(s), in collaboration with the assignee(s)/transferee(s), shall designate in writing the individual responsible for receiving the notices required or permitted hereby with respect to such co owned portion of the Leased Premises; provided, however, that Lessor shall not seek to terminate this Lease in whole or in part or assess any penalty or liquidated damages on any co-lessee(s) without providing direct written notice to such co-lessee(s). Exceptions from this requirement shall require Board approval.

- (D) An Assignment by Lessee, notwithstanding approval by Lessor, and regardless of any understanding, agreement, language or reference set forth in the Assignment instrument, and in accordance with the applicable provisions of The Mineral Code of the State of Louisiana, does not release nor relieve the assignor(s) from satisfying and complying with the terms, conditions, duties, responsibilities and/or obligations required by this Lease.

- (E) Lessee understands and agrees that Lessor may refuse to consent to such Assignment if, in the Lessor's reasonable opinion, the proposed assignee/transferee lacks the necessary financial capacity to meet the obligations required by this Lease or technical capacity to sustain reasonable development of the Leased Premises. Should Lessor not approve the Assignment, regardless of whether the Assignment instrument is duly recorded, the assignor and its ancestors in title shall remain responsible for satisfying and complying with the terms, conditions, duties, responsibilities and obligations of this Lease.
- (F) Upon approval of the Assignment by Lessor, all terms, provisions, conditions, duties, responsibilities and obligations of this Lease shall be binding upon and inure to the benefit of approved assignee(s)/transferee(s), except as otherwise set forth herein.
- (G) Assignees, sublessees and other transferees are responsible for researching the records maintained by OMR and the Clerk of Court in and for the parish(es) wherein the Leased Premises is located to determine whether this Lease proposed for assignment remains valid and is subject to lawful assignment by the assignor."

Interested Parties identified Paragraph D as problematic because it does not expressly limit the Assignor's obligations post-assignment to only those accruing prior to the Board's approval of the Assignment. Interested Parties' preference is for Paragraph D to be revised to read as follows:

"An Assignment by Lessee, notwithstanding approval by Lessor, and regardless of any understanding, agreement, language or reference set forth in the Assignment instrument, does not release nor relieve the assigning/transferring Lessee from satisfying and complying with any of its obligations accrued prior to Lessor approval date of such Assignment arising under the terms, conditions, duties, responsibilities and/or obligations required by this Lease. The assigning Lessee shall not be responsible for any obligations its approved assignee/transferee accrues after the approval date of the Assignment in favor of such party."

Staff does not recommend that the Board adopt this proposed language. The law applicable to an Assignor's continuing liability is unclear.¹ As such, Staff remains firm in

¹ The statutes applicable to this issue are:

recommending that an Assignor's continuing liability be determined in accordance with Louisiana law. To not retain this reference but instead, to adopt the language proposed by Interested Parties **may** result in the State forfeiting rights afforded by law. The uncertainty of the law on this issue is expressly acknowledged in the Memorandum dated April 6, 2016 from Ms. Nicholson, et.al:

"As we appreciate the provisions of the Mineral Code relating to assignments, we believe that the law is unclear on exactly what obligations an assignor would or would not be responsible for. While Mineral Code Article provides ..., it does not specify whether these obligations and liabilities include ones that do not accrue until after the assignment."

Interested Parties also recommended that parties (brokers) who secure leases solely as agents on behalf of another should not retain liability for development/production activities occurring subsequent to approval of an assignment. Staff concurs with this recommendation under this unique scenario. To encourage leasing, brokers and agents who directly and indirectly perform no work on the Leased Premises should be afforded the possibility of being relieved of responsibility for future lease obligations.

Staff recommends adoption of the following revised language for Article 4, Paragraph D:

"Unless discharged by the Board expressly and in writing, an Assignment by Lessee, notwithstanding approval of the Assignment by Lessor, and regardless of any understanding, agreement, language or reference set forth in the Assignment instrument, does not release nor relieve the Assignor(s) from satisfying and complying with the terms, conditions, duties, responsibilities and/or obligations required by this Lease. Rather, the continuing responsibilities and obligations of the Assignor(s) shall be determined in accordance with the applicable statutory and code provisions of the State of Louisiana.

Notwithstanding the foregoing, upon request and in conjunction with the processing of an Assignment of all rights and interests under this Lease, an original Lessee acting on behalf of another who has not engaged in any activity in furtherance of the development and production of oil and gas on or affecting the Leased Premises, may be released and relieved by the Board from satisfying and complying with any and/or all terms,

La. R.S. 31:128 – "To the extent of the interest acquired, an assignee or sublessee acquires the rights and powers of the lessee and becomes responsible directly to the original lessor for the performance of the lessee's obligations"; and

La. R.S. 31:129 – "An assignor or sublessor is not relieved of his obligations or liabilities under a mineral lease unless the lessor has discharged him expressly and in writing."

conditions, duties, responsibilities and/or obligations required by this lease.”

Staff’s recommended language permits brokers and agents, under defined conditions, to petition the Board to request relief from continuing responsibility under the Lease. Further, Staff’s recommended language does not foreclose other assigning lessees’ ability to request Board approval to be discharged from responsibilities and obligations under the Lease. Staff envisions the development of a policy, with defined criteria, to process such requests.

Audit Rights and Records Retention

Article 10, entitled Audit Rights, as proposed to the Board on March 9, 2016, reads as follows:

“ARTICLE 10 - AUDIT RIGHTS

- (A) Lessee shall keep a complete and accurate account of all its books and records pertaining to its calculation of royalty utilizing accounting systems and methods in compliance with Generally Accepted Accounting Principles consistently applied to ensure the most accurate figures reasonably available. Lessee shall retain in its possession detailed papers, books, records, accounts and other documents relative to its calculation and payment of royalties and other sums due by Lessee hereunder for examination by OMR personnel at all reasonable times. Such documentation shall be maintained in an organized manner and otherwise in the manner that such documentation is regularly maintained by Lessee in the ordinary course of its business. Upon reasonable notice, Lessor, through OMR, shall have the right to review and audit such documents and systems for purposes of verifying their accuracy and reporting requirements. To the extent allowed by law, all documents, working papers and information provided for review, audit and/or access shall be maintained by OMR personnel in strict confidence.

- (B) In addition to all other audit rights set forth in this Lease or required by law, OMR personnel shall have access to all books, records, papers, reports, accounts and documents of Lessee to facilitate any such examination or investigation. If records are maintained in machine-sensible and hard copy formats, Lessee shall make such records available to OMR in said format.”

Interested Parties identified Article 10 as problematic because it does not limit records retention to a specific timeframe. The concern expressed is that lessees/operators should not be expected to maintain records indefinitely. Interested Parties substantially concur in the above proposal, but argue in favor of a fixed duration for retaining records and prefer that the following language be added to the end of Paragraph A:

“Nonetheless, upon conclusion of an audit for a particular period of time, Lessee shall no longer be obligated hereunder to keep any books or records for such period of time.”

The right to audit is expressly provided in La. R.S. 30:136(A)(1)(c) that states, “A Lessee, operator, or other person directly involved in developing, producing, transporting, purchasing, or selling oil, gas, or other minerals from state leases shall establish, maintain, and make available for inspection by office of mineral resources auditors any information that is reasonably relevant to the computation of royalties...”. In addressing this right to audit, the Board must remember that “...any payments, rent, or royalties derived from state-owned properties” are not subject to a prescriptive period under La. C.C. art. 3494(5). As such, Staff cannot endorse any language in the lease form that would expressly authorize the destruction of records that support the production and sale of minerals from the Leased Premises.

The lease form does not **require** Lessees to maintain records indefinitely. Records retention is a management decision to be made by the lessee/operator. The lease form, however, in accordance with law, does call upon Lessees to retain detailed documentation to support the calculation of royalties or other sums due for examination by OMR at all reasonable times. This does not mandate that Lessees maintain records in perpetuity.

OMR has the right, at any time, to audit any period. Since 1996, OMR has conducted 204 audits (24%) with overlapping audit periods for the same payor company. There are a number of reasons an audit period may be re-opened:

- Suspected fraud
- Unleased interest found post audit
- Any state interest not previously recognized but found post audit
- Concursus or other title dispute settlement
- Severance Tax exemptions and deductions
- Limited scope audit

Conclusion

The Proposed New Lease Form has been revised consistent with the preceding Staff recommendations. A copy of the revised form, all comments received from Interested Parties, and Staff's response has been posted on the Department of Natural Resources' website.

In accordance with Resolution # 16-03-008, Staff will recommend final approval of the Proposed New Lease Form at the May 11, 2016 State Mineral and Energy Board meeting of the Legal & Title Controversy Committee.