THE "FREE RIDER" IN LOUISIANA—THE "LOUISIANA RISK FEE" ACT

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I. Background on "Free Riding"

The "free rider" has been the proverbial thorn in an operator's side for as long as the oil and gas industry has been around. The admittedly pejorative moniker of "free rider" refers to a person or entity that, having the right to conduct drilling activities to exploit mineral resources, prefers to have another person or entity do so at its sole cost, risk, and expense. Then, if the exploration venture is unsuccessful (a "dry hole"), the "free rider" simply walks away, but, if it is successful (the completion of a well capable of producing oil or gas in commercial quantities), seeks to receive its share of the production, in both cases, with no personal responsibility for costs or expenses. Put another way, absent express consent, a "free rider"—whether an unleased mineral owner or a non-consenting lessee—has no personal liability for costs of the operation. Rather, the operator is relegated to withholding proceeds of production in order to recoup such costs. There is, however, a jurisprudential exception to this rule that is presented when the third party initiates the unitization proceeding. *Superior Oil Co. v. Humble Oil & Ref. Co.*, 165 So. 2d 905 (La. Ct. App. 4th), *writ den'd*, 167 So. 2d 668 (La. 1964).

The practice of "free riding" was cogently explained by commentators as pertaining to the situation in which "the developing cotenant bears the risk of development, with the non-developing cotenant free riding on the coattails of a successful well and disclaiming any responsibility for any unsuccessful well." Timothy C. Dowd, Wade C. Mann & Anthony J. Ford, *Statutory Pooling and the Unleased Mineral Owner*, 65 ROCKY MT. MIN. L. INST. 13-1, 13-15 (2019).

In Louisiana, the practice of "free riding" was essentially unrestrained or unfettered prior to January 1, 1985. Before adoption of the Risk Fee Act, Act No. 345 of 1984, it was the established law that an "owner" in a compulsory unit had no personal, "out of pocket" responsibility for costs of drilling a unit well in the absence of expressly consenting to have such personal responsibility. At the time of adoption of this legislation, "owner," for purposes of Louisiana's Conservation Act, was defined as "the person who has the right to drill into and to produce from a pool and to appropriate the production either for himself or for others." LA. REV. STAT. ANN. § 30:3(8) (1984).

At the same time, a landowner (or mineral servitude owner) had no duty to grant a mineral lease, and could elect to "hold out" and not facilitate the drilling by another. *See Ark. Fuel Oil Corp. v. Weber*, 149 So. 2d 101, 108 (La. Ct. App. 2d) (recognizing that the "right of an owner to refrain from exercising his right of ownership is absolute"), *writ den'd*, 151 So. 2d 493 (La. 1963). The operator could nonetheless drill the well and assume all cost, risk, and expense of such venture.

If the well was successful, the operator had the right to withhold *all* revenue attributable to the "free rider's" allocated share of unit production until the operator recouped the nonconsenting party's share of the costs of drilling, testing, completing, equipping, and operating the unit well. LA. REV. STAT. ANN. § 30:10(A)(2)(b)(i). However, upon achievement of "payout," the "free rider" was due its proportionate share of production (called "8/8ths"), subject to bearing its proportionate share of current operating expenses. While there is no statutory definition of "payout" for purposes of the Conservation Act, industry custom and usage would deem payout to have been achieved when the operator has been reimbursed for the costs of drilling, testing, completing, equipping, and operating the unit well, out of production.

The courts have recognized that the potential that the operator will eventually be reimbursed out of production can be a hollow remedy, noting:

> It is obvious that, if [the "free rider"]'s contention is maintained, it will have obtained a substantial advantage over [the operator], in that the well satisfies its obligation to its lessor to develop and that it will ultimately receive its share of the proceeds thereof, all without the outlay of one penny. The suggestion that payment will ultimately be made from proceeds of production is not an answer to this situation, as [the operator] will then be required to finance [the "free rider"] during the entire time required to obtain reimbursement from proceeds of production. In short, [the operator] alone will have been required to make the entire investment, whereas the return will accrue only partly to it, and partly to [the "free rider"].

Superior Oil, 165 So. 2d at 908.

II. 1984 Adoption of the Louisiana "Risk Fee Act"

After several unsuccessful attempts to enact a legislative solution to the problem of "free riding," the Louisiana legislature finally enacted what is now called the "Risk Fee Act" in 1984. (Notably, the legislation, which now reposes in LA. REV. STAT. ANN. § 30:10(A)(2)(a)–(i) (exclusive of §§ (2)(f) and (g)), does not utilize the term "risk fee," but characterizes the recoupment factor that an operator might impose as a "risk charge.") The objective of the Risk Fee Act is to create an incentive to a working interest owner to share in the cost, risk, and expense of a unit operation, and correspondingly, to provide remuneration to the party who undertakes the drilling of a unit well at its sole cost, risk, and expense.

In many respects, the structure of the 1984 legislation mimics the contractual regime for the conduct of "subsequent operations" under a model form operating agreement. *See* Patrick S. Ottinger, *Be Careful What You Ask For: Subsequent Operations Under the Model Form Operating Agreement, in* CTR. FOR AM. & INT'L L., SIXTY-THIRD ANNUAL INST. ON OIL & GAS L. ch. 7 (LexisNexis 2012).

In summary, the Risk Fee Act establishes a mechanism whereby a party—called a "drilling owner" in the statute (usually the unit operator)—desiring to drill a unit well (and now, by subsequent statutory amendments, a substitute unit well, an alternate unit well, or a cross-unit well) may call upon all other "owners" in the unit by certified mail (subsequently changed to registered mail, as hereinafter noted) to make an election to participate or not in the cost, risk, and expense of the well.

The Act only applies in the absence of a contractual relationship between the "drilling owner" and the other party to whom a notice is sent, and pertains expressly only to "a drilling unit which has been established by the commissioner as provided in R.S. 30:9(B)." LA. REV. STAT. ANN. § 30:10(A). Additionally, it is distinctly provided that "[t]he provisions of R.S.

30:10(A)(2) shall be applicable to ultra deep structure units, including the applicable risk charge." *Id.* § 30:5.1(B)(9). The Act has no relevance whatsoever to a "lease basis well."

The notified party has thirty days to respond to the operator's notice. Should a notified party fail to affirmatively elect to share in these costs, the operator is entitled to withhold—in the normal, historical fashion—all proceeds allocable to the interest of the nonparticipating party until payout is achieved. Additionally, the operator may assess a "risk charge" of 100% of such party's share of the costs of drilling, testing, and completing the unit well; the risk charge does not apply to costs of equipping and operating the well. This risk charge was increased in 2008 to 200% of such costs.

Other amendments have been made to the Risk Fee Act since is 1984 adoption, including an amendment in 2012 to expand the provisions of the Act so as to apply to a substitute unit well, an alternate unit well, or a cross-unit well that serves as either a substitute or alternate unit well. However, the risk charge is 100% with respect to an alternate unit well or cross-unit well that will serve as an alternate unit well.

Also, in 2012, the mode of transmittal of notices and responses was changed from "certified" mail to "registered" mail, but also including "other form[s] of guaranteed delivery and notification method" (such as a reliable commercial courier service), but "not including electronic communication or mail." *Id.* § 30:10(A)(2)(a)(i). Because the Risk Fee Act is viewed as penal in nature, it is to be strictly construed by the courts, with the consequence that a failure on the part of the "drilling owner" to dispatch the well proposal in one of the modes of communication enumerated in the statute would result in the inability to impose the risk charge. For example, see *Browning v. Exxon Corp.*, 848 F. Supp. 1241, 1246 (M.D. La.), *aff'd*, 43 F.3d 668 (5th Cir. 1994), in which a demand for a "sworn, detailed itemized statement of drilling costs" dispatched by an unleased mineral owner to the operator under the Louisiana Well Cost Reporting Statute was ineffective when it was mailed by *certified*, rather than *registered*, mail as explicitly required by the statute.

Importantly, under no circumstance may the operator assess a risk charge to an unleased mineral owner. LA. REV. STAT. ANN. § 30:10(A)(2)(e)(i) states expressly that the provisions of the Act "with respect to the risk charge shall not apply to any unleased interest not subject to an oil, gas, and mineral lease."

After the enactment of the Risk Fee Act, but prior to 2012, the "free rider" was obligated to pay royalties to its own lessor even though it was receiving no revenue out of the well prior to payout. *Gulf Explorer, LLC v. Clayton Williams Energy, Inc.*, 964 So. 2d 1042 (La. Ct. App. 1st 2007). This circumstance, of course, constituted a disincentive to a party to decline to participate in the drilling of the unit well as it would be required to pay its lessor royalty "out of pocket."

III. 2012 Amendments to the Risk Fee Act

In 2012, controversial amendments were made to the Risk Fee Act that removed that disincentive by requiring the operator to pay over to the "free rider" the necessary amount of proceeds in order that the lessor's royalty would be paid. This overturned a century of jurisprudence as outlined above. *See* Patrick S. Ottinger, *It's a Risky Business, but There's an Act for That: The Louisiana Risk Fee Act*, 63 ANN. INST. ON MIN. L. 61 (2016).

This newly imposed requirement had the result of diminishing the revenue stream to which an operator was entitled, thus delaying payout. This reversal of the former entitlement was not well received by the industry, and was repugnant to a sound public policy that encourages joint development. The nonparticipating owner's lessor was not without a remedy for unpaid royalty as it had the ability, after written notice of non-payment, to seek "double damages" and, in a proper case, dissolution of the mineral lease.

IV. 2022 Amendments to the Risk Fee Act

Subsequent to 2012, the legislature in 2016 adopted Senate Resolution No. 31 to study the Risk Fee Act, particularly as it pertains to the new requirement that an operator must pay over to a "free rider" the proceeds for payment of its lessor's royalty. The Resolution tasked the Louisiana State Law Institute (LSLI) to undertake this study, and the Risk Fee Act Committee was formed by the LSLI for the purpose. In the interest of full disclosure, this author served as Reporter of this Committee. It was composed of practitioners and academicians throughout the state of Louisiana.

After delays caused by the COVID-19 pandemic, the Committee submitted a report that was adopted by the Council of the LSLI in December 2020, and sent to the legislature for its consideration. Introduced as Senate Bill No. 59, it was converted during the 2021 session to a study resolution and a Risk Charge Commission was formed. Again, by way of disclosure, this author served as Vice-Chair of this Commission.

The Commission rendered a report after conducting extensive studies and debates over several months. The recommendations of the Commission were introduced as Senate Bill No. 38, which was unanimously adopted, resulting in Act No. 5 of the 2022 legislative session, effective August 1, 2022.

The new legislation amended the Risk Fee Act in many respects, clarifying existing inconsistencies and adding new beneficial features to both the "drilling owner" as well as to the lessor of a nonparticipating owner. The following is a "high level" summary of the salient provisions now incorporated into the Act as a result of the 2022 legislation.

The 2022 legislation addresses textual uncertainties in the original legislation by defining the terms "risk charge notice" (a written notice to "all other owners in the unit of the drilling or the intent to drill," giving "each owner an opportunity to elect to participate in the risk and expense of such well") and "lessor royalty."

The Risk Fee Act now authorizes the "drilling owner" issuing a risk charge notice to include a "cash call." If a cash call is included in the risk charge notice, then, in order to avoid the imposition of a risk charge, the party affirmatively electing to participate in the proposed operation must also advance its share of costs as estimated in the authorization for expenditure (AFE) required to accompany the risk charge notice. So as to ensure that the costs estimated in the AFE are reasonably current and accurate, the AFE "shall be dated within one hundred twenty days of the date of the mailing of the risk charge notice." LA. REV. STAT. ANN. § 30:10(A)(2)(a)(i)(aa). As the costs advanced are only an estimate, the 2022 legislation contains a provision for a "true up" of estimated versus actual costs of the operation, to be accomplished "within sixty days of receipt of detailed invoices in order to account for the difference between any cost estimates and actual costs." *Id.* § 30:10(A)(2)(a)(ii).

If the well proposed by a risk charge notice is not commenced within ninety days of receipt of the initial risk charge notice, the drilling owner must send a supplemental notice in order for the provisions of the Act to apply. *Id.* § 30:10(A)(2)(a)(iii).

As previously noted, amendments to the Risk Fee Act in 2012 imposed a new (and controversial) duty on the part of the operator to pay over to the nonparticipating party the amount of royalties to which its lessor is entitled. The scope and nature of this duty was clarified in 2022 to require the nonparticipating party to provide to the "drilling owner" (typically, the operator) certain specified information, including a copy of the relevant mineral lease (which may be redacted provided it includes those lease provisions pertaining to the calculation of royalty) and a "sworn statement of ownership." *Id.* § 30:10(A)(2)(b)(ii)(gg). In its discretion, the nonparticipating owner may also provide a copy of any title opinion in its possession. *Id.* The operator is authorized to procure a title opinion on the lands burdened by the mineral lease held by the nonparticipating owner, and charge the costs thereof to the tract in question. *Id.* § 30:10(A)(2)(b)(ii)(jj).

These new deliverables are important because it is often the case that the operator has not examined title to any tract in which it owns no interest and, thus, might not have any basis to calculate the royalty to which the lessor of the nonparticipating party might be entitled. The royalty to be paid over by the "drilling owner" to the nonparticipating party is to be calculated and paid in accordance with the terms of the relevant mineral lease. Although Louisiana law permits parties to file for registry, in lieu of the actual mineral lease, a memorandum or extract of lease to serve as public notice to third parties, the statute authorizing the filing of this simple instrument does not require that it include the royalty to which the lessor is entitled, and certainly not the lease terms pertinent to the calculation of the lessor's royalty. Hence, the operator—having no interest in the land or lease in question—is unaware of the amount of the royalty or of any contractual provisions relative to the computation thereof. By way of example, if the nonparticipating lessee's mineral lease contains a "No Deductions Clause," which contractually disallows the assessment of "post-production costs" against the lessor's royalty, that provision must be honored in the computation of the lessor's royalty. While not explicitly addressed, the lessee's interest in the tract should remain responsible for these costs vis-à-vis the operator.

The Act explicitly negates any presumption or contention that it creates a relationship between the operator and the lessor of the nonparticipating party, and does not relieve the nonparticipating party from its obligations under its lease to its own lessor. Further, the operator is to be indemnified by the nonparticipating party with respect of royalties paid by the operator in reliance on the information provided by the nonparticipating party. The 2022 legislation also introduces a "notice of change of ownership" feature that creates a safe harbor for the operator to continue to pay royalties unless and until it is notified of a change in ownership of the land or minerals giving rise to the royalties being paid over to the nonparticipating party for the benefit of its lessor.

Provisions comparable in nature to those features dealing with the payment of the lessor's royalty are also contained with respect to any overriding royalty burdens of the nonparticipating owner. An important distinction is that there is a cap on the amount of the overriding royalty burdens for which the "drilling owner" is duty-bound to pay over to the nonparticipating owner. It is only required to pay over the

> lesser of: (I) the nonparticipating owner's total percentage of actual overriding royalty burdens associated with the existing lease or leases which cover each tract attributed to the nonparticipating owner reflected of record at the time of the risk charge notice; or (II) the difference between the weighted average percentage of the total actual lessor royalty and overriding royalty burdens of the drilling owner's leasehold within the unit and the weighted average percentage of the total actual lessor royalty of the nonparticipating owner's leasehold within the unit reflected of record at the time of the risk charge notice.

Id. § 30:10(A)(2)(b)(ii)(bb). While admittedly "wordy," this mechanism is intended to avoid any concern or possibility that the nonconsenting owner would endeavor to "game the system" by creating an unreasonably excessive overriding royalty to an affiliated entity for which the "drilling owner" would be liable to pay over proceeds.

A lessor under a mineral lease held by a nonparticipating owner who has not received its lessor royalty may invoke the remedies of the Louisiana Mineral Code relative to unpaid royalty. However, the procedure is expanded to include the requirement that any notice of non-payment must include a copy of the relevant mineral lease.

Importantly, the provisions of the Risk Fee Act have been extended to "subsequent unit operations." The term is defined in the legislation, as are the various types of activities or operations coming within the ambit of that term. A proposal to conduct "subsequent unit operations" is issued in the same manner and form as a proposal to drill an initial well, with different set of enumerated information to be included.

If the "subsequent unit operation" is proposed at a time when the notified party is subject to an outstanding, and unsatisfied, risk charge arising out of a prior operation in which it went non-consent, the "drilling owner" can require the notified owner to "come current" on the prior expenditures (and risk charge) as a prerequisite to participation in the proposed "subsequent unit operation" so as to avoid the imposition of a further risk charge associated with that "subsequent unit operation." The risk charge for such an operation is 100% "of the tract's allocated share of the actual reasonable expenditures incurred in conducting the subsequent unit operation, including a charge for supervision, regardless of whether the wellbore on which such operations were conducted is a unit well, alternate unit well, substitute unit well, or cross-unit well." *Id.* § 30:10(A)(2)(b)(v).

V. Conclusion

While it is possible that further refinement of the Risk Fee Act will be pursued, it is sufficient to say that great progress has been made to address the situation of the "free rider."