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The Jones Walker Energy E*Zine reviews and discusses developments in the energy industry, with a particular focus on matters that affect Louisiana. It addresses all legal disciplines within the energy industry, including the exploration and production of oil, gas, and other hydrocarbons; as well as the processing, marketing, and valuation of these products.

Can the Possessor Recover Expenses Incurred After the Filing of a Petitory Action?: The Louisiana Third Circuit Issues Conflicting Opinions

The Louisiana Third Circuit Court of Appeal has issued conflicting opinions on the identical legal issue of whether a mineral lessee that is considered to be a good faith possessor becomes a bad faith possessor upon the filing of a petitory action and thereafter ceases to have the right to recoup exploration and operating expenses under La. Civ. Code art. 488. The *Lamson Petroleum Corporation v. Hallwood Petroleum, Inc. et al.*, series of identically-captioned cases involves disputes between mineral lessees over the ownership of certain roadbed tracts in the Scott Field area of Lafayette Parish.

In 1989 Hallwood began exploring for and producing minerals in the Scott Field. Lamson discovered through the public records that certain roadbeds tracts allegedly covered by Hallwood's mineral leases may not have been owned by Hallwood's lessors. In the mid1990's Lamson acquired leases from those whom it believed to be true owners of the roadbed tracts. Lamson filed petitory actions against Hallwood and all others who claimed ownership in or received oil and gas royalties or production from the roadbed tracts. In the particular cases discussed herein, the district court concluded that Hallwood's lessors did not own the area covered by the roadbeds and that the Lamson lessors did. The trial court also held, however, that Hallwood and its lessors were good faith possessors even after Lamson's filing of suit and allowed Hallwood to deduct exploration and operating expenses from the amounts owed to Lamson. Lamson appealed the "good faith" portion of the trial court's ruling.

In the first of these cases, *Lamson Petroleum Corporation v. Hallwood Petroleum, Inc. et al.*, 2001-01156 (La. App. 3 Cir. 04/10/02) 814 So.2d 134, the Third Circuit reversed the trial court on the good faith issue and followed its prior holding in *Edmundson Bros. Partnership v. Montex Drilling Co.*, 98-1564 (La. App. 3 Cir. 05/05/99), 731 So.2d 1049. In *Ed-*

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mundson, the Third Circuit had held that a mineral lessee ceases to be in good faith under La. Civ. Code arts. 487 and 488 at the time of judicial demand and ceases to be entitled to recover costs of production regarding his lease. In other words, although he may be in good faith prior to the judicial demand, he ceases to be in good faith after the filing of a petitory action. The Third Circuit panel in this Lamson decision followed the plain language of La. Civ. Code art. 487, which provides that the possessor ceases to be in good faith when defects are made known to him or when an action is instituted against him by the owner for the recovery of the thing. It then concluded that, because La. Civ. Code art. 488 provides that a possessor in bad faith does not have the right to reimbursement of expenses, Hallwood and its lessors were not entitled to deduct expenses incurred after the filing of the petitory action.

In another of the *Lamson* decisions involving the identical issue, 2001-1201 (La. App. 3 Cir., 3/20/02) 814 So.2d 596, a different Third Circuit panel, in a 2-1 decision with a dissent from a panel member in the above opinion, distinguished *Edmundson* and upheld the trial court's determination that Hallwood was in good faith even after the filing of the petitory action. To reach its conclusion, the Third Circuit relied on La. Civ. Code art. 3481, which contains a presumption of good faith that neither error of fact nor law can defeat. This presumption is rebutted on proof that the possessor knows, or should know, that he is not the owner of the thing that he possesses. Despite noting the rebuttal language of article 3481, the panel refused to find that Hallwood was in bad faith following the initiation of litigation, apparently on the basis that a bona fide dispute as to the ownership of the property was resolved only after lengthy litigation.

Finally, in a third case in the *Lamson* series to consider the same good faith issue, 2002-138 (La. App. 3 Cir. 07/10/02) 2002 La. App. Lexis 2368, yet a different panel of the Third Circuit again overruled the trial court and held that Hallwood and its lessors were not in good faith and not entitled to recover production expenses incurred after the filing of suit. The third panel also followed *Edmundson* and held that, despite the holding in *Lamson*, 814 So.2d 596, the plain language of article 487 provides that a possessor ceases to be in good faith when an action is instituted against it. The court stated that there is no exception or qualification to the rule set out in this article.

Based on these conflicting opinions, writs from both sides are presently pending before the Louisiana Supreme Court with respect to the good faith issue.

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LOWLA Creditors Subordinated to Prior-Recorded Bank Mortgages

In *In Re: Equinox Oil Company, Inc.*,300 F.3d 614 (5th Cir. 2002), the U.S. Fifth Circuit affirmed the holding of the Eastern District of Louisiana that pre-existing bank mortgages primed liens filed by certain creditors pursuant to the Louisiana Oil Well Lien Act ("LOWLA").

Equinox Oil Company, Inc. ("Equinox") operated oil and gas leases owned by Alma Energy Corp. ("Alma"). Den norske Bank, ASA, BNP Paribas and Comerica Bank- Texas (the "Bank Group") loaned over $106 million to Equinox and Alma, securing the loans by mortgages and other security interests in all the assets of Alma. In the course of operations, Equinox incurred unpaid debts to numerous vendors and service providers (the "M&M Creditors"), which perfected liens pursuant to the LOWLA against the same property secured by the Bank Group. The Bank Group filed the mortgages and financing statements before the effective date of the LOWLA liens.

In September 1998, a blowout occurred at a well on an Alma lease, causing property damage and an oil spill. Numerous companies provided services and equipment (the "Remediation Creditors") to Equinox to stop the blowout and clean up the spill. Equinox's insurer paid to Equinox $700,000 in partial settlement of a claim brought by Equinox under its well control policy, and Equinox paid these proceeds to some but not all of the Remediation Creditors. In May 1999 Equinox was placed in involuntary Chapter 7 bankruptcy, which it converted to Chapter 11, and in June 1999 Alma also filed a Chapter 11 proceeding. The bankruptcy court joined the two proceedings.

The Fifth Circuit, relying on the reasons set forth in the district court's opinion, *In Re: Equinox Oil Company, Inc.*, 2001 U.S. Dist. LEXIS 8165 (E. D. La. 2001), held that the Bank Group's mortgage was superior in ranking to the LOWLA privileges of the M&M Creditors. While conceding that their liens arose after the recordation of the Bank Group's mortgages, the M&M Creditors argued that their mechanic and materialmen's liens constituted "Permitted Encumbrances" under the express language of the Act of Mortgage from Alma to the Bank Group. The Act of Mortgage defined Permitted Encumbrances to include "Liens under operating agreements, pooling orders and unitization agreements, and mechanics and materialmen's Liens, and

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similar statutory Liens for services or materials for which payment is not yet due." The district court focused on the "not yet due" language and interpreted the provision to apply to only those Permitted Encumbrances filed after perfection of the security interest but for work that started before the effective date of the perfected security interest.

The testimony of a Houston oil and gas attorney, who had been qualified as an expert, supported the district court's interpretation. The expert testified that the term "Permitted Encumbrances" in a mortgage of mineral interests customarily refers to liens that are extant at the time the mortgage is executed. The district court also rejected equitable arguments of the M&M Creditors based on theories of unjust enrichment and the law of accession. In affirming the district court, the Fifth Circuit simply noted the clear language in the LOWLA, which states that mortgages that are effective as to third persons before the privilege is established are superior in rank and priority to the liens. La. R.S. 9:4870(B)(2).

Insurance Proceeds Under Well Control Policy Held to Be Property of the Estate

Also in *Equinox*, the Fifth Circuit considered, apparently as an issue of first impression, whether the proceeds of an indemnification policy designed to reimburse the debtor for losses owed to third parties is property of the debtor's estate. On appeal, Equinox's Remediation Creditors argued that, because Equinox's well control policy covered Equinox for the cost of work they did in responding to the blowout and spill, the proceeds of the policy should be excluded from the bankruptcy estate and instead paid directly to them. The Fifth Circuit, after reviewing two prior decisions, *In Re: Edgeworth* and *In Re: Louisiana World Exposition, Inc.* (*LWE*), agreed with the district court that proceeds of the policy belonged to the bankruptcy estate.

The Fifth Circuit noted that the definition of property included within the bankruptcy estate under Section 541 of the Bankruptcy Code covers "all legal and equitable interest of the debtor in property as of the commencement of the case" and "proceeds . . . of or from property of the estate." It further noted that an insurance policy owned by the debtor is generally considered property of the estate. However, the central question, as developed in *Edgeworth* and *LWE,* for determining whether insurance proceeds associated with a policy are property of a bankruptcy estate is whether, in the absence of the bankruptcy proceeding, the proceeds of the policy would belong to the debtor when the insurer pays a claim. When the insurer's payment cannot inure to

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the debtor's pecuniary benefit, then that payment should neither enhance nor decrease the bankruptcy estate.

In applying this principle to the Equinox policy, the court observed that the policy named Equinox as the Assured and that the policy did not name the Remediation Creditors as loss payees. Under the policy, the underwriters agreed to "reimburse the Assured" for expenses incurred in relation to well blowouts. The court found therefore that the policy covered losses of Equinox itself and provided for payment of those losses to Equinox. Unlike the policies involved in *Edgeworth* and *LWE*, the Remediation Creditors had no right under the policy to claim its proceeds nor was the policy designed to protect the losses of third parties. While recognizing that the position of the Remediation Creditors had an "equitable tug," the court pointed out that those creditors were not unlike other unfortunate creditors whose debts are owed but who cannot establish a priority under state law or the Bankruptcy Code to advance their priority over other general creditors.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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