NORTON ROSE FULBRIGHT

Energy companies facing scrutiny over undrilled reserves and resources estimates

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For the past two years oil companies have been experiencing pressure on their revenues and profits due to the precipitous decline in the price of oil from over $100 a barrel to less than $50—including one particularly grim period during which oil fell below $27 a barrel. The industry-wide decline has not gone unnoticed by the SEC and investors, who are considering whether certain optimistic disclosures made by oil companies during tough economic times were false or misleading. This article discusses two categories of disclosures currently undergoing scrutiny. First, the SEC is questioning whether oil and gas companies failed to properly write down proved undeveloped reserves ("PUDs") in light of changed economic conditions. Second, the SEC and others are expressing interest in whether estimates made outside of SEC filings concerning non-SEC reserves, sometimes referred to as resource estimates, were false or misleading.

SEC scrutiny of PUDs

As demonstrated by recent media attention and comment letters, the SEC is aggressively scrutinizing oil and gas companies for (1) improperly including PUDs on their books without a realistic five-year development plan and (2) failing to remove PUDs from their books when it is no longer reasonably certain that they will be developed within five years. The five-year rule has led to substantial write-downs of oil and gas assets by companies that cannot develop them profitably under current pricing or budgetary conditions, with energy companies slashing reserves by more than $200 billion since the start of the oil-price downturn. Given the substantial investor losses and the SEC Enforcement Division's previously expressed concerns that companies are not properly applying the five-year rule, it is unsurprising that the SEC is carefully reviewing energy companies' disclosure practices, and it appears increasingly likely that the SEC will institute enforcement actions against companies that did not correctly apply the five-year rule. Energy companies may also face significant risk from disappointed investors, who may attempt to bring securities lawsuits over alleged noncompliance with PUD-reporting requirements.

In particular, the SEC is examining whether companies' actual historical development of PUDs is consistent with the 20% annual development rate one would expect under a five-year plan, and has suggested that some companies may have overstated their reserves by including PUDs that never had a realistic five-year plan at the outset. The SEC has also pointedly questioned whether companies have maintained adequate internal controls over PUD reporting, which is consistent with the Enforcement Division's overall institutional focus on internal controls. Under SEC guidance, energy companies must maintain adequate documentation that a five-year plan exists, must normally remove PUDs from their books if drilling within five years is no longer reasonably certain, and must maintain adequate internal controls and disclosure controls to ensure that the impact of planned spending reductions or changed

business plans on a company's PUD reporting receives full consideration. In addition to satisfying these basic standards, management should also make sure that their boards are aware of potential changes to development plans and the potential impact of these changes on reserve reporting, and companies should provide transparent risk disclosures so that investors understand the risk that PUDs may have to be removed.

Revisions to PUD reporting requirements

As part of its 2008 efforts to "modernize" reserve reporting, the SEC liberalized the requirements for calculating PUDs, including by allowing companies to count oil and gas located farther from producing wells if the company could establish with reasonable certainty that the reserves could be economically produced.[1] Many oil and gas companies have taken advantage of these changes to report substantial increases in their reserves.[2] According to one recent article, reported reserves have surged by 67 percent since the rules became effective in 2009.[3]

The new rules, however, came with a significant catch: PUDs may not be recognized unless companies have a detailed development plan in place to drill the wells within five years, and the PUDs may not remain on the books if it is no longer "reasonably certain" that they will be drilled within five years after they are recognized.[4] The "modernized" rules provide an exception to the five-year requirement if there are "specific circumstances" warranting a longer development period.[5] Unfortunately, while the SEC has identified several factors to consider in determining whether circumstances exist that would justify an exception, those factors do not include low commodities prices or a desire to extend the economic life of an oil or gas field.[6]

Recent media focus on PUDs

Over the last year, *Bloomberg* published a series of articles examining the effect of the oil-price depression on PUD reporting and reporting on the large write-downs several shale operators took before filing for bankruptcy.[7] For example, one company erased nearly half of its reserves this year before declaring bankruptcy in April.[8] The article observed that 59 U.S. oil and gas companies had written down more than 9.2 billion barrels of reserves—representing more than 20 percent of their inventories—and that several of the profiled companies had previously received comment letters from the SEC's Division of Corporation Finance ("Corp Fin") questioning their development plans and asking them to revise their estimates.[9] The article also noted that several of the profiled companies appeared to have taken actions inconsistent with an intent to develop PUDs within five years.[10]

With total industry-wide write-downs now eclipsing $200 billion since the collapse of oil prices,[11] as well as mounting bankruptcies and investor losses, it is unsurprising that securities regulators are scrutinizing whether reserves were appropriately reported in the first instance. As *Bloomberg* reported, the SEC is continuing to examine whether companies have properly recognized PUDs and whether they are taking appropriate write-downs.[12] For example, one of the profiled companies had a pattern of developing only 4% of its PUDs each year (well below the 20% per year one would expect if the company were following a five-year plan), while the CEO of

1 Gerard G. Pecht & Peter A. Stokes, *Key Securities Litigation and Enforcement Issues Affecting Energy Companies*, Norton Rose Fulbright (2014), available at http://www.nortonrosefulbright.com/files/20140423-key-securities-litigation-and-enforcement-issues-affecting-energy-companies-115660.pdf; *see also* Marc Folladori & Jeff Dobbs, *Studies Show Further Guidance Needed on Revised Oil and Gas Disclosure Rules*, Oil & Gas Fin. J., Dec. 1, 2010, http://www.ogfj.com/articles/print/volume-7/issue-12/features/studies-show-further-guidance-needed-on-revised.html.

2 Ian Urbina, *S.E.C. Shift Leads to Worries of Overestimation of Reserves*, N.Y. Times, June 27, 2011, http://www.nytimes.com/2011/06/27/us/27gasside.html.

3 Asjylyn Loder, *Why Billions in Proven Shale Oil Reserves Suddenly Became Unproven*, Bloomberg (June 15, 2016, 8:08 AM), www.bloomberg.com/news/articles/2016-06-15/shale-drillers-paper-wells-draw-sec-scrutiny-before-vanishing.

4 Ian McNeill, *How Changes to SEC Disclosure Requirements Five Years Ago Are Affecting E&P Companies Today*, Oil & Gas L. Dig., Sept. 21, 2015, https://oilandgaslawdigest.com/primers-insights/how-changes-to-sec-disclosure-requirements-five-years-ago-are-affecting-ep-companies-today/.

5 *Id.*

6 *Id.* The SEC has instructed companies to consider the following factors in assessing whether an exception applies: (i) the company's level of ongoing significant development activities in the area to be developed; (ii) the company's historical record of completing development of comparable long-term projects; (iii) the amount of time in which the company has maintained the leases, or booked the reserves, without significant development activities; (iv) the extent to which the company has followed a previously adopted development plan; and (v) the extent to which delays in development are caused by external factors relating to the physical operating environment, rather than by internal factors. Id.

7 Loder, *supra* note 3; Asjylyn Loder, *Millions of Barrels of Oil Are About to Vanish*, Bloomberg (May 22, 2015, 4:36 AM), http://www.bloomberg.com/news/articles/2015-05-21/oil-s-whodunit-moment-coming-with-millions-of-barrels-to-vanish; Asjylyn Loder, *The Price of Oil Is About to Blow a Hole in Corporate Accounting*, Bloomberg (Mar. 4, 2015, 11:33 AM), http://www.bloomberg.com/news/articles/2015-03-04/oil-at-95-a-barrel-discovered-in-sec-rules-on-reserves.

8 *Id.*

9 *Id.*

10 *Id.*

11 Collin Eaton, *Drillers Write Down $200 Billion in Assets*, FuelFix (July 6, 2016), http://fuelfix.com/blog/2016/07/06/drillers-write-down-200-billion-in-assets/.

12 Loder, *supra* note 3.

another profiled company publicly stated that "under almost no scenario" would the company resume gas drilling despite continuing to retain PUDs on its books.[13]

PUD comment letters

The SEC's recent comment letters bear out the concerns highlighted by *Bloomberg*. Over the past eighteen months, Corp Fin has aggressively questioned whether oil and gas companies are complying with the five-year rule, whether they have adequate internal controls over PUD recognition and have sufficiently made their directors aware of their development plans, whether they are correctly applying impairment tests, and whether they are making adequate disclosures regarding the effects of a sustained depression in commodities prices on their ability to develop PUDs.[14] The SEC is also asking companies to quantify anticipated near-term impairments that have a reasonable possibility of occurring.

While it is not clear to what extent Corp Fin is coordinating with the SEC's Enforcement Division on these matters, members of the Enforcement Division have also publicly stated that they are concerned about whether companies are correctly recognizing PUDs and are correctly applying the "five-year development plan" rule.[15] Given the substantial overlap between the comment letters and the Enforcement Division's stated priorities, it is reasonable to presume that energy companies face significant enforcement risks regarding the types of issues identified in the comment letters.

1. Failure to develop PUDs within five years

The SEC, for example, sent the following comment letter to an oil and gas company on December 15, 2015, which questioned whether the company's original recognition of PUDs in 2010 complied with SEC rules given that the company only developed 72% of the reserves in the succeeding five years:

> We note your response . . . refers to the reclassification as of December 31, 2014 to unproved of 4.1 MMBOE of PUD reserves initially booked as of December 31, 2010. Your 2010 Form 10-K disclosed the 2010 initial strata of PUD reserves booked (on page 29) as 14.4 MMBOE. It appears 28% . . . of these initial PUDs were not developed. This does not agree with [your prior statement that] "[w]e have historically viewed our commitment to develop booked proved undeveloped reserves, or PUDs, as a commitment to develop within the five year development horizon from the date of first booking." These results do not comply with the definition of proved oil and gas reserves (Rule 4-10(a)(22) of Regulation S-X) which requires/describes the project to recover proved reserves as "...The project to extract the hydrocarbons must have commenced or the operator must be reasonably certain that it will commence the project within a reasonable time." In part, Rule 4-10(a)(24) describes Reasonable Certainty as "...reasonable certainty means a high degree of confidence that the quantities will be recovered. If probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate. A high degree of confidence exists if the quantity is much more likely to be achieved than not..." The ultimate development of 72% of the PUD reserves booked on 2010 does not appear to comply with Regulation S-X. Given these historical results and your 2013-2015 single digit percent conversion to proved developed status, please explain to us how you intend to develop the PUD reserves you will book as of December 31, 2015. Include annual schedules for the projected PUD volumes drilled, location count, drilling rig count, required PUD development capital and development capital to be incurred. Please address the sources you will employ for this capital.[16]

2. Internal controls and director familiarity with changes to development plans

The SEC has also expressed concerns about whether companies that consistently fall short of initial PUD development plans have adequate internal controls, as indicated by this comment from December 15, 2015:

> Information provided in response to prior comment number two from our letter dated September 16, 2015 describes a number of factors that contributed to low PUD conversion rates and a lack of adherence to previously adopted development plans in recent

13 *Id.*

14 *See* PricewaterhouseCoopers, 2015 *SEC Comment Letter and Disclosure Trends: Energy and Mining* 7, 11 (2015), *available at* http://www.pwc.com/us/en/energy-mining/publications/assets/pwc-energy-sec-trends-publication-2015.pdf; Marc Folladori, 2014-2015 *SEC Staff Comments on Oil and Gas Disclosures*, Oil & Gas Fin. J., Jan. 12, 2016, *available at* http://www.ogfj.com/articles/print/volume-13/issue-1/features/sec-comments.html; Marc Folladori, Robin L. Clarkson & Jeff M. Dobbs, *SEC Comments on Companies' Compliance With Amended Oil and Gas Disclosure Rules*, Oil & Gas Fin. J., Jan. 1, 2013, *available at* http://www.ogfj.com/articles/print/volume-10/issue-1/features/sec-comments-on-companies-compliance.html.

15 G. Allen Brooks, Musings: *Low Nat Gas Prices and the SEC Shale Gas Investigation*, Rigzone (Apr. 11, 2012), http://www.rigzone.com/news/article.asp?a_id=116833.

16 Clayton Williams Energy, Inc., Response to SEC Comment Letter (Mar. 17, 2016) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/880115/000110465916105932/filename1.htm.

> years. In view of these reoccurring factors, expand your disclosure regarding the internal controls used in estimating your reserves to describe the steps taken by management to ensure that there is reasonable certainty of proceeding with your development plans. As part of your revised disclosure, explain how changes in drilling plans factor into the management of your drilling program. Refer to Item 1202(a)(7) of Regulation S-K.[17]

The SEC issued a very similar comment letter on April 30, 2015:

> Information provided in your response to prior comment 1 appears to demonstrate a low conversion rate for proved undeveloped reserves ("PUDs") over the last five fiscal years. Based on your reply, it appears there are a number of factors contributing to low conversion rates and a lack of adherence to previously adopted development plans. In view of these reoccurring factors, please describe the internal controls used in estimating your reserves to illustrate the steps taken by management to ensure that there is reasonable certainty of proceeding with your development plans. As part of your revised disclosure, explain how changes in drilling plans factor into the management of your drilling program. Refer to Item 1202(a)(7) of Regulation S-K.[18]

In another comment letter, the SEC inquired whether the company's Board of Directors itself was fully informed regarding changes to PUD development plans:

> Describe for us the processes through which changes to previously adopted PUD development plans are taken into consideration in determining that current PUD volumes meet the reasonable certainty criteria. As part of your response, please clarify for us the extent to which the Board of Directors is fully apprised or aware of all changes, such as changes implemented during the fiscal year by the Capital Committee, to previously adopted PUD development plans. Also tell us the extent to which the Board is aware that the budget and development plan approved for the upcoming fiscal year continues to include PUD reserves in areas where PUD reserves are removed at or before fiscal year-end.[19]

The SEC has also asked for detailed information regarding the "nature and content" of information that is provided to the Board and has insisted that directors be "fully apprised or aware of all changes to previously adopted development plans":

> We note from your response to prior comment 3, regarding our request for a description of the internal controls you have established over the process of PUD rescheduling and reprioritization that final approval of the yearly LRP is made by the board of directors. Please describe for us in greater detail the nature and content of the information presented to the board of directors for their consideration. As part of your reply, please clarify the extent to which your senior management and Board of Directors, when adopting current or multi-year development plans, are fully apprised or aware of all changes to previously adopted development plans, including all previous deferrals, associated with locations for which PUD reserves continue to be claimed.[20]

While it is unclear to what extent Corp Fin is coordinating with the SEC's Enforcement Division, internal control deficiencies have been one of the Enforcement Division's priority targets over the past three years. In 2013, the SEC launched a dedicated task force, based partially in Fort Worth, to pursue claims over deficient internal controls and misstatements in SEC filings.[21] The SEC emphasized that one significant area of inquiry would be the failure by audit committees to recognize "red flags" indicating a likelihood of improper accounting practices or internal control deficiencies.[22] At last count, the task force had more than twelve lawyers and accountants with specific expertise addressing these types of issues.[23] In a growing number of cases, the SEC has brought enforcement claims even where there is no allegation of fraudulent conduct. The SEC has emphasized that material weaknesses require only a "reasonable possibility" that a material misstatement will go undetected and has pursued claims against companies

17 *Id.* (emphasis added).
18 Energy XXI Ltd., Response to SEC Comment Letter (May 8, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/1343719/000114420415028862/filename1.htm.
19 Atlas Energy, L.P., Response to SEC Comment Letter (June 30, 2015) (emphasis added), available at https://www.sec.gov/Archives/edgar/data/1532750/000119312515241989/filename1.htm.
20 Energy XXI Ltd., *supra note* 18 (emphasis added).
21 Andrew Ceresney, Co-Director, Div. of Enf't, U.S. Sec. & Exch. Comm'n, Remarks at American Law Institute Continuing Legal Education, Washington, D.C.: Financial Reporting and Accounting Fraud (Sept. 19, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539845772.
22 *Id.*
23 *Id.*

that do not timely recognize and report material weaknesses. In addition, the SEC has emphasized the requirement under Item 308 of Regulation S-K that management "must maintain *evidential matter, including documentation, to provide reasonable support* for management's assessment of the effectiveness of the registrant's [ICFR]." Companies should thus be prepared to *document*—not just state—why they believe it is "reasonably certain" that production will be commenced within five years. Moreover, as noted above, companies should be prepared to document how changes to development plans are reported to the Board.

3. Failure to develop one-fifth of aggregate PUDs each year

The SEC additionally has focused on companies that historically fail to convert 20% of their PUDs to "proved developed" status each year. For example, in a September 21, 2015 letter, the SEC questioned how a company could be following a five-year development plan when it consistently developed far less than one-fifth of its aggregate PUDs per year:

> It is the staff's position that it is reasonable to expect cumulative PUD conversion to have an average rate equivalent to about 20 percent per year. Your three year average appears to be four percent. Please explain to us how your future PUD conversion will comply with Rule 4-10(a)(31)(ii).[24]

Another oil company received a similar comment letter on September 24, 2015, which likewise expressed concern over the company's "low historical conversion" of PUDs to developed status:

> Disclosure provided in Form 10-K for the fiscal years ending December 31, 2013 and 2014 indicates that you only converted 2.1 Bcfe and 1.6 Bcfe of net proved undeveloped reserves to developed status, respectively. You also disclose on page 7 that your 2015 capital expenditure budget of approximately $50.6 million represents a decrease of over 73% compared to 2014 and on page 2 that your "priorities for 2015 will be to limit drilling until commodity prices improve and/or service costs decline." Please tell us how you have taken into consideration your low historical conversion and proposed reduction in 2015 capital budget in adopting a development plan that results in the conversion of the 66.5 Bcfe of proved undeveloped reserves as of December 31, 2014 within five years of initial disclosure of such reserves.[25]

4. Explicit representations that some PUDs will not be developed in five years

The SEC has also taken aim at Form 10-K disclosures in which companies explicitly acknowledge that some PUDs are not actually scheduled for development within five years. For example, the SEC issued the following comment letter on November 10, 2015, stating that:

> You disclose that 94% of your proved undeveloped locations are "scheduled to be drilled within the next five years." However, disclosures made pursuant to Item 1203(d) of Regulation S-K should clarify the circumstances under which reserves have remained undeveloped for five years or more since initial disclosure, based on the definitions in Rule 4-10(a)(31)(ii) of Regulation S-X. Please clarify for us the extent to which your undeveloped reserves as of December 31, 2014 were not scheduled to be developed within five years of initial disclosure of these reserves.[26]

5. Economic impracticability of development and skepticism over cost projections

Further, Corp Fin has asked companies for detailed strategic information on how they plan to respond to low energy prices and on how reductions in capital expenditure budgets are impacting their ability to develop PUDs on schedule.[27] According to *Bloomberg*, oil and gas companies are expected to cut more than $1 trillion from planned exploration and development spending due to low prices.[28]

Against this backdrop, the SEC has asked oil and gas companies to explain how they can adequately finance a five-year development plan while slashing capital budgets, as in this September 21, 2015 comment:

> We note the statement in your filing that a sustained depression of oil and natural gas prices may affect your ability to obtain funding necessary to implement your development plan. Disclosure in your filing

24 Goodrich Petroleum Corp., Response to SEC Comment Letter (Oct. 15, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/943861/000119312515344690/filename1.htm.

25 Contango Oil & Gas Co., Response to SEC Comment Letter (Oct. 22, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/1071993/000107199315000051/filename1.htm.

26 Sanchez Prod. Partners LP, Response to SEC Comment Letter (Nov. 24, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/1362705/000155837015002742/filename1.htm.

27 *Id.*

28 Angelina Rascouet, *Oil Industry to Cut $1 Trillion in Spending After Price Fall*, Bloomberg (June 15, 2016, 6:45 AM), http://www.bloomberg.com/news/articles/2016-06-15/oil-industry-to-cut-1-trillion-in-spending-after-price-slump.

> also states that you intend to fund your capital expenditure program with cash flows from your operations and borrowings under your credit facility. Considering the reduction in the borrowing base under your credit facility and negative cash flows from operating activities for the six months ended June 30, 2015, please tell us how you concluded that you have adequate financing to support the recordation of proved reserves reported as of December 31, 2014. Refer to Rule 4-10(a)(26) of Regulation S-X.[29]

The SEC similarly questioned how another company was able to avoid any PUD write-downs despite reporting significant reductions in rig counts and capital expenditures:

> You disclose under this section significant reductions in rig counts and capital expenditures for 2015 as compared to 2014. However, it appears that you did not remove any PUD volumes during 2014 as a result of these reductions. Tell us the extent to which your disclosed PUD volumes as of December 31, 2014 include quantities that were delayed, deferred or re-scheduled to future periods as a result of planned reductions in capital spending and development activities. Indicate the number of locations and reserve quantities delayed, deferred or re-scheduled as well as the initial and revised development years. Additionally, tell us the pricing assumptions used in developing your PUD development schedule as of December 31, 2014.[30]

These concerns have been extended to newly recognized PUDs from recent exploration activity. As the SEC stated in a July 9, 2015 comment letter:

> We note that your proved undeveloped reserves ("PUDs") increased due to extensions and discoveries of 2,158 Bcfe and 2,829 Bcfe during the fiscal years ended December 31, 2013 and 2014, respectively. As a result, PUDs increased by approximately 67% in 2013 and 65% in 2014. Please tell us how your decision to reduce your capital expenditure spending plan in response to decreases in commodity prices will impact your ability to develop your new PUDs in a timely manner. As part of your response, please tell us whether this change to your capital expenditure spending plan was made in anticipation of an improvement in commodity prices over the term of your development plan. In addition, please explain how your development plan will be affected if commodity prices remain at current levels. Refer to Rule 4-10(a)(31) of Regulation S-X.[31]

The SEC has also expressed skepticism over future cost estimates for converting PUDs that are lower than historical development costs. For example, the SEC made the following comment on May 2, 2016:

> Your reported historical costs for PUD conversion are $19.73/BOE on average for the three years 2013-2015 and are $20.59/BOE for 2015. These projected PUD conversion costs do not appear to be supported by incurred cost history.
>
> Please explain the reasons for this lower projected five year unit cost. Given that proved reserves are required to be economically producible "under existing economic conditions", we would expect these conversion costs to reflect the levels you have incurred. If applicable, please address your treatment of Drilled UnCompleted ("DUC") wells, e.g. whether they were included with converted PUDs.[32]

The SEC expressed similar skepticism in a March 2, 2016 comment letter:

> We note disclosure of your 2015 incurred cost of $1 billion for development of 81.3 MMBOE PUD reserves (page 7) which indicates a unit development cost of $12.30/BOE. The five years' (2016-2020) projected development cost - $6.5 billion - for your total PUD reserves - 700.6 MMBOE - appears to present a five year unit development cost of $9.28/BOE. Please explain the reasons for this lower five year unit cost. Given that proved reserves are required to be economically producible "under existing economic conditions", we would expect these conversion costs to reflect the levels you have incurred. Please address your treatment of "DUC" wells, e.g. whether they were included with converted PUDs.[33]

29 Goodrich Petroleum Corp., *supra* note 24 (emphasis added).
30 Apache Corp., Response to SEC Comment Letter (July 28, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/6769/000119312515266696/filename1.htm
31 EQT Corp., Response to SEC Comment Letter (July 22, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/33213/000110465915052522/filename1.htm.
32 Clayton Williams Energy, Inc., Response to SEC Comment Letter (May 24, 2016) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/880115/000110465916123071/filename1.htm.
33 Cont'l Res., Inc., Response to SEC Comment Letter (May 5, 2016) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/732834/000119312516580048/filename1.htm.

6. Lease expirations

Additionally, the SEC has expressed concerns about companies recognizing PUDs on leases that are currently set to expire before the PUDs are scheduled to be developed. On September 25, 2015, for example, the SEC issued the following comment:

> We note your disclosure that the portion of your net undeveloped acres subject to expiration over the next three years is approximately 26% in 2015, 29% in 2016 and 13% in 2017. Please tell us the extent to which you have assigned any proved undeveloped reserves to locations which are currently scheduled to be drilled after lease expiration. If your proved undeveloped reserves include any such locations, please expand your disclosure here or in an appropriate section elsewhere to explain the steps which would be necessary to extend the time to the expiration of such leases.[34]

7. "Reasonably possible" future impairments

Going forward, the SEC has also asked companies to quantify future near-term reductions to reserves and development plans. For example, the SEC advised a company on April 19, 2016 that:

> [Y]ou disclose on page 27 that if oil and gas prices remain at low levels, holding other factors constant, you expect that you will be required to reduce your proved reserve estimates due to economic limits.
>
> Please expand your disclosure to quantify the reasonably possible near-term changes to your proved reserves and development plans if prices remain at low levels, including a discussion of all the key factor assumptions that you use in quantifying your estimates.[35]

The SEC similarly advised another company on June 23, 2015 as follows:

> You indicate that a continued low price environment could cause a "significant revision" in the carrying value of oil and gas properties in future periods.
>
> Section III.B.3. of SEC Release No. 33-8350 provides guidance regarding quantitative disclosure of reasonably likely effects of material trends and uncertainties. Please revise to provide more extensive discussion, including, where reasonably practicable, quantification of the impact of current commodity prices on the carrying value of your oil and gas properties. Your revised disclosure should also quantify the impact of potential scenarios deemed reasonably likely to occur on your estimated reserve volumes.[36]

For companies that use the full cost method, the SEC indicated in one letter that it should be reasonably possible for such companies to quantify future "reasonably possible" near-term ceiling test impairments attributable to lower pricing:

> We continue to believe that, given the manner by which the ceiling test is performed under the full cost method, there would be a reasonable basis to quantify reasonably possible near-term ceiling test impairments attributable to lower pricing. Similarly, as commodity pricing is integral to the estimation of oil and gas reserves, there would be a reasonable basis to quantify reasonably possible near-term changes to reserves and development plans.
>
> For example, when preparing your Form 10-Q for the third quarter of 2015, the additional history of market prices after September 2015 would appear to provide a reasonable basis to quantify the reasonably possible impact of impairment for the fourth quarter of 2015. To the extent that these prices result in the expectation of future impairment charges, disclose the quantified reasonably possible impact of such charges.
>
> Additionally, if you deferred or rescheduled development of oil and gas reserves to future years based on an expectation of higher prices, rather than to derecognize reserves based on current prices, quantify the reasonably possible change to reserves if the higher prices are not attained.[37]

34 Whiting Petroleum Corp., Response to SEC Comment Letter (Oct. 5, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/1255474/000119312515337679/filename1.htm.

35 Carrizo Oil & Gas, Inc., Response to SEC Comment Letter (May 3, 2016) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/1040593/000104059316000166/filename1.htm.

36 Cabot Oil & Gas Corp., Response to SEC Comment Letter (July 20, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/858470/000119312515256808/filename1.htm.

37 W&T Offshore, Inc., Response to SEC Comment Letter (Nov. 4, 2015) (emphasis added), *available at* https://www.sec.gov/Archives/edgar/data/1288403/000119312515365791/filename1.htm.

Securities litigation risks arising from the failure to write down PUDs

In addition to SEC enforcement risk, energy companies may also face significant shareholder litigation risk if they are forced to write down PUDs that they should never have recorded in the first place (or which they should have written down earlier). Both shareholders and bondholders who provided capital to energy companies in better times may cite alleged overstatements of PUDs as a basis for attempting to recover their lost investments through litigation.

Courts have been willing to allow securities fraud claims over reserves that were overstated from inception. In *Rubinstein v. Collins*, the seminal Fifth Circuit opinion on natural gas reserves, the court allowed a securities class action to proceed where the company claimed to have discovered substantial new natural gas reserves while failing to disclose that the initial tests of the discovery well allegedly failed to substantiate the predicted reserves.[38] The Fifth Circuit reversed the district court's dismissal and held that the company's generalized cautionary statements about the unpredictability of reserves failed to cure the purportedly false impression conveyed by the company's specific optimistic statements about the new discovery.[39]

A number of district courts have likewise allowed securities fraud claims premised on alleged inaccurate reserve reporting to survive dismissal. The "motion to dismiss" stage is particularly significant in federal securities litigation because plaintiffs cannot take discovery—which significantly increases litigation cost—unless and until the complaint survives a challenge on the pleadings. In *In re Triton Energy Ltd. Securities Litigation*, for instance, the Eastern District of Texas refused to dismiss a securities class action lawsuit alleging that Triton Energy misclassified certain reserves as proved reserves in violation of SEC and Society of Petroleum Engineers requirements.[40] Similarly, in *WRT Energy Securities Litigation*, the Southern District of New York allowed a federal securities class action to go forward after the company overstated its reserves by more than 100%.[41] While the company claimed that it included risk disclosures warning that its reserves were estimates and could change, the court held that "the gravamen of Plaintiffs' claims is that [the company] failed to reveal adverse information about current conditions," and "[t]he [law] does not protect against such failure to disclose *current* adverse conditions."[42] In *Wieland v. Stone Energy Corp.*, the Western District of Louisiana denied dismissal in a securities fraud action involving allegations that an energy company overstated proved oil and gas reserves by more than 20% over a four-and-one-half-year period and was later forced to restate its reserves.[43] The complaint included allegations from anonymous witnesses claiming that the company's CEO "redrew geological maps to be bigger than they were in order to inflate Stone's proved reserves" and rejected reserve numbers provided by the company's engineers.[44]

That said, securities fraud plaintiffs nevertheless face difficult requirements in pleading fraud claims based on allegedly inaccurate reserve reporting. In *In re TETRA Technologies, Inc. Securities Litigation*, for example, the Southern District of Texas dismissed a securities fraud claim based on the alleged overstatement of reserves and a related $70 million impairment on oil and gas properties that both allegedly should have been written off earlier than they were.[45] As with the other cases cited above, the court held that the generalized disclaimers that reserve estimates are subject to change would not preclude a securities fraud claim if the company knew that estimates were inaccurate.[46] But here the court held that the "confidential witness" allegations supporting the fraud claims were insufficiently specific and did not show "that the reserves were intentionally overestimated or by how much they were overestimated."[47]

Accordingly, companies could face significant securities litigation risk over alleged misstatements of reserves due to improper PUDs reporting. While bare allegations that a company misapplied accounting standards are generally insufficient to survive dismissal, specific allegations showing that a company acted recklessly by misapplying a bright-line rule leading to a large potential error may defeat a motion to dismiss under Rule 12(b)(6). Companies can also mitigate the risk of shareholder litigation by making more fulsome risk disclosures, such as by disclosing near-term "reasonably possible" future impairments (as described above) and by identifying specific factors that could result in future write-downs.

38 20 F.3d 160, 167 (5th Cir. 1994).
39 *Id.*
40 No. 5:90-CIV-256, 2001 WL 872019, at *10 (E.D. Tex. Mar. 30, 2001).
41 No. 96 Civ. 3610, 1999 WL 178749, at *8 (S.D.N.Y. Mar. 31, 1999).
42 *Id.* at *7.
43 No. 05-2088, 2007 WL 2903178, at *1, *7 (W.D. La. Aug. 17, 2007).
44 *Id.* at *5-6.
45 No. 4:08-cv-0965, 2009 WL 6325540, at *21-27 (S.D. Tex. July 9, 2009).
46 *Id.* at *21.
47 *Id.*

Tips for mitigating risks arising from PUDs

Given the SEC's stated concerns over reserve reporting and the potential for shareholder litigation over widespread industry losses, energy companies must be particularly careful in calculating PUDs and in determining when PUDs should be written off. In particular:

- Companies should make sure their public statements and disclosures are consistent with an intent to develop PUDs within five years.
- Companies should maintain adequate documentation showing that a five-year plan exists and cannot rely on the bare statement that they intend to drill within five years.
- Management must ensure that they have adequate internal controls over the estimation of reserves and are able to describe the specific steps they have taken to ensure that there is a reasonable certainty of proceeding with the company's development plans.
- Companies must carefully assess changes in budgets and economic conditions to determine whether they affect the reasonable certainty of adhering to existing development plans.
- Management should ensure that the Board of Directors is sufficiently informed regarding actual and potential changes to development plans and the impact of such changes on PUDs currently recognized on the company's books.
- Companies must have a compelling explanation if they habitually fail to develop 20% of their PUDs each year and may face significant enforcement risk.
- Companies must explain their plans for extending leases if they recognize PUDs on leases scheduled to expire before the PUDs are to be developed.
- Companies must be prepared to identify "reasonably possible" future near-term write-downs and should provide fulsome and transparent disclosures to minimize the risk of investor surprise if PUDs are later removed.

If the SEC's Enforcement Division opens an inquiry, the SEC will likely subpoena all documents relating to the company's plans for drilling PUDs to determine whether the internal documents contradict the company's implicit public representations that PUDs would be drilled within five years.

Resource estimates

The SEC permits companies to disclose in their SEC filings only proved, probable, and possible reserves. Regulation S-K and Regulation S-X provide specific definitions for each of these terms and explain how the terms are to be applied and interpreted.[48]

Companies often estimate hydrocarbon quantities in situations where the estimated quantities are not yet certain enough to qualify as "reserves" as that term is defined by the SEC. Such estimates are particularly common during the exploration phase of a project, both before and during the drilling of exploratory wells. Although such estimates may not be included in SEC filings such as a Form 10-K or a Form 10-Q, companies are not restricted from publicly disclosing, and in fact they commonly do disclose, such estimates in non-filed materials, including in press releases and investor presentations.

The SEC's reporting rules provide guidance with respect to reserves disclosed in SEC filings. The SEC's rules, however, do not address estimates provided outside of SEC filings. Accordingly, companies are left to decide (1) how much and what type of supporting data should be present before disclosing an estimate outside of an SEC filing, and (2) what specific language and terms should be used to describe the estimate. These issues are interdependent since the language used to describe the estimate will be influenced by the quality and amount of supporting information underlying the estimate.

While there are no SEC rules specifically addressing oil and gas estimates made outside of SEC filings, certain jurisdictions outside of the U.S. have adopted such rules. Canada, for example, requires all publicly disclosed estimates to be prepared in accordance with the Canadian Oil and Gas Evaluation Handbook, which includes specific guidelines for the estimation and classification of resources other than reserves.[49]

The reasonable basis requirement

In the U.S., while the SEC does not specifically regulate oil and gas estimates made outside of SEC filings, the general prohibition on false or misleading statements set forth in Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder applies to all public company disclosures. Claims under Section 10(b) and Rule 10b-5 require proof of material misstatements in connection with the purchase or sale of securities, with scienter, which the Supreme Court has defined as an "intent to

48 Modernization of Oil and Gas Reporting, 74 Fed. Reg. 2158, 2164, 2167 (Jan. 14, 2009) (codified at 17 C.F.R. pt. 210).
49 Standards of Disclosure for Oil and Gas Activities, Nat'l Instrument 51-101 (Can.).

deceive, manipulate, or defraud."[50] Although recklessness may be sufficient to satisfy the scienter requirement, recklessness in this context is usually defined to mean an extreme departure from the standards of ordinary care approaching intentional misconduct.[51]

In addition to Section 10(b) and Rule 10b-5, which require that a materially false or misleading statement be made with scienter, Section 17(a) of the Securities Act of 1933 (the "Securities Act") prohibits certain false or misleading statements made without scienter. Specifically, Section 17(a) makes it unlawful for a person in the offer or sale of securities:

> (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made . . . not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[52]

Scienter need not be proved to establish violations of subsections (2) and (3) of Section 17(a).[53]

Estimates, especially hydrocarbon estimates that are made during the exploration phase and are described with appropriate limiting language, are properly viewed as statements of opinion.[54] In determining whether a statement of opinion is false, courts consider whether the speaker actually believed the statement and whether the speaker had a reasonable basis for the statement when it was made.[55] Accordingly, when the SEC or an investor challenges an estimate, the heart of the inquiry is often whether the estimate is supported by a reasonable basis.[56]

With respect to estimating hydrocarbons in particular, whether an estimate is supported by a reasonable basis is a fact-specific inquiry that can easily devolve into a battle of experts. The uncertainty of such an inquiry is exacerbated by the fact that preliminary oil and gas estimates are often highly subjective, and it is common for experts and industry professionals to hold widely divergent views with respect to the value of a particular prospect. Nevertheless, companies can limit their exposure by ensuring that their estimates are supported by a technical analysis using observable data such as seismic information, well logs, etc. (recognizing that different professionals may interpret the data differently), and by carefully describing each estimate and its limitations.

Describing the resource estimate

Many U.S. companies use the term "resources" to describe estimates outside of filings that do not qualify as SEC-defined "reserves." This practice, however, is not uniform, and even companies that use "resources" use many variations of the term. Examples of terms used by companies to describe estimates that do not fit within the SEC reserve definitions include "resource opportunity," "estimated net resources," "prospective resources," "contingent resources," "resource potential," and "reserve potential," among numerous other terms. In fact, it is not uncommon for companies to use the term "reserves" to describe preliminary estimates made during the exploration phase, although it is often apparent from the context that such references do not describe "reserves" as the term is defined by the SEC.

Although SEC rules do not expressly address estimates made outside of SEC filings, many of the terms the SEC specifically defines for filings, such as proved, probable, and possible reserves, are designed to be consistent with the Petroleum Resource Management System ("PRMS").[57] The PRMS is a standard for the management of petroleum resources developed by several industry organizations. The PRMS uses the term "resources," specifically "contingent resources" and "prospective resources," to describe certain petroleum estimates that do not rise to the level of "reserves."[58] Since

50 *Tellabs, Inc. v. Makar Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007).
51 *See, e.g., Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 866 (5th Cir. 2003) (explaining that scienter includes "severe recklessness," which is "limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it"); *Novak v. Kasaks*, 216 F.3d 300, 312 (2d. Cir. 2000) (holding that the scienter requirement may be satisfied by "conscious recklessness," which is a "state of mind approaching actual intent"); I*n re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 975 (9th Cir. 1999) (adopting "deliberate recklessness" standard).
52 15 U.S.C. § 78q(a) (2016).
53 *See, e.g.*, Steadman v. SEC, 603 F.2d 1126, 1133 (5th Cir. 1979).
54 *See, e.g., City of Westland Police & Fire Ret. Sys. v. MetLife, Inc.*, 129 F. Supp. 3d 48, 68, 76 (S.D.N.Y. 2015) (characterizing reserve estimates as "statements of opinion or belief, not of fact," given that such estimates "necessarily require judgment").
55 *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1328-29 (2015); *see also In re Oracle Corp. Sec. Litig.*, 627 F.3d 376, 389 (9th Cir. 2010) (affirming summary judgment where plaintiffs were "unable to prove that Defendants lacked at least a reasonable basis for their belief in the 3Q01 forecast"); *In re Merck & Co. Sec. Litig.*, 543 F.3d 150, 166 (3d Cir. 2008) ("We have explained that for 'misrepresentations in an opinion' or belief to be actionable, plaintiffs must show that the statement was 'issued without a genuine belief or reasonable basis' . . . ."); *Eisenstadt v. Allen*, No. 95-16255, 1997 WL 211313, at *4 (9th Cir. Apr. 28, 1997) (affirming summary judgment because company's past experience provided reasonable basis for future estimates); *Makar Issues & Rights, Ltd. v. Tellabs, Inc.*, 735 F. Supp. 2d 856, 911 (N.D. Ill. 2010) (granting summary judgment where evidence established a reasonable basis for defendants' projections).
56 *See, e.g., Kowal v. MCI Commc'ns Corp.*, 16 F.3d 1271, 1277 (D.C. Cir. 1994) ("The 'only truly factual elements involved in a projection are the implicit representations that the statements are made in good faith and with a reasonable basis.' Accordingly, projections and statements of optimism are false and misleading for the purposes of the securities laws if they were issued without good faith or lacked a reasonable basis when made.").
57 Modernization of Oil and Gas Reporting, 74 Fed. Reg. at 2160.
58 *See* Soc'y of Petroleum Eng'rs et al., Petroleum Resources Management System 6 (2007), *available at* http://www.spe.org/industry/docs/Petroleum_Resources_Management_System_2007.pdf#redirected_from=/industry/reserves/prms.php.

SEC-defined terms are designed to be consistent with PRMS definitions, companies that correctly use PRMS terms to describe estimates outside of SEC filings, including by using the term "resources" to describe estimates that are not yet deemed commercial and are therefore not yet SEC "reserves," would have a strong argument that the terminology used is not misleading.

In one recent case, the SEC brought charges against an exploration-and-production company for failing to use PRMS terminology for estimates disclosed outside of SEC filings, even though SEC rules do not require the use of such terms.[59] In that case, the company published an investor presentation that included a reference to a broad range of "estimated recoverable reserves" based on "leads or prospects." It was apparent from the context, including that the estimate was a range premised on leads or prospects, that the statement did not refer to "reserves" as that term is used by the SEC. Nevertheless, the SEC asserted that the company's failure to use the term "resources" instead of "reserves" was false or misleading and specifically cited the PRMS definition of "resources" to bolster its claim. The company paid $400,000 to settle the case, which involved other additional issues, without admitting or denying wrongdoing.

In addition to selecting a particular term to describe the estimate itself, oil and gas companies commonly preface statements of opinion, including resource estimates and statements about the quality of a prospect or a well, with cautionary language. This language comes into play in two contexts. First, in considering whether a statement of opinion is false, a court must read the statement "in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information."[60] Thus, cautionary language often serves to temper the statement, making it less likely to be deemed misleading or material. In fact, the SEC itself has acknowledged that it is appropriate to use certain cautionary language when discussing estimates that, unlike SEC-defined reserves, may not be included in SEC filings.[61]

Second, in some circumstances the cautionary language itself may provide an independent ground for defeating a claim. In private securities class actions, for example, there is a statutory safe harbor for forward-looking statements accompanied by meaningful cautionary language.[62] While the statutory safe harbor does not apply to claims brought by the SEC, it is possible to make similar arguments under the common law "bespeaks caution" doctrine.[63]

Tips for mitigating risks arising from public resource estimates

The following are ways to mitigate the risks associated with publicly disclosing resource estimates:

- Confirm that the estimate is supported by observable data and is the result of a technical review and analysis of the data.
- Consider instituting a process whereby estimates are reviewed by other industry professionals, either inside or outside the company, prior to public disclosure. Some companies utilize internal peer-review processes to vet estimates prior to disclosure.
- Make clear that the estimate is not intended to and does not represent "reserves" as that term is defined by the SEC. Consider using the term "resources" instead of "reserves" in accordance with the PRMS definitional system.
- Consider using the specific cautionary language recommended by the SEC and include in that cautionary language references to the actual terms used to describe the estimate.[64]
- Unambiguously state that the reported figures are estimates, statements of opinion, and forward-looking, note that actual results may differ, and explain the reasons why actual results may differ.
- Depending on the nature and certainty of the estimate, consider using additional limiting language such as "potential" or "opportunity."

59 *See* Hous. Am. Energy Corp., Securities Act Release No. 9621 (Aug. 4, 2014). The authors here acted as counsel for the issuer in this case.
60 *Tongue v. Sanofi*, 816 F.3d 199, 211 (2d Cir. 2016).
61 *See, e.g.*, Div. Corp. Fin., U.S. Sec. & Exch. Comm'n, Current Issues and Rulemaking Projects 66 (2000), *available at* https://www.sec.gov/pdf/cfcr112k.pdf.
62 15 U.S.C. § 77z-2(c) (2016).
63 *See, e.g., In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1413 (9th Cir. 1994)
64 Div. Corp. Fin., *supra* note 61.

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