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W. THOMAS KELLAHIN*
*NEW MEXICO BOARD OF LEGAL SPECIALIZATION RECOGNIZED SPECIALIST IN THE AREA OF NATURAL RESOURCES-OIL AND GAS LAW

JASON KELLAHIN (RETIRED 1991)

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July 14, 1997

HAND DELIVERED

Mr. Michael E. Stogner, Hearing Examiner
Rand Carroll, Esq., Division Attorney
Oil Conservation Division
2040 South Pacheco
Santa Fe, New Mexico 87504

Re: ***NMOCD Case 11792***
Amended Application of Doyle Hartman
concerning the Myers Langlie Mattix Unit,
Lea County, New Mexico

Gentlemen:

In accordance with Mr. Carroll's phone message to me late Friday afternoon, and on behalf of OXY USA Inc., please find enclosed the following memorandum concerning the following issues discussed at the motion hearing held in the referenced case on June 30, 1997:

(1) construction of Section 70-7-7(F) NMSA (1978)

(2) meaning of prudent operator standard.

Very truly yours,

W. Thomas Kellahin

cc: Hand Delivered:
Gene Gallegos, Esq.
Michael Condon, Esq.
attorneys for Hartman
cc: William F. Carr, Esq.
cc: OXY USA Inc.

GALLEGOS LAW FIRM
A Professional Corporation

460 St. Michael's Drive
Building 300
Santa Fe, New Mexico 87505
Telephone No. 505-983-6686
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J.E. GALLEGOS *

October 8, 1997
(Our File No. 97-1.75)

HAND-DELIVERED
Michael E. Stogner, Chief Hearing Examiner
New Mexico Oil Conservation Division
2040 South Pacheco
Santa Fe, NM 87505

Re: Application of Doyle Hartman, Case No. 6987, 11792

Dear Examiner Stogner:

In connection with research on another matter we came across the opinion in Archer v. Grynberg, 738 F. Supp. 449 (D. Utah 1990) a copy of which is enclosed. The federal court there makes observations concerning the New Mexico Statutory Unitization Act. As to Section 70-7-7 it is said "Te Act requires that the order of unitization shall approve or prescribe a unit agreement which includes certain specified provisions . . . [enumerating ones pertinent to that case]."

We provide this as additional helpful authority on the issues you have under advisement.

Very truly yours,

GALLEGOS LAW FIRM, P.C.

By J.E. GALLEGOS

JEG:sa
cc: Rand Carroll, Esq. (w/encl.)
Thomas Kellahin (w/encl.)
Doyle Hartman (w/encl.)

* New Mexico Board of Legal Specialization
Recognized Specialist in the area of
Natural Resources-Oil and Gas Law

John D. ARCHER and Elizabeth B. Archer, Plaintiffs,
v.
Jack GRYNBERG, Defendant.

Civ. No. 88-C-850W.

United States District Court,
D. Utah, C.D.

June 1, 1990.

Property owners brought action against operator of gas wells for his alleged failure to properly develop area and alleged fiduciary breach. Operator moved for partial summary judgment. The District Court, Winder, J., held that clause in unit agreement, obligating operator of gas well to "proceed with diligence to reasonably develop" area once unitized substances in paying quantities were discovered, did not modify nature of operator's obligation to property owners under operating agreement.

Motion granted.

[1] MINES AND MINERALS ⚿109
260k109
Clause in unit agreement, obligating operator of gas wells to "proceed with diligence to reasonably develop" area once unitized substances in paying quantities were discovered, did not modify nature of operator's obligations to property owners under operating agreement, which provided that no liability would be imposed except for gross negligence or willful misconduct.

[2] MINES AND MINERALS ⚿97
260k97
Operator of gas wells did not, by executing farmout agreement, become partner with property owners in development of gas wells, where farmout agreement expressly stated that parties did not intend to create partnership.

[3] MINES AND MINERALS ⚿109
260k109
Language of operating agreement setting out rights and duties of operator will normally prevail over any obligations imposed on operator by general law of fiduciaries.

***450** E. Craig Smay, Salt Lake City, Utah, for plaintiffs.

Steven Rowe, F. Alan Fletcher, Frederick M. MacDonald, Salt Lake City, Utah, for defendant.

MEMORANDUM DECISION AND ORDER

WINDER, District Judge.

This matter is before the court on defendant's motion for partial summary judgment. Oral argument was held on May 23, 1990. Plaintiffs were represented by E. Craig Smay and defendant was represented by Steven P. Rowe. Prior to the argument, the parties had thoroughly briefed the motion, and the court had carefully read all of the materials filed for and against the motion. After taking the matter under advisement, the court has further considered the law and the facts relating to this motion, and, now being fully advised, renders the following memorandum decision and order.

BACKGROUND

In the Fall of 1981, plaintiffs invested, on a 50/50 basis, with defendant in a gas well or wells to be drilled in Eddy County, New Mexico. Plaintiffs claim that defendant is an experienced petroleum engineer who for many years, in partnership with his wife Celeste, has conducted a business of locating, drilling, completing, maintaining, operating, and selling the products of oil and gas wells on behalf of himself and others. Plaintiffs' Memo Oppos. at 3.

Plaintiffs entered into three agreements with Celeste Grynberg: a Unit Agreement signed on October 16, 1981 but effective as of February 6, 1981; an Operating Agreement signed on October 26, 1981 but effective as of February 6, 1981; and a Farmout Agreement executed on October 23, 1981. [FN1] The Operating Agreement designates Celeste as Operator. On or about January 26, 1983, defendant was substituted for and assumed all duties and obligations of Celeste as Operator. Plaintiffs, in their complaint, refer to defendant, and not to Celeste, "as operator under the subject agreements." Complaint ¶ 14. In any event, both parties agreed during oral argument that defendant was subject to the Operating Agreement and the Unit Agreement either as the Operator in his own right or as the agent of Celeste.

> FN1. The Farmout Agreement states that it is entered into by "Celeste C. Grynberg and Jack J. Grynberg, Spouse, ... hereinafter referred to as "Grynberg" or "Operator." The Farmout Agreement is signed by plaintiffs, defendant, and Celeste.

DISCUSSION

[1] In his motion for partial summary judgment, defendant seeks to establish that ***451** defendant has no liability to plaintiffs except for gross negligence or willful misconduct, the standard of care set forth in Article V.A of the Operating Agreement. Plaintiffs, on the other hand, argue that the applicable standard of care is that set forth in the Unit Agreement, which provides that "after discovery of unitized substances in paying quantities, unit operator shall proceed with diligence to reasonably develop the unitized area as a reasonably prudent operator would develop such area under the same or similar circumstances." See Defendant's Memo in Support, Exhibit 2. The issue before the court, therefore, is one of contract interpretation, which may be decided by reference to the three relevant documents between the parties.

After consideration of all three agreements, and more particularly the Operating Agreement and the Unit Agreement, the court is of the opinion that the defendant, as Operator, has no liability to plaintiffs except for gross negligence or willful misconduct. In making this conclusion, the court has taken into consideration the nature of the agreements and the intended purpose of each.

An Operating Agreement is defined as

> an agreement between or among interested parties for the testing and development of a tract of land. Typically one of the parties is designated as the operator and the agreement contains detailed provisions concerning the drilling of a test well, the drilling of any additional wells which may be required, the sharing of expenses, and accounting methods. The authority of the operator, and restrictions thereon, are spelled out in detail in the typical agreement.

8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, Manual of Terms 659 (1987). The Operating Agreement is an agreement between mineral interest owners which designates an Operator and sets out in some detail the responsibilities assumed by the Operator. Article V.A of the Operating Agreement in this case provides that the Operator

> shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of, this agreement. It shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.

Defendant's Memo in Support, Exhibit 1 (emphasis added).

The purpose of a pooling or unitization agreement, on the other hand, is to prevent the physical and economic waste that accompanies the drilling of unnecessary wells and to permit the entire field to be operated as a single entity, without regard to surface boundary lines. 6 H. WILLIAMS AND C. MEYERS, OIL AND GAS LAW § 901 (1989). The Unit Agreement in this case states that "it is the purpose of the parties hereto to conserve natural resources, prevent waste and secure other benefits obtainable through development and operation of the area subject to this agreement under the terms, conditions and limitations herein set forth." Defendant's Memo in Support, Exhibit 2 at 2.

Under the Statutory Unitization Act, N.M.STAT.ANN. §§ 70-7-1 through 70- 7-21 (1987) (the "Act"), New Mexico has established a process whereby any working interest owner may apply to the Oil Conservation Division of the Energy, Minerals and Natural Resources Department (the "Division") for unitization. N.M.STAT.ANN. § 70-7-5 (1987). After an application for unitization has been filed with the Division and after notice and hearing, the Division determines whether the application meets the specified conditions required for an order of unitization. N.M.STAT.ANN. § 70-7-6 (1987). The Act requires that the order of unitization shall approve or prescribe a unit agreement which includes certain specified provisions including, inter alia, a legal description of the surface area of the unit, a statement of the nature of the operations contemplated, and "a provision designating the unit operator and providing for the supervision and conduct of the unit operations, including the selection, ***452** removal or substitution of an operator from among the working interest owners to conduct the unit operations." N.M.STAT.ANN. § 70-7-7 (1987).

In this case, Section 9 of the Unit Agreement addresses the obligations of the Operator after discovery of unitized substances in paying quantities.

> After discovery of unitized substances in paying quantities, unit operator shall proceed with diligence to reasonably develop the unitized area as a reasonably prudent operator would develop such area under the same or similar circumstances.
>
> If the unit operator should fail to comply with the above covenant for reasonable development, this agreement may be terminated by the Commissioner as

> to all lands of the State of New Mexico within the unit area ...; but in such event, the basis of participation by the working interest owners shall remain the same as if this agreement had not been terminated as to such lands
> ....

See Defendant's Memo in Support, Exhibit 2.

Section 13 of the Unit Agreement provides that

> The terms, conditions and provisions of all leases, subleases, operating agreements and other contracts relating to the exploration, drilling, development or operation for oil or gas of the lands committed to this agreement, shall as of the effective date hereof, be and the same are hereby expressly modified and amended insofar as they apply to lands within the unitized area and to the extent necessary to make the same conform to the provisions hereof.

See Defendant's Memo in Support, Exhibit 2. Plaintiffs argue that as a result of Section 13 of the Unit Agreement, Section 9 of the Unit Agreement is the controlling provision for the standard of care with regard to the Operator. This argument, in essence, effectively negates the provision in the Operating Agreement limiting the Operator's liability to gross negligence or willful misconduct.

The court is of the opinion that there is no conflict between Article V.A and Section 9. The Operating Agreement calls for the Operator to conduct all operations in "a good and workmanlike manner." The Unit Agreement requires the Operator to "proceed with diligence to reasonably develop" the area once unitized substances in paying quantities are discovered. If the Operator fails to reasonably develop the unit once unitized substances in paying quantities are found, the State of New Mexico has the right to terminate all State lands within the unit area. The Operating Agreement requires the Operator to conduct all operations in a good and workmanlike manner. In addition, it provides that the parties agree that the Operator is liable to the other parties (i.e. plaintiffs) for gross negligence or willful misconduct only.

This construction of the relevant documents is such that Article V.A is not rendered superfluous and also comports with the understanding in the oil and gas industry that it may be prudent to limit the liability of an operator to non-operators. Hazlett, Drafting of Joint Operating Agreements, 3 ROCKY MTN.MIN.L.INST. 277, 302-03 (1957).

[2][3] Plaintiffs have also argued that defendant has a separate and distinct relationship with plaintiffs, other than as Operator. Plaintiffs argue that by executing the Farmout Agreement, defendant became a partner with plaintiffs in the development of the gas wells. Plaintiffs contend that because of this "partnership," defendant had a fiduciary duty to plaintiffs. Plaintiffs' Memo. Oppos. at 17. This argument lacks merit for two reasons. First, the Farmout Agreement expressly states that the parties do not intend to create a partnership. [FN2] See Defendant's Memo in Support, Exhibit 3, ¶ 19. Second, it is understood in the oil and gas industry that the language of the Operating Agreement setting out the rights and duties of the Operator***453** will normally prevail over any obligations imposed by the general law of fiduciaries. Smith, Duties and Obligations Owed by an Operator to Nonoperators, Investors, and Other Interest Owners, 32 ROCKY MTN.MIN.L.INST. 12-1, 12-15 (1986).

> FN2. The Unit Agreement also states explicitly that the parties do not intend to create a partnership. See Defendant's Memo in Support, Exhibit 1, Art. VIIA.

Accordingly, based on the foregoing and good cause appearing,

IT IS HEREBY ORDERED that defendant's motion for partial summary judgment is granted. Defendant shall have no liability to plaintiff except for gross negligence or willful misconduct. This order will suffice as the court's ruling on this motion and no further order need be prepared by counsel.

END OF DOCUMENT

Date of Printing: OCT 08,97

KEYCITE

CITATION: **Archer v. Grynberg, 738 F.Supp. 449 (D.Utah, Jun 01, 1990) (NO. CIV. 88-C-850W)**

History of the Case

Direct History

=> 1 **Archer v. Grynberg,** 738 F.Supp. 449 (D.Utah Jun 01, 1990) (NO. CIV. 88-C-850W)

Affirmed by

2 Archer v. Grynberg, 951 F.2d 1258 (10th Cir.(Utah) Dec 12, 1991)
(TABLE, TEXT IN WESTLAW, NO. 90-4166)

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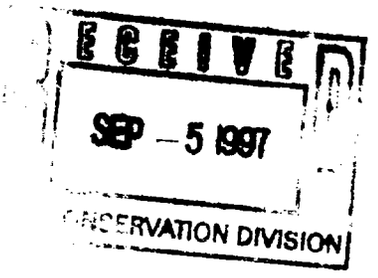
September 5, 1997



HAND DELIVERED

Mr. Michael E. Stogner, Hearing Examiner
Rand Carroll, Esq., Division Attorney
Oil Conservation Division
2040 South Pacheco
Santa Fe, New Mexico 87504

Re: ***NMOCD Case 11792***
Amended Application of Doyle Hartman concerning the Myers Langlie Mattix Unit, Lea County, New Mexico

Gentlemen:

On behalf of OXY USA Inc., I am responding to Mr. Condon's letter delivered to you this morning in which he transmits a copy of **Nearburg v. Yates Petroleum Corporation**, Court of Appeals Opinion Number 1997-NMCA-069 and urges on behalf of Hartman that this case "refutes the argument OXY raised at the June 30 hearing" of Division Case 11792.

Mr. Condon's enthusiasm is misplaced. If anything, **Nearburg** supports OXY's contention that the Division should deny Hartman's attempt to re-write the 1973 unit contracts.

In **Nearburg**, it was not disputed that the 1977 version of the model Joint Operating Agreement did contain an unambiguous "non-consent" provision for subsequent operations.

In Hartman's case it is not disputed that the 1973 MLMU Operating Agreement **did not** contain a "non-consent" provision for subsequent operations.

In **Nearburg**, Yates argued that it was a consenting party because it interpreted the "non-consent" provision to give it the right to change its election from being a non-consenting to a consenting party. The Court found Yates' "position to be a strained interpretation of the operating agreement."

Mr. Condon omits the following instructive provisions of the **Nearburg** opinion:

"A court cannot change contract language for the benefit of one party to the detriment of another",

"In the absence of ambiguity, a court must interpret and enforce the clear language of the contract and cannot make a new agreement for the parties."

In Hartman's case, among other things, OXY argued that:

(1) unlike the model Joint Operating Agreement (such as in the **Nearburg** case), there is no provision in the MLMU Operating Agreement to allow a working interest owner (Hartman) whose interest was originally committed to the unit, to elect to be carried "non-consent" on subsequent AFE for unit costs and by that act limit his share of unit costs to his share of unit production;

(2) that this original 1973 Unit Operating Agreement **without amendment** was incorporated into the 1980 statutory unitization order (R-6447) which found that these existing agreements complied with the Statutory Unitization Act.

What Mr. Condon is now suggesting in his September 5, 1997 letter, is that the Division can rewrite the 1973 contracts which is contrary to the opinion in the **Nearburg** upon which he attempts to find comfort.

Very truly yours,

W. Thomas Kellahin

fxc: Michael Condon, Esq.
William F. Carr, Esq.
OXY USA Inc.
Greg Curry, Esq.

STATE OF NEW MEXICO
ENERGY, MINERALS AND NATURAL RESOURCES DEPARTMENT
OIL CONSERVATION DIVISION

IN THE MATTER OF THE HEARING CALLED BY THE OIL CONSERVATION DIVISION FOR THE PURPOSE OF CONSIDERING:

CASE NO. 11792

AMENDED APPLICATION OF DOYLE HARTMAN TO GIVE FULL FORCE AND EFFECT TO COMMISSION ORDER R-6447, TO REVOKE OR MODIFY ORDER R-4680-A, TO ALTERNATIVELY TERMINATE THE MYERS LANGLIE-MATTIX UNIT, LEA COUNTY, NEW MEXICO.

OXY USA INC'S MEMORANDUM OF LAW AND ARGUMENTS CONCERNING SECTION 70-7-7(F) NMSA (1978) AND PRUDENT OPERATOR STANDARD

OXY USA INC. ("OXY") by its attorneys, Kellahin and Kellahin, W. Thomas Kellahin and Campbell, Carr Berge & Sheridan, P.A., William F. Carr submit this Memorandum in further support of its oral arguments made at the motion hearing held on June 30, 1997 in this case. This Memorandum is limited to two issues: (1) construction of Section 70-7-7(F) NMSA (1978) and the definition of the "prudent operator standard".

NATURE OF DISPUTE

Hartman's application arises out of a dispute over OXY's right and remedies for Hartman's failure to pay his share of unit expenses incurred by OXY as the operator of the Myers Langlie-Mattix Unit ("MLMU") in which Hartman acquired a working interest.[1]

Hartman's contentions

Hartman's contends that:

> (a) Section 70-7-7(F) NMSA (1978) of the Statutory Unitization Act ("the Act") requires the Commission to find that the 1973 MLMU unit operating agreement contains a special type of carrying provision applicable to all working interest owners ("WIO") and if not then to prescribe that there is one;
>
> (b) Section 7(F) mandates but a single type of carrying provision which is a "carried type" meaning that a WIO can "non-consent" certain unit projects and thereby limit his liability by paying his share of unit costs only out of his share of future unit production;
>
> (c) this "carried type" must apply to both a WIO whose interest is involuntarily committed to the unit by a statutory unitization order ("involuntarily committed WIO") and to a WIO who voluntarily signed or ratified the unit operating agreement ("voluntarily committed WIO");
>
> (d) despite the fact that his predecessors in interest were voluntarily committed WIO to the original unit agreements and ratified the 1980 statutory unitization order, Hartman can limit his liability to OXY as the unit operator, by declaring himself to be a non-

[1] See summary of relevant facts attached as Exhibit B.

consenting "carried type" WIO in the came category as if he held an involuntarily committed WIO interest.

Hartman challenges the 1973 MLMU operating agreement and Division Order R-6447 entered in 1980 and contends that notwithstanding the 1973 contracts or the 1980 order and the ratification thereof, Section 7(F):

> (a) must be available to any WIO whose interests are not voluntarily committed **and** to those whose interests are voluntarily committed to the unit;
>
> (b) Section 7(F) is an **exclusive remedy** for the operator which allows **any** WIO to elect to go non-consent and thus to be carried with his share of costs being paid only from his share of remaining future unit production; and
>
> (c) Hartman must be allowed to be "carried" as a non-consenting WIO.

OXY's contentions

OXY contends that under the proper construction of Section 70-7-7(F) NMSA (1979):

(a) The use of the word **"carrying"** is not synonymous with **"carried."**

(b) Section 7(F) provides that a unit operating agreement shall contain a provision for **carrying** a working interest owner who is forced into a unit. A working interest owner can be "carried" on (1) a limited basis; (2) a carried basis; or (3) a net-profits basis. Each of these methods of "carrying" refers to a different method by which a working interest may be carried.

(c) Order No. R-6447, which approved statutory unitization in 1980, **did not** modify the Unit contracts to include additional provisions for carrying working interest owners because the Division found the unit operating agreement contains a provision for carrying a working interest owner on a limited basis as required by Section 7(F). This finding was reasonable, became final in 1980, and may not now be reconsidered by the Division. See, **Armijo v. Save "N Gain**, 771 P. 2d 989, 994 (N.M. Ct. App. 1989).

(d) In a statutory unit, there are two categories of working interest owners: (a) those whose interest have been voluntarily committed to the unit either by joinder or ratification of a statutory unitization order, and (b) those involuntarily committed pursuant to the Statutory Unitization Act. Each of these groups of working interest owners is subject to different carrying provisions.

(e) The owner of a working interest which is **not** voluntarily committed to the unit, but, instead, forced into the unit by statute is non-consent and is a **"carried"** working interest owner. This owner's share of unit expense are recovered by the operator only out of future production. This is the operator's exclusive remedy.

(f) The owner of a working interest which is voluntarily committed to the Unit, either by joinder or by ratification of a statutory unitization order, is a working interest owner who has agreed by his voluntarily commitment of his interest to the unit plan to bear his share of unit costs. These owners are subject to the **"carrying"** provisions of the unit contracts which authorize the operator to recover these costs by any of several non-exclusive remedies which include recoupment of costs out of the working interest owner's share of future production **plus** the other debt

collection remedies authorized by the operating agreement.

(g) Section 7(F) only mandates that the Division find that any one or more of these carrying provisions are contained in the unit contracts and that these provisions are fair, just and reasonable.

(h) When a working interest owner voluntarily commits its interest to a unit, thereafter it is subject to the carrying provisions of the subject agreements. This type of working interest owner may not at a later date limit its costs by becoming a "carried" working interest owner.

(i) Hartman's predecessors in interest voluntarily committed the interest he now owns to the unit agreements and ratified the 1980 statutory unitization order. Accordingly, Hartman is not a "carried" working interest owner and the unit operator has all remedies set out in the unit operating agreement for collecting Hartman's debt.

(j) Because all working interest owners ratified the unit pursuant to the order, there never were and cannot now be any "carried" working interest owners in the unit.

(k) Hartman can not switch from a voluntarily committed working interest owner to a "carried" working interest owner involuntarily committed to the Unit.

(l) 7(F) does not relieve a working interest owner who has voluntarily committed his interest to a unit of any private contractual obligations nor deprive the unit operator of any private contractual remedies.

(m) Hartman is attacking the 1980 order, misinterpreting 7(F) and re-writing the 1973 contracts.

OXY's contentions are supported by Professor Patrick H. Martin who has analyzed the various applicable definitions, statutes and case law.[2] OXY's Motion to Dismiss Hartman's claim that Section 70-7-7(F) NMSA (1978) provides him the right to be a carried type WIO who can elect to be carried should be **granted** because:

> (a) The original 1973 Unit Operating Agreement **without amendment** was incorporated into the 1980 statutory unitization order which found that these existing agreements complied with the Statutory Unitization Act.
>
> (b) There is no provision in the Unit Operating Agreement to allow a WIO whose interest was originally committed to the unit, to elect to be carried "non-consent" on a subsequent AFE for unit costs and by that act **limit** his share of unit costs to his share of unit production. Thus the consenting WIO can collect the non-consenting WIO share of unit costs from his unit assets and non-unit assets.
>
> (c) Division has consistently ruled in statutory unitization cases that the subject statute provides a non-cosnet "carried" Interest only to those working interests who have not voluntarily committed their interest to the unit. The Division established an interpretation of Section 70-7-7(F) which allows the unit operator to apply a "carried type" of carrying provision only to those working interest owners who fail to initially commit their interest to the unit. See Pelto Unit Case (Case No. 9210, Order R-8557); Corbin-Queen Unit Case (Case No. 10062, Order R-9336); Marathon's Tamano Unit Case (Case No. 10341, Order R-9548): and Hanson's Shugart Unit Case (Case No. 10685, Order R-9894).

---

[2] See Professor Martin's affidavit dated July 9, 1997, attached as Exhibit A.

(d) Section 70-7-7(F) of the Statutory Unitization Act does not mandate an exclusive type of non-consent carried interest provision as Hartman contends.

(e) The statutory unitization of certain royalty owners makes this 70-7-7.F provision in Order R-6447 extraneous because it should apply only to WIO who initially fail to commit their interest to the unit or who fail to ratify the unit. By his own admission, Hartman is not in that category because his predecessors in interest of all the tracts he now owns joined and ratified the unit. Hartman should not be allowed to use this extraneous provision to change the character of his interest from that of a committed interest owner who has voluntarily subjected his interest to the provisions of the unit contracts to that of a working interest owner who was forced into the unit by statutory unitization and who would have the option to be "carried" for the initial development costs.

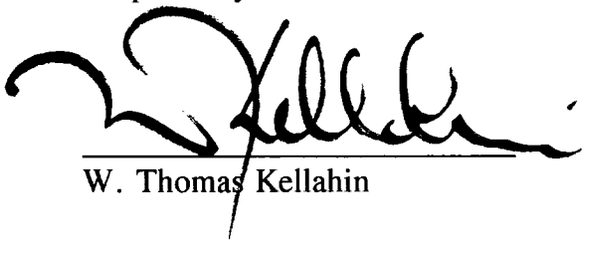
Hartman argues that he has declared himself to be a "non-consenting" working interest owner and therefore OXY's sole remedy is to "take" Hartman's share of unit production until such time as OXY has been reimbursed for Hartman's share of the costs. Unfortunately, if that is OXY's remedy, which they deny, Hartman has prevented OXY from taking Hartman's share of his oil because he now has taken an estimated 16,728 barrels of oil and keeps switching purchasers in order to avoid OXY's right to take.

PRUDENT OPERATOR ISSUE

The "prudent operator standard" is the generally applicable test for determining whether the lessee (operator) has breach his implied covenants with his lessor. The lessee is held to that performance of the lease covenants that would be made by an ordinary, prudent operator under the same or similar circumstances.[3]

The Division should limit the issue concerning the "prudent operations in the MLMU" to the issue of water injection within the immediate vicinity of the Myers "B" Federal Well No. 30. OXY's proposed order submitted on July 10, 1997 at paragraphs 12 and 13 page 5-6, provide a reasonable means to specifically limited the scope of such an inquiry to the relevant facts surrounding the Myers "B" Well No. 30 and MLMU Injection Well No. 142 by limiting the inquiry to the one-half mile radius used by the Division pursuant to its Underground Injection Control authority.

Respectfully submitted,



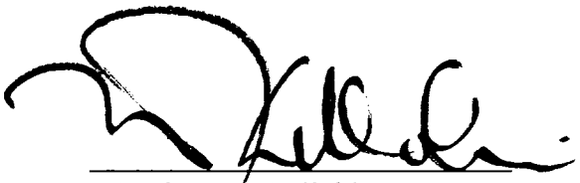
W. Thomas Kellahin

[3] See Exhibit C, attached. Section 806.3 "Performance by lessee: Prudent-operator standard" Williams & Myers Oil and Gas Law (1996).

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Memorandum was hand delivered this 14th day of July, 1997 to the offices of:

Michael J. Condon, Esq.
Gene Gallegos, Esq.
460 St. Michael's Drive, Suite 300
Santa Fe, New Mexico 87505



W. Thomas Kellahin

STATE OF NEW MEXICO
ENERGY, MINERALS AND NATURAL RESOURCES DEPARTMENT
OIL CONSERVATION DIVISION

IN THE MATTER OF THE HEARING
CALLED BY THE OIL CONSERVATION
DIVISION FOR THE PURPOSE OF
CONSIDERING:

CASE NO. 11792

AMENDED APPLICATION OF DOYLE HARTMAN,
TO GIVE FULL FORCE AND EFFECT TO
COMMISSION ORDER R-6447, TO REVOKE
OR MODIFY ORDER R-4680-A, TO
ALTERNATIVELY TERMINATE THE MYERS
LANGLIE-MATTIX UNIT,
LEA COUNTY, NEW MEXICO

AFFIDAVIT OF PATRICK H. MARTIN IN SUPPORT OF OXY USA INC.'S MOTION TO DISMISS

STATE OF NEW MEXICO §
§
COUNTY OF SANTA FE §

BEFORE ME, the undersigned authority, on this day personally appeared **PATRICK H. MARTIN**, being by me duly sworn, who deposed and stated as follows:

1. My name is Patrick H. Martin. I am over the age of twenty-one (21) years, and of sound mind, capable of making this Affidavit. I have personal knowledge of the facts herein stated and each such fact is true and correct.

2. I have previously filed an Affidavit in this proceeding under date of June 30, 1997, together with my resume. In response to the request made at the hearing, I now file this supplemental affidavit.* The testimony stated in this Affidavit is the same that I would give in Court or before the agency under oath if called to testify as a witness.

3. An important issue in this administrative proceeding and the related lawsuit is the proper treatment to be given to the finding in Order R-6447 that the Myers Langlie-Mattix Unit Operating Agreement provides for unit operation on "terms that are fair, reasonable, and

* As stated prviously, Louisiana State University and Law Center are in no way involved in my participation in this matter; the opinions expressed herein are based on my own experience and expertise and do not represent any view of the University or Law Center.

EXHIBIT
A

equitable," and which includes "a provision for carrying any working interest owner on a limited, carried or net-profits basis, payable out of production, upon such terms and conditions which are just and reasonable . . ." [Order R-6447 ¶ 21(d)]. This finding tracked the requirements of the pertinent statute.

4. In my previous affidavit I stated that "It is my opinion that there is a reasonable basis for the agency to have concluded in 1980 that the statutory criteria for a unit were satisfied by the Unit Operating Agreement." I will now explain that "reasonable basis".

5. It is to be noted that the statute and the finding refer to the unit operating agreement "carrying" a working interest owner "on a limited, carried or net-profits basis . . . " The concept of carrying is simply this: that the party doing the carrying is responsible for the operating costs and expenses attributable to the non-carrying interest. The concern of the statute and the conservation agency in having one party responsible for carrying another interest in a unit is two-fold: a) fairness to a party forced into a unit, and b) having some interest who must bear the costs of the interest in the unit. On the latter point, if there is not some party or parties carrying all costs in the unit, there will be a portion of unit costs -- such as those incurred for plugging and abandonment, remediation, possible well-blowouts and the like -- that will leave the state holding the bag on such costs. See NMSA 1978, § 70-7-7E.

6. The "carrying" party can accomplish the carrying by means of one of three methods of carrying: a) a limited basis; b) a carried basis; or c) a net-profits basis. Each of these three is different. I will address these in last-to-first order.

7. A net profits interest is defined as "A share of gross production from a property, measured by net profits from operation of the property. It is carved out of the working interest." 8 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 679 (1996). The term "net profits interest" has been construed by a New Mexico court in *Christy v. Petrol Resources Corp.*, 102 N.M. 58, 691 P.2d 59 (N.M. Ct. App. 1984). In this case, the plaintiff sought to quiet title, alleging that he was "the owner and holder in fee simple of (i) a 10% net profits interest, and (ii) an overriding royalty of 1% of the amount of all oil, gas,

casinghead gas and other hydrocarbon substances . . . " The court concluded that in New Mexico law "the phrase 'net profits interest' has no independent meaning . . . " 691 P.2d at 62. Under the circumstances of the case, the court found that the plaintiff's "net profits interest" was an interest in a certain cash payment and was not an interest in the proceeds of production. The Utah Supreme Court in *Atlas Corp. v. Clovis Nat'l Bank*, 737 P.2d 225 at 231 (Utah 1987), similarly concluded that the term "net profits interest" has not "acquired a fixed and immutable meaning such that all interests so formed automatically are entitled to treatment as estates in land. There is no body of law that clearly defines the nature and incidents of the net profits interest."

8. A "carried interest" has been defined as follows:

> A fractional interest in oil and gas property, usually a lease, the holder of which has no personal obligation for operating costs, which are to be paid by the owner or owners of the remaining fraction, who reimburse themselves therefor out of production, if any. The person advancing the costs is the carrying party and the other is the carried party. Three general types of carried interest are recognized: the Abercrombie-type carried interest, the Herndon-type carried interest, and the Manahan-type carried interest.

8 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 135 (1996). This same *Treatise*, for which I am co-author for update and revision with Professor Kramer, makes the further observation that there is no standard carried interest arrangement. It states:

> The details of a carrying agreement vary considerably, e.g., whether the operator (the party who is putting up the cost of development) has control of the oil and the right to sell it or the carried party can sell his part of the oil; whether the carried interest is to be carried for the initial development period only of the operation or for the life of the lease; whether interest is to be charged and, if so, the rate; who would own the equipment, such as pipe, motors and pumps, if and when production ceased; etc. See Ashland Oil & Refining Co. v. Beal, 224 F.2d 731, 5 O.&G.R. 387 (5th Cir. 1955), cert. denied, 350 U.S. 967 (1956). As observed by Professor Masterson, Discussion Notes, 5 O.&G.R. 396 (1956):

> "The numerous different forms these interests are given from time to time make it apparent that the terms 'carried interest' and 'net profits interest' do not define any specific form of agreement but rather serve merely as a guide in preparing and interpreting instruments."
>
> Professor Masterson further noted the close kinship between carried interests and net profits interest. Either type may be employed where one coowner is to advance the entire costs of drilling.

Id., 135-36.

9. Although a "carried interest" and a "net profits interest" have a kinship, they are different. The same *Treatise* goes on to describe the usual difference between the treatment of the two:

> The major difference between the two interests is that it is customary for a carried interest relationship to cease when all costs as to the carried interest are paid; thereafter the carried and carrying parties jointly own the working interest and share in costs and receipts. A net profits interest, on the other hand, usually continues for the duration of the leasehold, one party continuing to bear costs and the other receiving a share of proceeds after payment of such costs.

8 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 136 (1996)

10. As observed earlier, the statute and order provide that "carrying" can be on a "limited" basis. The same *Treatise* I have been quoting from states the following definition for a "Limited carried interest":

> A Carried interest (q.v.) which is to be carried for the initial development phase only of the operation. After the operator has recouped his advances to the carried interest, the carry terminates.

8 P. Martin & B. Kramer, *Williams & Meyers Oil and Gas Law* 589 (1996). When there is a carrying on a limited basis the carry terminates, and the non-carrying party must be responsible for its share of costs or the interest itself may terminate or be relinquished. This has been the treatment in New Mexico law for such an interest. The meaning of carrying a working interest owner on a limited basis is seen in a New Mexico case decided the very same year that the unit operating agreement was signed. This was in *Bolack v. Sohio Petroleum Co.*,

475 F.2d 259 (10th Cir. 1973). In this case, Tom Bolack sold and assigned to Sohio Petroleum Company a producing Federal oil and gas lease, reserving an interest described as a "limited term carried working interest." Bolack's interest was not to begin until seven-eighths of the production subsequent to the sale and transfer of the producing lease amounted to 1,500,000 barrels, and the interest was then to terminate when the "reasonably estimated quantity of oil that is recoverable from said lands has declined to four hundred thousand (400,000) barrels." The question in the case concerned whether the limiting condition had occurred, and the court concluded that it had indeed occurred and that the carrying party's obligations ceased and the noncarrying party's interest had terminated. Thus, it should be clear that at the time the New Mexico legislature in 1975 adopted the statute in question in this proceeding, the concept of carrying another interest on a limited basis was recognized in the New Mexico courts.

11. Other states' statutes providing for options for working interest owners in pooling and unitization have provided for carrying on a "limited" basis as well as a "carried" basis. The Kansas Statute is quite similar to the New Mexico statute with provision for "carrying any nonoperating working interest owner on a limited, carried or net-profits basis, . . ." K.S.A. § 55-1305(g). The West Virginia pooling statute, W. Va. Code § 22C-9-7(b)(5)(ii), enacted originally in 1972, provides for options available to the owner of an operating interest who does not elect to participate in the risk and cost of the drilling of a deep well: "To participate in the drilling of the deep well on a ***limited*** or ***carried*** basis on terms and conditions which, if not agreed upon, shall be determined by the commissioner to be just and reasonable." [emphasis added]. The Kentucky pooling statutes, Ky. Rev. Stat. § 353.640(3), contain a provision whereby the nonconsenting owner may be afforded certain options, including one in which the owner "May elect to participate in the drilling, deepening or reopening of the well on a ***limited*** or ***carried*** basis upon terms and conditions determined by the director to be just and reasonable." [emphasis added]. A similar provision is contained in the Pennsylvania statutes 58 Pa. Stat. § 408(c).

12. The concept of a working interest owner participating on a "limited" as opposed to "carried" basis in unitization operating agreements has been brought forward in requests by parties for such carrying. An especially significant case for this proceeding is *Newkirk v. Bigard*, 125 Ill.App. 454, 80 Ill.D. 791, 466 N.E.2d 243, *affirmed in part and reversed in part*, 109 Ill.2d 28, 92 Ill.D. 510, 485 N.E.2d 321 (1985), cert. denied, 475 U.S. 1140, *reh. denied*, 477 U.S. 909 (1986). In this case the applicant for an order for a unit requested that the Illinois Mining Board "Provide that Walter Newkirk may elect to participate in the drilling and operation or operations of the well on a limited or carried basis upon the terms and conditions to be just and reasonable." 466 N.E.2d at 245. Newkirk did not attend the hearing. The order was issued in 1980 but did not provide for Newkirk's participation on "a limited or carried basis" but instead that he was simply responsible for his share of costs. The order failed to state a time and manner in which Newkirk could elect to participate in the unit and did not provide, as requested by the applicants, one or more equitable alternatives if Newkirk elected not to participate in the risk and cost of the drilling and operations; it did state Newkirk would participate in the costs and risks of the drilling units and set out the participation factors. Omission of the election of the statutory alternatives to participation in the drilling of the well rendered the order voidable, not void; thus it was not subject to collateral attack. The order was defective because it did not give alternatives, but this did not mean the board was without jurisdiction to enter the order. The nonconsenting party could not now challenge the order. As an appendix to this Affidavit I have reproduced pertinent pages from B. Kramer & P. Martin, Pooling and Unitization, §25.06[7] (1996), for which I am the co-author, concerning the fact that a conservation agency's failure to afford a nonconsenting party the statutory alternatives cannot be attacked collaterally later by that nonconsenting party.

13. From the foregoing discussion of the New Mexico statute, it should be obvious that the terms "carrying" on a "limited" basis or a "carried" basis or a "net-profits" basis refer to several different conceptual bases on which the "carrying" might be accomplished. After reviewing the Unit Operating Agreement for the Myers Langlie-Mattix Unit, I am of the

opinion that the responsible New Mexico agency in 1980 in Order R-6447 had a very reasonable basis for concluding that the Operating Agreement did provide for "carrying" on a "limited basis" under terms that were just and reasonable.

The unit operating agreement does provide for a limited carrying of nonconsenting parties. If, for example, the nonoperating party fails to authorize and pay for certain operations he may do so for a time. The other working interest owners will have a right to a lien on the production. If the operations are successful, the nonoperating party will have his share of costs deducted out of production and then can resume taking his share of production after the carrying parties have recouped their costs. If it appears the operations are to be unsuccessful, the nonconsenting party may relinquish his interest and thereby avoid any liability for costs incurred subsequent to his relinquishment. This example would certainly qualify as carrying the nonconsenting party on a limited basis. Because the working interest owners had all participated the Unit Operating Agreement for some seven years and had enjoyed substantial benefits thereunder, it is very reasonable to conclude that the limited carrying provision of the agreement was "just and reasonable".

14. I am also of the opinion that any challenge to the agency's 1980 conclusion and Order R-6447 must be dismissed by this agency or by a court as a collateral attack on the order. It is further my opinion that there is no reasonable basis on which the agency could conclude that the statute or Order R-6447 imposes a particular method for carrying on "limited" basis or "carried" basis, or "net profits" basis. Such an end could only be achieved by rewriting the Unit Operating Agreement since none of these terms has a precise meaning that could imported, and the statute in no way indicates which of these three broad concepts should be employed. While it may be open to question whether in 1980 the agency could have refused to approve the Unit and the Unit Operating Agreement for not containing a satisfactory carrying provision when no working interest owner made complaint, it is my opinion that the agency has no statutory authority and no power under the circumstances to impose a new

operating agreement upon parties to an existing unit operating agreement. It is quite simply unheard of and unprecedented in case law.

FURTHER AFFIANT SAYETH NOT.

Patrick H. Martin

SUBSCRIBED AND SWORN TO BEFORE ME on this 9th day of July 1997, to certify which witness my hand and official seal of office.

Notary Public, In and for the
State of Louisiana

My commission expires:

for life

[7] Illinois

The Illinois conservation act allows suit by any interested person affected by the act or by any rule, regulation, or order of the Illinois Mining Board in the circuit court of the county where any part of the affected land.[92] Any such suit is to be determined as expeditiously as possible. The burden of proof is on the party challenging the validity of the act or rule, regulation, or order and any rule, regulation, or order is deemed prima facie valid.

Omission of election of statutory alternatives to participation in drilling of well rendered order voidable, not void, thus it was not subject to collateral attack — The case of *Newkirk v. Bigard*[93] involved an order of the Illinois Mining Board, which had force-pooled and integrated 40 acres into two drilling units of 20 acres each. The complainants had a one-half interest in 30 acres and contended the order was void as it had not spelled out any election they could make as to whether they paid costs up front or whether they were to be carried to payout or given some other basis for paying costs. Notice had been given, but they had not taken part in the hearing. They also contended the other one-half interest, which was a term interest, had expired as there were no operations on the land itself but instead on unit lands for a void unit. The order failed to state the time and manner in which Newkirk could elect to participate in the unit and did not provide, as requested by the applicants, one or more equitable alternatives if Newkirk elected not to participate in the risk and

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ty-day provision for challenging an order of the commission thereby giving the plaintiff a full year to bring a suit against the commission claiming that the order of the agency is in violation of the statute. It could seem to refer to tort suits between private parties for claims based on violations of commission regulations and orders, such as a well blowout, pollution, or failure to account for production. However, is it also a restriction on the authority of the commission to enforce its own statutes or regulations or orders? In a doubtful matter, the authors do not think a court should read a restriction to limit the ability of the state to enforce its exercise of the police power.

[92] Ill. Rev. Stat. ch. 96, § 5416, at § 30.13A *infra*.

[93] Newkirk v. Bigard, 92 Ill. Dec. 510, 485 N.E.2d 321, 87 O.&G.R. 266 (Ill. 1985), *cert. denied*, 475 U.S. 1140, *reh'g denied*, 477 U.S. 909 (1986).

cost of the drilling and operations; it did state Newkirk would participate in the costs and risks of the drilling units and set out the participation factors. The Mining Board said that inasmuch as it had the authority to enter orders pertaining to the integration of mineral interests, and as notice had been given to all affected owners, its integration order could not be attacked collaterally. The court of appeals, however, disagreed. It stated: "[T]he Mining Board, as an administrative agency, is a creature of statute, having no general or common-law powers. It must find within the statute the authority to act, and if it lacks the inherent power to make or enter the particular order involved,' that order may be attacked at any time or in any court, either directly or collaterally." [94] Interestingly enough, the court found that the order was not completely void so the term interest had not expired; it was only void as to the interest of the claimants. In other words, the board had jurisdiction, but not to make part of the order it had entered. This approach makes the collateral attack rule almost meaningless and encourages parties not to take part in unit hearings.

The Illinois Supreme Court reversed. Omission of the election of the statutory alternatives to participation in the drilling of the well rendered the order voidable, not void; thus it was not subject to collateral attack. The order was defective because it did not give alternatives, but this did not mean the board was without jurisdiction. The board had personal jurisdiction over Newkirk and had subject matter jurisdiction. It had inherent authority to issue the order. The order was authorized by statute and not subject to collateral attack; agency jurisdiction or authority is not lost merely because its order might be erroneous.[95] The general rule is that a party cannot collaterally attack an agency order in a proceeding such as this unless the order is void on its face as being unauthorized by statute.[96] The court observed:

> Plaintiffs' argument would allow a collateral attack on an order whenever the agency has failed to follow the

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[94] 466 N.E.2d at 247, 82 O.&G.R. at 247-248.

[95] 485 N.E.2d at 324-325, 87 O.&G.R. at 273.

[96] 485 N.E.2d at 325-326, 87 O.&G.R. at 274.

> exact letter of a statutory provision. A party could merely point to any provision of a statute which was not complied with and claim that the agency did not have authority to act unless the provision was complied with.[97]

The court noted the distinction "between orders which are void and subject to collateral attack, and those which are merely voidable and subject to attack only through the applicable administrative and judicial review proceedings."[98] The mining board's failure to include the omitted provisions did not render the order void; it merely made the order voidable. On its face the order was authorized by statute and thus not subject to collateral attack by means of a declaratory judgment action.[99]

The standard of review in Illinois in a case not involving an order of the Mining Board but instead an order of the Illinois Commerce Commission was taken up in the case of *Canady v. Northern Illinois Gas Co.*[100] However, it will be of interest for conservation matters as well. The case involved the expropriation of a gas storage easement. The Illinois Commerce Commission found that the underground water supply would not be injured by the gas storage. The court stated:

> It is not a question of whether we agree or disagree with the findings below, or whether we would have made such findings had we heard the case in the first instance. The sole question is whether as a court of review, we can say that the findings of the Illinois Commerce Commission and of the circuit court are manifestly contrary to the weight of the evidence, i.e. are obviously wrong.[101] Substantial evidence was introduced to support the contentions of the Gas Company,

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[97] 485 N.E.2d at 326, 87 O.&G.R. at 274.

[98] 485 N.E.2d at 326, 87 O.&G.R. at 275.

[99] 485 N.E.2d at 326, 87 O.&G.R. at 275.

[100] Canady v. Northern Illinois Gas Company, 43 Ill. App. 2d 112, 193 N.E.2d 48 19 O.&G.R. 1 (1963).

[101] 193 N.E.2d at 50.

Statement of Facts
Relevant to 7(F) Issue

(1) On November 16, 1973, the Division entered Order R-4660 in Case 5086 approving Skelly Oil Company's Myers Langlie Mattix Unit. This is a voluntary unit for the purpose of conducting secondary recovery. Neither the Unit Agreement nor the Unit Operating Agreement limited the type of recovery operations to be conducted.

(2) The Unit, as originally proposed, would have consisted of 9,923.68 acres. However, Tract Nos 4, 5, 9, 50, 51, 67, 78, and 82 did not qualify for inclusion in the Unit and only 9,006.56 acres were originally unitized. In 1976 Tracts 50 and 51 qualified, were voluntarily committed to the Unit, and the Unit was expanded to 9,326.56 acres. Thereafter the size of the Unit remained unchanged.

(3) The Unit is subject to a Unit Agreement which provides in part that each working interest owners ("WIO") shall separately own and shall separately take or dispose of its share of unitized substances and to a Unit Operating Agreement which provides upon the non-payment by a voluntarily committed WIO of joint interest bills, the Unit Operator is allowed to collect the sum owed by the defaulting WIO by an of the following:

(a) Option One - Bring suit to collect for unpaid expenses with or without foreclosing on this interest. Under this option, the WIO keeps his interest in the Unit and continues to receive production revenue but must pay his outstanding indebtedness. The Unit Operator does not have to net-out the debt from the proceeds.

(b) Option Two - The Unit Operator can net-out the indebtedness. The WIO keeps his interest in the Unit but does not receive any production proceeds until the Unit Operator recoups his share of the expenses plus interest.

(c) Option Three - The Unit Operator can foreclose on the interest of the delinquent WIO who would then lose its interest in the Unit.

(4) Section 17.1 provides that any WIO can withdraw from further participation in the unit by assigning all of that WIO's interest to those WIO in the unit who desire to continue unit operations.

EXHIBIT
B

(5) On June 21, 1980, Getty, then the unit operator, filed Case 6987 and applied to the Division for a statutory unitization order (Case 6987) because a small percentage of royalty owners in 13 tracts in the unit had never ratified the unit agreement.

(6) Getty's statutory unitization application was to unitize certain uncommitted royalty owners. Until these royalty interest were committed to the Unit, Getty was required to maintain separate production facilities which resulted in less efficient operations. In addition the unsigned royalty interest stood in the way of Getty entering into lease line agreements which were necessary before Getty could convert certain producing wells to injection wells.

(7) On August 27, 1980, the Oil Conservation Commission entered Order R-6447 which approved the Myers Langlie-Mattix Unit and found:

> "( ) That the Myers Langlie-Mattix Unit Agreement and the Myers Langlie-Mattix Unit Operating Agreement provide for unitization and unit operation of the Myers Langlie-Mattix Unit Area upon terms and conditions that are fair, reasonable, and equitable, and which **include**:
>
> > (d) a provision for carrying any working interest owner on a limited, carried, or net-profits basis, payable out of production, upon such terms and conditions which are just and reasonable,..."

(8) Order R-6447 (Case 6987) did not change the unit boundary, the unit acreage, the participation of **any** WIO **or any Unit documents.**

(9) In 1981 Texaco Exploration & Production Inc. ("Texaco") acquired the interest of Getty and replaced Getty as operator of the unit.

(10) In January, 1986, Hartman obtained his 4.869% WI in the unit. This working interest previously had been voluntarily committed to the unit.

(11) On April 28, 1994, OXY provided the WIOs, including Hartman, with information including an AFE for the 1994 EOR project.

(12) By June, 1994, the project had been approved by the necessary percentage of the WIO.

(13) On August 19, 1994, OXY wrote Hartman informing him that the Unit Operating Agreement did not have a non-consent option for capital project.

(14) On August 23 and 24, 1994, Hartman wrote to OXY objecting about the proposed 1994 project.

(15) On September 13, 1994, OXY wrote Hartman again advising Hartman if he did not want to participate in the 1994 program his option was to assign his interest to the unit pursuant to Article 17.1 of the operating agreement.

(16) Commencing in August, 1994, Hartman stopped paying his share of the joint interest billings for the unit.

(17) On September 13, 1994, OXY notified Hartman that he could withdraw from the unit by tendering his interest in accordance with Section 17.1 of the Unit Operating Agreement and thereby be relieved from any further liability concerning unit operations.

(18) Hartman has not elected to withdraw and decided to continue to participate in the unit by taking his share of production **without** paying his share of costs which as of May 1, 1997 OXY contends were $ 729,000.00.

(19) Some 17 years after the statutory unitization order and some three years after the EOR order, now Hartman has filed this application before the NMOCD claiming that:

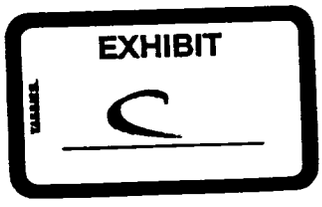
> Section 7(F) of the Statutory Unitization Act mandates a special type of carrying provision which limits his liability.

§ 806.3 Performance by lessee: Prudent-operator standard

The great majority of oil and gas producing jurisdictions apply the prudent-operator standard in testing performance of implied covenants by lessees. While verbal formulations of the standard differ somewhat from case to case, a widely quoted statement appears in *Brewster v. Lanyon Zinc Co.* [1] In rejecting the good faith test and requiring a higher standard of conduct, the court (through Judge, later Justice, Van Devanter) said:

> "The object of the operations being to obtain a benefit or profit for both lessor and lessee, it seems obvious, in the absence of some stipulation to that effect, that neither is made the arbiter of the extent to which or the diligence with which the operations shall proceed, and that both are bound by the standard of what is reasonable. This is the rule in respect of all other contracts where the time, mode, or quality of performance is not specified, and no reason is perceived why it should not be equally applicable to oil and gas leases. There can, therefore, be a breach of the covenant for the exercise of reasonable diligence, though the lessee be not guilty of fraud or bad faith.
>
> "But, while this is so, no breach can occur save where the absence of such diligence is both certain and substantial in view of the actual circumstances at the time, as distinguished from mere expectations on the part of the lessor and conjecture on the part of mining enthusiasts. The large expense incident to the work of exploration and development, and the fact that the lessee must bear the loss if the operations are not successful, require that he proceed with due regard to his own interests, as well as those of the lessor. No obligation rests on him to carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result from them. It is only to the end that the oil and gas shall be extracted with benefit or profit to both that reasonable diligence is required. Whether or not in any particular instance such diligence is exercised depends upon a variety of circumstances, such as the quantity of oil and gas capable of being produced from the premises, as indicated by prior exploration and development, the local market or demand therefor or the means of transporting them to market, the extent and results of the operations, if any, on adjacent lands,

§ 806.3 [1] Brewster v. Lanyon Zinc Co., 140 Fed. 801 at 814 (8th Cir. 1905).



> the character of the natural reservoir—whether such as to permit the drainage of a large area by each well—and the usages of the business. *Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required. . . .*"[2]

The italicized sentence in the preceding quotation epitomizes the rule that has been approved by a great majority of the states having decisions on the point.

[States adopting prudent-operator standard]

We list below the states that have adopted the prudent-operator standard as the general rule governing performance of implied lease covenants:

Arkansas: *Ezzell v. Oil Associates,* 180 Ark. 802, 22 S.W.2d 1015 (1930).

The prudent-operator standard was applied in *Brixy v. Union Oil Co.,* 283 F. Supp. 353, 28 *O.&G.R.* 541 (W.D. Ark. 1968), wherein the court denied cancellation of a lease, finding that the requirements of the standard had been met. The court gave consideration not only to acts of the lessee but also to the acts of other operators owning leases in the immediate area, declaring:

> "The evidence concerning the activity not only of the defendant and the intervenor but other companies in the area is convincing that both the defendant and the intervenor acted in the utmost good faith and made every effort to develop leases held by them, which, of course, included the lease of plaintiffs of Section 6, and it does not seem necessary to comment further on the question of diligence on the part of defendant and intervenor." 283 F. Supp. at 358–359, 28 *O.&G.R.* at 551–552.

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[2] 140 Fed. at 814.

See also Tidelands Royalty "B" Corp. v. Gulf Oil Corp., 611 F. Supp. 795 at 801, 86 *O.&G.R.* 162 at 173 (N.D. Tex. 1985), declaring that the reasonably prudent operator standard is now applied in most states to determine whether or not a lessee has breached an implied covenant. The judgment in this case was reversed and remanded on other grounds, 804 F.2d 1344, *O.&G.R.* 604 (5th Cir. 1986). See § 802.1 note 30, *supra.*

In *Amoco Prod. Co. v. Ware,* 269 Ark. 313, 602 S.W.2d 620, 68 *O.&G.R.* 416 (1980), the court applied a prudent-operator standard in an action seeking termination of a lease for alleged breach of implied lease covenants. Emphasized by the court were: (1) the deference that should be given the operator regarding how development should proceed, and (2) the obligation of the lessee to balance the desires of one lessor with those of other lessors in the same area.

California: *Hartman Ranch Co. v. Associated Oil Co.,* 10 Cal.2d 232, 73 P.2d 1163 (1937).

Colorado: *Mountain States Oil Corp. v. Sandoval,* 109 Colo. 401, 125 P.2d 964 (1942).

Idaho: *Alumet v. Bear Lake Grazing Co.,* 112 Ida. 441, 732 P.2d 679 (Ida. App. 1986), dealing with a phosphate lease, applied the standard of "a reasonably prudent, similarly situated businessman" to the implied development covenant, *on subsequent appeal,* 19 Ida. 946, 812 P.2d 253 (1991).

Illinois: *Daughetee v. Ohio Oil Co.,* 263 Ill. 518, 105 N.E. 308 (1914); *Carter Oil Co. v. Dees,* 340 Ill. App. 449, 92 N.E.2d 519 (1950).

Kansas: *Myers v. Shell Petroleum Corp.,* 153 Kan. 287, 110 P.2d 810 (1941); *Fischer v. Magnolia Petroleum Co.,* 156 Kan. 367, 133 P.2d 95, *on rehearing,* 156 Kan. 722, 137 P.2d 139 (1943); *Temple v. Continental Oil Co.,* 182 Kan. 213, 320 P.2d 1039, 8 *O.&G.R.* 717, *on rehearing,* 183 Kan. 471, 328 P.2d 358, 9 *O.&G.R.* 642 (1958).

Kentucky: *McMahan v. Boggess,* 302 S.W.2d 592, 7 *O.&G.R.* 1396 (Ky. 1957). See also § 806.2, note 9, *supra.*

Louisiana: *Caddo Oil and Mining Co. v. Producers' Oil Co.,* 134 La. 701, 64 So. 684 (1914); *Coyle v. North American Oil Consolidated,* 201 La. 99, 9 So.2d 473 (1942); *Gennuso v. Magnolia Petroleum Co., 203 La. 559, 14 So.2d 445 (1943).*

Michigan: *Compton v. Fisher-McCall,* 298 Mich. 648, 299 N.W. 750 (1941).

Mississippi: See *Phillips Petroleum Co. v. Millette,* 221 Miss. 1, 72 So.2d 176, 3 O.&G.R. 803 (1954) (dictum that the

prudent-operator standard governs most implied covenants but is not applicable where lessee causes the drainage from the leasehold); *Wells v. Continental Oil Co.,* 244 Miss. 509, 142 So.2d 215, 17 *O.&G.R.* 527, at 536 (1962) (dictum that prudent-operator rule governs development of leasehold lands excluded from a pooling unit).

In *Southwest Gas Producing Co. v. Seale,* 191 So.2d 115 at 119, 25 *O.&G.R.* 316 at 322 (Miss. 1966), the court cited this section of the TREATISE for the proposition that "The great majority of jurisdictions, including Mississippi, apply the 'prudent operator' standard."

Montana: *Fey v. The A. A. Oil Corp.,* 129 Mont. 300, 285 P.2d 578, 4 *O.&G.R.* 1324 (1955).

Nebraska: *George v. Jones,* 168 Neb. 149, 95 N.W.2d 609, 10 *O.&G.R.* 947, 76 A.L.R.2d 710 (1959) (this case involved an implied covenant to use due diligence in extracting gravel but is equally applicable to implied covenants in oil and gas leases).

New Mexico: *Clayton v. Atlantic Refining Co.,* 150 F. Supp. 9, 7 *O.&G.R.* 1426 (D. N.M. 1957); *Libby v. DeBaca,* 51 N.M. 95, 179 P.2d 263 (1947); *State ex rel. Shell Petroleum Corp. v. Worden,* 44 N.M. 400, 103 P.2d 124 (1940) (dictum).

North Dakota: *Hermon Hanson Oil Syndicate v. Bentz,* 77 N.D. 20, 40 N.W.2d 304 (1949).

Ohio: *Harris v. Ohio Oil Co.,* 57 Ohio St. 118, 48 N.E. 502 (1897).

Oklahoma: *Ramsay Petroleum Corp. v. Davis,* 184 Okla. 155, 85 P.2d 427 (1938); *Texas Consolidated Oils v. Vann,* 258 P.2d 679, 2 *O.&G.R.* 1335 (Okla. 1953); *North American Petroleum Co. v. Knight,* 321 P.2d 964, 8 *O.&G.R.* 794 (Okla. 1958).

For another application of the prudent-operator standard in Oklahoma, see *Spiller v. Massey & Moore,* 406 P.2d 467, 23 *O.&G.R.* 767 (Okla. 1965), wherein the court commented as follows:

> "The object of such operations being to obtain profits for the lessor and lessee then, absent some stipulation to that effect,

neither is the arbiter of the extent of the diligence to which, or with which, operations must proceed, and both are bound by the standard of what is reasonable. . . . Whether diligence has been exercised in a particular instance depends upon a variety of circumstances: (1) the quantity capable of being produced from the premises as indicated by prior exploration and development; (2) the local market or demand; (3) means of transporting to market; (4) extent and result of operations, if any, on adjacent lands; (5) character of the reservoir; (6) usages of the business. In view of these considerations what would be expected of operators of ordinary prudence is what is required." 406 P.2d at 471–472, 23 *O.&G.R.* at 771–772.

Texas: *Texas Pacific Coal and Oil Co. v. Barker,* 117 Tex. 418, 6 S.W.2d 1031 (1928); *Clifton v. Koontz,* 160 Tex. 82, 325 S.W.2d 684, 10 *O.&G.R.* 1109 (1959); *Amoco Prod. Co. v. Alexander,* 622 S.W.2d 563, 72 *O.&G.R.* 125, 18 A.L.R.4th 1 (Tex. 1981) (specifically adopting the prudent operator standard); *United States Steel Corp. v. Whitley,* 636 S.W.2d 465 (Tex. App., Corpus Christi, 1982, error ref'd n.r.e.) (concluding that the prudent operator standard was applicable to the covenant obligations of a lessee under an uranium lease). See also the discussion of *Texas Oil & Gas Corp. v. Hagen* in Section 853, note 2, *infra.*

Federal Leases: *Nola Grace Ptasynski,* 89 I.D. 208, 63 IBLA 240, GFS (O&G) 1982–117 (Interior Board of Land Appeals 1982), concluded that the prudent operator standard is applicable to federal leases with the possible exception of cases of so-called "fraudulent drainage." See § 824, *infra.*[2.1]

[Brewster v. Lanyon Zinc Co. discussed further]

It will be noted in the passage from the *Brewster* opinion quoted above that Judge Van Devanter makes the following statement:

"No obligation rests on him [the lessee] to carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result from them."

[2.1] For another discussion of application of the prudent operator standard to federal leases, see GSX Oil & Gas Corp., 95 I.D. 148, 104 IBLA 188, GFS (O&G) 1988-87 (Sept. 9, 1988).

This language has been seized on by some commentators[3] to support the proposition that there can be no violation of the prudent-operator standard unless the operations demanded by the lessor will be profitable to the lessee. As we shall demonstrate later, the courts have not read the language so broadly.[4] The quoted statement was made in the context of overruling a demurrer to a complaint based on breach of the duty to use due diligence in developing a known, producing gas field by the drilling of additional wells. In a later case before the United States Supreme Court, Justice Van Devanter joined in the opinion of the court upholding the lessor's right to conditional cancellation of the lease for failure of lessee to drill *exploratory* wells, where there was no finding that such drilling would be profitable.[5]

[Meaning and effect of prudent-operator standard]

We postpone detailed consideration of the prudent-operator standard to the sections dealing with particular implied covenants, for the standard is best understood in the context of a particular kind of dispute. Our purpose here is to discuss the nature of the general standard and its function in litigation.

The prudent-operator standard may serve three important functions in litigation:

First, it is used to test the sufficiency against demurrer of the allegation of a complaint. Thus, the plaintiff must allege that the act or omission of the defendant operator was in

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[3] See *e.g.,* Brown, "The Proposed New Covenant of Further Exploration: Reply to a Comment," 37 *Texas L. Rev.* 303 at 308–309 (1959).

[4] See the discussion of the implied covenant of further exploration in §§ 841–847, *infra,* particularly §§ 842.3, 842.4 and 847.

[5] Sauder v. Mid-Continent Petroleum Corp., 292 U.S. 272 (1934). The trial court specifically found that profitability *vel non* could be determined only by drilling.

See also Sinclair Oil & Gas Co. v. Masterson, 271 F.2d 310, 11 *O.&G.R.* 632 (5th Cir. 1959), *cert. denied,* 362 U.S. 952, *rehearing denied,* 363 U.S. 809 (1960), holding that the *Brewster* case does not preclude relief for failure to explore, although proof of profit is not shown by lessor.

violation of the prudent-operator standard, and depending on the practice rules of the jurisdiction, the plaintiff may have to allege with particularity how the prudent-operator standard was violated. For example, in claiming breach of the offset well covenant, the plaintiff may be required to allege the existence of drainage, the amount thereof, the cost of a protection well, and the length of time it will take to recover costs and obtain a profit. However, this kind of specificity is seldom required in these days of decline in the art of pleading.

Second, in litigation presenting fact issues to be resolved by the jury, the prudent-operator standard must be stated and defined in the instructions.[6]

Third, the sufficiency of the evidence to support the findings or verdict is determined by the prudent-operator rule. To use an offset well case as an example again, if the judge or jury has found for the plaintiff, but the evidence does not show that defendant can profitably drill a protection well, the judgment will be reversed (in the ordinary drainage case) because of the insufficiency of the evidence to show a violation of the prudent-operator standard.[7]

In summary, the prudent-operator standard has the same function in oil and gas litigation as the reasonable man standard has in negligence litigation.

[Prudent-operator standard defined]

This analogy to the reasonable man of tort law also helps to explain the meaning of the prudent-operator standard. The prudent operator is a reasonable man engaged in oil and gas

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[6] See *e.g.,* Texas Pacific Coal and Oil Co. v. Barker, 117 Tex. 418, 6 S.W.2d 1031 (1928);

Perkins v. Mitchell, 153 Tex. 368, 268 S.W.2d 907, 3 *O.&G.R.* 1146 (1954).

[7] See *e.g.,* Gerson v. Anderson-Pritchard Production Corp., 149 F.2d 444 (10th Cir. 1945) (affirming judgment denying recovery to plaintiff lessor where he failed to prove that an offset well would be profitable);

Fischer v. Magnolia Petroleum Co., 156 Kan. 367, 133 P.2d 95, *on rehearing,* 156 Kan. 722, 137 P.2d 139 (1943).

operations.[8] He is a hypothetical oil operator who does what he ought to do not what he ought not to do with respect to operations on the leasehold. Since the standard of conduct is objective, a defendant cannot justify his act or omission on personal grounds or by reference to his peculiar circumstances. It is no excuse that defendant failed to drill the offset well a prudent operator would have drilled because defendant is short of cash, over-committed on drilling programs, has no need for more production, or prefers to spend his money on other things. In short, the question is not what was meet and proper for *this* defendant to do, given his peculiar circumstances, but what a hypothetical operator acting reasonably would have done, given circumstances generally obtained in the locality.[8.1]

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[8] See Galvin, "Meyers v. Brown—Jurisprudence in Action," 7 *U.C.L.A. L. Rev.* 589 at 607 (1960).

See also Sundheim v. Reef Oil Corp., 248 Mont. 244, 806 P.2d 503 at 510, 114 *O.&G.R.* 42 (1991);

> "This [prudent operator] standard is best understood through analogy to the reasonable man standard of tort law. Simply stated, the prudent operator is a reasonable man engaged in oil and gas operations. He is a hypothetical oil operator who does what he ought to do not what he ought not to do with respect to operations on the leasehold. Williams and Meyers, Oil and Gas Law § 806.3 (1990)."

[8.1] See Johnson v. Hamill, 392 N.W.2d 55, 91 *O.&G.R.* 77 (N.D. 1986) (quoting the preceding two paragraphs of this Treatise to define the prudent-operator standard).

Shelton v. Exxon Corp., 719 F. Supp. 537, 112 *O.&G.R.* 153 (S.D. Tex. 1989), in concluding that a lessee had breached the implied covenant to market gas, observed that "the lessee's duty was to do that which would be done by a reasonable, prudent operator holding *only* the lease in question." 719 F. Supp. at 549 (emphasis supplied). The court then noted that "the reasonable, prudent operator standard should not be reduced as to the plaintiffs because Exxon [the lessee] has corporate warranty contracts legally unrelated to the King Ranch leases [which were in question in the instant case] . . .. Exxon could have gained these significant benefits for the mineral interest owners [plaintiff] without itself incurring costs related to the King Ranch lease operations and without by the same actions subjecting the mineral interest owners to any risks. Prudent marketing required Exxon to do so." *Shelton v. Exxon Corp.* was rev'd on the prudent marketing point in 921 F.2d 595, 112 *O.&G.R.* 180 (5th Cir. 1991)

[Confusion between tort and contract basis of implied covenants]

The similarity between the reasonable man in tort law and the prudent operator in oil and gas law may account for expressions in some opinions suggesting that the implied duty of the lessee is *ex delicto* rather than contractual.[9] Substantively, it probably makes little or no difference whether the prudent-operator standard is based on tort law or contract law, but procedurally it may become important to remember that the duty is contractual.[10]

(concluding that the imprudent marketing claim had been released by a 1980 settlement).

See also Archer v. Grynberg, 738 F. Supp. 449, 111 *O.&G.R.* 385 (D. Utah 1990), discussed in § 921.18 note 26 (concerned with alleged inconsistency of the language of an operating agreement excusing the Operator from losses and liabilities "except such as may result from gross negligence or willful misconduct," and language of a unit agreement requiring the operator to develop the unitized area "as a reasonably prudent operator"), *aff'd w/o opinion,* 951 F.2d 1258 (10th Cir. 1991).

[9] See *e.g.,* Hamilton v. Empire Gas & Fuel Co., 297 Fed. 422 (8th Cir.), *cert. denied,* 266 U.S. 607 (1924);

Sunray Mid-Continent Oil Co. v. McDaniel, 361 P.2d 683, 14 *O.&G.R.* 348 (Okla. 1961).

Explicitly rejecting a tort-based duty in the case of drainage caused by lessee's operations is Billeaud Planters v. Union Oil Co. of California, 245 F.2d 14, 7 *O.&G.R.* 798 (5th Cir. 1957).

[10] Basing implied covenants on contract or on tort may determine the statute of limitations applicable to the action, the defenses available to the lessee, the liability of a lessee after assignment, and the efficacy of express provisions against liability. These are the same consequences that follow from classifying covenants as implied in fact or implied in law. See § 803 *supra.* Indeed, it would seem that the implied "in fact"—"in law" distinction is just another name for the contract-tort distinction.

For cases dealing with the question of whether the prudent-operator standard is based on tort law or on contract law, see the following:

Veazey v. W.T. Burton Industries, Inc., 407 So. 2d 59, 72 *O.&G.R.* 60 (La. App. 1982), *writ granted, exception of no cause of action overruled and case remanded for further proceedings,* 412 So. 2d 88 (La. 1982);

In summary, so long as it is borne in mind that implied covenants are contractual obligations and not tort duties, the hypothetical reasonable man of negligence law is a useful analogy for understanding the definition and function of the prudent-operator standard in oil and gas law.

§ 807. Express Lease Clauses Modifying Prudent-Operator Standard

An examination of a number of lease forms and a review of the cases involving implied covenants indicates that no widespread effort has been made by lessees to modify the prudent-operator standard by express provision. Only a few reported cases reflect attempts by lessees to lessen the burden of the prudent-operator standard by express provision specifying a lower standard.[1] The language of express

(Text continued on page 43)

Amoco Production Co. v. Alexander, 622 S.W.2d 563, 72 *O.&G.R.* 125 (Tex. 1981).

On the effect of the tort-contract analysis upon liability of a lessee for exemplary damages, see § 825.2, note 14, *infra*.

§ 807 [1] See *e.g.*, the following cases:

Dauer v. Sun Oil Co., 125 F.2d 246 (5th Cir. 1942);

Brooks v. Arkansas-Louisiana Pipe Line Co., 77 F.2d 965 (8th Cir. 1935);

Coats v. Brown, 301 S.W.2d 932, 8 *O.&G.R.* 27 (Tex. Civ. App. 1957);

King v. Swanson, 291 S.W.2d 773, 6 *O.&G.R.* 471 (Tex. Civ. App. 1956);

Magnolia Petroleum Co. v. Page, 141 S.W.2d 691 (Tex. Civ. App. 1940, error ref'd).

(Footnote continued on page 43)