

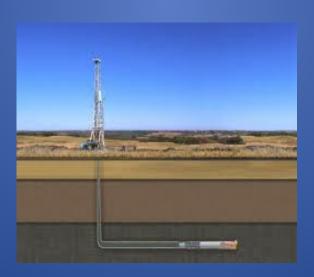
# The Prudent Operator Standard in the 21<sup>st</sup> Century

Presented by:
Jonathan D. Baughman
McGinnis, Lochridge & Kilgore LLP
Rocky Mountain Mineral Law 58<sup>th</sup> Institute
Newport Beach, California
July 20, 2012

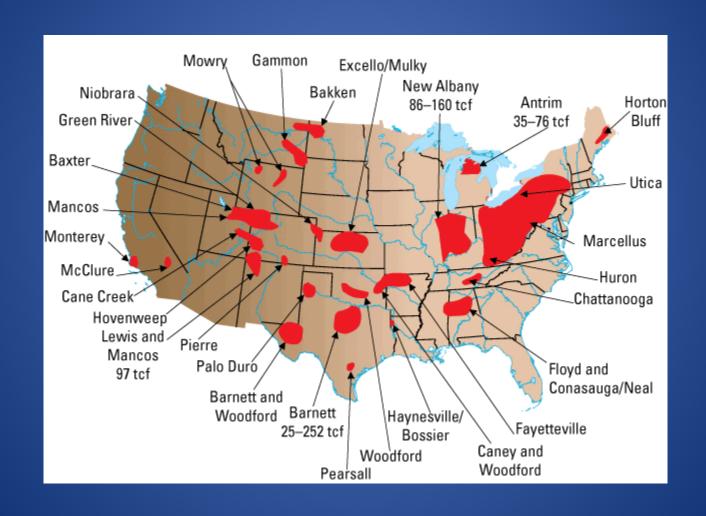
#### WHAT HAS CHANGED?

## 21st Century

- Substantial increase in horizontal drilling
- Substantial increase in multistage hydraulic fracturing



### 21st Century





#### PRUDENT OPERATOR STANDARD



# RELATIONSHIP BETWEEN LESSEE AND LESSOR



## Implied Covenants

- Duty to Develop
- Duty to Protect Against Drainage
- Duty to Market
- Duty to Conduct Operations with Reasonable
   Care and Due Diligence

#### **Prudent Operator Standard**

The test is what a reasonable lessee would do considering the interests of both the lessor and the lessee

**Not** a Fiduciary duty

## **Prudent Operator Standard**

Objective test, not subjective test

 Good faith, subjective honesty of the lessee is not the test.



## **Prudent Operator Standard**

- Same standard applies whether major oil company, small company or individual
- Number of lessors or leases does <u>not</u> change standard
- Economic situation of lessee does <u>not</u> change standard; only concerned with the economics of a hypothetical prudent operator

# HORIZONTAL DRILLING—NEW SHALE DEVELOPMENT





#### **Ferrara**

V.

#### Questar Exploration & Production, Co.,

70 So.3d 974 (La. App. 2 Cir. 6/29/11)



#### **Factual Background**

6 INDIGO CHK Fisher 6-12-15H	5 BEUSA	4 BEUSA	3 BEUSA	2 BEUSA	1 BEUSA
7 снк	8 BEUSA	9 BEUSA	10 BEUSA LCBlount Jr 10 #3	11 BEUSA MW Lavigne 11 #2	12 BEUSA Larry Franklin 12H
18 COM	17 снк	16 CHK	15 снк	14 CHK	13 снк
19 COM Heard 18 HZ	20 J W Register 20	21 JW	22	23 BEUSA Ben ONeal et al 14H	24 BEUSA Ben ONeal et al 13H
30 EOG Faglie 30/Grantham 30 #1 & 30 #2	29	28	27 CHK Collins 27H	26 снк	25 BPA
31 EOG	32	33 сом	34 BPA	35 BPA	36 BPA Con Baker 36

T12N - R15W



#### **Trial court:**

 Dissolved lease as to all depths below the Hosston formation for Questar's failure to act as a reasonably prudent operator

 Trial court found that Questar knew of Haynesville Shale's economic viability yet had no intention to develop the deep rights on their land.



#### **Court of appeals:**

 Noted that "totality of the circumstances" should be considered

Identified factors



- Factors to consider:
  - Geological data
  - Number and location of wells drilled
  - Productive capacity of wells
  - Cost of drilling operations compared to profits
  - Time intervals between completion of the last well and demand for additional operations
  - Acreage involved in disputed lease



 Court of appeal held that lessors failed to provide geological data showing that a prudent operator would have drilled on the Ferrara's property to the Haynesville Shale depth by the date of trial



**Opinion in Denying Rehearing** 

# PRUDENT OPERATOR STANDARD OR FIDUCIARY DUTY?



# Hebble v. Shell Western E & P Inc., 238 P.3d 939 (Okla. Civ. App. 2009)



## **Factual Background**



#### Jury found in favor of Plaintiffs:

\$13.2 million in damages and \$53 million in punitive damages



#### Court of Appeals:

 held that operator <u>owed a fiduciary duty</u> to the royalty owners when drilling and spacing units are created under Oklahoma statute

 Court reasoned that the leases no longer control after unitization—fiduciary duty owed as a result of invoking police powers of the state



Court of appeal:

 applied the discovery rule to breach of fiduciary duty claims of Plaintiffs

Statute of limitations begins to run when
 Plaintiffs knew or should have known of injury

Numerous Class actions pending in Oklahoma based on Hebble decision



 On May 8, 2012, Oklahoma Legislature passed "Litigation Reform Act", Section 901 of Title 52



- Act expressly provides:
  - Prudent operator standard applies to operators of well under a "private agreement, statute, governmental order or common law"
  - There shall <u>not</u> be implied "any fiduciary duty, quasi-fiduciary duty or other similar special relationship in any private agreement, statute or governmental order or common law" relating to oil and gas



Remaining part of Act contains language:

 That cannot recover punitive or exemplary damages or disgorgement damages unless clear and convincing evidence that the holder failed to pay with the actual, knowing and willful intent



# IMPACT OF CONSERVATION RULES, UNITIZATION ORDERS AND OTHER STATUTES



Conservation rules may limit or expand lessee's duty under the implied covenants to act as a prudent operator



#### Some states have codified Reasonably Prudent Operator Standard

#### Arkansas

 Statute expressly rejects fiduciary duty. Expressly requires lessee to act as a prudent operator

#### Louisiana

 No fiduciary duty but bound to perform as reasonably prudent operator.

#### Kansas

 Codified lessee's covenant to reasonably explore and develop premises and places burden on lessee



# PRUDENT OPERATOR STANDARD IN CONTEXT OF THE JOA— OPERATOR/NON-OPERATOR RELATIONSHIP

#### **AAPL Form 610 JOA**



#### A.A.P.L. FORD( 600 - 1989 MODEL FORM OPERATING AGREEMENT

OPERATIDAS AGREEMENT. DATED CERRATUR: CONTRACT AREA COUNTY OR PARTITION STATEOF

6455,30-to-um

	SERVING VARIABLE.
i.	THE ARREST PRINT IN THE PARTY AND THE PARTY
3	bosons despited and offered to be "Operate" and the regiment purp or partie of the Operate control
4	boskeds releast constitutes at "Son-Speece" and releaseds as "Non-Speece"
5	REFSEREND.
	PRESENCE the papers to the operand on more of oil and the Least sorte oil and the binners in the be
7	should be 16000 No.2 and the poster factor them couldn't a represent to popios and strong than become settle to
8	and includes to the probation of Colombian the rests and as breaked you still.
	SCIC TRIBLETING A suggestion below:
80	ARTICALS.
20	description  according to a granted. No tillness produce colonies Add for a facultation our facts being
ű.	A. The hairs "offic" dust man as Authority the Appointment are required in a party in the manuscript file. But manuscript in the appointment file that manuscript in the second control of the file appointment file.
ű.	attending the particle by particle and delicate an appearance of a particle particle and appearance of the particle part
'n.	S. To can Transcor a Transcor Address a state present the contract of a complete a real as a probability
M.	sed lies in your proof liets, including, but and limbed in the sering of particular compact profession, and electric
10.	minus from minus makent medicantina.
100	1: "No con "Color dos" and have of of the man, bit and by Laws and by the first the brown broad in
35	divided and sected for AT and the project code for agreement. Their deals, for our his basis and city and his
#	Streets are described on District in ""
2	D. Tea tree, Treated that case a single appoint wheeler a will in Albeit to an elemine Zinc below the Asse
D.	Law, a which do, well was preciously delived, or below the Designation property to the control of \$100, whichever, it is
Ð.	
**	E. The least Chilling Party' and Chemistry Party' And some a party role agree in pass in and part in America'
25	on disciplose renderand transmit things over
Ħ	F. The term 1995ing their delictions the man than for the setting of one wall be order or spin of any man or below.
T.	both being authority. If a Drilling field is see than by any reals only in order, a Delling from that he has seeing seet.
ä	unablished by the patient of all they in the Control Assembling Bred by representative that Colling Paties.
Ξ	<ol> <li>The term "beliefe" shall be set the Col and the Lanc or CO and the Square or which a proposed out a to a bound.</li> </ol>
-	A. The transition of the state of property in Alberta September 1990 Annual September 19
10	L. The later Transcriptor and the service is selected by the of participation control or opening.
	MUNICIPAL AND THE
	1. The latest "Stort-Delling Plats" and "Hard Residing State" shall come a part, who calculum to participate to
ii.	invasid medits
M-	E. To ten 'Oi set 'Or' still you id, you complete you pre-contents, write all size light to your
12	transactions and other medically subseque produced elements, realises are most to hear the technological field today.
	specificity and
gsi.	1. Denote "till and the femole" at "paging" and now record for all stored attents a fill and for a far
	of faul frequentiants, control any stack an record by particular than agreement.
٠.	M. The been "10 and the loan," "Loan" and "Loadwolf" shall make the off and partitions or solven them
42	communicate of fixed (yielg exhibition Common Ayes which are remodify the parties to this agreement.
**	St. The ten. The Intil And note a right motion shade a Anno Time a dealered in sole to small
44	Smaltinia salelines See.
0	<ol> <li>Street, Normalist A. Street, and sense a poster shorts a trapitor is not first a simple in contract a trapitor in a Africa Carl wide Security willow.</li> </ol>
5	E. To air South And age is perfect colored to the reflect of a red after a company to not
	ration, in progress produces, in a line office, in particular species produces in the produce, a last produce and particular species and
Ξ.	ser, ad Janual In. and charlest species; the parties species care at presence with a Africa State of
Ξ.	Greenina, Comircina, Novembrina, et Proprio, Reduction and
	is. The law "Salest" old note the descript would not produce decision of a neil from retain or a s-
11	charge the britten have brooking makes about the straighten the later or differ about just in the later to common with
77	subsold Military
**	1. No see that and see a seem of set unions a begin is seen a seem assumed of the
ėr.	On agrain the standard A. Den any other columns account to a C. St. and Col.
AL.	Taken the arginal otherwischedy existion, when total in the steptice action the plant, this word (some) include
4-	copied and artificial persons, the plant limitate that stepsian and any greate tradicals the especiation, best size, and writer
4	40000
25	EMBES .
81	The first explosions, an obscure full was and associated to the explosion is not made upon benuf.
4	- L. Didde N., and retail of blooms interests:
42	Village about of bank referal to the specient.
41	CENTERIOR. If any na in lights Demantics, or substance.
*	(1) Parties in agreement in address of the Sphillips (1) and the prince of the second
	(ii) formaniges in Planting of American of positions distributions.  (iv) of and the 1 cases and or 10 and the formation object ordinary contract.
86	A CANADA A LONGO.
2	S. Hille T. Terri Philos
Ξ	C 1000 17 June Product
ς.	D. Solder V. Seed east
	E. Fisher V. Van Sterney Agrance.
ŭ.	
	Estado V./ Inc. Copresso and Confinence of the Improproach address     Estado VI./ Yes Internaligo

A.A.P.L. FORSIGHO-REGISEL FORM OPERATING AGREEMENT - 1989

ANTHER BY

A THE COMMONS

The profession of the best first the first three the profession of the profe John Stanfor The party shall provide commonths, an a principles from Englast New No. principles in contrast the contrast of the party.

tions or copily cross, and if such other polythoraus or copily cross should decide the monte subtract on a highly principles, the polytoped fining the official Land decilines the officiant copily broken decided to teach highly principles.

processors, to perform the confidence of confidence and confidence confidence in confidence in confidence process.

In this processor is not considerable to the lowest as expressed as of considerable confidence of confidence considerable and confidence and conf

E. San jedi Kr. sakilistici sirka i Linux. J. Noto i M. L. Scholer i M. s. kappane iz polenni gen n. metti.

R. San jedi Kr. sakilistici sirka i Linux. J. Noto i M. L. Scholer i M. s. kappane i prime i prime i metti i malkitici sirka i Linux. J. M. s. kappane i J. M. San i M. San i

The earth of the control of the cont

As the linearisation and to each of the State of an impact of a place is common and a state, a person and the state of the No continues shall be stake in the Stiffely of an proposal web prior to commensure of Afrika, specimes and

#### **AAPL 1989 JOA:**

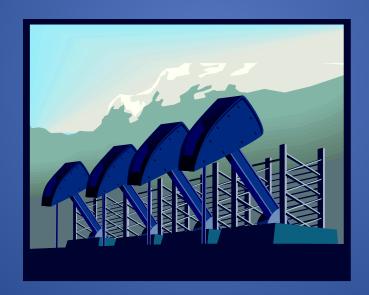
"Operator shall conduct its activities under this agreement as a reasonably prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulation....,

#### Reasonably Prudent Operator



- "operator of ordinary prudence"
- "operator has neither the highest nor the lowest prudence, but merely possesses average prudence and intelligence and acts with diligence under the same or similar circumstances"

### Objective Standard—Not Subjective





 Whether Operator acted as a "reasonably prudent operator" is a question of fact for the jury to determine.

 Not a matter within the knowledge of an average juror—requires expert testimony.

#### **AAPL 1989 JOA:**

#### **Exculpatory Clause:**

....but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct."



- Gross negligence = actual subjective knowledge of an extreme
  - risk or serious harm

- Willful misconduct = specific intent by the operator to cause
  - substantial injury to the non-operators



#### **Exculpatory Language:**

 Applicable to all of operator's activities or just those related to physical operations?

Applicable to administrative and accounting duties?



# Stine v. Marathon Oil Co

# Stine v. Marathon



## **Factual Background**

## Stine v. Marathon



Fifth Circuit held that the exculpatory clause controlled virtually all disputes between the parties—even administrative and accounting.



# PYR Energy Corp. v. Samson Resources Co.

### PYR v. Samson



- Complicated facts
- PYR claimed that JOA imposed a contractual duty on Samson to form a unit containing only productive acreage
- Samson claimed not liable under the JOA but could only be liable if found to be grossly negligent or engaged in willful misconduct relying upon Stine.



 District Court questioned the Fifth Circuit's decision in Stine and noted no court in Texas had followed Stine.

 District Court followed Stine since bound by precedent in Fifth Circuit.



# Abraxas Petroleum Corp. v. Hornberg

# Abraxas v. Hornberg



Court found that the parties did not intend for the exculpatory clause to apply to any and all claims.



Cone

V.

Fagadau Energy Corp.

## Cone v. Fagadau



Court held that exculpatory clause did not apply to Cone's claims for breach of specific terms of JOA in nature of accounting.



# IP Petroleum v. Wevanco Energy, LLC

#### IP v. Wevanco



Court held that exculpatory clause applied to non-operator's claims because claims based on allegations that operator failed to conduct operations in a good and workmanlike manner.



# Castle Texas Production Ltd. Partnership

V.

**Long Trusts** 



# Shell Rocky Mountain Prod. v.

**Ultra Resources** 

### Shell v. Ultra



Court held that exculpatory clause did not apply to claims that operator had failed to abide by specific and express contractual duties.

### Shell v. Ultra



Court stated it made no sense to apply the exculpatory clause to administrative and accounting duties where the operator can profit by "cheating, or simply overcharging, its non-operators."



# Forest Oil Corp.

V.

Union Oil Co. of America

# Forest Oil v. Union Oil

 Court interpreted exculpatory clause as being limited to physical operations and did not excuse breaches of express contractual duties.

 Court stated 10<sup>th</sup> circuit's decision in Shell was better interpretation compared to 5<sup>th</sup> Circuit's decision in Stine.

# Conclusion



### **Contact Information**

## Jonathan Baughman

McGinnis Lochridge & Kilgore, LLP
1111 Louisiana, Suite 4500
Houston, Texas 77546
(713) 615-8500, (713) 615-8585 FAX

jbaughman@mcginnislaw.com

Website: www.mcginnislaw.com