



**McGINNIS
LOCHRIDGE
& KILGORE_{LLP}**

The Prudent Operator Standard in the 21st Century

Presented by:

Jonathan D. Baughman

McGinnis, Lochridge & Kilgore LLP

Rocky Mountain Mineral Law 58th Institute

Newport Beach, California

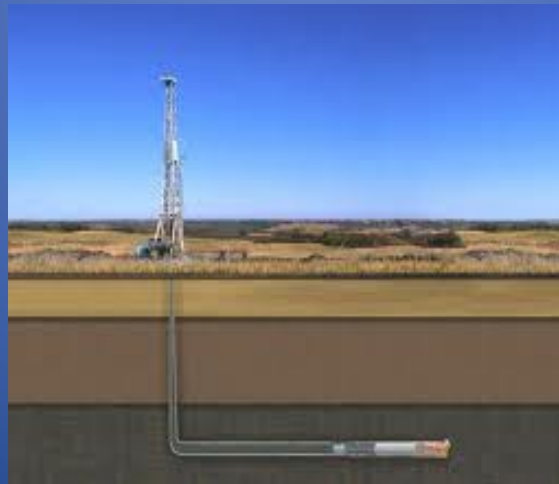
July 20, 2012



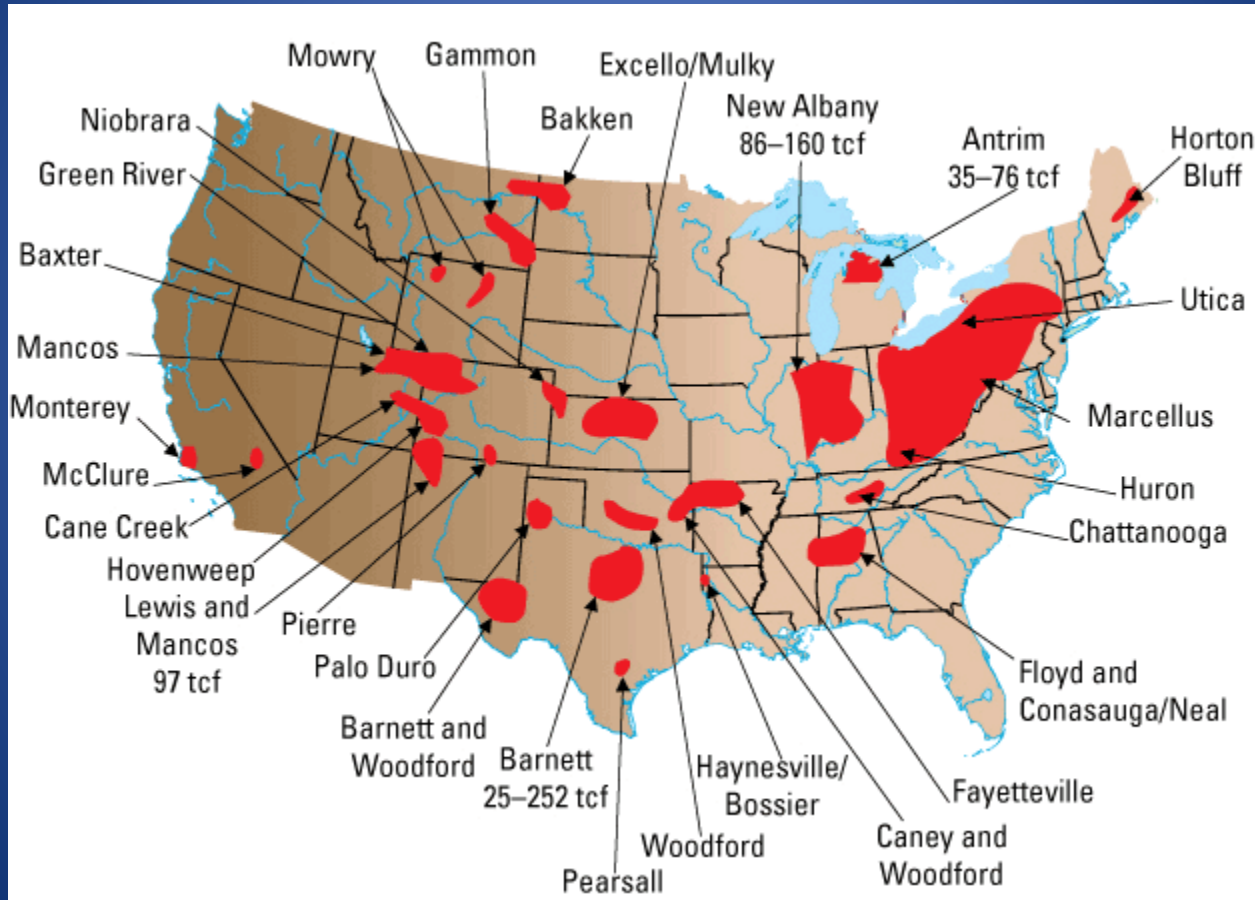
WHAT HAS CHANGED?

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.

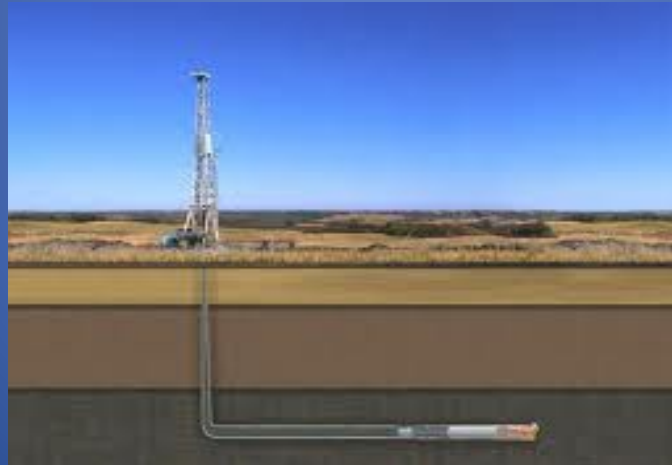


Prudent Operator Standard

- Same standard applies whether major oil company, small company or individual
- Number of lessors or leases does not change standard
- Economic situation of lessee does not 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)

Ferrara v. Questar



Factual Background

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

T12N - R15W

Ferrara v. Questar



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.

Ferrara v. Questar



Court of appeals:

- Noted that “totality of the circumstances” should be considered
- Identified factors

Ferrara v. Questar



- **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

Ferrara v. Questar



- 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

Ferrara v. Questar



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)**

Hebble v. Shell



Factual Background

Hebble v. Shell



Jury found in favor of Plaintiffs:

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

Hebble v. Shell



- **Court of Appeals:**
 - held that operator owed a fiduciary duty 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

Hebble v. Shell



- **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**

Hebble v. Shell



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

Hebble v. Shell



- **Act expressly provides:**
 - Prudent operator standard applies to operators of well under a “private agreement, statute, governmental order or common law”
 - There shall not 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

Hebble v. Shell



- **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**



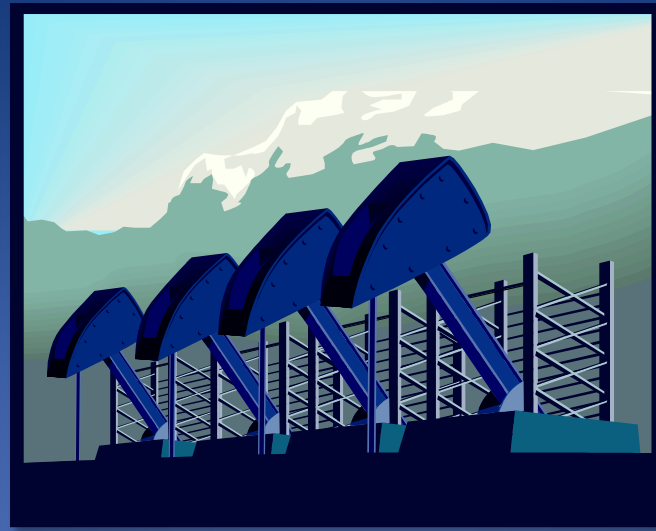
IMPACT OF CONSERVATION RULES, UNITIZATION ORDERS AND OTHER STATUTES



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 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....,

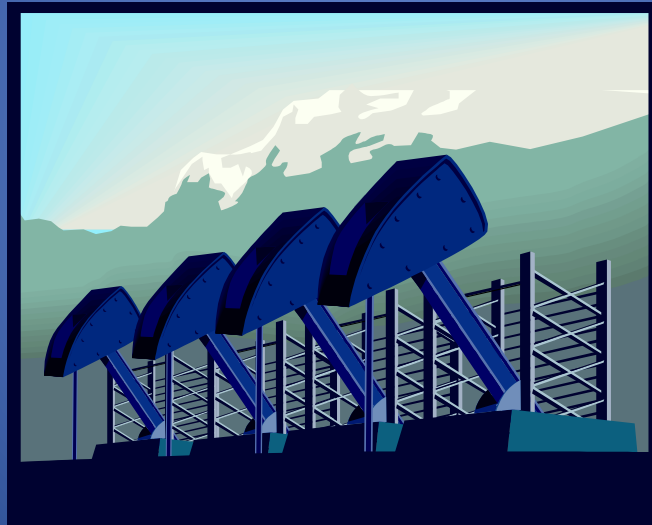
- Reasonably Prudent Operator

- “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 10th circuit's decision in Shell was better interpretation compared to 5th 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