IN THE COURT OF APPEALS OF THE STATE OF NEW MEXICO

CHISOS, LTD.,

Plaintiff-Appellant

Vs.

JKM ENERGY, L.L.C.

Defendant-Appellee

COA No. 29265
EDDY COUNTY
CV-06-609

Appeal from the Fifth Judicial District Court, Eddy County, New Mexico
The Honorable Ralph D. Shamas, District Judge

BRIEF OF APPELLANT CHISOS, LTD.

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Statement of Compliance Pursuant to Rule 12-213(G) NMRA

This brief complies with the type-volume limitation of Rule 12-213(F)(3) NMRA because this brief contains 8,042 words, excluding the parts of the brief contemplated by Rule 12-213(F)(1) NMRA.

TABLE OF AUTHORITIES

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SUMMARY OF THE PROCEEDING

I. NATURE OF CASE

Appellant Chisos, Ltd. ("***Chisos***") filed its Petition in the Court below seeking a declaration that under the terms of a September 1, 2005 Conveyance and Bill of Sale (the "***Conveyance***") from Chisos to Appellee JKM Energy, L.L.C. ("***JKM***") Chisos only conveyed to JKM rights to the well bore of the Stetson "2" State Com #1 Well (the "***Stetson #1 Well***") located on the W/2 of Section 2, Township 19 South, Range 29 East, N.M.P.M., Eddy County, New Mexico (the "***W/2 of Section 2***"). JKM counterclaimed asserting that the Conveyance conveyed to JKM all of Chisos' oil and gas operating rights in the W/2 of Section 2 and not just the rights to the well bore of the Stetson #1 Well. JKM also claimed that it was entitled to an accounting for oil and gas produced by Chisos from a second well located in the W/2 of Section 2, the State HL-2 #1Y Well (the "***HL2 Well***") following operations conducted by Chisos on the HL2 Well in 2006.

II. COURSE OF PROCEEDINGS AND DISPOSITION OF THIS CASE BELOW

This case was tried before the Honorable Ralph D. Shamas, District Judge for the Fifth Judicial District, Eddy County, New Mexico, without a jury on September 18th and 19th, 2008. After considering the parties Requested Findings of Fact and Conclusions of Law and post-trial briefs, the Trial Court entered its Decision on November 19, 2008 finding that judgment should be entered in favor

of JKM.[1] The Final Judgment in favor of JKM was entered by the Trial Court on January 15, 2009.[2] Chisos filed Notice of Appeal on February 16, 2009[3] and this appeal is therefore timely in accordance with Rule 12-201(A)(2) NMRA. This is therefore an appeal from the Judgment of the Trial Court finding that the Conveyance conveyed to JKM all of Chisos' oil and gas rights in the W/2 of Section 2 and not just Chisos' rights in the wellbore of the Stetson #1 Well, as contended by Chisos. This is also an appeal from the Judgment of the Trial Court that Chisos was required to account to JKM for costs and revenues relating to operations conducted on the HL2 Well[4] and to provide JKM a retroactive opportunity to participate in said well.

III. SUMMARY OF FACTS RELEVANT TO THE ISSUES PRESENTED FOR REVIEW

Background Facts

Appellant Chisos is a Texas limited partnership engaged in the oil and gas business in Eddy County, New Mexico. Appellee JKM is a New Mexico limited liability company which is also engaged in the oil and gas business in Eddy County, New Mexico.

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[1] TRP at 329. Chisos cites to the Transcript of Record Proper herein as follows: "TRP at [Page #]." Chisos cites to the Transcript of Proceedings herein as follows: "Tr. [Page #], [Vol. 1 or Vol.2]." Chisos cites to Exhibits introduced into evidence at trial as either "Plaintiff's Exhibit No. ___" or "Defendant's Exhibit No. ___."

[2] TRP at 341.

[3] TRP at 387.

[4] As set out below, at the time Chisos executed the Conveyance to JKM, Chisos only owned 50% of the operating rights in the W/2 of Section 2. Pure Energy Group, Inc. owned the remaining 50% of the operating rights in the W/2 of Section 2. However, in 2007 Pure conveyed its 50% interest in the HL2 Well to Chisos.

Prior to 2005, Chisos had obtained, by mesne conveyances, interests in two State of New Mexico oil and gas leases[5] covering, among other lands, the W/2 of Section 2. In August 2005, there were two oil and gas wells which had been drilled upon the W/2 of Section 2. The first well drilled on the W/2 of Section 2 was the HL2 Well, which was drilled in October, 1981.[6] In August 2005, the HL2 Well was completed in the Atoka formation, but had not actually produced from the Atoka since 2003.[7] The second well drilled on the W/2 of Section 2 was the Stetson #1 Well which was drilled in June 2000.[8] In August 2005, the Stetson #1 Well was completed in and producing from the Atoka formation.

On August 17, 2005 Jack Matthews ("***Matthews***") as President of JKM submitted an offer to Chisos to purchase 100% of the working interest and all of the net revenue interest in the Stetson #1 Well for $43,000.[9] By e-mail dated August 29, 2005, Sue Ann Craddock ("***Craddock***") as President of Chisos responded to Matthews' offer to purchase the Stetson #1 Well by making a counter-offer to sell a 100% working interest and a 75% net revenue interest in the Stetson #1 Well for $55,000.[10] Matthews accepted Craddock's counter-offer and

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[5] State Lease B-7717-13 and State Lease B-9739-26. See Plaintiff's Exhibit No. 38.
[6] Plaintiff's Exhibit No. 25.
[7] Defendant's Exhibit P.
[8] Plaintiff's Exhibit No. 32.
[9] Plaintiff's Exhibit No. 1.
[10] Plaintiff's Exhibit No. 3.

agreed to purchase a 100% working interest and a 75% net revenue interest in the Stetson #1 Well for $55,000.[11]

Matthews prepared a form of Conveyance of Oil and Gas Properties[12] which was submitted to Craddock.[13] On or about September 13, 2005, Craddock called Matthews and told him that the form of conveyance prepared by Matthews (the "***JKM Form of Conveyance***") was not acceptable and that she required a number of changes be made to the JKM Form of Conveyance. Matthews admits that during this call Craddock told him that the JKM Form of Conveyance was unacceptable and that changes to the JKM Form of Conveyance would be required.[14] However, Matthews testified that Craddock was "mistaken" when she testified that Matthews was told during this call that Chisos only intended to convey the wellbore of the Stetson #1 Well to JKM.[15]

Following the conversation described above, Craddock revised the JKM Form of Conveyance and submitted the revised form of Conveyance to Matthews.[16] Plaintiff's Exhibit No. 7 sets out the changes made by Craddock to the JKM Form of Conveyance by making a comparison of the differences between the JKM Form of Conveyance and the revised Conveyance. Matthews accepted all of the changes made by Craddock without objection or further communication with

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[11] Tr. 56, Vol. 1.
[12] Plaintiff's Exhibit No. 4.
[13] Tr. 57-58, Vol. 1; Tr. 36, Vol 2.
[14] Tr. 36, Vol. 2.
[15] Tr. 38, Vol. 2.
[16] Tr. 59, Vol. 1; Tr. 106, Vol. 1.

Craddock and signed and recorded the revised Conveyance at Book 613, Page 682 of the Records of Eddy County, New Mexico on September 30, 2005.[17]

The Stetson #1 Well and the HL2 Well on the W/2 of Section 2 are subject to an operating agreement dated effective November 12, 1999 originally between Bellwether Exploration Company, as Operator and Pure Energy Group, Inc., as Non-Operator.[18] At the time that the Conveyance was executed by Chisos and JKM in 2005, Pure Energy Group, Inc. ("***Pure***") owned an undivided 50% of the oil and gas operating rights in the W/2 of Section 2 and in the HL2 Well and Chisos owned the remaining 50% of the operating rights in the W/2 of Section 2 and 100% of the operating rights in the Stetson #1 Well. Pure did not own any rights to the production from the Stetson #1 Well because Pure had elected to go "non-consent" in the drilling of the Stetson #1 Well.[19]

By letter dated December 2, 2005, the New Mexico Oil Conservation Division (the "***OCD***") notified Chisos, which was the operator of record of the HL2 Well, that no production had been reported from the HL2 Well for the past twelve months.[20] The purpose of this letter was to advise Chisos that it was required to either plug and abandon the HL2 Well or conduct operations to place it back on production.[21] After the OCD denied Chisos' request to temporarily

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[17] Tr. 64, Vol. 1; Plaintiff's Exhibit No. 6.
[18] Plaintiff's Exhibit No. 16; Tr. 52-53, Vol. 1.
[19] Tr. 50-55, Vol. 1.
[20] Plaintiff's Exhibit No. 12.
[21] Tr. 68-70, Vol. 1.

abandon the HL2 Well, Chisos advised the OCD of Chisos' intent to put the HL2 Well back on production from the Atoka formation.[22]

On or about October 19, 2006, Chisos commenced operations to enter the existing wellbore of the HL2 Well to re-establish production from the Atoka formation. During those operations Matthews drove up to the well site and advised Chisos' contractors that Chisos had no right to be conducting workover operations. Matthews claimed that JKM had purchased all of Chisos' oil and gas operating rights in the HL2 Well and that Chisos was trespassing on JKM's lease.[23] Chisos disputed JKM's interpretation of the revised Conveyance contending that it was the intent of the parties, as evidenced by reading of the "four corners" of the Conveyance, that JKM had only received a wellbore assignment of Chisos' interest in the Stetson #1 Well.[24] Because of this dispute with JKM, Chisos temporarily abandoned its operations to re-establish production from the HL2 Well.

Following the events described above, Chisos obtained an assignment from Pure of all of Pure's rights in the wellbore of the HL2 Well (an undivided 50% interest) pursuant to the terms of a Limited Term Assignment dated March 13, 2007.[25] JKM does not dispute the validity of this Limited Term Assignment.[26]

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[22] Plaintiff's Exhibit Nos. 25 and 26.
[23] Tr. 74-75, Vol. 1.
[24] Plaintiff's Exhibit No. 19.
[25] Plaintiff's Exhibit No. 20.
[26] Tr. 101, Vol. 2.

By letter dated May 11, 2007, Chisos advised JKM that Chisos had acquired Pure's 50% operating rights in the wellbore of the HL2 Well and that Chisos intended to commence operations to re-enter and re-establish production from the HL2 Well. JKM was also advised in the May 11, 2007 letter that Chisos was giving notice of the described operation under Section VI.A.(1) of the Operating Agreement for the HL2 Well and that pursuant to the terms of the Operating Agreement JKM had 48 hours in which to elect to participate in this operation by paying to Chisos its alleged 50% share of the costs of the above-described operation.[27] Under Section VI.A.(1) of the Operating Agreement, if a party does not timely elect to participate in a proposed operation, such party is deemed to have elected not to participate and such party is therefore deemed to be "non-consent" in such operation relinquishing all of its rights in the well until a 300% "non-consent penalty" has been recovered by the participating party out of production.[28] During the 16 month time period between JKM's receipt of this letter and the trial of this case, JKM ***never*** responded to Chisos' May 11, 2007 letter or provided any notice to Chisos about whether it intended to exercise its right, if any, to participate in the proposed operations to re-establish production from the HL2 Well.[29]

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[27] Plaintiff's Exhibit No. 22.
[28] Plaintiff's Exhibit No. 16.
[29] Tr. 44, Vol. 2.

Summary of Evidence Supporting No Substantial Evidence Claims

The Trial Court's finding that Chisos knew or should have known that JKM intended to obtain all of Chisos' operating rights in the W/2 of Section 2[30] is not supported by substantial evidence. It is undisputed that Craddock redrafted the JKM Form of Conveyance with the intent and for the purpose of changing the JKM Form of Conveyance from a conveyance of all of Chisos' operating rights in the W/2 of Section 2 to a conveyance expressly limited to Chisos' rights in the wellbore of the Stetson #1 Well.[31] It is also undisputed that Craddock told Matthews that the JKM Form of Conveyance, which conveyed all of Chisos operating rights in the W/2 of Section 2, was unacceptable.[32] It is further undisputed that after telling Matthews that the JKM Form of Conveyance was unacceptable, Craddock made substantial changes to the JKM Form of Conveyance,[33] and JKM's own expert admitted that the changes made by Craddock are consistent with the type of changes required to revise an operating rights conveyance to be a wellbore conveyance.[34] It is finally undisputed that Matthews accepted all of Craddock's changes without comment or objection.[35] In summary, it is undisputed that (a) Matthews prepared an operating rights conveyance, (b) Craddock told Matthews his operating rights conveyance was

[30] TRP at 329, Finding Nos. 14 and 22.
[31] Tr. 57-59, Vol. 1.
[32] Tr. 36, Vol. 2.
[33] Plaintiff's Exhibit No. 7.
[34] Tr. 90, 92-95, Vol. 2.
[35] Tr. 64, Vol. 1.

unacceptable, (c) Craddock revised the operating rights conveyance with express purpose and intent to make it a wellbore conveyance, (d) the revisions made by Craddock were the type of revisions that are required to change an operating rights conveyance to a wellbore conveyance, and (e) Matthews accepted the revised Conveyance without objection or comment. Under this set of undisputed facts, the Trial Court's finding that Chisos knew or had reason to know that JKM intended to obtain all of Chisos' operating rights under the revised Conveyance was not supported by substantial evidence.

Likewise, for similar reasons, the Trial Court's finding that JKM did not know or have reason to know that Chisos intended for the revised Assignment to be limited to a wellbore assignment of the Stetson #1 Well is not supported by substantial evidence. Even if one accepts as true Matthews' testimony that Craddock did not specifically tell him that Chisos only intended to convey the wellbore of the Stetson #1 Well to JKM, this only means the issue was not specifically discussed. There was ***no testimony*** by Matthews that during this conversation or at any other time, he said anything to Craddock that would put her on notice that it was JKM's intent that it would receive an operating rights assignment. Instead, Matthews testified that he was fully aware of the fact that Craddock objected to his form of Conveyance, following which Craddock made substantial changes to the JKM Form of Conveyance of the type necessary to change an operating rights conveyance to a wellbore conveyance. Under this set of

facts, the Trial Court's finding by the Trial court that Matthews did not have reason to know of Chisos' intent is not supported by substantial evidence.

ARGUMENT

I. **The Conveyance, when Considered in Light of Surrounding Circumstances, Course of Dealings and Performance, was Unambiguous and Only Conveyed to JKM Chisos' Rights to the Producing Wellbore of the Stetson #1 Well.**

A. **The Trial Court Erred in Finding, as a Matter of Law, that the Conveyance[36] was Ambiguous.[37]**

B. **The Trial Court Erred, as a Matter of Law, in Finding that the Conveyance Conveyed all of Chisos' Operating Rights in the W/2 of Section 2 to JKM.[38]**

Standard of Review

The question of whether an agreement contains an ambiguity is to be decided as a matter of law. Accordingly, the Trial Court's determination of whether an agreement is ambiguous is not binding upon an Appellate Court. Instead this question of law is to be decided on appeal based upon a *de novo* consideration of the documents presented to the trial court. *Mark V, Inc. v Mellekas,* 114 N.M. 778, 782, 845 P.2d 1232, 1236 (1993). *See also, Gates v. N.M. Taxation and Revenue Dept.*, 2008-NMCA-023, ¶ 18, 143 N.M. 446, 176 P.3d 1178; *State v. Johnson*, 2004-NMCA-058, ¶ 12, 135, N.M. 567, 92 P.3d 13. In determining whether an agreement is ambiguous, a court may consider evidence of the circumstances surrounding the making of the contract and of any relevant

[36] Plaintiff's Exhibit 6.
[37] TRP 329, Conclusion No. 2.
[38] TRP 329, Finding No. 2.

usage of trade, course of dealing, and course of performance. *C.R. Anthony Co. v. Loretto Mall Partners,* 112 N.M. 504, 508 – 509, 817 P.2d 238, 242-243 (1991).

Argument

1. The Conveyance, considered in light of the objective evidence demonstrates an unambiguous intent to convey wellbore rights only.

An examination of a few of the fundamental changes made by Craddock to JKM's Form of Conveyance makes it abundantly clear that it was Chisos' intent that the Conveyance be limited to the wellbore of the Stetson Well and that JKM knew or should have known that was Chisos' intent. Set out below are examples of some of the changes that were made by Craddock to the JKM Form of Conveyance, as reflected by Plaintiff's Exhibit No. 7, which demonstrate this conclusion:[39]

A. Craddock's changes to the first "WHEREAS" clause of the JKM Form of Conveyance:

> WHEREAS, Assignor is the owner of record of 100.00% of the operating rights in State Oil and Gas Lease - Stetson "2" State Com ~~insofar as said lease covers the following described lands in Eddy County, New Mexico:~~ No. 1 Well, API Number 30-015-31012, located 990 feet from the south line and 990 feet from the West line, Section 2, Township 19 South, Range 29 East, NMPM, Eddy County, New Mexico (the "Well"); and
> ~~Section 2: W/2~~

As can be seen, in the first WHEREAS clause, JKM had originally recited that Chisos was the owner of 100% of the operating rights ***in the W/2 of Section***

[39] In the comparison, strikethroughs reflect deletions made by Craddock and double underlining reflect additions made by Craddock.

2.[40] Chisos changed that recital to read that Chisos was the owner of 100% of the operating rights ***in the Stetson "2" State Com No. 1 Well*** demonstrating Chisos' clear intent that the subject matter of the Conveyance was being changed from the entire W/2 of Section 2 to the Stetson #1 Well. The Stetson #1 Well is described by Chisos by reference to its exact location and its unique API number.[41] The Stetson #1 Well is then specifically defined in the revised Conveyance as the "Well." Although it was argued by JKM at trial that "Well" really means "Lease," this argument makes no sense. See for example, Plaintiff's Exhibit No. 9 where the Change of Operator form prepared by JKM for the transfer of operatorship of the Stetson #1 Well specifically describes the well (not the lease) as "Stetson 2 State Com #1".

JKM's case largely lives or dies on its contention that the language "State Oil and Gas Lease - Stetson "2" State Com No. 1 Well, API Number 30-015-31012 ..." really means two state oil and gas leases (New Mexico Lease B-7717-9 and New Mexico Lease B-9739) and not just the Stetson "2" State Com No. 1 Well. This argument is based upon the fact that "Stetson '2' State Com" is preceded by the language "State Oil and Gas Lease" and that in the field, when people say the "Ajax Well," they sometimes mean not only the Ajax Well, but also the oil and gas lease that goes with the well. However, even accepting the premise

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[40] For aid in comparison, See Plaintiff's Exhibit No. 4, which is the original JKM Form of Conveyance.

[41] Each oil and gas well in New Mexico (and the rest of the United States) is assigned a unique American Petroleum Institute identification number.

that sometimes in the field the casual use of the term "well" is intended to also mean the accompanying lease, it makes no sense to adopt such an interpretation here.

The language selected by Craddock is not casual conversation in the oil and gas field. This is a legal document where Chisos took pains to specifically and narrowly describe the "Well" by its unique API number and specific location (down to the exact foot). The Williams and Meyers Manual of Oil and Gas Terms (13th Edition) defines "well" as an "orifice in the ground made by drilling, boring or in any other manner." Every case and statute cited by this manual gives similar definitions, with some including the physical equipment surrounding the bore. However, no mention is made of the lease on which a well is bored as being included in the definition of "well." There is absolutely no way that the inclusion of the language "State Oil and Gas Lease -" before the very specific description of the Stetson #1 Well by unique API number and exact location could legitimately be interpreted to transform a description of a specific well into two State of New Mexico oil and gas leases. This conclusion is further supported by the fact that Craddock deleted, in its entirety, the broad language, supplied by JKM, which stated "insofar as said lease covers the following described lands in Eddy County, New Mexico: . . . W/2 of Section 2." In place of the deleted language, Craddock described a specific well by exact API number and by exact location, down to the foot, and defined that specific well as "the Well."

In this regard, it should also be noted that the Stetson #1 Well was located on a State Oil and Gas Lease. This explains the use of the descriptive term "State Oil and Gas Lease –" as part of the description of the Stetson #1 Well in the first WHEREAS clause. This type of description of a well on a State Oil and Gas Lease is not uncommon as can be seen from the attachment to Plaintiff's Exhibit No. 12. In that attachment, the OCD refers to the HL2 Well as the "***State*** HL2 #001Y" and further identifies the HL2 Well by reference to its unique API number. JKM, as an experienced oil and gas operator certainly knew that the OCD used the descriptive term "State" along with API numbers to identify wells on state leases. Chisos described the Stetson #1 Well in the Conveyance in an almost identical manner.

Further, the fact that Chisos chose the term "Well" as the defined term in the Conveyance is important. Chisos (and JKM) clearly knew the difference between a well and a lease. Further, the HL2 Well is also located on this lease and it makes no sense to argue that the parties really intended for the "Stetson "2" State Com No. 1 Well, API Number 20-015-31012 ..." to really mean an entire lease that also included the HL2 Well, API Number 30-015-23962.[42] Finally, it is important to note that no oil and gas lease is described in the Conveyance, something one would surely expect to be included if an interest in an oil and gas lease was actually being conveyed.

[42] Plaintiff's Exhibit No. 30.

B. Craddock's Changes to the second "WHEREAS" clause of the JKM Form of Conveyance:

> WHEREAS, it is the desire of the parties hereto to place Assignee as owner of record of the Well.

As can be seen, Chisos changed the second WHEREAS clause to read that it is "the desire of the parties to place Assignee as owner of record ***of the Well.***" It is submitted that it would be virtually impossible for Chisos to come up with a clearer statement than this of its intent to limit this Conveyance to the Stetson #1 Well. JKM's own expert had to admit that he could not think of a much clearer way to state the intent of the parties to limit this Conveyance to a wellbore conveyance.[43] It is only through a distorted interpretation of the term "Well" to actually mean two State of New Mexico oil and gas leases that anyone could logically argue to the contrary.

C. Craddock's changes to the description of the grant in the JKM Form of Conveyance:

> a. 100% of the operating rights and 75% of the ~~NRI in the Stetson "2" State Com. #1, insofar as~~net revenue interest in and to the Well and spaced unit, INSOFAR AS AND ONLY INSOFAR AS said lease covers the ~~lands in~~ West Half (W/2) of Section 2, Township 19 South, Range 29 East, NMPM, Eddy County, New Mexico ~~described above~~; subject, however, to the reservation by Assignor, described below, and the restrictions, exceptions, reservations, conditions, limitation, existing royalties, overriding royalties, production payment interests, burdens on production and other matters, if any, heretofore created and validly shown of record;

[43] Tr. 92, Vol. 2.

It is important to note first that the description of what Chisos is conveying to JKM under the revised language above is limited to "100% of the operating rights and 75% of the net revenue interest in and to the Well and spaced unit. . ." As was conceded by JKM's own expert, everything after that language (i.e., starting with "INSOFAR AND ONLY INSOFAR") ***actually limits*** what is being granted to JKM;[44] it does not expand or add to what is being conveyed to JKM. What is actually conveyed to JKM in subparagraph (a) is "100% of the operating rights and 75% of the net revenue interest in and to the Well and spaced unit." ***Nothing more is granted.*** JKM's expert could not dispute this fact.[45]

Focusing on the actual language describing what is being granted: "in and to the Well and spaced unit" it is clear that leasehold rights are ***not*** being granted. Phil Brewer, JKM's expert, admitted in his testimony that a spaced (spacing) unit has nothing to do with leasehold rights.[46] It defines the extent of an oil and gas reservoir that can be efficiently drained by a well, as determined by the New Mexico OCD.[47] Each producing well in New Mexico is assigned a spacing unit (i.e., the amount of acreage it can efficiently drain) and that spacing unit relates solely to wells and not to leases. An owner of the rights to a producing wellbore with no leasehold rights outside of the wellbore has a spacing unit assigned by the

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[44] Tr 99, Vol. 2.
[45] *Id.*
[46] Tr. 96-98, Vol. 2.
[47] Tr. 97, Vol. 2.

OCD to that wellbore.[48] As a result, the only thing granted by Chisos to JKM is the Well and the spaced unit for that Well. There is no grant of any leasehold interests. The language that follows (relied upon so heavily by JKM) cannot logically or legally add to what has been granted. It can only limit or define what has already been granted. The only logical explanation for the remaining language is that it further defines the acreage assigned to the spacing unit associated with the "Well," which in fact is the W/2 of Section 2. This is entirely consistent with the testimony by all concerned that a producing wellbore assignment has to convey the rights to produce from the spacing unit for the well in order for the assignee to acquire the right to actually produce from the well.[49]

All the remaining changes to the Conveyance made by Chisos make no sense other than to demonstrate a clear intent to change the JKM Form of Conveyance from an operating rights conveyance to a wellbore conveyance. Further, the correspondence between Chisos and JKM, both before and after the execution of the Conveyance, supports the conclusion that the Conveyance was intended to be a wellbore only conveyance.

1. After receiving Matthew's offer to purchase the "Stetson #1" well for $43,000.00,[50] Craddock responded via e-mail by making a counteroffer of $55,000.00. The subject of Craddock's e-mail was "Stetson No. 1 - Eddy County, New Mexico,"[51] demonstrating

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[48] *Id.*

[49] Tr. 161-163, Vol. 1; Tr. 78 & 96-97, Vol. 2.

[50] Plaintiff's Exhibit No. 1.

[51] Plaintiff's Exhibit No. 3.

Craddock's intent to sell the Stetson #1 Well, not the entire W/2 of Section 2, which also included the HL2 Well.

2. The cover letter from Craddock to Matthews transmitting the executed Conveyance specifically stated "Enclosed is the Conveyance and Bill of Sale from Chisos, Ltd. to JKM Energy LLC for the ***Stetson 2 State Com No. 1 Well,*** once again demonstrating Craddock's intent to convey only the Stetson #1 Well.[52]

3. Following the execution of the Conveyance, Kenetta Matthews (Matthew's wife) faxed a Change of Operator Form for the Stetson 2 Well to Craddock and stated in the fax cover sheet "This should be the last step in transferring ***this well.***[53] This demonstrates both that (a) Matthews knew or had reason to know Chisos only intended to sell the Stetson # 1 Well and (b) Craddock did not know or have reason to know that JKM attached a different meaning to the Conveyance.

Matthews' conduct following the execution of the Conveyance further demonstrated that he did not believe he was receiving anything more than a wellbore conveyance. Matthews never asked Craddock to provide him with copies of the lease files for the leases which he now asserts he owns.[54] Matthews never contacted Pure to advise Pure that it had a new working interest partner in the W/2 of Section 2.[55] Matthews never paid or offered to pay the rentals due to the State of New Mexico on the leases he now claims to own.[56]

Finally, Matthews did not testify that he, at any point in time, ever told Craddock that he intended to purchase the entire W/2 of Section 2 or that he intended for the Conveyance to convey the entire W/2 of Section 2. As a result,

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[52] Plaintiff's Exhibit No. 5.
[53] Plaintiff's Exhibit No. 8.
[54] Tr. 40-41, Vol. 2.
[55] Tr. 41-42, Vol. 2
[56] Tr. 42-43, Vol. 2.

the ***only*** evidence in the record that could possibly put Craddock on notice that Matthews intended to purchase the entire W/2 of Section 2 was the JKM Form of Conveyance.[57] The JKM Form of Conveyance did, in fact, appear to provide for a conveyance of all of Chisos' operating rights in the W/2 of Section 2. However, as pointed out above, it is undisputed that (a) Craddock called Matthews and told him the JKM Form of Conveyance was unacceptable and (b) Craddock then made significant revisions to the JKM Form of Conveyance, which Matthews accepted without objection. It is submitted that the changes made by Craddock could have no possible purpose other than to change the form of conveyance from a working interest conveyance to a wellbore conveyance and under the circumstances present in this case, the Conveyance, as a matter of law, only conveyed to JKM the rights to the wellbore of the Stetson #1 Well.

In sum, the evidence in this trial demonstrated an unambiguous intent for the Conveyance to be a producing wellbore assignment and not an assignment of operating rights in the entire W/2 of Section 2. The Trial Court accordingly erred in finding that the Conveyance transferred to JKM all of Chisos' operating rights in the W/2 of Section 2.[58] This issue was preserved in the court below through Requested Findings of Fact and Conclusions of Law.

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[57] Plaintiff's Exhibit No. 4.

[58] Trial Court compounded this error by inexplicably finding that although the Conveyance supposedly conveyed all of Chisos' operating rights in the W/2 of Section 2, somehow Chisos retained plugging liability for the HL2 Well along with the rights to the surface and downhole equipment in the HL2 Well (TRP 329, Finding No. 25). Since the Conveyance contains absolutely no language to support such a ruling, it is difficult to understand this strange result.

II. **In the Alternative, if the Trial Court Did Not Err in Finding that the Conveyance was Ambiguous, the Trial Court Erred in Interpreting the Conveyance in the Manner Contended by JKM.**

A. **The Trial Court's Finding that Chisos Knew or Should Have Known that JKM Intended to Obtain all of Chisos' Operating Rights in the W/2 of Section 2[59] Was Not Supported by Substantial Evidence.**

B. **The Trial Court's Finding that JKM Did Not Know or Have Reason to Know That Chisos Intended the Conveyance to be Limited to the Wellbore of the Stetson #1 Well[60] Was Not Supported by Substantial Evidence.**

C. **Application of § 201(2) of the Restatement of Contracts Requires the Conveyance to be Construed in the Manner Contended by Chisos or, in the Alternative, Requires Rescission of the Conveyance.**

D. **The Trial Court Erred in Applying Canons of Contract Construction in this Case.**

Standard of Review

Courts of Appeal review factual questions for substantial evidence. *Sitterly v. Matthews,* 2000-NMCA-037, ¶ 22, 129 N.M. 134, 2 P.3d 871.

Argument

1. Under New Mexico law, the Conveyance should be interpreted based upon the principles set out in §201(2) of Restatement (Second) of Contracts, which result in a finding that the Conveyance was a wellbore conveyance as contended by Chisos.

If an ambiguity is found to exist, a New Mexico court must resolve the ambiguity by ascertaining its meaning. *Mark V, Inc. v. Mellekas*, 114 N.M. 778, 781-82, 845 P.2d 1232, 1235-1236; *C.R. Antony Co. v Loretto Mall Partners*, 112

[59] TRP 329, Finding Nos. 14 and 22.
[60] TRP 329, Finding No. 23.

N.M. 504, 507, 817 P.2d 238, 241. Ascertaining an ambiguity's meaning requires examination of extrinsic evidence to determine what each party *intended* by the ambiguous term. *Mark V, Inc.*, 114 N.M. at 781-82, 845 P.2d at 1235-1236. Determining each party's intent is paramount in determining meaning. *Schultz & Lindsay Construction Co. v. State*, 83 N.M. 534, 535, 494 P.2d 612, 613 (1972); *Manuel Lujan Ins., Inc. v. Jordan*, 100 N.M. 573, 575, 673 P.2d 1306, 1308 (1983).

If each party attaches a different meaning to an agreement, then the interpretive methodology set forth in the Restatement (Second) of Contracts § 201 is applied. *Farmington Police Officers Ass'n v. City of Farmington*, 2006-NMCA-077, ¶¶ 18-23, 139 N.M. 750, 137 P.3d 1204. Section 201(2) provides a road map for a court to determine which party's meaning should prevail.[61] § 201 of the Restatement (Second) of Contracts provides as follows:

> § 201. WHOSE MEANING PREVAILS
>
> (1) Where the parties have attached the same meaning to a promise or agreement or a term thereof, it is interpreted in accordance with that meaning.
>
> (2) Where the parties have attached different meanings to a promise or agreement or a term thereof, it is interpreted in accordance with the meaning attached by one of them if at the time the agreement was made

[61] Note that it is only when the parties' intentions cannot be determined that traditional canons of construction are used - see the discussion below.

(a) that party did not know of any different meaning attached by the other, and the other knew the meaning attached by the first party; or

(b) that party had no reason to know of any different meaning attached by the other, and the other had reason to know the meaning attached by the first party.

(3) Except as stated in this Section, neither party is bound by the meaning attached by the other, even though the result may be a failure of mutual assent.

Restatement (Second) of Contracts § 201 (1979).

Proceeding under the assumption that Chisos and JKM each attached different meanings to the Conveyance, the analysis begins with § 201(2). Section 201(2) provides that one party's meaning prevails over the other's when two conditions are met. First, the prevailing party must neither know nor have reason to know of the other party's meaning. Second, the other party must know or have reason to know of the prevailing party's meaning.

At the time of the parties' execution of the Conveyance, Chisos neither knew nor had reason to know that JKM intended the Conveyance to be a transfer of all of Chisos' operating rights in the W/2 of Section 2. It is undisputed that during the telephone conversation between Craddock and Matthews on September 13, 2005, Craddock told Matthews that the JKM Form of Conveyance, which appeared to convey all of Chisos' operating rights in the W/2 of Section 2 to JKM, was unacceptable. It is also undisputed that Matthews never told Craddock that he intended for the Conveyance to be an assignment of all of Chisos' operating rights

in the W/2 of Section 2. Following that conversation, Craddock revised the JKM Form of Conveyance making those changes necessary to change a conveyance from an operating rights conveyance to a wellbore Conveyance. The revised Conveyance was then submitted to JKM along with a cover letter, which communicated to Matthews, Craddock's clear understanding of the conveyance: "Enclosed is the Conveyance . . . ***for the Stetson '2' State Com No. 1 Well.***" Without protest or comment, Matthews executed the revised Conveyance. Therefore, at the time the conveyance was executed, Chisos did not know, nor did it have any reason to know, that JKM may have attached a different meaning to the Conveyance.[62] The Trial Court's finding to the contrary was not supported by substantial evidence.

Further, at the time of the execution of the Conveyance, JKM knew or had reason to know that Chisos intended for the Conveyance to be limited to the wellbore of the Stetson Well. As is set out above, on or about September 13, 2005, Craddock telephoned Matthews, to tell him that the JKM Form of Conveyance was not acceptable. Craddock then revised Matthews' draft in the manner described above. The revisions made by Craddock clearly communicated to JKM the intent of Chisos to change the JKM Form of Assignment from an operating rights conveyance to a wellbore conveyance. These facts clearly demonstrate that

[62] In addition to the other evidence described above, it is instructive to compare what JKM paid for the Stetson #1 Well ($55,000.00) with the revenue he had received from Stetson #1 Well at the time of trial ($350,000). See Tr. 31, Vol. 2. Although Chisos does not begrudge JKM making a good deal, it is not realistic that Chisos believed that JKM was offering $55,000 for the entire W/2 of Section 2.

Matthews knew or should have known that Chisos attached a different meaning to the Conveyance from that JKM alleged during trial that he attached to the Conveyance. The Trial Court's finding to the contrary is not supported by substantial evidence.

Because Chisos neither knew nor had reason to know of JKM's intention, while JKM did know or have reason to know of Chisos' intention, under New Mexico law, the interpretive principles of § 201(2) establish by more than substantial evidence Chisos' position as the prevailing interpretation.

2. In the alternative, if after applying the principles of interpretation set out in § 201(2), the Court is still not able to interpret the Conveyance in favor of one party or the other (i.e., they intended different meanings and neither had reason to know what the other party intended), then, according to § 201(3), there is a failure of mutual assent, the result of which is the remedy of rescission.

Section 201(2) may fail to deliver a result in two situations. One: neither Chisos nor JKM knew or had reason to know of the other's intended meaning; or two: both Chisos and JKM did know or have reason to know of the other's intention. In the event that either of these situations arises, a court should turn next to § 201(3). If this section applies, a court, by default, has found that the parties' "agreement" lacks mutual assent (that is, there was no meeting of the minds), the result being that neither party is bound by the other's meaning. *Restatement (Second) of Contracts* § 201 cmt. d; *see Restatement (Second) of Contracts* § 20(1). As the Court of Appeals of New Mexico has held: "If after hearing all the

evidence, the jury is unable to resolve the ambiguity and determine the intent of the parties, the contract may fail altogether." *McNeill v. Rice Engineering and Operating*, 2003-NMCA-078, ¶ 13, 133 N.M. 804, 70 P.3d 794. Where minds fail to meet as to the material terms of an agreement, rescission (which is often accompanied by restitution) is the appropriate remedy. *See Shoels v. Klebold*, 375 F.3d 1054, 1066-1067 (10th Cir. 2004); *Holcomb v. Ætna Life Insurance Co.*, 255 F.2d 577, 582 (10th Cir. 1958). *McNeil*, 2003-NMCA-078, ¶ 13. *C.R. Anthony Co.*, 112 N.M. at 513 n.7, 817 P.2d at 241; *Highway & Transportation Dept. v. Garley*, 111 N.M. 383, 387, 806 P.2d 32, 36 (1991). In this case, if the Court were to find that there was no substantial evidence to support the Trial Court's finding that Chisos knew or had reason to know of the meaning ascribed to the Conveyance by JKM, but that the Trial Court did not err in finding the JKM did not know or have reason to know of the meaning ascribed to the Conveyance by Chisos, then the Trial Court erred in not granting rescission as a remedy in this case since the result would be that the parties had materially different intents and neither party knew or had reason to know the other party's intent.

3. The Trial Court Erred in Applying Rules of Construction.

The clear wording of § 201(3) is that where the rules stated in § 201 do not apply, "neither party is bound by the meaning attached by the other, even though the result may be a failure of mutual assent" (i.e., rescission). Once § 201 is determined to be the appropriate interpretive guide, then by § 201's terms a court

can only proceed down two avenues: the application of subsections 1 and 2, or the application of subsection 3. Canons of construction do not and cannot arise in conjunction with § 201. Applying canons of construction in conjunction with §201 will result in a violation of the clear directive of §201(3), *viz.* forcing one party who did not know or have reason to know of the meaning attached by the other to be bound by that meaning. Canons of construction can only arise where § 201, in its entirety, is inapplicable – i.e., where a court is not supplied with *any* evidence of either party's intent.

Farmington states that in applying § 201, "we have assumed that the parties will come forward with extrinsic evidence bearing upon what the [parties] knew or should have known of the other's understanding." 2006-NMCA-077, ¶ 24. Immediately thereafter, *Farmington* quotes *Mark V, Inc. v. Mellekas*: "'[I]n the event the parties ***do not offer evidence of the facts and circumstances surrounding execution of the agreement*** and leading to conflicting interpretations as to its meaning, the court may resolve any ambiguity using accepted canons of contract construction . . . .'" *Id.* In this case, however, both parties offered extensive evidence of the facts and circumstances surrounding the execution of the Conveyance and Chisos' intent was undisputed. Therefore, it is § 201 that should be applied and not canons of contract construction that contradict the clear directive of §201(3).

Rules of construction only have application if after hearing all the evidence it is still not known what the parties intended. *Southwestern Bell Telephone and Telegraph Co. v. Florida East Coast Railway Co.,* 399 F.2d 854, 856 (5th Cir. 1968). It was error for the Trial Court to apply rules of construction in this case.

This issue was preserved in the court below through Requested Findings of Fact and Conclusions of Law.

III. **The Trial Court Erred in Finding that Chisos Violated the Joint Operating Agreement and the Rules and Regulations of the New Mexico Oil Conservation Division by Failing to Provide JKM Notification of Chisos' Intent to Produce the HL2 Well from the Same Formation as the Stetson #1 Well.**[63]

Standard of Review

A trial court conclusion of law is reviewed *de novo. Gates v. N.M. Taxation and Revenue Dept.*, 2008-NMCA-023, ¶ 18, 143 N.M. 446, 176 P.3d 1178; *State v. Johnson,* 2004-NMCA-058, ¶ 12, 135 N.M. 567, 92 P.3d 13.

1. The HL2 Well Complied with Applicable Spacing Requirements.

Both the HL2 Well and the Stetson Well are located within the same 320 acre spacing unit consisting of the W/2 of Section 2.[64] Under 19.15.3.104.C(2)(b) NMAC,[65] the HL2 Well and the Stetson Well, being both completed in the Atoka formation, complied with the spacing requirements for wells completed in the Atoka formation which permits the drilling of one initial well (in this case the HL2

[63] TRP 329, Finding No. 6.

Well) and one infill well (the Stetson Well) with both wells being located in different quarter sections.

2. The Trial Court Erred in Finding that Chisos Did Not Give JKM Proper Notification Under OCD Rules and Regulations of Its Intent to Produce the HL2 Well from the Atoka Formation.[66]

A reading of 19.15.3 104.E(2) NMAC[67] ("Section E2") makes it clear that notice by one operator to another operator of its intent to operate a well in the same spacing unit only applies if the first operator intends to drill, deepen or plug back a well. In this case, Chisos did not file an application to drill, deepen or plug back a well, which is a pre-requisite to the applicability of Section E2. Instead Chisos filed a Sundry Notice of its intent to re-establish production from the zone in which the HL2 Well was already completed - the Atoka zone.[68] As a result, it was clear error for the Trial Court to find that Chisos did not give proper notice under Section E2 since no such notice was required.

3. The Trial Court Erred in Finding that Chisos Violated Article VI.A of the Operating Agreement.

Article V1.A of the Operating Agreement (page 8, first full paragraph) provides "that without the mutual consent of all the parties, no wells shall be completed in or produced from a source of supply from which a well located elsewhere on the Contract Area is producing, ***unless the well conforms to the***

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[64] Plaintiff's Exhibit No. 11.
[65] Plaintiff's Exhibit No. 40.
[66] TRP Finding No. 32.
[67] Plaintiff's Exhibit No. 40.
[68] Plaintiff's Exhibit No. 15.

then-existing well spacing pattern for such source of supply."[69] [emphasis supplied] The Trial Court inexplicably found that since the Stetson 2 Well was already producing from the Atoka formation, Chisos violated the Operating Agreement by re-establishing production from the HL2 Well from the same formation. As is discussed above, applicable New Mexico rules and regulations[70] expressly authorize the production of both the HL2 Well and the Stetson 2 Well from the Atoka formation. Even JKM's expert acknowledged this fact.[71] As a result, Chisos' production of the HL2 Well from the Atoka formation conformed with the then existing well spacing patterns and there was clearly no violation of the Operating Agreement. It was error for the Trial Court to find to the contrary.

These issues were preserved in the court below through Requested Findings of Fact and Conclusions of Law.

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[69] Plaintiff's Exhibit No. 16.
[70] TRP Finding No. 32.
[71] Tr. 101 -102, Vol. 2.

IV. Trial Court Erred in Finding that Chisos Acted in Bad Faith in Providing JKM 48 Hours Notice of its Operations on the HL2 Well[72] and the Trial Court Therefore Erred in Ordering Chisos to Provide JKM With a Retroactive Election to Participate in Operations for the HL2 Well.[73]

Standard of Review

A trial court conclusion of law is law is reviewed *de novo*. *Gates v. N.M. Taxation and Revenue Dept.*, 2008-NMCA-023, ¶ 18, 143 N.M. 446, 176 P.3d 1178; *State v. Johnson,* 2004-NMCA-058, ¶ 12, 135 N.M. 567, 92 P.3d 13.

Argument

Article VI.A.2 of the Operating Agreement[74] sets out the manner in which a party who wishes to drill, re-work, deepen or plug back a well on the lands covered by the Operating Agreement can propose and proceed forward with such an operation even if the other party to the Operating Agreement elects not to participate. If one party proposes such an operation (the "consenting party") and the other party does not elect to participate (the "non-consenting party"), the consenting party can proceed forward with the operation (the "non-consent operation") at its sole cost, risks and expense. In consideration for assuming all the cost, risk and expense of the non-consent operation, the consenting party is entitled to recover a 300% non-consent penalty from the revenues attributable to such operation that would otherwise be payable to the non-consenting party.

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[72] TRP 329, Finding Nos. 31, 32, 33 and 34.
[73] TRP 329, Finding Nos. 7, 8 and 9.
[74] Plaintiff's Exhibit No. 16.

The mechanics associated with this process under the Operating Agreement are that the party who wishes to conduct the operation is required to give notice of such operation to the other party to the Operating Agreement and the other party then normally has 30 days to elect to participate or not participate (with a non-response being deemed to be an election not to participate). However, if a drilling rig is on location when the operation is proposed by a party, the time in which the other party has to elect to participate or not participate is shortened to 48 hours.[75] This is because of the expense of having a drilling rig on standby while the proposing party is waiting for a response. In this case, it is undisputed that at the time Chisos provided notice to JKM of its proposed operation to re-work the HL2 Well on May 11, 2007,[76] there was a rig on location.[77] Although the rig on location was a workover rig and not a drilling rig,[78] the rationale for limiting the time to respond to 48 hours is exactly the same[79] and JKM was required to respond to the notice within 48 hours or it was deemed to be non-consent in the operation subject to the non-consent penalty in the Operating Agreement. It is undisputed that JKM did not respond within the 48 hours required by the Operating

[75] Plaintiff's Exhibit No. 16 at VI.A.2(j).
[76] Plaintiff's Exhibit No. 22.
[77] Tr. 79-80, Vol. 1.
[78] Tr. 132, Vol. 1.
[79] Tr. 79-80, Vol. 1

Agreement. It is further undisputed that JKM never responded within 30 days or even a year's time after receiving the notice.[80]

For some inexplicable reason, the Trial Court found that Chisos acted in bad faith in providing JKM 48 hours notice of its proposed operation to re-work the HL2 Well. The Operating Agreement expressly provides the procedures for proposing an operation such as the one proposed by Chisos. The Operating Agreement expressly provides for only 48 hours notice if a rig is on location. One cannot be in bad faith by following the express terms of the governing contract. Additionally, even if it were assumed, for arguments sake that JKM should have had 30 days notice (while the workover rig was sitting on location accruing standby charges), JKM chose not to respond in 30 days or ever. JKM has waived any right to participate in the operation to re-complete the HL2 Well by sitting idly by while Chisos assumed all the cost, risk and expense of performing the operation and JKM was able to observe the results of the operation for over a year. In New Mexico, a party who is entitled to enforce a right waives that right if he neglects to exercise his right for such a period of time that the other party may infer that such right has been waived or abandoned. *Magnolia Mountain Limited Partnership v. Ski Rio Partners, Ltd.*, 2006-NMCA-027, ¶ 29, 139 N.M. 288, 131 P.3d 675. The Trial Judge's ruling that JKM should be permitted to sit on the sidelines for a year without being required to make an election and then be able to retroactively review

[80] Tr. 81-82, Vol. 1; Tr. 43-44, Vol. 2.

the results of the operations, receive an accounting of costs and revenues and then make a decision with the benefit of 20/20 hindsight, makes no sense. It is inequitable and violates the spirit, intent and express provisions of the Operating Agreement.

This issue was preserved in the court below through Requested Findings of Fact and Conclusions of Law.

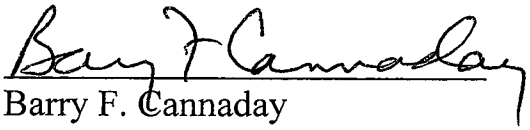
CONCLUSION

For the reasons set forth above, Chisos respectfully requests that this Court reverse and render the Trial Court's Judgment and enter a judgment in Chisos' favor finding that, as a matter of law (or in the alternative, by substantial evidence), it was established in the Court below that the Conveyance only assigned Chisos' rights in the producing wellbore of the Stetson 2 Well to JKM and that accordingly, the Trial Court erred in ordering Chisos to provide JKM an accounting of costs and revenues for the HL2 Well and provide JKM a retroactive right to participate in the HL2 Well. In the alternative, Chisos respectfully requests that this Court reverse and render the Trial Court's Judgment and enter a judgment in Chisos' favor rescinding the Conveyance as a result of failure of mutual assent of the parties thereto. Chisos respectfully also requests that this Court find that the Trial Court erred, as a matter of law, by finding that Chisos violated the Operating Agreement and New Mexico rules and regulations by not providing JKM notice of its intent to produce the HL2 Well from the Atoka formation and by finding that

Chisos' notice to JKM with respect to the proposed operations for the HL2 Well was in bad faith. Chisos additionally requests that it be awarded its costs both in the trial court and in pursuing this appeal.

Respectfully submitted,

SONNENSCHEIN NATH & ROSENTHAL LLP

By: 

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CERTIFICATE OF SERVICE

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