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

REPLY 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 3,931 words, excluding the parts of the brief contemplated by Rule 12-213(F)(1) NMRA.

I. FACTS RELEVANT TO THE ISSUES PRESENTED FOR REVIEW

In its Answer Brief,[1] JKM[2] attempts to obfuscate the issues in the case by repeatedly citing facts that are misleading or unsupported by the record. The most glaring examples include its allegation, related to the evidence of the parties' intent, that the interest being conveyed was generally referred to as the "Stetson #1 property".[3] Although never used in either of the exhibits cited by JKM to support that fact, JKM's use of the word "property" creates the illusion that the parties contemplated more than just the sale of the Stetson #1 wellbore. A cursory review of the record reveals that was never the case.[4]

JKM further alleges that Chisos misrepresented that it could convey 100% of the operating rights in the Stetson #1 Well, and infers that Chisos made the same misrepresentation to this Court in its Brief in Chief.[5] As it is clearly reflected in its Brief in Chief, at the time of the conveyance, Chisos was entitled to receive 100% of the production from the Stetson #1 Well based on Pure's decision to go "non-consent". Chisos' expert recognized that fact, and credited JKM with the right to receive 100% of the production from the Stetson #1 Well.[6] If anything, these facts show that Chisos intended the Conveyance to be of the wellbore only because the

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[1] References to the Appellee's Answer Brief will be cited as AB followed by the page number.
[2] Capitalized terms not otherwise defined in Appellant's Reply Brief shall have the meanings ascribed thereto in Appellant's Brief in Chief.
[3] AB at 15.
[4] Exhibit 1; Exhibit 3.
[5] *Id.*
[6] Exhibit 38.

rights to 100% of the production from the Stetson #1 Well wellbore is the only thing Chisos could legitimately claim 100% of.

Finally, JKM's citation to trial testimony is equally misleading. For example, JKM refers to the record to argue that the explicit use of the term "State Oil and Gas Lease" refers to a real property interest.[7] In fact, the testimony of JKM's expert is not nearly so clear.[8]

Looking at the evidence submitted at trial, unobstructed by smoke screens and diversions, it is clear that the Trial Court erred in finding that the Conveyance was ambiguous, or alternatively, if it was ambiguous, that Chisos knew or had reason to know that JKM placed another meaning on the Conveyance.

II. THE CONVEYANCE WAS UNAMBIGUOUS AND ONLY CONVEYED TO JKM CHISOS' RIGHTS TO THE PRODUCING WELLBORE OF THE STETSON #1 WELL.

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 this Appellate Court. Instead this question of law is to be decided on this appeal based upon a *de novo*

[7] AB at pg. 9.

[8] TR. 78-79, Vol. 2. JKM conveniently chose to leave out the portion of its expert's testimony that did not neatly fit its argument. In fact, Mr. Brewer said that reference to 100% of the operating rights in a state oil and gas lease refers to a property interest. The distinction is key, 100% of the operating rights refers to a property interest, as Mr. Brewer indicates. The "state oil and gas lease" is merely an for identification purposes, like it was used to identify that the Stetson #1 Well was located on a State of New Mexico lease.

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).

Argument

A. The Definition of "Well" as Drafted by Chisos was Unambiguous.

JKM argues that the inclusion of the words "State Oil and Gas Lease" in front of the name of the Stetson #1 Well creates an ambiguity as to what the parties intended to assign.[9] JKM makes this argument despite the fact that the words "State Oil and Gas Lease" do not specifically identify either of the two leases which cover the W/2 of Section 2, and despite the fact that the revisions made by Chisos can only be rationally explained as an intent to identify a single wellbore.

To support its claim that "State Oil and Gas Lease" makes the parties' intent unclear, JKM cites testimony stating that the explicit use of "State Oil and Gas Lease" refers to a real property interest.[10] In reality, the testimony of JKM's expert was that reference to "a hundred percent of the operating rights in state oil and gas lease" referred to a real property interest.[11] The reference to 100% of the operating rights in a lease does refer to an property interest. The qualifier "state" is just that, a qualifier that aides in the identification of the real property interest being described. The cited testimony does nothing more than prove Chisos' point, that

[9] AB at pg. 8.
[10] AB at pg. 9.
[11] TR. 78-79, Vol. 2.

the phrase "State Oil and Gas Lease" is merely a descriptive term that aides in the identification of the Stetson #1 Well.

Additionally, the language "State Oil and Gas Lease" appeared in the JKM Form of Conveyance.[12] Comparing the drafts of the Conveyance, it is evident the language "State Oil and Gas Lease" was simply carried over.[13] The changes Chisos made to the JKM Form of Conveyance, specifically describing the Stetson #1 Well by reference to its exact location and its unique API number, made it clear that Chisos' intent was to convey only the wellbore of the Stetson #1 Well.[14]

B. The Granting Clause Unambiguously Conveyed Only the Wellbore of the Stetson #1 Well.

JKM argues that the use of the term "lease" after the "INSOFAR" language in the granting clause of the Conveyance is ambiguous. In doing so JKM confuses the language of the grant clause and attempts to include language in the grant that its own expert conceded actually ***limited*** what was granted to JKM.[15]

As the evidence at trial showed, the "INSOFAR AND ONLY INSOFAR" was a limiting clause, and everything after that language limited what was granted to JKM.[16] All of the language after the limiting language could not have expanded what was assigned, thus, what is actually conveyed to JKM in subparagraph (a) of the granting clause is "100% of the operating rights and 75% of the net revenue

[12] AB at pg. 9.
[13] Exhibit 7.
[14] Each oil and gas well in New Mexico (and the rest of the United States) is assigned a unique American Petroleum Institute identification number.
[15] Tr 99, Vol. 2.
[16] *Id.*

interest in and to the Well and spaced unit." JKM's expert could not dispute this fact.[17]

The explanation for the words after the "INSOFAR" language is that it further defines the acreage assigned to the spacing unit associated with the "Well," which is in fact the W/2 of Section 2. The assignment of the spacing unit, which JKM's expert admitted has nothing to do with leasehold rights,[18] was necessary to produce the Stetson #1 Well.

C. The Remainder of the Conveyance Unambiguously Evidenced the Intent to Convey Only the Wellbore of the Stetson #1 Well.

Contrary to JKM's assertions, the entirety of the Conveyance clearly evidences the parties' intent to convey only the Stetson #1 Well. The fact that the granting clause conveys rights in contracts is not, as JKM argues, consistent with an assignment of operating rights in an oil and gas lease.[19] First, because Chisos changed the Conveyance to be a wellbore only assignment, any reference to contracts was limited to the rights in such contracts insofar and only insofar as those contracts related to the Stetson #1 Well. That fact is recognized by Paragraph (b)(iii) of the granting clause, which limited the contract rights conveyed to those related to "the property described above," namely the "Well".[20] Second, a party must own the contract rights related to a particular well in order to

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[17] *Id.*
[18] Tr. 96-98, Vol. 2.
[19] AB at pg. 12.
[20] Exhibit 7.

effectively produce it. In this situation, Chisos' rights in the JOA, insofar as it covered the Stetson #1 Well, were assigned to provide for the joint operation of the Stetson #1 Well. Because contract rights may be unique to a particular well, it is logical that contracts rights would be attendant to an assignment of a wellbore, and would, therefore, not provide any evidence of an intent to assign operating rights in an oil and gas lease.

Similarly, JKM argues that Paragraph (c) of the Conveyance creates an ambiguity because of its inconsistent use of the words "property" and "interests".[21] However, it is clear that the use of those words were purposeful and showed an intent to convey only an interest in the Stetson #1 Well. Looking at the changes Chisos made to the JKM Form of Conveyance, it is clear that in nearly every instance that the term "interests" or "properties" was used, Chisos changed the plural form of the word to the singular.[22] That simple change clearly shows the intent to alter the JKM Form of Conveyance to an instrument that did not convey multiple wells and interests, but only a single well, the Stetson #1 Well. Additionally, the use of the word "property" or "interest" was almost always coupled with the phrase "described above".[23] The property or interest described above was the narrowly defined Stetson #1 Well.

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[21] AB at pg. 12.
[22] Exhibit 7.
[23] Exhibit 7.

D. The Changes Made by Chisos, the Parties' Testimony and Their Conduct Make Clear the Intention to Convey Only the Wellbore of the Stetson #1 Well.

JKM argues that changes to the JKM Form of Conveyance do not clear up the ambiguities contained in the agreement. It contends, for example that it made no sense for Chisos to move the description of the Well out of the actual granting clause if that is all that Chisos intended to convey.[24] JKM conveniently ignores that Chisos employed an age old legal drafting device, incorporating the description of the property being conveyed into the granting clause using a defined term. Specifically, the granting clause used the defined term "Well," which is narrowly defined as the Stetson #1 Well. Chisos narrowly defined the term "Well" by reference to the API Number and its exact location. That is more indicative of the parties intent rather than the location of the defined term within the instrument.

With respect to the parties' conduct, JKM claims that in negotiations the parties referred to the well as the "Stetson #1 property".[25] There is absolutely no support in the record for that contention; it is clear that JKM has taken liberty with the language in the record to create non-existent support for its arguments. What is more accurate is that during negotiations between the parties, they referred almost exclusively to the property being conveyed as the "Stetson #1" or the "Stetson #1--Eddy County, New Mexico".[26] The fact that sometimes in the field, referring to a

[24] AB at pg. 14.
[25] AB at pg. 15.
[26] Exhibits 1, 3 and 5.

well also refers to the leases associated with the Well is totally negated in this instance, because Chisos took steps to define the term "Well" as the Stetson #1 Well, using its API Number and its exact location within the W/2 of Section 2, and excluding any reference to the leases that covered the W/2 of Section 2.

Despite JKM's contrary assertions, the evidence shows that the changes, as well as the parties' conduct, was wholly consistent with Chisos' clear intent to convey only the wellbore of the Stetson #1 Well.

III. IF THE CONVEYANCE WAS AMBIGUOUS THE TRIAL COURT ERRED IN INTERPRETING THE CONVEYANCE UNDER NEW MEXICO LAW.

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

A. The Trial Court's Finding that Chisos Knew or Should Have Known That JKM's Intent is Not Supported by Substantial Evidence.

In its answer, JKM sets forth the evidence relied upon by the Trial Court to conclude that Chisos knew or should have known that JKM intended to acquire all of Chisos' rights by the Conveyance. Looking at each such fact, it is clear that there is no substantial evidence sufficient to support the Trial Court's judgment, and it should therefore be overturned.

JKM alleges that the form of conveyance submitted by JKM was one of operating rights, which purportedly put Chisos on notice of JKM's intent.[27] However, it is undisputed that Chisos rejected any idea of conveying leasehold rights to JKM, made its intention to reject such an idea clear to JKM and JKM accepted such rejection. Specifically, it is undisputed that Chisos redrafted the JKM Form of Conveyance with the intent of changing it 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.[28] It is also undisputed that Chisos told JKM that the JKM Form of Conveyance, which conveyed all of Chisos' operating rights in the W/2 of Section 2, was unacceptable.[29] It is further undisputed that after telling JKM that the JKM Form of Conveyance was unacceptable, Chisos made substantial changes to the JKM Form of Conveyance,[30] and JKM's own expert admitted that the changes made by Chisos are consistent with the type of changes required to revise an operating rights conveyance to be a wellbore conveyance.[31]

Further, when Chisos sent the revised conveyance to JKM, Chisos expressly communicated its intent to JKM that the revised conveyance was intended to be limited to the wellbore of the Stetson #1 Well. The cover letter from Craddock to

[27] AB at 22.
[28] Tr. 57-59, Vol. 1.
[29] Tr. 36, Vol. 2.
[30] Plaintiff's Exhibit No. 7.
[31] Tr. 90, 92-95, Vol. 2.

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.[32]

Finally, the Change of Operator form for the Stetson #1 Well reinforces that Chisos had no reason to know of JKM's intent. The Change of Operator form is consistent with Chisos' belief that it sold only the wellbore of the Stetson #1 Well and retained the operating rights in the remainder of the W/2 of Section 2. When JKM forwarded the Change of Operator form for only the Stetson #1 Well, but not the HL2 Well, Chisos could not have known that it was JKM's intent to receive the operating rights in the W/2 of Section 2.

B. <u>The Trial Court's Finding That JKM Did Not Know or Should Not Have Known That Chisos Intended to Assign Only the Wellbore Rights is Not Supported by Substantial Evidence</u>.

JKM additionally sets forth the evidence relied upon by the Trial Court to conclude that JKM did not know or should not have known that Chisos intended to convey only the Stetson #1 Well.[33] Looking at each of those cited facts, it is clear that there is not substantial evidence sufficient to support the Trial Court's judgment, and it should therefore be overturned.

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[32] Plaintiff's Exhibit No. 5

[33] AB at pg. 23.

The Trial Court found that Chisos never informed JKM of its intent to convey only the wellbore.[34] However, it undisputed that Chisos informed JKM that the form of conveyance was unacceptable and then made changes consistent with a wellbore assignment.[35] JKM claims that Mr. Matthews' previous use of a wellbore assignment put him on notice of the typical provisions of a such assignments.[36] Armed with that knowledge, then, the changes Chisos made to the form of conveyance, consistent with a wellbore assignment, would have or should have put JKM on notice of Chisos' intent.

Finally, JKM argues that it does not make economic sense to agree to pay more money for less rights.[37] However, it makes less economic sense for Chisos to sell the rights to two wells, the Stetson #1 Well and the HL2 Well for what amounted to the salvage value of just one well.[38]

IV. THE TRIAL COURT'S RULINGS THAT CHISOS VIOLATED PROVISIONS OF THE JOA OR ACTED IN BAD FAITH ARE ERROR

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.

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[34] *Id.*
[35] TR. 90, 92-95, Vol. 2.
[36] AB at pg. 24.
[37] *Id.*
[38] Tr. 30-31, Vol. 2.

Argument

JKM continues to purposely mislead and distract the Court from the issues that are relevant in this case. JKM claims that Chisos twice tried to recomplete the HL2 Well without any notice to JKM, the first such time being in October 2006.[39] The operation conducted in October 2006 was the spark that ignited this litigation. As the evidence at trial showed, Chisos believed that JKM owned no rights in the HL2 Well in October of 2006, a belief that it maintains to this day. To infer that Chisos, who was not yet aware of JKM's claim, was somehow required to notify JKM prior to conducting the initial reworking operation is disingenuous, and merely an attempt to paint Chisos in a poor light, unjustified by the facts of this case. The only time Chisos was ever arguably required by the JOA to provide notice, it undisputedly did.[40] The May 11, 2007 letter sent by Chisos to JKM gave JKM notice of the proposed operation. To claim that JKM twice tried to recomplete the HL2 well without giving JKM notice ignores and misrepresents the facts of this case.

A. Chisos Gave Proper Notice of the Proposed Operation Pursuant to the JOA.

JKM repeatedly claims that Chisos planned to rework the HL2 well as far back as October 2006, which proves that Chisos did not give proper notice of its intent to rework the HL2 Well. JKM argues that it should have had 30 days to

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[39] AB at pg. 31, Para. 7.
[40] Exhibit 22.

respond to the notice instead of 48 hours. That argument ignores the express language of the JOA. JKM's argument places undue weight on when Chisos allegedly planned to conduct the reworking operation, a fact that is wholly irrelevant under the JOA,[41] and, therefore, equally irrelevant in this case and insufficient to support JKM's claim that Chisos' actions were improper under the JOA.

The JOA required Chisos to give JKM notice of the proposed operation, it does not prescribe a time period under which Chisos was required to provide the notice.[42] The notice periods in the JOA set forth the amount of time afforded to a non-operator to respond before it is deemed to have declined to participate. Receipt by the operator of the non-operator's election, or the expiration of a prescribed time period are not pre-requisites to the performance of an operation under the JOA. An operator can proceed with an operation absent a non-operator's response to a subsequent operations notice. The operator's obligation is to allow the non-operator to participate in the benefits of an operation if the non-operator affirmatively responds within the relevant time period. As a practical matter, an operator might wait until it receives the non-operator's response before proceeding to ensure it does not have to bear the risk and expense of an operation on its own,

[41] A reworking rig was on location when the May 11, 2007 letter was sent to JKM. The language of the JOA only afforded JKM 48 hours to make its election.
[42] Exhibit 16 at pg. 4.

but no provision in the JOA requires it to do so. All that is required of the operator under the JOA is that notice be provided, and in this case, it was.

The undisputed facts show that Chisos provided JKM notice of its proposed reworking operations on May 11, 2009, which such notice complied with express provisions of the JOA.[43] When the notice was received by JKM, a workover rig was on location at the HL2 Well.[44] Pursuant to the JOA, when a rig is on location, the non-operators have only 48 hours to elect to participate in the risk and expense of the operation.[45] JKM did not respond in 48 hours, or ever.[46] The notice was provided exactly as prescribed in the JOA.

The fact that Chisos planned to conduct the workover does not change the language of the JOA, which was strictly adhered to. An operator is not required to give non-operators notice of every stage of its thought process with respect to a proposed operation. It is only required to give the notices required under the JOA, which Chisos did in this case. The Trial Court's decision that Chisos did not properly notify JKM was clear error, and must be reversed.

B. Chisos Did Not Act in Bad Faith in Proposing the Reworking Operations on the HL2 Well.

Chisos could not have, as a matter of law, acted in bad faith, and it was error for the Trial Court to find so. A party cannot be found to have acted in bad faith

[43] Exhibit 22.
[44] Tr. 79-80, Vol. 1.
[45] Exhibit 16 at VI.A.2.(j).
[46] Tr. 81-82, Vol. 1; Tr. 43-44, Vol. 2.

when the contract specifically allowed the conduct that the party engaged in. *Continental Potash, Inc. v. Freeport-McMoran, Inc.*, 115 N.M. 690, 707, 858 P.2d 66, 83 (N.M. 1993)(holding that it would be incongruous to hold that the defendants acted in bad faith in acting in accordance with an express contractual provision). The JOA requires that any party desiring to rework a well at the joint expense of the parties, shall give notice to the other party. It is undisputed that Chisos provided notice of the operation on May 11, 2009.[47] The JOA places no other burden on the operator with respect to such notices, except to afford the non-operator the opportunity to participate in the operation if the non-operator timely responds. Chisos performed in a manner completely consistent with the terms of the JOA, and it is undisputed that JKM did not timely respond.[48] As such, Chisos cannot have acted in bad faith.

Additionally, the fact that Chisos planned to rework the HL2 well as far back as October 2006 is also not indicative that it acted in bad faith performance. Under the JOA, if operations are not commenced within 90 days from the date the notice period expires, the operator must resubmit that proposal to the other party.[49] Thus, at the time Chisos actually conducted the reworking operation, it is not accurate to state that it had planned that reworking operation since 2006, because the original proposal lapsed under the JOA.

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[47] Exhibit 22.
[48] Tr. 81-82, Vol. 1; Tr. 43-44, Vol. 2.
[49] Exhibit 16 at VI.A.1.

Finally, JKM's argument defies common sense. The flawed logic of JKM's argument that Chisos acted in bad faith by only providing 48 hours notice of the subsequent operation is evidenced by the very existence of a 48 hour notice exception in the JOA. JKM's basic argument is that because Chisos knew it would conduct the operation for at least two months prior to actually undertaking it, the fact that it did give JKM less notice was in bad faith. If, in order to avoid JKM's claim that it acted in bad faith, Chisos was required under the JOA to give JKM notice of its plans when they were devised, there would be no need for a 48 hour notice provision in the first place. The plan to conduct subsequent operations would be revealed far in advance of the rig being delivered. However, 48 hour notice provisions do exist, so it is clearly contemplated that an operator may plan to undertake an operation, be surprised by the sudden availability of a rig, and be forced to require non-operators to respond to its notice in a much shorter time than they normally would. That scenario is clearly contemplated by the JOA and therefore Chisos cannot be found to have acted in bad faith when it found itself in that position in real life. All the JOA requires is that notice be provided, thus, JKM's insistence that Chisos acted in bad faith because it did just that is unfounded.

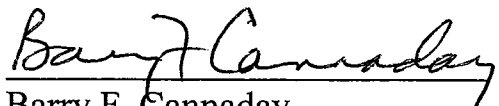
CONCLUSION

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 Trial Court that the Conveyance only assigned Chisos' rights in the producing wellbore of the Stetson #1 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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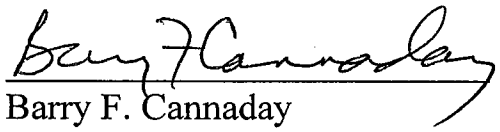
By: 
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