NEW MEXICO

*By: Derek V. Larson**

I. New Mexico Supreme Court

A. *Edwin Smith LLC v. Synergy Operating, L.L.C.*[1]

This case involves the question of whether a joint tenancy in realty can be terminated and converted into a tenancy in common by a mutual course of conduct between the various owners of property located in San Juan County who demonstrate an intent to hold the property as tenants in common.[2]

1. Background

The history of the 160-acre tract in San Juan County (the "Property") begins in 1931, when Herman Hasselman died, leaving his one-half interest in the Property to his widow, Margaret Hasselman Jones, and his three daughters, Julia Hasselman Keller, May Hasselman Kouns, and Jennie Hasselman Hill.[3]

The widow and three daughters (the "Hasselman Women"), in 1951, conveyed their interest in the Property to May's husband, Earl Kouns, who subsequently deeded his property interest back to the

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1. Edwin Smith LLC v. Synergy Operating, L.L.C., 2012-NMSC-034, 285 P.3d 656.

2. *See generally id.*

3. *Id.* ¶ 3.

Hasselman Women "not in tenancy in common but in joint tenancy."[4] In 1958, the Hasselman Women filed a lawsuit to quiet title to the Property, and the San Juan County Court ultimately entered judgment in their favor, finding them owners in fee simple of the one-half interest in the Property.[5]

Over the next few decades, the Hasselman Women leased the Property for oil and gas exploration and production.[6] Specifically, in 1959, the Hasselman Women, as well as the husbands of Margaret and Jennie, leased the Property to Hugh J. Mitchell to develop oil and gas resources.[7] After May died in 1962, the remaining Hasselman Women; Margaret's husband; and May's four children, executed a Power of Attorney appointing Jennie's husband, Henry Hill, "for the purpose of granting and conveying easements, surface leases and mineral leases, on and over the [Property], to the extent of our right, title and interest in and to such real estate . . . ."[8] The Power of Attorney granted Henry Hill "full power and authority to do the acts aforesaid as fully as we ourselves could do such acts."[9]

After Henry Hill died, the same individuals executed a Designation of Agent appointing Jennie as their "agent and attorney in fact for the purpose of receiving, for their account, any and all royalties" that might be owed by the oil, gas, and mineral lessee (Pan American Petroleum Corporation) from the 1959 agreement.[10] The Designation of Agent form stated that "the interest owned by May Hasselman Kouns (deceased) has been vested in her children . . . share and share alike," and that "the interest shared by Jennie Hasselman Hill, and her late husband, Henry H. Hill, is now owned in its entirety by Jennie Hasselman Hill."[11]

In March 1965, Jennie entered into an oil and gas lease with Claude Smith.[12] Then, in June 1965, the Pan American Petroleum Corp. prepared a division order title opinion, which lists ownership interests to determine proper distribution of royalties.[13] The division order listed each of the three surviving Hasselman Women as owning a 1/8th share of the Property, and each of May's four children as owning a 1/32nd share, all of which added to the one-half interest in the Property originally conveyed to the Hasselman Women.[14] The division order title opinion also stated that, by virtue of her appointment as agent, Jennie

4. *Id.*
5. *Id.* ¶ 4.
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.* ¶ 5.
10. *Id.* ¶ 6.
11. *Id.*
12. *Id.* ¶ 7.
13. *Id.*
14. *Id.*

would receive royalties on behalf of May's children and the surviving Hasselman Women.[15]

After Julia died in 1973, and Margaret died in 1974, Jennie executed a warranty deed purporting to convey an undivided one-half interest in the Property to herself and to her daughter, June Hill Walmsley, "as joint tenants," before her own death in 1988.[16] Respondents claimed that before her death in 1995, June Hill Walmsley deeded the Property through her will to a bypass trust bearing her name and administered by her husband, Jerry Walmsley.[17] In 2004, petitioner Synergy Operating, LLC, tracked down and purportedly obtained assignments from approximately fifteen of Julia, Margaret, and May's heirs of all or a portion of the interests Synergy asserted they owned in the Property.[18]

2. Procedural History

After Synergy began demanding royalty payments from Respondents, in January 2006 they initiated a quiet title case seeking a judgment confirming that Jerry Walmsley, on behalf of his wife's trust, owned the entire one-half interest in the Property that had been conveyed to the four Hasselman Women as joint tenants in 1951.[19] Petitioners counterclaimed and cross-claimed to quiet title in their favor and for an accounting of the proceeds of the wells on the Property.[20]

Both Respondents and Petitioners filed cross-motions for summary judgment, and after hearing testimony in November 2007, the district court granted Respondents' motion.[21] The district court confirmed that a valid joint tenancy was created in 1951 when May's husband reconveyed the Property to the Hasselman Women as joint tenants.[22] The district court also agreed that the Hasselman Women had not "legally convey[ed] any interest in the property to other individuals," meaning that the joint tenancy remained intact.[23] Petitioners appealed, arguing that a joint tenancy was not created in 1951, and that even if a joint tenancy had been created, the Hasselman Women subsequently terminated the joint tenancy through their conduct.[24]

The court of appeals affirmed the district court's determination of title to the Property and further specified that New Mexico recognizes two methods of terminating a joint tenancy: (1) a conveyance or other act that destroys one or more of the "essential four unities of time,

15. *Id.*
16. *Id.* ¶ 8.
17. *Id.*
18. *Id.*
19. *Id.* ¶ 9.
20. *Id.*
21. *Id.* ¶ 10.
22. *Id.*
23. *Id.*
24. *Id.* ¶ 11.

title, interest or possession," and (2) a "severance by implication," which the court of appeals defined as "an express agreement between all of the joint tenants . . . [that] was inconsistent with one of the unities or with the right of survivorship."[25] In affirming the district court, the court of appeals determined that "[n]one of the alleged acts [of the Hasselman Women] destroyed one of the four unities that is necessary under either mode of severance recognized in New Mexico."[26]

The only question before the New Mexico Supreme Court was whether the lower courts erred in granting summary judgment to Respondents with respect to the termination of the joint tenancy, as Petitioners no longer challenged that a joint tenancy was created in 1951.[27]

3. Discussion

a. *Definition and History of Joint Tenancies*

Adopting a de novo standard of review, the New Mexico Supreme Court began its analysis by briefly discussing the origin and features of a joint tenancy. Referencing Anne L. Spitzer's *Joint Tenancy with Right of Survivorship: A Legacy from Thirteenth Century England*, the Supreme Court defined a joint tenancy as form of concurrent ownership between two or more people with its origins in the thirteenth century.[28] The Court also noted that joint tenancies differ from other forms of concurrent ownership, primarily due to the right of survivorship.[29] Specifically, upon the death of a tenant in common, that tenant's share passes to his or her heirs rather than to the cotenants.[30] However, in a joint tenancy, "upon the death of one joint tenant, his interest does not pass to his heirs or representatives, but the entire tenancy remains to the surviving cotenants, and the last surviving tenant takes the whole."[31]

The Court also noted that "four unities" of interest, title, time and possession are required for a joint tenancy.[32] "[U]nity of interest [means] that the joint tenants' shares are all equal and the duration and quality (legal or equitable) of their estates are the same."[33] "[U]nity of title means that . . . joint tenants had to acquire their interest by the same conveyancing instrument."[34] Unity of time "involves a necessity that the interests of all the joint tenants vest at the same time," a characteristic that almost always will be present when joint

25. *Id.* (citing *Edwin Smith*, 2011-NMCA-003, ¶¶ 28, 31).
26. *Id.* (citing *Edwin Smith*, 2011-NMCA-003, ¶ 38).
27. *See id.* ¶ 1.
28. *Id.* ¶ 13 (citing Anne L. Spitzer, *Joint Tenancy with Right of Survivorship: A Legacy from Thirteenth Century England*, 16 TEX. TECH. L. REV. 629 (1985)).
29. *Id.* ¶ 14.
30. *Id.* ¶ 15 (citing U.S. v. Craft, 535 U.S. 274, 280 (2002)).
31. *Id.* (citing Hernandez v. Becker, 54 F.2d 542, 547 (10th Cir. 1931)).
32. *Id.* ¶ 16.
33. *Id.* ¶ 1 (citing Swink v. Fingado, 850 P.2d 978, 989 n.15 (1993)).
34. *Id.* ¶ 15 (citing Zanelli v. McGrath, 166 Cal. App. 4th 615, 629 n.10 (2008)).

tenants acquire their interest from the same conveyance.[35] Finally, unity of possession refers to the feature inherent in both joint tenancies and tenancies in common where "each . . . tenant is in possession of the whole estate, and . . . each is also entitled to an equal undivided share of the whole."[36]

Despite the prevalence of joint tenancies throughout common law, the Supreme Court noted that joint tenancies have fallen out of favor over time.[37] The Supreme Court also acknowledged that New Mexico is consistent with common law definitions and principles regarding joint tenancies, citing section 47-1-36 of the New Mexico Statutes Annotated 1978:

> A joint tenancy in real property is one owned by two or more persons, each owning the whole and an equal undivided share, by a title created by a single devise or conveyance, when expressly declared in the will or conveyance to be a joint tenancy, or by conveyance from a sole owner to himself and others, or from tenants in common to themselves, or to themselves and others, or from husband and wife when holding as community property or otherwise to themselves or to themselves and others, when expressly declared in the conveyance to be a joint tenancy, or when granted or devised to executors or trustees.[38]

As in other states, New Mexico recognizes but disfavors joint tenancies.[39] However, any inclinations against joint tenancies are in no way novel, as territorial laws clearly favored tenancies in common.[40] The Supreme Court cited section 47-1-15 of the New Mexico Statutes Annotated 1978 for this proposition: "All interest in any real estate, either granted or bequeathed to two or more persons other than executors or trustees, shall be held in common, unless it be clearly expressed in said grant or bequest that it shall be held by both parties."[41] Despite the fact that joint tenancies are disfavored under New Mexico law, New Mexico's statutes make it clear that if a joint tenancy is validly created, it is entitled to legal recognition—unless and until it is terminated.[42]

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35. *Id.* (citing 2 HERBERT THORNDIKE TIFFANY, THE LAW OF REAL PROPERTY § 418, at 197 (3d ed. 1939)).

36. *Id.* (citing *Swink*, 850 P.2d at 989 n.15).

37. *Id.* ¶ 18.

38. *Id.* ¶ 19 (citing N.M. STAT. ANN. § 47-1-36 (1971)).

39. *Id.* ¶ 15 (citing Brown v. Jackson, 4 P.2d 1081, 1081–82 (1931) ("American law has been in opposition to joint-tenancy and has shown more favor to tenancies in common.") (internal citations omitted).

40. *Id.* ¶ 20.

41. *Id.* (citing § 47-1-15 (1851–52)).

42. *Id.* ¶ 21; *see also* § 47-1-35 (1947).

b. Termination of a Joint Tenancy

While the question at issue on appeal was resolved solely based on the question of whether the joint tenancy created in the Hasselman Women was terminated, New Mexico statutes are silent regarding termination of a joint tenancy.[43] With such a limited framework, the Supreme Court looked to New Mexico's foremost decision regarding joint tenancy termination, *Romero v. Melendez*.[44] Though not entirely analogous because the property at issue in *Romero* was personal property rather than real property, and because *Romero* does not explain which acts destroy one or more of the units of a joint tenancy, nor what type of conduct or course of dealing is sufficient to evidence the joint tenants' intent to treat their interest as a tenancy in common, *Romero* is instructive because it references two decisions from the Kansas Supreme Court, including *Carson v. Ellis*, to identify three ways that a joint tenancy may be terminated: (1) by destruction of one or more of the four unities, (2) by mutual agreement, or (3) by certain conduct or course of dealing.[45]

While it is widely accepted that a conveyance of property to a third party will terminate a joint tenancy, termination of a joint tenancy does not, in every instance, require destruction of one or more of the four unities; termination can also be effected by an agreement or course of conduct between the joint tenants, as acknowledged by *Romero*.[46] The New Mexico Supreme Court noted that no American case law exists that establishes that course of conduct or agreement may terminate a joint tenancy; termination by course of conduct has actually been recognized in treatises and judicial decisions for well over a century.[47]

Despite the lack of American case law acknowledging termination through agreement or conduct, the Court recognized that the "progenitor of the principle," cited by *Romero*, is *Williams v. Hensman*.[48] *Williams* concluded that:

> A joint-tenancy may be severed in three ways: in the first place, an act of any one of the persons interested operating upon his own share may create a severance as to that share. . . . Secondly, a joint-tenancy may be severed by mutual agreement. And, in the third place, there may be a severance by any course of dealing sufficient to intimate that the interests of all were mutually treated as constituting a tenancy in common.[49]

43. *Id.* ¶ 22.
44. *Id.* (citing Romero v. Melendez, 83 N.M. 776, 498 P.2d 305 (1972)).
45. *Id.* (citing *Romero*, 498 P.2d at 305–06, *and* Carson v. Ellis, 348 P.2d 807 (1960)).
46. *Id.* ¶¶ 24–25.
47. *Id.*
48. *Id.* ¶ 26 (citing Williams v. Hensman, 1 Johns. & H. 546, 70 Eng. Rep. 862 (1861)).
49. *Id.* (citing *Williams*, 1 Johns. & H. at 557, 70 Eng. Rep. at 867).

Relying on the common law espoused in *Williams*, the Supreme Court found that the court of appeals, in its ruling, "conflated" the two methods of termination by agreement or conduct into a category it defined as "severance by implication."[50] The Supreme Court stated that, even though both mutual agreement and course of conduct are "by implication" in that they do not represent an actual conveyance of property, the court of appeals went further, holding that "[w]hether a severance by implication has occurred turns on two questions: (1) whether there was an express agreement between all of the joint tenants; and (2) whether that agreement was inconsistent with one of the unities or with the right of survivorship."[51] This test, according to the Supreme Court, misstates the common law in two ways.[52]

First, the test ignores mutual conduct as a method of termination and limits an effective termination to express agreements. Second, the test restricts termination even more by requiring that the express agreement be "inconsistent with one of the unities or with the right of survivorship."[53] While New Mexico's statutes at section 47-1-36 make clear that the four unities of interest, title, time, and possession must be present for a joint tenancy to be created, there is no corresponding statutory provision that limits termination only to acts that destroy any of the four unities.[54] As the Kansas case of *Carson* held, in language adopted by *Romero*, destruction of one or more of the four unities is merely one method of terminating a joint tenancy and is in no way an exclusive method of termination.[55]

Noting that other states, such as Minnesota, have limited methods of terminating a joint tenancy by statute, the Supreme Court found that New Mexico has not followed such an approach, and the Supreme Court expressly rejected doing so.[56]

> In light of the well-established common law principle that a joint tenancy may be terminated by conduct evidencing the parties' mutual intent to terminate, and mindful of joint tenancy's disfavored status, absent a clear legislative mandate to do so, we will not impose restrictions on terminating a joint tenancy in derogation of the common law.[57]

In conclusion, the Supreme Court held that a joint tenancy may be terminated by the owners' course of conduct and not only by an overt act destroying one of the four unities.[58] Because the Hasselman Women included some of their husbands and heirs in the decision-making

50. *Id.* ¶ 31.
51. *Id.*
52. *See id.*
53. *Id.* ¶ 32.
54. *Id.*
55. *Id.*
56. *Id.* ¶ 33.
57. *Id.*
58. *Id.* ¶ 35.

regarding the Property, as well as in executing legal documents affecting the Property, and because those third parties received many years' worth of royalties from oil and gas development on the Property, summary judgment was inappropriate.[59] The Supreme Court remanded the matter for a determination of whether the Hasselman Women's conduct rose to a level sufficient to show an intent to terminate the joint tenancy.[60]

B. *ConocoPhillips Co. v. Patrick H. Lyons*

The New Mexico Supreme Court limited the holdings in this case to the question of how to calculate royalties payable pursuant to two statutorily promulgated forms of state oil and gas leases for the years 1931 and 1947, and pursuant to the power granted to the Commissioner of Public Lands (the "Commissioner") under section 19-10-1 of the New Mexico Statutes Annotated 1978.[61]

1. Background

ConocoPhillips Co. originates from the Commissioner's 2005 and 2006 audit of ConocoPhillips Co. and Burlington Resources Oil & Gas Co.'s (together, "Lessees") royalty payments to the State Land Office.[62] Following the audit, the Commissioner notified Lessees that they had been underpaying their royalty obligations and issued assessments for the underpayments because, under the Commissioner's interpretation of the statutory lease forms, Lessees could not deduct the costs necessary to prepare the gas for the market when calculating their royalty payments.[63] The Commissioner claimed that the improper cost deductions resulted in ConocoPhillips underpaying royalties by approximately $18.9 million and Burlington underpaying by approximately $5.6 million.[64]

To establish a framework for its analysis, the Supreme Court provided the relevant provisions of the statutory state leases.[65] The 1931 lease royalty clause provides:

> 2. The lessee agrees to pay the lessor the one-eighth of the net proceeds derived from the sale of gas from each well. If casing-head gas produced from said land is sold by the lessee, the lessee shall pay the lessor as royalty one-eighth of the net proceeds of said sale; if casing-head gas produced from said lands is utilized by the lessee otherwise than for carrying on the lessee's operations for producing

59. *Id.*
60. *Id.*
61. ConocoPhillips Co. v. Lyons, 2013-NMSC-009, 299 P.3d 844 (discussing N.M. Stat. Ann. § 19-10-1 (1953)).
62. *Id.* ¶ 1.
63. *Id.* ¶¶ 4–5.
64. *Id.* ¶ 5.
65. *Id.* ¶ 2 (citing relevant statutes).

> oil or gas from said lands, then the lessee shall pay the lessor the market value in the field of the equal one-eighth part of the casinghead gas so utilized at the time of such utilization.[66]

The royalty clause of the 1947 statutory lease provides, in relevant part:

> 2. Subject to free use without royalty, as hereinbefore provided, the lessee shall pay the lessor as royalty one-eighth of the cash value of the gas, including casinghead gas, produced and saved from the leased premises and marketed or utilized, such value to be equal to the greater of the following amounts: (a) the net proceeds derived from the sale of such gas in the field, or (b) five cents ($.05) per thousand cubic feet (m.c.f.) . . . . Provided, however, the cash value for the royalty purposes of carbon dioxide gas and of hydrocarbon gas delivered to a gasoline plant for extraction of liquid hydrocarbons shall be equal to the net proceeds derived from the sale of such gas, including any liquid hydrocarbons recovered therefrom.[67]

Both the 1931 and 1947 leases specify that the payment of royalties should be calculated as a percentage of the "net proceeds" resulting from the sale of gas, in which "net proceeds" constitute "the sum remaining from gross proceeds of sale minus payment of expenses."[68] Based on the plain definition, the Supreme Court concluded that the statutory lease forms contemplate the deduction of certain costs.[69]

2. Procedural History

In response to the Commissioner's audit and assessments, Lessees filed a preemptory complaint in the fifth judicial district court seeking a declaration that the Commissioner's assessment of additional royalty was a "deprivation of due process, an unconstitutional impairment of contract, and breach of contract."[70] The Lessees further complained that the Commissioner had acted beyond his constitutional and statutory powers by issuing the assessments and had "usurped" legislative power by seeking royalty payments based on calculation methods not approved by the Legislature.[71] The Commissioner counterclaimed for breach of contract, breach of the implied covenant of good faith and fair dealing, and breach of the implied covenant to market, and further sought a declaratory judgment, accounting, injunction, and cancellation of the leases.[72] The Lessees sub-

66. *Id.* ¶ 3 (citing 1931 N.M. Laws, ch. 18, § 2).
67. *Id.* (citing 1947 N.M. Laws, ch. 200, § 1).
68. *Id.* (citing Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does the Lease Provide?*, 8 APPALACHIAN J.L. 1, 6 (2008)).
69. *Id.*
70. *Id.* ¶ 5.
71. *Id.*
72. *Id.*

sequently moved for summary judgment, which was granted as discussed below.[73]

The appeal to the Supreme Court was accepted on certification after the district court certified the orders at issue to the court of appeals for interlocutory appeal.[74] The orders at issue included: (1) Lessees' granted motion for summary judgment on the meaning of three provisions in the 1931 and 1947 leases: the "net proceeds" royalty obligation, the "free use" clause, and Lessees' obligation to pay royalty on drip condensate; (2) Lessees' granted motion for summary judgment on the meaning of the maximum price clause in the 1947 lease form; (3) the denial of the Commissioner's motion for reconsideration of the district court's previous dismissal of his claim for breach of the implied covenant to market; and (4) Lessees' granted motion for summary judgment on the deduction of reasonable costs of affiliated transactions in calculating royalty in State oil and gas leases.[75]

3. Discussion

After adopting a de novo standard of review, the Court provided background information regarding the natural gas production process, including the various types of gas produced by oil and gas wells, such as casinghead gas, conventional gas, and coalbed methane gas.[76] With this framework, the Supreme Court discussed each relevant order in turn.[77]

a. The First Order: Summary Judgment on the Meaning of Net Proceeds Royalty Obligation, Free Use Clause, and the Drip Condensate Royalty Obligation

i. Net Proceeds

Borrowing from Texas law, the New Mexico Supreme Court cited *Cartwright v. Cologne Production Co.* for the proposition that the definition of net proceeds "expressly contemplates deductions," and the Supreme Court noted that the parties' disagreement regarding the net proceeds language involved only "what costs may be considered when calculating Lessees' royalty obligations and the point in time at which the value of the gas is fixed for the purpose of calculating the royalty obligation."[78]

73. *Id.*
74. *Id.* ¶ 6.
75. *Id.*
76. *See generally id.* ¶¶ 11–14.
77. *See generally id.*
78. *Id.* ¶ 16 (citing Cartwright v. Cologne Prod. Co., 182 S.W.3d 438, 445 (Tex. App. 2006)).

Royalty clauses in oil and gas leases typically specify that net proceeds are calculated "at the well."[79] "At the well" means that the lessee is entitled to deduct "all costs that are incurred subsequent to production, including those necessary to transport the gas to a downstream market and those costs, such as dehydrating, treating, and processing the gas, that are either necessary to make the gas saleable in that market or that increase the value of the gas."[80]

The Supreme Court noted that New Mexico courts have also endorsed this approach to interpreting a royalty obligation when the language specifies at the well in the case of *Creson v. Amoco Production Co.*; however, the statutory lease forms at issue provide for royalty to be paid on net proceeds "from the sale of such gas in the field" (1947 lease) and "from the sale of gas from each gas well" (1931 lease), begging the question of whether the leases require a different royalty calculation than a lease specifying at the well.[81]

The lower court had relied on circumstances surrounding the enactment of the 1931 and 1947 leases, as well as subsequent lease forms enacted by the Legislature, subsequent regulatory policy, and the course of performance and dealing between Lessees and the Commissioner, in concluding that the net proceeds royalty obligation in the 1931 and 1947 lease forms was unambiguous, and that Lessees may "net (deduct) from their gross sales price any post-production costs they reasonably and necessarily incur in selling the gas . . . whether the gas sold is casinghead gas, conventional gas or coalbed methane gas, and whether the sale occurs at the wellhead, the plant tailgate or farther downstream."[82]

However, on certification, the Commissioner argued that, because the lease forms place the valuation point "in the field," Lessees should not be allowed to deduct any costs incurred between the wellhead and the plant tailgate when calculating their royalty payments.[83] The Commissioner also alleged the district court relied on improper legal authorities in interpreting the net proceeds royalty obligation.[84] The Lessees countered this argument by asserting that "the lease forms require royalty payments to be based simply on the 'net proceeds' from the gas that is sold, regardless of where the sale occurred and regardless of whether it is conventional gas from a gas well or casinghead gas from an oil well."[85]

79. *Id.* ¶ 17 (citing Scott Lansdown, *The Marketable Condition Rule*, 44 S. Tex. L. Rev. 667, 671 (2002–2003)).

80. *Id.*

81. *Id.* ¶ 18 (citing Creson v. Amoco Prod. Co., 2000-NMCA-081, ¶¶ 11–12, 129 N.M. 529, 10 P.3d 853).

82. *Id.* ¶ 20.

83. *Id.* ¶ 21.

84. *Id.*

85. *Id.* ¶ 22.

The Supreme Court ultimately upheld the district court's ruling that the net proceeds royalty obligations are unambiguous, and rejected the Commissioner's argument.[86] The district court had opined that under a net proceeds royalty clause, royalties are to be paid based on the amount actually received by the lessee from the sale of the product less "post" production costs.[87] Any costs incurred after production are "considered post-production costs and are generally deducted from the sale of the product regardless of where the sale takes place."[88] Moreover, the lower court reasoned that requiring the state to pay reasonable compensation to state lessees for the use of their processing facilities indicated that the Legislature was aware of the "reality that was occurring in the field with respect to post-production costs."[89] Therefore, the Supreme Court found that section 19-10-61's requirement that the state pay reasonable compensation to state lessees for the use of their processing facilities supports the district court's determination that post-production costs may be netted from the gross sales price when calculating royalty payments.[90]

The Court next analyzed the Commissioner's argument that the district court relied on improper sources in interpreting the net proceeds royalty obligation, specifically asserting that: (1) the district court could not rely on the parties' course of dealing and course of performance because estoppel is not applicable against the state; (2) the district court could not rely on extrinsic factual evidence because the court was only to consider legal issues in the first phase of the case; and (3) the district court's reliance on factual circumstances to interpret the lease was erroneous in light of its refusal to permit full discovery on how Lessees actually calculated their royalty obligations.[91]

With respect to the Commissioner's first argument, the Supreme Court found that the first order did not address whether Lessees could present an equitable estoppel defense; it only addressed the meaning of the net proceeds royalty obligations.[92] Consequently, because New Mexico law permits courts to consider course of dealing and course of performance evidence when determining whether a contractual term is ambiguous, the Court held that the district court's reliance on course of dealing and course of performance evidence was proper.[93]

Regarding the lower court's reliance on extrinsic factual evidence, the Court again disagreed with the Commissioner in ruling that New

86. *Id.* ¶ 32.
87. *Id.* ¶ 24 (citing Frederick R. Parker, Jr., *Costs Deductible by the Lessee in Accounting to Royalty Owners for Production of Oil or Gas*, 46 LA. L. REV. 895, 897 (1985–1986)).
88. *Id.* (citing Bice v. Petro-Hunt L.L.C., 2009 ND 124, ¶ 19, 768 N.W.2d 496, 502).
89. *Id.* ¶ 26.
90. *Id.* ¶ 29.
91. *Id.* ¶ 30.
92. *Id.*
93. *Id.*

Mexico law permits courts to consider extrinsic evidence when making the legal determination regarding whether a contract term is ambiguous.[94] The Court, however, did not address the Commissioner's third contention, as the discovery order had not been certified for the Court's review.[95]

ii. Free Use

The parties' dispute surrounding the free use clauses centered on the scope of the clause and whether it granted Lessees the free use of plant and field fuel.[96] A free use clause is an express provision that appears in most oil and gas leases and governs the right of a lessee to use products derived from the leased premises in the operation of said lease.[97] The district court found that field fuel and plant fuel are costs that Lessees remit to processing service providers, do not amount to proceeds, and are not subject to royalties even though the fuel was used off the lease.[98]

The Supreme Court affirmed the district court's findings and found that field and plant fuel are costs that Lessees may pay for processing services.[99] The Court crafted a novel explanation that, because they are not sold or retained by Lessees, even though used off the lease, the field and plant fuel are not subject to royalty payments.[100]

The Commissioner argued that the free use clause does not include the use of field or plant fuel but rather restricts Lessees' use of oil and gas without the payment of royalty to the leased premises.[101] In support of his argument, the Commissioner relied on *Roberts Ranch Co. v. Exxon Corp.*, where the Oklahoma court concluded that, because lessees in that case were obligated to bear all costs associated with making gas marketable, a free use clause should not be read as passing the post-production costs on to the lessors.[102] Lessees rejected this argument, asserting a requirement that royalties be paid for the use of field and plant fuel would contradict the free use clause and net proceeds language of the lease forms and "would transform a permissive benefit into an affirmative obligation."[103]

The Supreme Court noted that, when a royalty clause provides that the lessee is privileged to use gas in operating the lease, it is generally

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94. *Id.*
95. *Id.*
96. *Id.* ¶ 33.
97. *Id.* (citing 8 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 644.5, at 573–74.1).
98. *Id.* ¶ 34.
99. *Id.* ¶ 37.
100. *Id.*
101. *Id.* ¶ 34.
102. *Id.* (citing Roberts Ranch Co. v. Exxon Corp., 43 F. Supp. 2d 1252 (W.D. Okla. 1997)).
103. *Id.* ¶ 36.

held that the gas used for these purposes should be excluded in the calculation of the lessor's royalty.[104] However, a lessee's right to use gas in the operations of the leased premises is not without limits and is generally interpreted as being limited to the leased premises unless the clause expressly states otherwise.[105] The Supreme Court also cited *Bice v. Petro-Hunt L.L.C.*, in which the North Dakota Supreme Court examined free use clauses similar to the free use clause contained in the 1931 and 1947 statutory lease forms and concluded that, "because the lessees were using the gas in furtherance of the lease operations, the free use clause did not limit the lessees' free use of the gas to the leased premises."[106]

In the instant case, the free use clauses granted Lessees "any and all rights and privileges necessary, incident to or convenient for the economical operation of said land, for oil and gas, with [the] right for such purposes to the free use of oil, gas casing-head gas, or water *from* said lands . . . ."[107] These rights, according to the Supreme Court's unique interpretation, were granted to Lessee "for the sole and only purpose of exploration, development and production of oil and gas *thereon* and *therefrom* with the right to own all oil and gas so produced and saved therefrom and not reserved as royalty by the lessor . . . ."[108] The Supreme Court stated that this language

> granted Lessees the right to own all oil and gas so produced and saved from the leased premises that was not otherwise reserved as royalty by the lessor and entitled Lessees to the free use of oil and gas produced *from* the leased premises, regardless of where the use occurred, so long as the oil and gas was being used to further the economical operations of said land.[109]

Based on the statutory lease, free-use clause in conjunction with the net proceeds language, the Supreme Court held that Lessees were entitled to the free use of both plant and field fuel so long as it was used in the operation of the state lease.[110]

iii. Drip Condensate

The last dispute stemming from the first order involved language regarding drip condensate, which is "the portion of a gas stream that becomes liquid during the transmission of the gas from [the leased

104. *Id.* ¶ 38.
105. *Id.* (citing Williams & Meyers, *supra* note 97, § 661.4, at 763 (providing "parties are free to authorize the provision of free gas without geographic limitation if their intent is expressed in the lease")).
106. *Id.* ¶ 39 (citing Bice v. Petro-Hunt L.L.C., 2009 ND 124, ¶ 22, 768 N.W.2d 496, 502–03).
107. *Id.* ¶ 40 (emphasis added).
108. *Id.* (emphasis added).
109. *Id.* (emphasis in original).
110. *Id.*

premises] to a processing plant."[111] The district court found that Lessees must pay royalties on their use of drip condensate to the extent that they derive profits from such use.[112]

However, the Commissioner contended that although the district court was correct in finding that the lease provisions require Lessees to pay royalties on drip condensate, it erred in finding that Lessees only had to pay royalties on drip condensate to *the extent they derived profits from such use*.[113] Lessees subsequently claimed that, because they do not receive any proceeds from the use of the drip condensate, they are not obligated to pay royalties for its use.[114]

The Supreme Court held that the language of the leases indicates that payment of royalties on drip condensate, a liquid hydrocarbon, is to be based on net proceeds "derived from the sale of . . . liquid hydrocarbons recovered therefrom" and upheld the district court's finding.[115] The Supreme Court went on to explain its novel conclusion by opining that since the Lessees' use of drip condensate was a cost remitted to processing service providers, the leases do not require royalties to be paid on the drip condensate to the extent that Lessees do not derive proceeds from such use.[116]

b. The Second Order: Summary Judgment on the Meaning of the Maximum Price Provision

In the second certified order, the district court addressed the meaning of the "maximum price" provision in the 1947 lease and found the maximum price provision to be "plain, clear and unambiguous."[117] The lower court also established that the maximum price clause does not require Lessees to pay a royalty based on the "highest gross price in the field or area, without netting (deducting) costs incurred by [Lessees] in selling the gas."[118] The maximum price provision of the 1947 lease provides:

> Notwithstanding the foregoing provisions, the lessor, acting by its commissioner of public lands, may require the payment of royalty for all or any part of the gas produced and saved under this lease and marketed or utilized at a price per m.c.f. equal to the maximum price being paid for gas of like kind and quality and under like conditions in the same field or area or may reduce the royalty value of any such gas (to any amount not less than the net proceeds of sale thereof in the field) if the commissioner of public lands shall determine such action to be necessary to the successful operation of the

111. *Id.* ¶ 42 (citing WILLIAMS & MYERS, *supra* note 97, § 296.1).
112. *Id.*
113. *Id.* ¶ 43.
114. *Id.*
115. *Id.* ¶ 47.
116. *Id.* ¶ 48.
117. *Id.* ¶ 49.
118. *Id.*

> lands for oil or gas purposes or to encouragement of the greatest ultimate recovery of oil or gas or to the promotion of conservation of oil or gas.[119]

The Commissioner interpreted the maximum price clause as providing him with authority to prohibit Lessees from deducting field-related expenses when calculating their royalty payments, but Lessees asserted that the Commissioner was attempting to convert the "net proceeds" royalty obligation to a "gross proceeds" royalty obligation and further confuses the concept of "payment of royalty" and "price."[120]

The Court opined that in oil and gas leases, the price, or market price, is considered to be the price that would be paid by a willing buyer to a willing seller in a free market.[121] Market price is determined by looking to comparable sales, which "are those [sales] that are comparable in time, quality, quantity, and availability of marketing outlets."

The Supreme Court found that under the 1947 maximum price clause, the Commissioner has the authority to require that Lessees deduct certain of their expenses from the maximum price being paid for gas of like kind and quality in the same field or area.[122] However, the Supreme Court affirmed the district court, finding that the maximum price clause of the 1947 statutory lease form grants the Commissioner authority to require royalty payments based on the maximum market price in the field or area if "such action [is] necessary to the successful operation[s] of the lands for oil or gas purposes."[123]

c. The Third Order: Denying Commissioner's Motion for Reconsideration of Dismissal of Commissioner's Breach of the Implied Covenant to Market Claim

In the lower proceedings, the district court granted Lessees' motion for judgment on the pleadings on Commissioner's breach of the implied covenant to market claim before ultimately dismissing the claim.[124] The Commissioner moved for reconsideration on the basis of *Davis v. Devon Energy Corp.*, and his motion was denied.[125] In *Davis*, the Court considered whether certification of a class action was appropriate where a group of royalty owners discovered that the defendant gas producers had breached an implied covenant to market; however, *Davis* expressly declined as unnecessary for purposes of class action

119. *Id.*
120. *Id.* ¶ 52.
121. *Id.* ¶ 53 (citing 3 EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 40.4(d), at 329 (1989)).
122. *Id.* ¶ 53.
123. *Id.* ¶ 54.
124. *Id.* ¶ 56.
125. *Id.* ¶ 55 (citing Davis v. Devon Energy Corp., 2009-NMSC-048, 218 P.3d 75).

certification, to confirm the existence or scope of the marketable condition rule under New Mexico law.[126]

The district court reasoned that to enforce the implied covenant, which required Lessees to bear the costs of placing the gas in a marketable condition, would require the district court to alter the express terms of the statutorily promulgated lease, which it lacked authority to do.[127] As a result, the district court found that because the legislatively defined royalty obligation is based on "net proceeds," Lessees are permitted to net the costs associated with placing the gas into a marketable condition.[128]

The Supreme Court treated Lessees' motion for judgment on the pleadings as a motion for summary judgment because the district court conducted a full review of the record.[129] On appeal, however, the Commissioner claimed that "under New Mexico law, the [s]tate leases *inherently* include a duty to market gas" and maintained that, because Lessees have an implied duty to place the gas in a marketable condition, Lessees are prohibited from deducting costs incurred to place the gas into a marketable condition when calculating their royalty obligations.[130] Lessees asserted that the district court's dismissal of the Commissioner's claim was correct because New Mexico law does not recognize "any variant of . . . the marketable condition rule" and further contended that because the statutory lease provisions expressly and unambiguously allow for the deduction of certain costs, it is improper for courts to imply duties.[131]

In *Davis*, the Supreme Court noted that a covenant implied in fact "requires an analysis of the parties' intentions," as expressed in the agreement, while a covenant implied at law "is merely a judicial determination of the duties the law imposes on the parties" and does not require analysis of the agreement.[132] However, *Davis* did not address that the marketable condition rule is inherent in the implied covenant to market or that the marketable condition rule is implied at law.[133]

In a nod to the four class action cases pending in the first judicial district based on New Mexico's marketable condition rule, implied as a matter of law in private oil and gas lease agreements, the Court explicitly declined to address this question in the instant case, reasoning that the Legislature expressed a policy decision that lessees under these statutory leases are entitled to recover some costs associated

126. *Id.* ¶ 56 (citing *Davis*, 2009-NMSC-048, ¶ 3, 14–15).
127. *Id.* ¶ 57.
128. *Id.*
129. *Id.* ¶ 58.
130. *Id.* ¶ 59 (emphasis in original).
131. *Id.* ¶ 60.
132. *Id.* ¶ 63 (citing *Davis*, 2009-NMSC-048, ¶¶ 32–33).
133. *Id.* ¶ 64.

with making the gas marketable.[134] The Court found that the legislative policy decision incorporated into state leases rendered moot the issue of the implied covenant to market and the marketable condition rule inherent therein.[135] Consequently, the Supreme Court affirmed the district court's dismissal of the Commissioner's counterclaim for breach of the implied covenant to market.[136]

d. The Fourth Order: Allowing the Deduction of the Cost of Processing Services Provided by Lessees' Affiliates to the Extent It is Reasonable

The district court found in the final order at issue that Lessees' deductions for processing services provided by Lessees' affiliates must be "reasonable."[137] This holding was based on statutory and regulatory history indicating that the New Mexico Legislature and the Commissioner of Public Lands intended both affiliated and non-affiliated transactions to be treated the same.[138] However, on certification, the Commissioner argued that deductions for services performed by Lessees' affiliated entities should be both actual *and* reasonable.[139] Lessees countered that the Legislature intended for the costs incurred in transactions with affiliated and non-affiliated third-party entities to be treated the same.[140]

The Supreme Court found that neither the 1931 nor the 1947 statutory lease forms address affiliate transactions and ruled that when a contract is silent regarding the subject matter at issue, "[e]vidence of custom and usage may be used to ascertain the intention in reference to matters about which the contract is silent."[141] Moreover, when "a contract is silent on an issue, the law implies a reasonable term to cover that issue."[142]

Because there was no support in the leases for the Commissioner's argument that deductions for affiliated transactions must be limited to actual costs, the Supreme Court ultimately upheld the district court's

134. *Id.* Those cases are: *Phillis Ideal v. Burlington Resources Oil & Gas Co.*, Cause No. D-0101-CV-2003-02309 in the First Judicial District Court of New Mexico; *Phillis Ideal and Collins Partners, Ltd. v. B.P. America Production Co.*, Cause No. D-0101-CV-2003-02310 in the First Judicial District Court of New Mexico; *Smith Family, LLC. v. ConocoPhillips Co.*, Cause No. D-0101-CV-2003-02311 in the First Judicial District Court of New Mexico; and *F. Ferrell Davis v. Devon Energy Co.*, Cause No. D-0101-CV-2003-01590 in the First Judicial District Court of New Mexico.

135. *ConocoPhillips*, 2013-NMSC-009, ¶ 64.

136. *Id.*

137. *Id.* ¶ 65.

138. *Id.* ¶ 68.

139. *Id.* ¶ 65.

140. *Id.*

141. *Id.* ¶ 67 (citing 21A Am. Jur. 2d Customs and Usages § 25 (2012)).

142. *Id.* (citing Melvin Aron Eisenberg, *Probability and Chance in Contract Law*, 45 UCLA L. Rev. 1005, 1027 (1998); Castle v. McKnight, 866 P.2d 323, 326 (1993) (providing that when a contract is silent as to the time of performance a reasonable time will be implied)).

ruling on the final order.[143] Thus, in agreeing with the lower court's findings regarding all four certified orders, the Supreme Court affirmed the district court's holdings in their entirety.[144]

II. New Mexico Court of Appeals

A. *Acosta v. Shell Western Exploration and Prod., Inc.*[145]

Acosta v. Shell was a small toxic tort class action lawsuit brought by more than 200 individuals claiming either personal injuries, property damage, or both, against Shell related to its operation of a crude oil tank battery and unlined storage pit used to dispose of oilfield waste between 1946 and 1993.[146] The plaintiffs alleged that Shell purposely or negligently deposited and left various petrochemicals in the ground where the Westgate neighborhood (Westgate) is presently located in Hobbs, New Mexico.[147] Westgate lies within the area of an active oilfield known as the Grimes lease.[148] The tank battery and storage pit were known as the Grimes battery and Tasker pit and, although the Grimes battery was dismantled and removed after it was decommissioned, in 1997 the soil and water table where the battery tanks previously stood were found to be contaminated with hydrocarbons.[149] Not long after contamination was detected at the former Grimes battery site, a housing developer discovered a layer of asphalt-like hydrocarbons beneath the ground in the area that used to be the Tasker pit.[150]

Plaintiffs alleged that their exposure to contamination from the Tasker pit, specifically pristane, benzene, and mercury, either caused or aggravated their lupus and other autoimmune medical conditions, as well as their respiratory, neurological, and psychiatric injuries.[151] Before trial, Shell filed, and the Court granted, several motions in limine and for summary judgment challenging the Plaintiffs' expert witness testimony on every claimed injury.[152] Shell attacked the Plaintiffs' expert's opinions on every claimed injury and argued that his opinions and testimony regarding causation were scientifically unreliable because they relied solely upon his own epidemiologic study.[153] "Shell argued that the district court should apply the stringent federal standard that has recently developed for determining whether expert testimony will be admitted to establish causation."[154] Plaintiffs, on the

143. *Id.* ¶ 68.
144. *Id.* ¶ 69.
145. Acosta v. Shell W. Exploration & Prod., Inc., 2013-NMCA-009, 293 P.3d 917.
146. *Id.* ¶¶ 2–3.
147. *Id.* ¶ 2.
148. *Id.* ¶ 3.
149. *Id.*
150. *Id.* ¶ 4.
151. *Id.* ¶ 7.
152. *Id.* ¶ 9.
153. *Id.*
154. *Id.* ¶ 10.

other hand, argued that their expert's testimony should be admissible under New Mexico case law for expert testimony that has developed following *Alberico*, which is considered less stringent than recent federal precedent.[155]

The main issue on appeal related to Plaintiffs' burden of proof in a toxic tort case and whether the district court abused its discretion when it excluded Plaintiff's expert's opinions under *Daubert v. Merrell Dow Pharmaceuticals*, and its New Mexico counterpart, *State of New Mexico v. Alberico*.[156] With one exception addressed below, the remainder of the issues on appeal dealt with proof of causation in toxic tort cases, Rule 11-702 and the application of *Daubert* and *Alberico*, the admissibility, relevance, and weight to be afforded expert opinions, and the requisite totality of evidentiary basis for causation conclusions.[157] As these factors are not unique to oil and gas law they are not discussed here in any further detail.

Following a defense verdict, Plaintiffs declined to poll the jury.[158] Instead, Plaintiffs moved for a new trial, asserting jury misconduct based upon affidavits from an alternate juror and three jurors who were involved in the deliberations, that "comments made by primarily two jurors affected juror deliberations and Plaintiffs' right to a fair trial."[159] Of significance for this review, and among six others, was a juror statement that "oil companies would 'pull out' in the event of a pro-plaintiff verdict."[160] On this point, the district court was unable to identify any evidence "that discussing the effect a verdict against Shell might have on Shell's continued activity in Hobbs entered into the jurors' deliberations or prejudiced the plaintiffs in any way."[161] In fact, the court noted that even Plaintiffs themselves discussed in their closing argument the possible effect a verdict in their favor might have on the oil and gas industry.[162] The district court acknowledged that "whether subtly or directly the parties argued the general effect a verdict would have."[163]

On appeal, the court of appeals ruled that, even though this and several of the other juror comments could be inferred to have been made during jury deliberations occurring throughout the trial and thus, that the district court had improperly considered them, the dis-

155. *Id.* ¶ 11 (citing State v. Alberico, 861 P.2d 192 (1993)).

156. *Id.* (citing Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 570 (1993); *Alberico*, 861 P.2d at 192)).

157. *See generally id.*

158. *Id.* ¶ 35.

159. *Id.*

160. *Id.* ¶ 46.

161. *Id.* ¶ 49.

162. *Id.*

163. *Id.*

trict court nonetheless properly denied Plaintiffs' motion for new trial.[164]

III. Update on the New Mexico Oil Conservation Commission Pit Rule Debate

The "Pit Rule," is the more common name given to the New Mexico Oil Conservation Division of New Mexico's Energy, Minerals, and Natural Resources Department's ("OCD") Rule 17, which was first promulgated in December 2003 at title 19, chapter 15, part 17 of New Mexico's Administrative Code 1978. As described more fully in the 2013 Survey, during former New Mexico Governor Bill "Grease-My-Palm" Richardson's administration, and at his behest, the OCD gradually imposed stricter rules related to disposal of oil field drilling waste.[165] On May 9, 2008, following a two-year public process by a Pit Rule Task Force and nearly three weeks of public hearings, the OCD application for repeal of existing Rule 50 and the adoption of Rule 17 was granted by the New Mexico Oil Conservation Commission ("OCC").[166]

The 2008 Pit Rule placed onerous and expensive burdens on industry, resulting in the Independent Petroleum Association of New Mexico's ("IPANM") and New Mexico Oil and Gas Association's ("NMOGA") appeals from the ruling. On February 18, 2009, then-Governor Richardson bowed to industry pressure and public outcry and directed the OCD to develop amendments that would reduce the cost of compliance with the Pit Rule. But environmental protection groups vigorously defended the Pit Rule, resulting in prolonged and profound litigation and public debate on the issue. Even while the 2008 and 2009 appeals were pending, the controversy raged on in the media and before the OCD in 2010 and 2011. Finally, on September 30, 2011, NMOGA filed proposed changes to the Pit Rule it described as "designed to make the oil and gas industry in New Mexico competitive with surrounding states for new drilling and development while maintaining groundwater and environmental protections."[167] Still, the debate with environmentalists raged on through 2012 and into the first half of 2013.

Hearings before the OCC went forward for five days during the week of May 14, 2012, and continued again on June 20–23, 2012; August 28–30, 2012; September 24, 25, 26 and 27, 2012; October 1, 4 and 5, 2012; and November 15, 2012. Following a holiday break, the OCC accepted evidence, argument, public comment on January 9, 2013, as well as the morning of January 10, 2013, before ordering the partici-

164. *Id.* ¶ 54.
165. Derek V. Larson, *New Mexico Oil & Gas Update*, 19 Tex. Wesleyan L. Rev. 475, 492 (2013).
166. *Id.*
167. *See id.* at 494 n.162.

pants to submit supplemental findings of fact and conclusions of law, limited to the evidence taken on January 9, 2013 and January 10, 2013. The OCC then closed the record, except for receipt of the supplemental findings and conclusions.[168]

Incredibly, the OCC then continued deliberations on the afternoon of January 10, 2013; on January 11, 17, and 18, 2013; and on February 13 and 15, 2013. On March 8, 2013, the parties filed an Amended Stipulated Exhibit List, which contained the list of the exhibits in the Stipulated Exhibit List, and also the exhibits tendered by the parties and accepted into evidence by the Commission during the January 9 and 10, 2013, portions of the hearing. In total, the OCC heard evidence, argument, and sat for public comment for a total of thirteen days, and deliberated for an additional thirteen days.[169] Finally, on June 6, 2013, in a fifty-one page order, the OCC recounted its reasons for repealing and changing replacing portions of the Pit Rule it had adopted following similarly exhaustive debate in 2009.[170]

Effective on June 28, 2013, the new Pit Rule revises the portions of the 2008 Pit Rule that address permitting, siting requirements, design and construction, operations, and closure. The new Pit Rule also adds definitions and rules to govern a type of pit that previously was unrecognized by the Pit Rule, the multi-well fluid management pit.[171] The amendments also result in a reorganization of parts of the Pit Rule, in an effort to make it easier to follow.[172] Some amendments were made in order to give more clarity and consistency to the Pit Rule, and to better enable compliance and enforcement.[173] The OCC, a panel appointed by New Mexico's Governor, stated that "it found parts of the previous regulations were cumbersome" and that "the new rule offers some flexibility but not at the expense of water quality or public safety."[174] Changes to the rule include allowing more than one well to use the fluid management pits at well sites and allowing operators to bury their drilling cuttings on the well location in those instances where doing so can be accomplished in an environmentally safe manner, rather than hauling the cuttings to a distant landfill or disposal

168. N.M. Oil Conservation Comm'n, Order of the Commission and Statement of Reasons for Amending NMAC Title 19, Chapter 15, Part 17 (June 6, 2013) [hereinafter Order of the Commission].

169. *Id.*

170. *Regulators Repeal, Replace State Rule*, Santa Fe New Mexican (June 6, 2013, 10:32 PM), http://www.santafenewmexican.com/news/local_news/article_1a277249-326e-5b85-82ef-53b4004d5a78.html.

171. N.M. Code R. § 19.15.17 (LexisNexis2013).

172. Order of the Commission, *supra* note 168.

173. *Id.*

174. Santa Fe New Mexican, *supra* note 170.

site.[175] Further, drillers no longer need to show impacts on soil, surface water and groundwater from waste pits or below-grade tanks.[176]

C. *Perceptions of the New Pit Rule*

NMOGA has not issued any press releases regarding the new Pit Rule, but in blog postings available on its website prior to the new Pit Rule, states:

> The changes, if approved, will encourage additional drilling by allowing lined production pits and on-site burial of drilling cuttings where the distance to groundwater is sufficient for these activities to be performed in a manner that is protective of the environment. In addition, the proposed changes provide for updates to the rules governing siting criteria, construction and closure of below-grade tanks and other facilities.
>
> "By allowing for the use of lined drilling pits and in-place burial of drilling cuttings when they can be used safely, New Mexico's oil and gas industry will be drilling more wells, adding more employees and paying more taxes," said Jason Sandel, Chairman of the New Mexico Oil & Gas Association.
>
> The proposed changes to the highly technical rule were developed with input by a wide range of New Mexico oil and gas companies under a set of criteria for the changes including: changes must be based on sound science, changes must maintain environmental safeguards, and changes must encourage environmentally responsible energy development and the resulting jobs and tax revenues.
>
> "The oil and gas industry worked extremely hard on this rule over several months," said Steve Henke, President of the New Mexico Oil & Gas Association. "The team knows how important changing the rule is to help New Mexico secure project funding that has been going to other states."[177]

Most recently, NMOGA has responded to an Op-ed written by Reverend Amstutz in the *Santa Fe New Mexican* critical of the new Pit Rule, stating:

> In her recent Op-ed, Reverend Amstutz asserted that Governor Martinez' "cronies" have somehow endangered New Mexican's health and our precious water as a result of the recent changes to the Pit Rule. Such a reckless accusation is political posturing from

175. *New Mexico Rewrite of Oil and Gas "Pit Rule" Gets Cheers and Jeers*, PLATTS (June 10, 2013, 2:44 PM), http://www.platts.com/latest-news/natural-gas/houston/new-mexico-rewrite-of-oil-and-gas-pit-rule-gets-21138478.

176. ORDER OF THE COMMISSION, *supra* note 168.

177. Press Release, N.M. Oil & Gas Ass'n, New Mexico Oil & Gas Association Proposes "Pit Rule" Changes (Sept. 30, 2011), *available at* http://www.nmoga.org/press-release-nmoga-proposes-pit-rule-changes.

> someone who either doesn't know or doesn't care about the facts.[178]

The New Mexico Environmental Law Center, on the other hand, has stated in its own press releases that, "No matter how you look at it, from our perspective, it's a bad deal for public health and the environment."[179] The New Mexico Environmental Law Center has also issued a separate press release detailing the specific "protections" that it believes have been "lost" under the new Pit Rule, stating, "New Mexico has lost major groundwater and public health protections during a time of unprecedented drought."[180]

IV. United States District Court for the District of New Mexico

D. *Anderson Living Trust v. ConocoPhillips Co.*

1. Introduction

In *Anderson Living Trust v. ConocoPhillips Co.* ("*Anderson*"), the United States District Court for the District of New Mexico recently examined the applicability of the marketable condition rule in the state of New Mexico and other related oil and gas lease covenantal issues.[181] The marketable condition rule is generally understood to require lessees and owners of working interests in oil and gas wells to render the extracted natural gas and hydrocarbons marketable at their own expense. The following discussion of the *Anderson* opinion may be of little precedential value outside of the United States District Court for the District of New Mexico and perhaps limited even to only the learned Judge Browning's courtroom. But the significance of the opinion, and in particular its seventh footnote, as a comprehensive review of the history and current status of the marketable condition rule in New Mexico cannot be genuinely disputed. Any survey of New Mexico Oil and Gas law would be grossly deficient if it did not include the seventh footnote, as it is an excellent resource for anyone practicing oil and gas law in New Mexico as it is not limited to the marketable condition rule but necessarily includes other common issues. Indeed, few could compile such an accurate summary on the topic. Further, since the passage of the federal Class Action Fairness Act,

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178. *See* Steve Hinke, *Response to Santa Fe New Mexican Op-ed*, N.M. Oil & Gas Ass'n (Sept. 3, 2013), http://www.nmoga.org/response-to-santa-fe-new-mexican-op-ed.

179. *See* Press Release, N.M. Envtl. Law Ctr., Commission Approves Pit Rule Amendments (June 12, 2013), *available at* http://nmenvirolaw.org/site/more/commission_approves_pit_rule_amendments.

180. *See* Press Release, N.M. Envtl. Law Ctr., The Protections We've Lost with the Gutting of the Pit Rule (June 12, 2013), *available at* http://nmenvirolaw.org/site/press-releases-more/the_protections_weve_lost_with_the_gutting_of_the_pit_rule.

181. *See generally* Anderson Living Trust v. ConocoPhillips Co., 2013 U.S. Dist. LEXIS 96877 (D.N.M. June 28, 2013).

the federal courts are likely to be the only realistic forum option for most future oil and gas class actions.

2. The Complaint

The Court drafted a consolidated opinion in *Anderson*, combining CV 12-0039 and CV 12-0040, because the plaintiffs and allegations against the defendants in each case were nearly identical and the motions to dismiss filed by the defendants in each case were nearly identical. The plaintiffs in *Anderson* brought causes of action against the defendants for: (1) failure to pay royalty on volumes of hydrocarbons, including drip condensate; (2) fraud and misstatement of value of gas and affiliate sales; (3) breach of duty to market hydrocarbons; (4) violation of the New Mexico Oil and Gas Proceeds Payment Act; (5) bad faith breach of contract; (6) unjust enrichment and declaratory relief; (7) conversion for value of drip condensate; and (8) class action allegations.[182] The cause of action alleging breach of the duty to market hydrocarbons, to which this memorandum is primarily focused, was dismissed and discussed extensively in the court's opinion with regard to the applicability of the marketable condition rule in New Mexico.[183] The court determined in its review of current case law from the Tenth Circuit[184] and the New Mexico Supreme Court[185] that the marketable condition rule could not conclusively be described as being implied as a matter of law into oil and gas leases.[186] The Court discussed in a supplemental opinion its reasoning for not certifying the question to the New Mexico Supreme Court of whether the marketable condition rule exists in New Mexico.

3. Facts

The dispute in *Anderson* centered on whether the plaintiffs could bring tort claims against defendants notwithstanding the parties' contractual relationship and whether the plaintiffs could bring a claim alleging that the defendants violated the marketable condition rule.

The plaintiffs were royalty holders who granted oil and gas mining leases and/or permits to the defendants.[187] The dispute arose largely over the royalty payments the defendants owed to the plaintiffs, who owned interests in hydrocarbons derived from wells in New Mexico and Colorado.[188] The plaintiffs brought their suit as a class action

182. *Id.* at *3.
183. *Id.* at *83.
184. Elliott Industries Ltd. P'ship v. BP Am. Prod. Co., 407 F.3d 1091 (10th Cir. 2005).
185. Davis v. Devon Energy Corp., 2009-NMSC-048, 218 P.3d 75; ConocoPhillips Co. v. Lyons, 2013-NMSC-009, 299 P.3d 844.
186. *Anderson*, 2013 U.S. Dist. LEXIS 96877, at *123.
187. *Id.* at *5.
188. *Id.* at *6.

against the defendants on behalf of all owners of "non-cost bearing" royalty interests in the subject wells.[189] Under the lease agreements, the defendants owed the plaintiffs a "duty to pay royalties on all hydrocarbons" for the value or price that the defendants do or should receive from the "arm's-length" sale of the hydrocarbons.[190] The leases gave the plaintiffs a right to royalties in the "drip condensate" recovered through oil and gas production.[191] The defendants calculated the plaintiffs' royalty interests based on the sale price received from the defendants' affiliated intermediaries, who then turned around and sold the hydrocarbons at a significant profit.[192] This significant profit was not passed on to the plaintiffs.[193] At times, the defendants failed to pay royalties until more than 45–90 days had passed after receiving the revenue from the plaintiffs' shares.[194] The defendants also failed to disclose to the plaintiffs the gross volume of gas produced from the wells, the gross revenue or value the defendants obtain from the gross production of gas, and the extent of costs that are deducted from the plaintiffs' royalty payments.[195] One of the costs the defendants deducted from the plaintiffs' royalty payments was the cost of making the gas and hydrocarbons marketable.[196]

4. Summary of Causes of Actions and Resulting Dispositions

a. Issue 1: Breach of Contract

The Court found that the plaintiffs had sufficiently alleged that the parties were in a contractual relationship and that the defendants breached the terms of the parties' leases so as to survive the motion to dismiss on the first allegation of breach of contract.[197]

The crux of the plaintiffs' complaint, and the first cause of action, was defendants' breach of contract, namely the lease requirements to pay royalties on the full volume and value of production.[198] The defendants cited to the Tenth Circuit's ruling in *Elliott* for the proposition that the plaintiffs failed to plead breaches of specific contractual terms and further failed to recite the chain of title between the original lessors and their current owners, therein failing to prove ownership and title to the leases.[199] However, unlike the plaintiffs in *Elliott* who specifically disavowed claims based in contract, the plaintiffs here

189. *Id.* at *7.
190. *Id.*
191. *Id.*
192. *Id.* at *8.
193. *Id.*
194. *Id.* at *9.
195. *Id.*
196. *Id.*
197. *Id.* at *170.
198. *Id.* at *12.
199. *Id.* (citing Elliott Industries Ltd. P'ship v. BP Am. Prod. Co., 407 F.3d 1091, 1099 (10th Cir. 2005)).

provided "information identifying the leases at issue, including the name of the lessors, name of the lessees, the date of execution, and a description of the lease."[200] Consistent with the requirements for asserting breach of contract, the plaintiffs alleged they were the royalty interest owners on leases to which the defendants held working interests for mining oil and gas, and that under the leases' terms, the defendants were required to pay royalties based on revenue the defendants derived from the sale of drip condensate.[201] The plaintiffs further alleged that the defendants failed to provide the plaintiffs with a percentage of the revenue, which caused the plaintiffs to incur money damages.[202] Since the court accepts as true all well-pleaded factual allegations in the complaints, and because the court determined that the plaintiffs indeed alleged the elements necessary to establish a breach of contract claim according to *McCasland v. Prather*, the court denied the defendants' request to dismiss since the plaintiffs sufficiently alleged a breach of contract claim.[203]

b. Issue 2: Fraud, Dismissed in Part

The plaintiffs sufficiently alleged the defendants' reporting and royalty calculation breached the defendants' duty of good faith and fair dealing, implied in every contract, so as to survive the motion to dismiss to the extent the claim was for breach of the duty of good faith and fair dealing.[204] However, the court dismissed the plaintiffs' standalone claim of fraud.[205]

The plaintiffs alleged in their second cause of action that the defendants committed fraud and violated their duty of good faith and fair dealing by failing to disclose (1) the gross volume of hydrocarbons produced from subject wells, (2) the gross revenue or value from that gross production, and (3) all the reductions, deductions, and costs calculated into the plaintiffs' royalty payments.[206] Furthermore, the plaintiffs alleged royalty payments were based upon non-arm's-length sales to affiliated intermediaries. The defendants, on the other hand, contended the plaintiffs' second cause of action sounded in tort and that *Elliott* precluded the plaintiffs from alleging a claim for fraud because the plaintiffs did not explain how the allegation of fraud was not in conflict with the parties' contractual duties.[207] The defendants contended they could not be liable in tort to the plaintiffs absent fiduciary

200. *Id.* at *10.
201. *Id.* at *7.
202. *Id.* at *10.
203. *Id.* at *108–09 (citing McCasland v. Prather, 585 P.2d 336, 338 (N.M. Ct. App. 1978)).
204. *Id.* at *4.
205. *Id.*
206. *Id.* at *111.
207. *Id.*

duties in favor of the plaintiffs and that New Mexico law did not impose fiduciary duties on lessees to mineral leases.[208]

i. Fraud

The plaintiffs contended the defendants' calculation of the royalty payments based on sales to affiliated intermediaries, and the defendants' failure to disclose the full volume of hydrocarbons derived from the subject wells and all of the deductions from the royalty payments, constituted fraud.[209] The plaintiffs also alleged that same conduct was a breach of the leases' terms and violated the defendants' duty of good faith and fair dealing.[210] Likewise, in the plaintiffs' seventh cause of action, the plaintiffs asserted that the defendants' retention of the monies and profits resulting from the sale of the plaintiffs' hydrocarbons was conversion.[211]

The court determined, however, that the plaintiffs could not bring claims in tort that conflict with the parties' contractual duties as the parties' leases define those obligations.[212] The court concluded that the parties' contractual duties, as the leases define those obligations, precluded the plaintiffs' causes of action that sounded in tort and arose from the same set of facts and alleged the same wrongful conduct as the plaintiffs' allegations of a breach of contract under *Isler v. Texas Oil and Gas Corp.*[213] Therefore, the plaintiffs' second cause of action for fraud and seventh cause of action for conversion were dismissed.[214]

ii. Duty of Good Faith and Fair Dealing

The court allowed the second cause of action to stand to the extent the plaintiffs alleged the defendants' conduct breached their duty of good faith and fair dealing in effectuating the leases' terms.[215] New Mexico law imposes a duty of good faith and fair dealing into every contract.[216] The Tenth Circuit also recognized that *Elliott* does not preclude a plaintiff from articulating that a lessor of an oil and gas

208. *Id.*
209. *Id.* at *110.
210. *Id.* at *111.
211. *Id.* at *110.
212. *Id.*
213. Isler v. Tex. Oil & Gas Corp., 749 F.2d 22, 23–24 (holding that a contract that specifically defines the parties' rights and duties precludes any extra contractual tort duty regarding the contract's subject matter); *see also* Continental Potash v. Freeport-McMoran, 858 P.2d 66, 77 (1993) (holding that a lessee's contractual duties to royalty owners did not automatically create fiduciary duties for the lessee in favor of the royalty owners so as to support a tort claim).
214. *Anderson*, 2013 U.S. Dist. LEXIS 96877, at *110.
215. *Id.* at *112.
216. *Id.* at *113 (citing Watson Truck & Supply Co. v. Males, 801 P.2d 639, 642 (N.M. 1990)).

lease breached the implied duty of good faith and fair dealing when that duty is necessary to effectuate an express contractual provision.[217] The Court likened the plaintiffs to the plaintiff landowners in *Abraham*, who articulated the "necessity of such a duty [of good faith and fair dealing] to effectuate the express provision" of the parties' contracts.[218] The plaintiffs alleged the defendants' failure to disclose the full amount of deductions from their royalty payments and the gross volume of hydrocarbons produced from the subject wells breached the defendants' duty to act in good faith and fair dealing.[219] According to the court, *Elliott* did not prevent the plaintiffs from making allegations of the defendants' failure to disclose, or that the defendants' sale of hydrocarbons to affiliated intermediaries was in complete contravention of the duties and covenants imposed upon the defendants.[220]

c. Issue 3: Breach of Implied Duty to Market Hydrocarbons, Dismissed

The plaintiffs alleged the defendants breached the duty to market hydrocarbons by passing the cost of rendering the hydrocarbons marketable on to the plaintiffs in violation of the marketable condition rule and by calculating the plaintiffs' royalty payments based on the defendants' sale of hydrocarbons to affiliated intermediaries.[221] However, New Mexico law, as the Tenth Circuit last construed it, does not recognize the marketable condition rule as part of the implied duty to market.[222] Additionally, the Tenth Circuit's interpretation of the implied duty to market under New Mexico law did not make unlawful the defendants' alleged sale of hydrocarbons to affiliated intermediaries or deduction of costs from the plaintiffs' royalty payments. The court's grounds for dismissal on this issue are discussed in more detail below.

d. Issue 4: NM Proceeds Payment Act Violations, Dismissed in Part

The plaintiffs sufficiently alleged the defendants failed to make timely payments as required under the New Mexico Proceeds Payment Act, but could not proceed under Colorado's Oil and Gas Conservation Act.[223]

The New Mexico Proceeds Payment Act's plain language covered the plaintiffs' claims for royalty underpayment and did not require the plaintiffs to provide the defendants with a division order before their

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217. *Id.* at *113, *115–16 (citing Abraham v. BP Am. Prod. Co., 685 F.3d 1196, 1205 (10th Cir. 2012)).
218. *See Abraham*, 685 F.3d at 1205.
219. *Anderson*, 2013 U.S. Dist. LEXIS 96877, at *116.
220. *Id.*
221. *Id.* at *128.
222. *Id.* at *129.
223. *Id.* at *4, *137.

rights under the Act were initiated.[224] Furthermore, the court noted *Elliott* recognized it is possible to bring a claim under the Act if the plaintiffs allege "a potentially successful claim for underpayment of royalties or theory of liability showing that it is legally entitled to such payments."[225] Since the plaintiffs in this case met the requirements under the Act and as interpreted by *Elliott*, the court allowed the plaintiffs' claim under the Act to stand.[226] However, the court lacked jurisdiction to enforce the plaintiffs' claims that the defendants' payment practices violated Colorado's Oil and Gas Conservation Act.[227]

e. Issue 5: Bad-Faith Breach of Contract, Not Dismissed

The plaintiffs sufficiently alleged that the defendants breached their duties under the leases, as required by the covenant of good faith and fair dealing, in bad faith.[228]

The plaintiffs alleged the defendants continuously, maliciously, and wrongfully withheld the benefits owed to them under the terms of the leases and that, as such, they were entitled to punitive damages for the defendants' bad-faith breach of the leases.[229] Although the defendants contended the parties' contractual relationship precluded the plaintiffs from alleging a claim for bad faith because the plaintiffs based their action in tort rather than contract, the court rejected this interpretation, instead determining that the plaintiffs' action sounded in contract.[230] Furthermore, New Mexico recognizes that although punitive damages are not normally available for a breach of contract, a plaintiff may recover punitive damages when defendant's breach was "malicious, fraudulent, [or] oppressive . . . ."[231] Because the plaintiffs plausibly alleged facts sufficient to support their allegations of bad-faith breach, the cause of action stood.[232]

f. Issue 6: Unjust Enrichment, Injunctive Relief & Declaratory Judgment, Dismissed in Part

The plaintiffs could not recover in equity for conduct that allegedly breached the parties' leases, so the claim for unjust enrichment was dismissed.[233]

224. *Id.* at *138–39.
225. *Id.* at *137 (quoting N.M. STAT. ANN. § 70-10-3 (2013)).
226. *Id.* at *137–38.
227. *Id.* at *143 (citing Atl. Richfield Co. v. Farm Credit Bank of Wichita, 226 F.3d 1138 (10th Cir. 2000) (interpreting the Oil and Gas Conservation Act to preclude federal district court jurisdiction over suits asserting injuries under the Act)).
228. *Id.* at *4.
229. *Id.* at *125.
230. *Id.* at *126.
231. *Id.* at *127.
232. *Id.* at *128.
233. *Id.* at *5.

Under the court's reasoning, the leases governed the defendants' royalty payment obligations.[234] Therefore, the plaintiffs could not allege the same actions that breach the terms of the leases constituted unjust enrichment and conversion.[235] The plaintiffs' claim for injunctive relief was also dismissed because the plaintiffs only alleged that the defendants' conduct would cause them monetary harm in the future, and monetary harm is not irreparable.[236]

The plaintiffs may be permitted to seek a declaratory judgment proscribing the defendants' future conduct under the leases because the court is able to award declaratory judgment notwithstanding that a contract remedy is another available remedy.[237]

g. Issue 7: Conversion for Value of Drip Condensate, Dismissed

The parties' leases precluded the plaintiffs from recovering in tort for breach of a duty that their leases cover, so no claim for conversion was permitted to stand.[238]

h. Issue 8: Class Action Allegations, Not Dismissed

The court did not apply the Supreme Court's holdings in *Ashcroft v. Iqbal*, and *Bell Atlantic Corp. v. Twombly* to dismiss Plaintiffs' class-action allegations.[239] Plaintiffs' class action allegations did not purport to state claim for relief, but rather put the parties and court on notice of the plaintiffs' chosen procedural method for litigating the case.[240] Second, even if the court were to apply the holdings in *Ashcroft* and *Bell Atlantic Corp.* to the plaintiffs' class-action allegations, the plaintiffs' allegations were sufficient to demonstrate they may bring this matter as a class action.[241]

5. The Court's Analysis of the Marketable Condition Rule in the Main Opinion

In this Author's opinion, the most significant part of the *Anderson* opinion, and the most relevant to this survey of New Mexico Oil and Gas Law, is Justice Browning's review of New Mexico's Marketable Condition Rule.[242] In his analysis, Justice Browning opined that "New Mexico implies in law a duty—to make diligent efforts to market the

234. *Id.* at *145.
235. *Id.* at *145–46.
236. *Id.* at *148.
237. FED. R. CIV. P. 57 ("The existence of another adequate remedy does not preclude a declaratory judgment that is otherwise appropriate."); *Anderson*, 2013 U.S. Dist. LEXIS 96877, at *147.
238. *Anderson*, 2013 U.S. Dist. LEXIS 96877, at *4.
239. *Id.* at *149 (citing Ashcroft v. Iqbal, 556 US 662 (2009); Bell Atl. Corp. v. Twombly, 550 US 544 (2007)).
240. *Id.* at *150.
241. *Id.* at *151–53.
242. *See id.* at *83–93.

production in order that the lessor may realize on his royalty interest—on oil-and-gas producers, in equity, without looking to the language of the agreements or other evidence of the parties' intentions."[243] However, the court was compelled to follow a highly criticized and controversial ruling from the Tenth Circuit that had determined that the marketable condition rule does not apply in New Mexico, in spite of contrary New Mexico Supreme Court authority existing for more than one-half a century[244], and because no recent New Mexico cases have been squarely presented with an opportunity to confirm that the marketable condition rule is implied as a matter of law in oil and gas leases in New Mexico.[245]

The *Anderson* Court first considered *Elliott* and explained that it prevented the court from confirming that the marketable condition rule is implied as a matter of law into oil and gas leases, in the face of the Tenth Circuit's holding.[246] In *Elliott*, the plaintiff royalty interest owners alleged BP America and ConocoPhillips were obligated under the implied duty to market to pay royalties based upon the best price reasonably available for oil and gas products and not the actual price minus cost deductions for processing, marketing, and transportation.[247] While the Tenth Circuit noted that the lessee or working interest owner has an implied covenant in New Mexico to market the oil and gas products after processing, the court could not imply a duty to market into an existing royalty agreement when such an agreement expressly covers the calculation of royalties.[248] The Tenth Circuit could not, however, apply historical New Mexico precedent and, instead, held that the conception that the implied duty to market requires working interest owners to "bear the burden of all costs incurred to put the gas in a marketable condition including the cost of removing the NGLs from the gas . . . finds no support in New Mexico."[249]

The *Anderson* Court was further limited in its consideration of the marketable condition rule in New Mexico by two recent New Mexico Supreme Court cases (post *Elliott*), each of which failed to address the marketable condition rule because the issue was not ripe to do so.[250] The court noted that in *Davis*, the New Mexico Supreme Court stated in its opinion that it could not address the existence of the marketable condition rule in New Mexico or its applicability, and that in *Lyons*

243. *Id.* at *83.
244. *See* Libby v. DeBaca, 179 P.2d 263 (N.M. 1947); Darr v. Eldridge, 346 P.2d 1042 (N.M. 1959).
245. *Anderson*, 2013 U.S. Dist. LEXIS 96877, at *85.
246. *Id.* at *82.
247. *Id.* at *83 (citing Elliott Indus. Ltd. P'ship v. BP Am. Prod. Co., 407 F.3d 1091, 1113–14 (10th Cir. 2005)).
248. *Id.* at *84 (citing *Elliott*, 407 F.3d at 1113–14).
249. *Id.* at *85 (citing *Elliott*, 407 F.3d at 1113–14).
250. *Id.*

the New Mexico Supreme Court further elaborated that whether the marketable condition rule applies in New Mexico was not ripe for review because the determination is essentially a legislative policy decision.[251] In *Lyons*, the State of New Mexico, as plaintiff, contended the defendant working interest owner was not allowed to deduct from royalty payments post-production costs necessary to render natural gas marketable.[252] The court held that although lessees must bear the costs incurred in producing oil and gas products, "absent an express contractual provision to the contrary . . . costs incurred subsequent to production are considered post-production costs and are generally deducted from the sale of the product regardless of the where the sale takes place."[253] Ultimately, without any current appellate court authority in New Mexico confirming the marketable condition rule, and in the face of the holding in *Elliott*, the court noted: "[w]hen a panel of this court had rendered a decision interpreting state law, that interpretation is binding on district courts in this circuit, and on subsequent panels of this court, unless an intervening decision of the state's highest court has resolved the issue."[254] Thus, the court was compelled to dismiss the plaintiffs' third cause of action, breach of duty to market hydrocarbons.

Although the court expressed a lack of confidence in the Tenth Circuit's ruling in *Elliott*, it recognized that it was compelled to apply the decision since there have been no subsequent appellate decisions expressly confirming the marketable condition rule in New Mexico.[255] However, the court concluded its analysis of New Mexico law, pertinent parts of which are set out in full, below, by opining that the Supreme Court of New Mexico will in the future find that the marketable condition rule is included in within the implied duty to market.[256]

> Although the Court is bound by the Tenth Circuit's interpretation of New Mexico law, the Court is not convinced that the *Elliott Indus.*' plaintiffs' "conception of the implied duty to market finds no support within New Mexico case law." From the time that the Tenth Circuit made this statement in *Elliott Indus.*, at least three New Mexico district courts have found that, "under the implied duty to market, the marketable condition rule applies in New Mexico." In *Davis v. Devon Energy Corp.*, the Supreme Court of New Mexico did not address the existence of the marketable condition rule, because it found that the matter was "not ripe for review at

251. *Id.* at *86 (citing Davis v. Devon Energy Corp., 2009-NMSC-048, ¶ 14, 218 P.3d 75; ConocoPhillips Co. v. Lyons, 2013-NMSC-009, ¶ 64, 299 P.3d 844).

252. *Id.*; *see generally Lyons*, 2013-NMSC-009.

253. *Lyons*, 2013-NMSC-009, at ¶ 24.

254. *Anderson*, 2013 U.S. Dist. LEXIS 96877, at *134 (citing Wankier v. Crown Equip. Corp., 353 F.3d 862, 866 (10th Cir. 2003)).

255. *Id.* at *88.

256. *Id.* at *93.

this time," as the New Mexico state district courts had left open questions regarding the scope of the rule. The Supreme Court of New Mexico made a similar statement in *ConocoPhillips Co. v. Lyons*. These pronouncements from the Supreme Court of New Mexico indicate, far from precluding the existence of the marketable condition rule as a matter of law within the state, that the Supreme Court of New Mexico considers the issue undetermined and, moreover, intends to address its existence when the record before the Supreme Court of New Mexico fully presents the issue.

The Court believes that, if and when the Supreme Court of New Mexico determines that the existence of the marketable condition rule is ripe for review, it will find that the rule is included in oil-and-gas contracts as part of the implied duty to market. Colorado, Wyoming, Kansas, and Oklahoma have all adopted a version of the marketable condition rule.

. . .

Texas, on the other hand, has not adopted the marketable condition rule, but, rather, interprets oil-and-gas leases more strictly in accordance with their terms. . . . The Court believes that, when the Supreme Court of New Mexico determines the existence of the marketable condition rule is ripe for review, it will find the reasoning of Colorado, Kansas, Oklahoma, and Wyoming more persuasive than that of Texas. Like Kansas and Colorado, which construe oil-and-gas leases against the lessees, the Supreme Court of New Mexico has established a "rule that an oil and gas lease is to be construed most strongly against the lessee." This canon of construction is consistent with the duties a lease imposes on a lessee, such as the duty of "achiev[ing] the primary purpose of the lease, to explore, develop and produce." Colorado and Kansas have recognized that, once a lessor assigns its working and operating interests to a lessee, the lessee possesses the ability to evaluate and choose which post-production measures are necessary to render a gas marketable. Based upon the lessee's ability to assess post-production measures, Kansas and Colorado have determined that the lessee, and not the lessor, should bear the cost of those measures, as lessors generally will have "'no ready means of ascertaining'" the cost-benefit of a post-production measure "'other than to take lessees' word for it.'"

A critique of the marketable condition rule is that it necessarily turns on questions of fact, which the Supreme Court of Colorado recognized in *Rogers v. Westerman Farm Co*., because, whether a buyer is willing to purchase a product, and at what point, will vary from case to case. The court does not believe that the factual questions necessary to determining marketability are fatal to the marketable condition rule. The cases discussed herein indicate that, in certain locations and with certain products, no willing buyer may be found until an oil or gas product is either transformed into a different condition, or transported to a different location. At a minimum, the burden which the marketable condition rule imposes is that a market-ready product is able to reach the hands of a willing buyer, which is a burden New Mexico has already determined lessees should bear. The court believes that the Supreme Court of New Mexico would find that, consistent with its holding that "pronouncement without disposition of the product is futile," the implied covenant to market includes a duty to render products marketable at the lessee's, and not lessor's, expense. While the situation which allows a buyer to purchase an oil or gas product will vary from case to case, the requirement that a royalty interest owner does not pay for the meeting of product and buyer is not onerous, and will, logically, be satisfied whenever a lessee realizes the goal of a lease: receiving a profit on oil-and-gas products. This finding leads to the second critique of the marketable condition rule: requiring a lessee to bear the burden of post-production costs is pointless, because the marketable condition rule will incentivize lessees to find purchasers that will purchase unrefined products. Unrefined or unprocessed oil and gas will necessarily sell at a lower cost, because purchasers of the unprocessed products will factor into the price their costs to process the oil or gas. This critique of the marketable condition rule concludes, therefore, that payments will be calculated on oil-and-gas profits less production costs, regardless whether the lessee bears those costs. In theory, therefore, the marketable condition rule may not increase royalty owners' profits beyond their present state, as the cost of production will be taken from royalty payments in either transaction. The only change is in the entity deducting postproduction costs. The court does not believe that the Supreme Court of New Mexico will find this critique persuasive. The court believes that the Supreme Court of New Mexico will conclude that, while it is true, in either situation, that post-production costs must be borne somewhere, the marketable condition rule, nonetheless, avoids an inefficient result. If oil-and-gas lessees may pass the cost onto lessors, the lessees lose the motivation for purchasing the most cost-efficient post-production measures. Oil-and-gas producers, as lessees, may attempt to pass those costs downstream to purchasers, but, in that instance, the purchaser will be assessing its own costs, and will, again, be incentivized to take on only cost-efficient post-production measures. In sum, the marketable condition rule incentivizes the entities with the most knowledge and ability to produce oil-and-gas in the most cost-effective manner. Without the marketable condition rule, oil-and-gas producers, as lessees, may pass post-production costs onto lessor-royalty-owners, who lack the knowledge and ability to evaluate and choose the best option. For these reasons, the court believes that the New Mexico Supreme Court will find that, included within the implied duty to market in New Mexico, is the marketable condition rule.[257]

257. *Id.* at *130–46 n.7.

6. The Court Denied Certification of the Marketable Condition Rule to the New Mexico Supreme Court

On June 29, 2013, the plaintiffs in *Anderson* filed a Motion to Certify a Question of Law to the New Mexico Supreme Court, and the court held a hearing on the Motion to Certify on September 14, 2013. In a Supplemental Opinion, the court denied the plaintiffs Motion to Certify because (1) the decision of the Tenth Circuit in *Elliott* was binding on the court, (2) the court dismissed the plaintiffs' cause of action relating to the marketable condition rule in the Main Opinion, and (3) the Supreme Court of New Mexico may only answer questions that a federal district court certifies to it if the answer may be determinative of an issue in pending litigation.[258]

Pursuant to section 39-7-4 of the New Mexico Statutes Annotated 1978, "the Supreme Court of New Mexico may answer questions that the federal district court certifies to it if they involve propositions of New Mexico law that may be determinative of the matter before the certifying court and there are no controlling precedents from the New Mexico appellate court."[259] Because the court dismissed the issue the plaintiffs sought to certify in the Main Opinion, the court reasoned it would be "unseemly" to certify the marketable condition issue to the Supreme Court of New Mexico.[260] In support, the court added, "the Tenth Circuit has stated it is generally not appropriate to certify questions to a state supreme court when the requesting party seeks certification only after having received an adverse decision from the district court."[261] The court further noted:

> [T]he proper procedure . . . is to let the issue proceed to the Tenth Circuit, and if the Tenth Circuit for any reason decides what the Court, the parties, or the Supreme Court of New Mexico have said undermine its confidence in the continuing viability of *Elliott Industries*, the Tenth Circuit—not this Court—is the appropriate judicial level to certify the issue to the Supreme Court of New Mexico.[262]

The court further noted that certifying such a question would be an end-run on the Tenth Circuit, and that such a decision is for the Tenth Circuit to make on appeal.[263]

E. *The Future of the Marketable Condition Rule in New Mexico*

In light of the *Anderson* court's skepticism of the continuing viability of the Tenth Circuit's opinion in *Elliott*, and recognizing the pendency of the four cases pending in the First Judicial District Court for

258. *Id.* at *18–19 (supplemental opinion) (on file with Author).
259. *Id.*
260. *Id.* at *22.
261. *Id.* at *21.
262. *Id.* at *22.
263. *Id.*

New Mexico with the New Mexico's marketable condition rule at their core, including the fact that the four different judges in three of the four cases have recognized the marketable condition rule in New Mexico, producers and royalty owners alike may not have to wait long, as the issue is likely to be decided in the very near future.[264] That pronouncement, whatever it may be, will be reported here in future editions of this Survey of New Mexico's Oil and Gas Law.

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264. One of the four cases, *F. Ferrell Davis v. Devon Energy Co.*, No. D-0101-CV-2003-01590, petitioned the New Mexico Supreme Court for a Writ of Certiorari to consider, on an interlocutory basis, the District Court's Order Granting the Class' Motion for Summary Judgment to Define the Marketable Condition Rule in New Mexico. The District Court had ruled:

> [U]nder the implied duty to market, that the Marketable Condition Rule applies in New Mexico. The implied duty to market is a legal duty implied on gas producers in equity. The implied duty to market incorporates the legal duty to put the coalbed methane natural gas, produced by Defendants in the San Juan Basin of New Mexico, into a marketable condition.

See Aug. 20, 2013, Order. After granting industry organizations leave to file amicus briefs, the New Mexico Supreme Court allowed oral arguments on Devon's petition on February 12, 2014, and then ruled unanimously from the bench to deny the petition and ordered the District Court Judge to complete the case by the end of the year. *See* Feb. 12, 2014, Order.