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# New Mexico

Derek V. Larson

Sarita Nair

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*By: Derek V. Larson & Sarita Nair*[1]

## I. Supreme Court Cases

### A. Ideal v. Burlington Res. Oil & Gas Co.[2]

The *Ideal* case developed existing New Mexico law concerning the "marketable condition rule." The New Mexico Supreme Court granted certiorari of an interlocutory appeal from the district court's class certification order because it was already considering a similar appeal of a companion case from the same district, *Davis v. Devon Energy Corp.*[3] In *Davis*, the Supreme Court noted that "[t]he common pre-tailgate deduction issues and the 'marketable condition rule' continue to dominate the overall case."[4] Following *Davis*, the Court concluded that certification was appropriate in *Ideal.*

#### 1. Implied duty to market and marketable condition rule applies in New Mexico.

Similar to the plaintiffs in *Davis*, the plaintiffs in *Ideal* asserted that the defendant had underpaid royalties by improperly deducting the costs and expenses associated with placing natural gas in a marketable

1. Derek V. Larson and Sarita Nair are shareholders at the law firm of Sutin, Thayer & Browne in Albuquerque, New Mexico. Mr. Larson practices primarily in the areas of oil and gas law and complex commercial litigation. Mr. Larson has represented royalty owners in class action litigation, and he represented the states of New Mexico and Wyoming as a special assistant attorney general to collect underpaid severance taxes and royalties due on oil and gas production. He also represents entities and individuals in a broad range of business disputes. Ms. Nair practices in the areas of corporate law, mergers and acquisitions, and environmental and water law, including representation of energy industry clients across New Mexico.

2. Ideal v. Burlington Res. Oil & Gas Co., 233 P.3d 362 (N.M. 2010).

3. 218 P.3d 75 (N.M. 2009).

4. *Ideal*, 233 P.3d at 363 (discussing *Davis*, 218 P.3d at 75).



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condition.[5] In *Davis*, the district court ruled that, pursuant to the implied covenant to market, the marketable condition rule applied in New Mexico. On appeal the New Mexico Supreme Court confirmed the implied duty to market had long been the law in New Mexico.[6] Although the Court did not expressly confirm the marketable condition rule in New Mexico, the *Davis* Court ruled that the district court's application of the rule predominated individualized issues in that case.

In *Ideal*, the district court had not expressly ruled that the marketable condition rule is implied in contracts as a matter of law. The Supreme Court remanded the case to the district court to make this determination noting that if the rule is implied as a matter of law, then certification would be appropriate, but if the rule is implied as a matter of the parties' intent, then the court would need to confirm that common issues would continue to predominate. Further, the Court reiterated its ruling in *Davis* stating "the analysis set forth in *Continental Potash* only applies to those promises that may be implied because the parties so intended them. Its analysis does not apply to covenants that impose legal duties upon contracting parties as a matter of law."[7]

The *Ideal* case raised two additional issues: (1) whether denial of class certification in a similar prior case precluded re-litigation of the marketable condition rule issue in the present case; and (2) whether the district court erred in ruling that New Mexico law applied to the case without undertaking a formal conflict of law analysis.

> 2. Putative class members from prior un-certified class actions are not considered parties for collateral estoppel purposes in subsequent case.

The New Mexico Supreme Court ruled that, because the prior case asserted by the defendant was not certified as a class action, the putative class members in the prior case could not be considered the same parties in the *Ideal* case for collateral estoppel purposes. The Court held that such preclusion would be fundamentally unfair and would be inconsistent with due process guarantees.[8]

> 3. Oil and gas contracts are realty claims properly decided under New Mexico law.

The defendant in *Ideal* argued that the district court erred by not making a record of its analysis of whether choice of law and conflict of law principles precluded certification. However, the Supreme Court

5. *Id.* at 363.

6. *Davis*, 218 P.3d at 86 (citing Darr v. Eldridge, 346 P.2d 1041 (N.M. 1959) & Libby v. De Baca, 179 P.2d 263 (N.M. 1947)).

7. *Id.* at 85.

8. *Ideal*, 233 P.3d at 367 (*citing* Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985)).

observed that the district judge had been presented with arguments and authority regarding the applicability of New Mexico law, which was adequate at the class certification stage. The Court went on to note that a district court's decision will be upheld as long as the right result was reached, even if the court reached the decision for the wrong reason.[9] The Court recognized that the oil and gas leases at issue in the case sound in realty, as opposed to personalty, and concluded that application of New Mexico law was proper.[10]

## II. COURT OF APPEALS CASES

### A. Chisos, Ltd. v. JKM Energy, L.L.C.[11]

The first issue before the Court of Appeals in *Chisos, Ltd. v. JKM Energy, L.L.C.* concerned whether the Conveyance and Bill of Sale entered into by the two parties conveyed all of the operating rights in the specified section, or just the rights to one of the two wells.[12] The second issue before the court was whether the district court's finding that Chisos gave insufficient notice of its intent to recomplete one of the two wells was supported by substantial evidence.[13] The Court of Appeals affirmed the district court ruling that the conveyance was ambiguous and should be interpreted to convey all of the rights in the section.[14] The court also ordered an accounting of the costs and revenues of the recompleted well, so the non-consenting party could then retroactively elect to participate.

The two parties, JKM Energy, L.L.C. ("JKM") and Chisos, Ltd. ("Chisos"), agreed that Chisos would sell the Stetson Well to JKM for $55,000, with JKM obtaining a 100% Working Interest and a 75% Net Revenue Interest.[15] The two wells on the unit at issue were subject to a joint operating agreement ("JOA") with Pure Energy Group, Inc. ("Pure") and Bellwether Exploration Company ("Bellwether") each holding a 50% interest in both wells.[16] Chisos acquired Bellwether's interest in the well. A portion of the JOA related to the procedure for electing whether to participate in the drilling and reworking of a well. If a party decided to participate, it would share in the cost of the work. If it elected not to participate, the participating parties would receive the non-participating party's share of the profits from the well until the profits amounted to six times the non-consenting party's share of the participation costs.[17]

9. *Id.* at 369 (*citing* Meiboom v. Watson, 994 P.2d 1154 (N.M. 2000)).
10. *Id.*
11. Chisos, Ltd. v. JKM Energy, L.L.C., 258 P.3d 1107 (N.M. Ct. App. 2011).
12. *Id.* at 1109.
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.* at 1109–10.
17. *Id.* at 1110.

After the conveyance was recorded, the State of New Mexico informed Chisos that the HL2 well had not shown signs of production for twelve months.[18] Chisos proceeded with fracturing the well to stimulate production and did not give notice to JKM as required by the JOA.[19] Once JKM saw Chisos' operations, it asserted trespass. Chisos filed suit, with JKM claiming rights in the HL2 well. Chisos obtained limited term rights from Pure, staged a workover rig on site, and sent a letter to JKM asking for participation within forty-eight hours.[20]

> 1. The conveyance instrument was ambiguous as a matter of law, and substantial evidence supported the district court's interpretation of the instrument.

In New Mexico, the existence of ambiguity in an agreement is an issue of law that is reviewed *de novo*.[21] Ambiguity exists in a contract if the contract is "reasonably and fairly susceptible of different constructions."[22] In determining if the contract is ambiguous, a court may hear circumstantial evidence surrounding the making of the contract.[23]

In *Chisos*, the Court of Appeals affirmed the district court's finding that the conveyance instrument was ambiguous.[24] At trial, different experts compared the conveyance to a wellbore assignment, a lease assignment, and an operating interest assignment.[25] The conveyance was reasonably susceptible to different constructions, and therefore deemed ambiguous.[26]

Once an agreement is deemed ambiguous, the meaning of the ambiguous agreement is a question of fact.[27] Factual issues include evidence that turns on witness credibility, is in dispute, or is susceptible to conflicting inferences.[28]

When faced with a dispute between parties over the meaning of terms, New Mexico has adopted the Restatement (Second) of Contracts § 201 (1981) to resolve the dispute.[29] The Restatement provides, in pertinent part:

> (2) Where the parties have attached different meanings to a promise or agreement or a term thereof, it is interpreted in accordance with

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18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.* (citing Mark V Inc. v. Mellekas, 845 P.2d 1232, 1235 (N.M. 1993)).
22. Mark V Inc. v. Mellekas, 845 P.2d 1232, 1235 (N.M. 1993).
23. C.R. Anthony Co. v. Loretto Mall Partners, 817 P.2d 238, 242–43 (N.M. 1991).
24. *Chisos, Ltd.*, 258 P.3d at 1111.
25. *Id.*
26. *Id.*
27. Mark V Inc. v. Mellekas, 845 P.2d 1232, 1235 (N.M. 1993).
28. C.R. Anthony Co. v. Loretto Mall Partners, 817 P.2d 238, 244 (N.M. 1991).
29. Farmington Police Officers Ass'n v. City of Farmington, 137 P.3d 1204 (N.M. Ct. App. 2006).

> the meaning attached by one of them if at the time the agreement was made,
> (a) that party did not know of any different meaning attached by the other, and the other knew the meaning attached by the first party; or
> (b) that party had no reason to know of any different meaning attached by the other, and the other had reason to know the meaning attached by the first party.[30]

The Court of Appeals held that a reasonable person could find substantial evidence to support the district court's factual finding that the proper meaning of the conveyance was the one intended by JKM.[31] Applying the Restatement, the Court of Appeals concluded that Chisos knew or had reason to know that JKM intended for the conveyance to encompass all of Chisos' operating rights in the property, and JKM did not know or have reason to know that Chisos intended the conveyance to be a mere wellbore assignment.[32]

> 2. The operator demonstrated bad faith and breached the joint operating agreement by failing to follow the procedure for participation in a well recompletion and by attempting to characterize the recompletion activity as a process requiring less advance notice.

In New Mexico, breach of contract is a question of fact that is reviewed under a substantial evidence standard.[33]

Both JKM and Chisos were parties to the JOA.[34] Under the JOA, Chisos was required to give JKM notice of its intent to recomplete wells, and to allow JKM thirty days to decide whether to participate in the recompletion.[35] Instead, Chisos tried to force JKM to commit to participate in just forty-eight hours.[36]

The district court found Chisos acted in bad faith because it attempted to stage a workover rig as a drilling rig in an attempt to trigger the forty-eight-hour notice provision in the JOA, applicable only to drilling rigs.[37] In New Mexico, bad faith exists when "the breaching party is consciously aware of, and proceeds with deliberate disregard for, the potential of harm to the other party."[38] Chisos knew that the rig was not a drilling rig when it was staged, and the Court of Appeals found substantial evidence supporting the district court's finding of

30. RESTATEMENT (SECOND) OF CONTRACTS § 201 (1981).
31. Chisos, Ltd. v. JKM Energy, L.L.C., 258 P.3d 1107, 1112 (N.M. Ct. App. 2011).
32. *Id.*
33. Collado v. City of Albuquerque, 45 P.3d 73 (N.M. Ct. App. 2002).
34. *Chisos, Ltd.*, 258 P.3d at 1112.
35. *Id.*
36. *Id.*
37. *Id.* at 1114.
38. Paiz v. State Farm Fire and Cas. Co., 880 P.2d 300, 310 (N.M. 1994).

bad faith.[39] The Court of Appeals upheld the district court's decision to allow JKM a retroactive opportunity to participate in the well that was recompleted.[40]

### B. Hess Corp. v. New Mexico Taxation & Revenue Department[41]

*Hess Corp. v. N.M. Taxation & Revenue Dep't* involved an additional severance tax assessment based on the settlement of a carbon dioxide royalty underpayment class action brought by overriding royalty interest owners in the Bravo Dome Carbon Dioxide Gas Unit in northeastern New Mexico (the "Bravo Dome Unit").[42] As an issue of first impression, the Court of Appeals held that the settlement of the royalty class action was an adjudicatory event that triggered additional severance tax.[43]

The New Mexico Taxation and Revenue Department (the "Department") issued Hess a severance tax assessment under NMSA 1978, section 7-29-4.3 (1985).[44] Hess paid the assessment and then submitted an administrative refund claim, which was denied.[45] Hess next filed a complaint in district court pursuant to the New Mexico tax refund statute, NMSA 1978, section 7-1-26(C)(2) (2007). The district court determined that the settlement proceeds were comprised of one-half price claims and one-half non-price claims. Price claims are subject to additional severance tax.[46] Therefore, the district court refunded Hess $4,432,323 plus interest of the $8 million originally levied in severance tax.[47]

#### 1. The settlement of the royalty class action was an adjudicatory event that triggered additional severance tax.

The issue on appeal, whether the settlement agreement triggered additional severance tax reporting and payment obligations, was guided by section 7-29-4.3:

> When an increase in the value of any product is subject to the approval of any agency of the United States of America or the State of New Mexico or any court, the increased value shall be subject to this tax . . . .

NMAC 3.18.7.8(A) contains similar language that the Court of Appeals said "applies to class action settlements like the one at issue . . ." and "impose[s] severance tax obligations when a court or agency is-

39. *Chisos, Ltd.*, 258 P.3d at 1114.
40. *Id.* at 1112–14.
41. Hess Corp. v. N.M. Taxation & Revenue Dep't, 252 P.3d 751 (N.M. Ct. App. 2011), *cert. denied* No. 32,865, 2011 N.M. LEXIS 123 (N.M. Mar. 16, 2011).
42. *Id.* at 753.
43. *Id.* at 755–56.
44. *Id.* at 753.
45. *Id.* at 754.
46. *Id.*
47. *Id.*

sues an order, and the effect of that order is to increase the value at the wellhead of products previously reported."[48]

The Department argued, and the Court of Appeals agreed, "that Section 7-29-4.3 covers the settlement of royalty class actions that have value claims underlying them," and that Hess incurred severance tax obligations because the settlement agreement was "a taxable event" under the statute.[49] The court reasoned that class action royalty suits brought under Fed. R. Civ. P. 23(e) are always subject to court approval, and the Legislature intended such a judicial event to be subject to additional severance tax reporting and payment obligations under section 7-28-4.3.[50] By settling the price claim for royalty underpayment, the court reasoned that "Hess settled the allegation that it suppressed the price of carbon dioxide produced from the Bravo Dome Unit.[51]

Hess made other arguments against the additional severance tax, which were also denied by the Court of Appeals. The court held that Hess, as the operator of the unit, had the responsibility of determining the "taxable value" of the carbon dioxide it extracted under NMSA 1978, section 7-29-4.1, 6, and 7 (2005).[52] Accordingly, Hess was "obligated to remit any severance taxes owed by the royalty interest owners," and was also liable for its own severance tax along with those owed by the royalty interest owners.[53]

The court also held that the district court did not err when it invoked its power under section 7-1-11(D) and used the "reasonable methods assessment approach" to determine Hess's tax liability.[54] A reasonable methods assessment is appropriate when the taxpayer's records and accounting books are insufficient to determine liability. In the *Hess* case, Hess underrepresented the value of previously reported taxable product, the carbon dioxide. Because of the undervaluation, the Department had the authority to use other sources of information, like expert testimony, to determine Hess's tax liability.[55]

The court rejected Hess's challenges of the statutory grounds for the assessment, the extended statute of limitations, and other ancillary points. It upheld the ruling of the district court to partially refund Hess for the additional severance taxes paid.[56]

48. *Id.* at 756.
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* at 757.
53. *Id.*
54. *Id.* at 758.
55. *Id.* at 758–59.
56. *Id.*