Oil and Gas, Natural Resources, and Energy Journal

Volume 2 | Number 3
2016 SURVEY ON OIL & GAS

September 2016

Oklahoma

Matt Schlensker

Follow this and additional works at: https://digitalcommons.law.ou.edu/onej

Part of the Energy and Utilities Law Commons, Natural Resources Law Commons, and the Oil, Gas, and Mineral Law Commons

Recommended Citation
Matt Schlensker, *Oklahoma*, 2 OIL & GAS, NAT. RESOURCES & ENERGY J. 275 (2016),
https://digitalcommons.law.ou.edu/onej/vol2/iss3/19

This Article is brought to you for free and open access by University of Oklahoma College of Law Digital Commons. It has been accepted for inclusion in Oil and Gas, Natural Resources, and Energy Journal by an authorized editor of University of Oklahoma College of Law Digital Commons. For more information, please contact Law-LibraryDigitalCommons@ou.edu.

ONE J

Oil and Gas, Natural Resources, and Energy Journal

VOLUME 2 NUMBER 3

OKLAHOMA

Matt Schlensker[*]

Table of Contents

I. Introduction 276
II. Regulatory Developments 276
III. Judicial Developments 276
A. State Cases 276
B. Federal Cases 280

* Matt Schlensker is an associate in The Woodlands office of Steptoe & Johnson PLLC.

Published by University of Oklahoma College of Law Digital Commons, 2016

I. Introduction

The Oklahoma Corporation Commission proposed regulations to protect the state from further seismic activity. Meanwhile, the Oklahoma Supreme Court tackled the Production Revenue Standards Act and the Rule Against Perpetuities, while the Tenth Circuit Court of Appeals upheld a broad definition of a "partnership" for tax purposes.

II. Regulatory Developments

On August 18, 2016, the Oil and Gas Conservation Division ("OGCD") of the Oklahoma Corporation Commission ("OCC") announced additional measures to combat recent seismic activity potentially triggered by saltwater disposal wells in Oklahoma and Lincoln counties. After recent earthquakes near Luther and Wellston, the OGCD required operators of all wells within a ten-mile buffer from these two events either shut-in the wells or operate at a reduced capacity, depending on their proximity to the events. The OGCD will review these actions every 180 days.[1]

This action is part of a series of regional responses to seismicity caused by oil and gas development; for example, a Regional Volume Reduction Plan issued in February and March of 2016 covered western and central Oklahoma and regulated shut-in or reduced production from disposal wells in that area of the state.[2]

III. Judicial Developments

A. State Cases

Krug v. Helmerich & Payne, Inc.

In *Krug v. Helmerich & Payne, Inc.*, the Supreme Court of Oklahoma ruled the Production Revenue Standards Act ("Act") did not apply to a settlement arising from uncompensated drainage from gas wells as opposed to actual production.[3]

The Act generally regulates the marketing, sale and production of minerals, and it imposes a timeframe on operators to pay royalty owners their share of production or face interest penalties. The Act entitles royalty

---

1. Press Release, Oklahoma Corporation Commission, Oil and Gas Conservation Division, *Reduction in Volumes for Wells Located in Area of Interest for Triggered Seismicity* (Aug. 18, 2016).

2. Media Advisory, Oklahoma Corporation Commission, Oil and Gas Conservation Division, *Regional Earthquake Response Plan for Western Oklahoma* (Feb. 16, 2016).

3. Krug v. Helmerich & Payne, Inc., 2015 OK 74, 362 P.3d 205.

https://digitalcommons.law.ou.edu/onej/vol2/iss3/19

owners to the "share of proceeds or other revenue derived from or attributable to any production of oil and gas that may be attributed to any royalty share."[4]

Krug represented a class of people who own mineral interests in a pair of 640-acre sections in Beckham County. The class leased their lands to the defendant, which operated natural gas wells on these lands from 1978 to 1998.[5]

The mineral owners brought suit seeking damages for uncompensated drainage of natural gas allegedly occurring between 1982 and 1989; they alleged the defendants received payment from a settlement related to uncompensated drainage but did not share any portion of the settlement with mineral owners.[6] Plaintiffs argued the Act entitled them to their share of the settlement because the settlement qualified as proceeds or other revenue attributable to production.[7]

The Court disagreed and referred to *Roye Realty & Developing, Inc. v. Watson*, which defined the word "produced" as discovery of a product and extraction of same from the ground; *Roye* defined "sold" as the point when gas enters the purchaser's pipeline.[8] The court ruled the Act does not apply because the settlement payment did not relate to any actual production of natural gas, and the legislature's clear intent was for the Act to only apply to production, not uncompensated drainage.[9]

American Natural Resources, LLC v. Eagle Rock Energy Partners, L.P.

The Supreme Court of Oklahoma ruled an agreement granting a party the right to participate in all future wells without a timeframe violated the rule against perpetuities ("Rule"), and a limited liability company cannot be a "life in being" for purposes of Article II, Section 32 of the Oklahoma Constitution.[10]

In 2005, Encore Operating, LP, defendants' predecessor in interest, entered into a letter agreement with American Natural Resources ("ANR"), which included an area of mutual interest ("AMI"). Within the AMI, ANR agreed to assign leases to Encore, and Encore would, among other things,

4. *Id.* ¶ 14, 362 P.3d at 212 (quoting OKLA. STAT. TIT. 52, §570.2(8) (2015)).
5. *Id*. ¶ 3, 362 P.3d at 208.
6. *Id*. ¶ 4, 362 P.3d at 209.
7. *Id*. ¶ 11, 362 P.3d at 210.
8. *Id.* ¶ 19, 362 P.3d at 213-14 (citations omitted).
9. *Id.* ¶ 20-21, 362 P.3d at 214.
10. Am. Nat. Res., LLC v. Eagle Rock Energy Partners, L.P., 2016 OK 67, 374 P.3d 766.

Published by University of Oklahoma College of Law Digital Commons, 2016

drill a test well and "allow ANR to participate in all future wells drilled in the AMI at any time whether or not the parties held a current lease."[11] The main conflict arises from the Option Provision: "In all subsequent wells within the AMI, ANR shall have the right to participate in the prospect area with a twenty-five (25%) working interest[.]" ANR alleged defendants completed seventeen wells in the AMI but did not allow ANR to participate in any of them.[12]

At the district court, defendants filed a motion to dismiss, arguing the Option Provision violated the Rule.[13] The District Court granted the motion to dismiss.[14] The Court of Civil Appeals affirmed in part and reversed and remanded in part for a determination of whether life of an organization could create an exception to the Rule.[15] The defendants appealed.[16]

Article II, Section 32 of the Oklahoma Constitution provides "perpetuities and monopolies are contrary to the genius of a free government, and shall never be allowed[.]"[17] In *Melcher v. Camp*, the Oklahoma Supreme Court adopted the commonly accepted definition of the Rule — "no interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest."[18]

ANR argued the Rule does not apply to joint operating agreements ("JOAs") because those contracts usually do not include property rights; however, the Court noted this Option Provision lies within a stand-alone AMI (not a JOA), which *does* determine the parties' rights to participate in drilling wells, i.e., property rights.[19]

Defendants relied on *Melcher*, wherein the parties entered into a top lease for minerals above a 5,500-foot depth split of a certain property.[20] A separate agreement required "that in the event [the lessors] shall at any time have an opportunity to lease the oil, gas and other minerals and mineral rights below 5,500 feet, [the lessee] is to be given a five day option of acquiring such lease himself on the same terms and conditions offered to [the lessors]."[21] This Court found that preemptive option violated the Rule

11. *Id.* ¶ 2, 374 P.3d at 767.
12. *Id.* ¶ 3, 374 P.3d at 767.
13. *Id.* ¶ 4, 374 P.3d at 768.
14. *Id.*
15. *Id.* ¶ 5, 374 P.3d at 768-69.
16. *Id*.
17. *Id.* ¶ 7, 374 P.3d at 769 (quoting OKLA. CONST. art. II, § 32).
18. *Id.* (quoting Melcher v. Camp, 1967 OK 239, 435 P.2d 107).
19. *Id.* ¶ 8, 374 P.3d at 769.
20. *Id.* ¶ 10, 374 P.3d at 769-70.
21. *Id.*

https://digitalcommons.law.ou.edu/onej/vol2/iss3/19

because the separate agreement would not terminate with the existing lease agreement, "the option was based on a condition precedent which might never occur," and "the lessors gave up their right to sell to whomever they wanted."[22]

The *Melcher* Court also noted an exception to the Rule: the option is within the lease and is exercisable within the term of the leasehold.[23] The plaintiff alternatively argued this exception should apply to the Option Provision, citing *Producers Oil Company v. Gore*, wherein this Court applied the *Melcher* exception and ruled a preemptive option did not violate the Rule.[24] But here, the Court distinguished *Producers* from *Melcher*.[25] The *Melcher* option depended on unleased property and would not expire if the leases terminated for lack of production, while the *Producers* lease required the non-operator to give the operator the right of first refusal, a task that was impossible if the lease expired and the non-operator lost its interest in the leasehold.[26]

In this case, the Court decided the Option Provision more closely resembled the option in *Melcher* — it is not part of a JOA or a lease but an AMI agreement, and it does not expire when an existing lease expires.[27] The Option Provision affects all future leases executed at any time.[28] In other words, the Option Provision violates the Rule.[29]

The plaintiff, an LLC, also argued an LLC could be a "life in being" based on this Court's ruling in *Cartwright v. Hillcrest Investments, Ltd.*, which stated "at the time the Constitution was adopted, the term 'person' was generally understood to include corporations."[30] However, this Court explained that just because a corporation may be a "person" does not mean it is necessarily a "life in being."[31]

Under common law, a corporation was not a life in being because it is not a human being, and the term intends to measure the human lifespan.[32]

---

22. *Id*.
23. *Id*. ¶ 11, 374 P.3d at 770.
24. *Id.* ¶ 12, 374 P.3d at 770 (citations omitted).
25. *Id.*
26. *Id.* ¶¶ 12–13, 374 P.3d at 770 (citations omitted).
27. *Id.* ¶ 13, 374 P.3d at 770.
28. *Id.*
29. *Id.*
30. *Id.* ¶ 15, 374 P.3d at 771 (quoting another source).
31. *Id.*
32. *Id.* ¶ 16, 374 P.3d at 771.

Published by University of Oklahoma College of Law Digital Commons, 2016

The United States Supreme Court also found that using a corporation as a life in being would violate the Rule.[33]

Without a measurable life in being, the Rule only permits a period not exceeding twenty-one years.[34] "[The plaintiff' right to participate in future wells is indeterminable, does not vest within the twenty-one-year limit, and may never vest. Thus, the Option Provision violates the rule against perpetuity."[35]

B. Federal Cases

Methvin v. Commissioner

The Tenth Circuit Court of Appeals ruled that a partnership existed, triggering self-employment tax, when a taxpayer entered into a purchase agreement and an operating agreement with an operator.[36]

In affirming the Tax Court, the Tenth Circuit explained that a partnership depends on the parties' intent.[37] The taxpayer argued his business arrangement did not qualify as a partnership because "his working interests are not governed by a separate organization" and "he is merely a passive investor."[38] However, he had the right to audit the books and inspect receipts, legal opinions, drilling logs, and core analyses. He and the operator also shared the costs, and the operating agreement described the venture as the development of joint property.[39]

The court compared these facts to the persuasive case of *Cokes v. Commissioner*.[40] Although the taxpayer argued he did not have the managerial rights present in *Cokes*, the Tenth Circuit ruled the Tax Court did not clearly err when it deemed the arrangement a partnership and affirmed the Tax Court.[41]

---

33. *Id.* (citing Fitchie v. Brown, 211 U.S. 321 (1908)).
34. *Id.* ¶ 17, 374 P.3d at 771.
35. *Id.* ¶ 18, 374 P.3d at 771.
36. Methvin v. Comm'r, No. 15-9005, 2016 U.S. App. LEXIS 11659 (10th Cir. June 24, 2016).
37. *Id.* at *3–4 n.1.
38. *Id.* at *3.
39. *Id.* at *3–4.
40. *Id*. at *4–5 (citing 91 T.C. 222 (1988)).
41. *Id*. at *5.

https://digitalcommons.law.ou.edu/onej/vol2/iss3/19