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DANIELLE SMITH

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CAPL MANAGEMENT NIGHT

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Segregation and NOAs: Are You Doing Enough or Too Much?

SINCE IT APPEARS THAT MOST OF THE CONVENTIONAL GAS IN THE WSB IS UP FOR SALE THIS YEAR, IT SEEMS LIKE A GOOD TIME TO TALK ABOUT A TOPIC NEAR AND DEAR TO THE A&D PROCESS. Not an apparently sexy issue, but you would be shocked and amazed at how many otherwise mild mannered land administrators go ballistic in meetings and brazenly advise that they never, ever, apply segregation to NOAs. A smaller percentage hold equally strong views on always applying segregation.

What is a mild mannered A&D lawyer to do? Well, I wish I had a good answer, however, as will become clear below, segregation is not an easy issue to resolve when issuing NOAs on dispositions.

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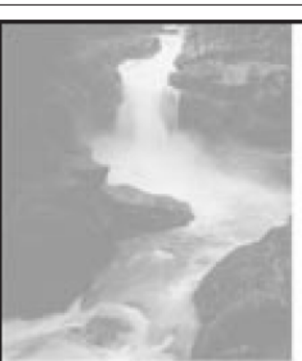

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What is Segregation?

In principle, segregation is a very simple concept. Clause 1301 of the 1990 CAPL sums it up nicely:

> 1301 OPERATING PROCEDURE TO APPLY *Where … any portion of the joint lands* ceases to be owned by the parties in the same percentages of interest as their working interests or *ceases to be owned by all of the parties*, the parties acquiring the different percentages of interest in such lands shall thereafter hold the same as if they are parties to a separate Operating Procedure … and *such portion of the joint lands shall cease to be 'joint lands' hereunder.* The parties holding working interest in the lands which cease to be joint lands under this Clause shall appoint one of them to be the initial Operator under the separate Operating Procedure … (emphasis mine)

The bottom line is that you can only have an oil and gas joint venture between parties that share a common interest in the subject matter underlying the agreement. The CAPL Operating Procedure (or any nonCAPL version of same) simply cannot work where you have strangers as "parties" to the agreement. As illustrated in clause 1301, the drafters of CAPL also acknowledged that an operating procedure cannot work where you have the same parties, but with different working interests.

This is not some archaic legal concept, this is just plain and simply the only way you can manage joint operations on lands. Things just cannot work where you try to insist that you maintain a single contract once a partial NOA has been issued. Without common parties and percentages, the operating procedure does not work.

Example and Application

Lets try an example class. Simple, simple facts:

- Two section JOA entered into by parties A and B each as to an undivided 50% working interest. Party A is operator. ROFR clause in the contract.
- Party A sells its interest in section 1 to party C. Accordingly the original lands are now held:
  - Section 1 party B 50% and party C 50%
  - Section 2 party B 50% and party A 50%.

Under segregation we now have two JOAs, one for section 1 and one for section 2. No one can argue this. Please stop. Clause 1301 is not unclear.

It helps to look at joint venture issues that clearly require segregation in order for the operating procedure to function. We shall examine three such issues:

Change of Operator

This is kind of like teeball. Once party A sells its interest in section 1 it can no longer be operator under the agreement. Says so in clause 1301 and just makes sense. A joint venture requires a common interest in common lands.

Interestingly enough, even where change of operator letters are issued on the sale by party A, the NOA will often still not be segregated on subsequent sales. This leads to the absurd scenario of having multiple operators appointed under a single contract.

IONs and AFEs

Now lets say the parties want to drill a gas well on section 1. The proper parties for the independent operations notice and AFE can only be parties B and C. They are the parties who have a working interest in the spacing unit for which the well will be drilled. It is just plain silly to argue that party A should receive the ION or have a right to participate in the well. No one ever disputes this application of segregation.

ROFRs

Lastly, let look at rights of first refusal. Lets pretend party B decides to sell its entire interest in the contract to party D. Who gets the ROFR(s)? Segregation tells us that upon the prior sale by A to C, the contract segregated such that after that time we actually have two separate agreements, one for section 1 and one for section 2.

Since we have two separate agreements, two separate ROFRs need to be issued as follows:

- ROFR notice to party C for section 1
- ROFR notice to party A for section 2

There are a small minority of landmen and land administers that balk at the segregated two ROFR result above. They argue that one ROFR notice from party B to parties A and C is ok. I call them segregation deniers. They must be shunned.

The problem can be illustrated by the issue of what happens if both parties A and C exercise under the single ROFR notice. Under the CAPL Operating Procedures (and almost all nonCAPLs) the rule is to prorate the share of the available disposition interest to the exercising parties. This simply cannot work where you issue a ROFR to a party who has no interest in the lands. Logically, they can only receive a zero percent prorated share for the lands they have no interest in.

It makes people very angry when you tell them they can buy something and later you tell them they get exactly zero percent of what they thought they were buying. If they get mad enough they might say, take you to court to insist that they somehow have a right to a portion of both section 1 and 2. Since you issued a single ROFR notice you are sort of kind of saying the same thing. Now the other party who should get the whole interest under segregation gets mad too. Maybe they sue. Please just say no to issuing a single ROFR notice on segregated lands.

The ROFR prorating issue is also a good example of why clause 1301 also speaks to segregation where you have the same parties but with different working interests. Same problem. Same solution. Segregation.

For all three of these areas above, I am a segregation enforcer. No compromise. Especially ROFRs. Please do not mess them up. Even where your last NOA lists like 12 parties with no interests in the bits of land you are selling, do not issue a single ROFR notice listing everyone. Apply segregation. Issue a ROFR notice only to those parties with a common interest in the same lands. Issue multiple ROFRs for the same contract when necessary. Do it with pride.

So Why Do We Screw Up The NOAs?

Now we come to issuing the NOA on a sale. Great big ugly contract file with 23 splits, bunch of different parties and lots of partial NOAs creating different splits. No ROFR. You flip the file and notice that the last 5 NOAs all list a whole whack of third parties. Sometimes you can see the third parties in your splits, sometimes you can't. A few third parties have written letters requesting that even more parties be adding to prior NOAs. Generally everyone seems to be just ignoring segregation and accepting the NOAs so long as enough third parties are listed. Yuck.

Lots of tough talk on segregation above, but now we get into the nitty gritty of what to do on an actual sale with these types of contract files.

The ugly truth is that segregation simply does not work very well with NOAs and contract files. Companies set up one contract file for each agreement, give it a nifty file number and enter it into their land system. If segregation occurs on sales, you simply add splits to your contract file and move on. I do not know of a single company that consistently creates a new contract file when segregation has occurred. Even trying to do this would be problematic since you would then have two contract files referring to the same agreement date and original parties. If you do not create a separate file it becomes very difficult to track separate contracts created by segregation.

Adding to the problem are a couple of features of the NOA that make it difficult to properly identify the various segregated JOAs:

- The land description at the top of the NOA is stated to be "For reference only: general land description". Therefore the industry standard form does not provide for a mechanism whereby you can differentiate between segregated splits for a single original contract; and
- The "Master Agreement" description in the NOA lists only the original agreement and original parties. Long ago when I still tried to enforce segregation I would add text to the Master Agreement description stating "as segregated by the NOA dated XXX with respect to the following lands XXX". Needless to say these NOAs were mercilessly rejected and I gave up.

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These problems have lead to the somewhat industry standard practice of ignoring segregation for NOAs.

Once we started to ignore segregation, the result became a self fulfilling prophecy. This is because in our busy lives we tend to review NOAs merely on the content of the last few accepted NOAs. If the last NOA has 12 third parties, administrators started to reject the next NOA that only had two third parties (based upon prior segregation). Once a few nonsegregated NOAs were binding, it is very cumbersome to try to unscramble the egg and apply segregation on the third parties for your next deal.

In many ways there may be more danger in trying to enforce segregation on a previously unsegregated NOA chain. By trying to retroactively enforce segregation, you may prompt third party rejections of your NOA which will break the chain of title. A bad thing.

One Contract One NOA

I understand that sometimes we do things wrong because it is simply unworkable to do them right, however I get concerned when this compromise somehow changes into a philosophy of how things ought to work.

By this I am referring to the "One Contract One NOA" rule I sometimes hear from administrators. Under this rule, segregation is seen to apply when necessary to make the operating procedure work (Operatorship, IONs, ROFRs) but deemed inapplicable for NOAs because at the end of the day there is still just one contract.

It is one thing to hold your nose and get things done. It is another to start thinking that the way we do things is the right way. My fear is that if landman and administrators see this "rule" as the right way to do things, they may inadvertently put their companies interests at risk. I believe the law is clear that segregation applies. We ignore it at our own risk.

Segregation and NonCAPL Operating Procedures

Lastly, I would like to touch on the nonCAPL segregation issue. Many old nonCAPL agreement simply refer to the "parties" to an agreement and do not have a segregation clause. This leads many people to draw a sharp distinction between segregation in CAPLs and no segregation in nonCAPLs.

I understand these views but I do not agree with them. Our discussion of operatorship, IONs and ROFRs above hopefully illustrates how you cannot simply ignore segregation in land contracts. They simply do not work unless segregation applies.

From a legal point of view we can also look to the concept of novation to support segregation. Every time a novation occurs (by A&N or NOA) the new parties at law enter into a new agreement. As stated in Chapter 5 of the CAPL Professionalism Manual:

> To novate means "to make new". Novation agreements involve the creation of a new contract which is entered into between the parties to an original contract and a new party. The original contract is essentially cancelled concurrently with the creation of the new contract, so that the transition is seamless.

The new parties novated into the JOA are only those parties who have an interest in the joint lands. In my view this is simply segregation by another name. I do not believe for one minute that it makes any difference whether you have a segregation clause in a contract or not. Segregation simply occurs by operation of law.

Conclusion

Does it matter if you apply segregation in NOAs? Normally I do not counsel clients to take any risk that can be avoided by simply doing things the right way. Sadly, I have come to believe that not a whole lot of material issues arise from simply including a few too many parties on NOAs. So long as the NOA is not rejected, I think you have a good argument at law that novation has occurred and that the assignor is relieved of its contractual obligations under the agreement and that the assignee has become a recognized party to same.

So what do I do? Most of the time I simply hold my nose and prepare the NOA with a bunch of inapplicable third parties. Don't cry for me Argentina. It does not bother me for very long.

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