Securities and Exchange Commission v. Nadel et al Doc. 1288

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

Case No. 8:09-cv-0087-T-26TBM

ARTHUR NADEL, SCOOP CAPITAL, LLC,
SCOOP MANAGEMENT, INC.

Defendants,

v.

SCOOP REAL ESTATE, L.P.,
VALHALLA INVESTMENT PARTNERS, L.P.,
VALWALLA MANAGEMENT, INC.,
VICTORY IRA FUND, LTD,
VICTORY FUND, LTD,
VIKING IRA FUND, LLC,
VIKING FUND, LLC, AND
VIKING MANAGEMENT, LLC

Relief Defendants.

FILED
2011 MAY -3 AM 11:55
CLERK, US DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
TAMPA, FLORIDA

v.

JOHN H. CARNEY, ET AL

Landlowners and
Respondents.

____/

BRIEF ON THE STATUS OF THE HATCHETT LEASE POST PRIMARY TERM AND WHETHER THE RECEIVER HAS ANY CLAIM TO THE LEASE OR LEASE EQUIPMENT IN HIS CAPACITY AS RECEIVER FOR QUEST ENERGY MANAGEMENT GROUP, INC.

TO THE HONORABLE RICHARD A. LAZZARA, UNITED STATES DISTRICT JUDGE:

Comes Now, John Hatchett Carney, Respondent Pro Se responding to the Receiver's claims of continued Interest In the Hatchett Ranch Oil and Gas lease and residual equipment.

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The simple answer is no, the Receiver has no rights under the Hatchett Ranch Leases or equipment or under Texas law. Although incorporated into one document, the Hatchett Lease document memorializes 24 separate leases on 24 separate tracts of land. Texas oil and gas law is clear and well litigated. The Texas Railroad Commission has the forum and experience to deal with the issues presented. Meaning no disrespect to this Court, but the Receiver appointed by this court lacks even a fundamental comprehension of the vernacular unique to the industry and no knowledgeable Texas oil and gas lawyers would even attempt to argue the position being asserted by the Receiver. This Respondent was lead counsel for the defense in the largest oil and gas SEC Ponzi Scheme allegation case in history, *SEC v.. Provident Royalties,*[1]involving over $1 Billion Dollars in Assets.

BACKGROUND

The lease on the Hatchett Ranch acquired by Quest (and by the Receiver as Quest) was a 5 year primary term lease, and was made on or about April 15, 2011 and expired on April 15, 2016. All production ceased when the wells were shut in in Receiver shut the wells down, which cut off the gas supply to Bill Hatchett's home. At

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1Litigation Release No. 21118 / July 7, 2009
Securities and Exchange Commission v. Provident Royalties, LLC, Provident Asset Management, LLC, Provident Energy 1, LP, Provident Resources 1, LP, Provident Energy 2, LP, Provident Energy 3, LP, Shale Royalties II, Inc., Shale Royalties 3, LLC, Shale Royalties 4, Inc., Shale Royalties 5, Inc., Shale Royalties 6, Inc., Shale Royalties 7, Inc., Shale Royalties 8, Inc., Shale Royalties 9, Inc., Shale Royalties 10, Inc., Shale Royalties 12, Inc., Shale Royalties 14, Inc., Shale Royalties 15, Inc., Shale Royalties 16, Inc., Shale Royalties 17, Inc., Shale Royalties 18, Inc., Shale Royalties 19, Inc., Shale Royalties 20, Inc., Paul R. Melbye, Brendan W. Coughlin, and Henry D. Harrison, defendants and Shale Royalties 21, Inc., Shale Royalties 22, Inc., Provident Operating Company, LLC, Somerset Lease Holdings, Inc., and Somerset Development, Inc., Case No. 3-09CV1238-L (N.D. Texas)

the time the 5 year primary term expired there was no production to hold the lease into a secondary term. The Inactive Well Query Results for Quest, Operator No. 684615 for Callahan County, Texas representing all of the Hatchett Ranch lease wells. The shut-in dates begin in 2006, with the last being 2013, so upon the expiration of the 5 year primary lease term there was no production to hold the lease. The Receiver was appointed on receiver over the Quest Entity and assets on May 24, 2013 (Doc. 1024). The Receiver had from May 24, 2013 until April 15, 2016 to undertake operations, market the assets and did virtually nothing but cause damage to the oil and gas assets and the surface estate.

The Receiver reported that "Quest had retained its license to operate, is working diligently to remain in compliance with applicable regulations, and its wells are collectively producing on average approximately 33 barrels of oil per day. This is not reporting from the Hatchett leases but other leases on other properties unrelated to the Hatchett leases. This misleading reporting has nothing to do with the Hatchett leases and it is beyond comprehension that the Receiver would claim production from unrelated wells would somehow hold a Hatchett lease. Not on drop of oil was prosecuted from a permitted oil and/or gas well, and flow back from a salt water injection well does not constitute production, let alone production in paying in paying quantities. Again he reports, "Since the Receiver's appointment, he has more than doubled production." What the Receiver fail to report to the court that his only action with regard to the Hatchett Lease was to "Shut-in" the last of the two (of 12) producing wells, never to produce again. From January 1, 2013 to April 15, 2016 did nothing, produced nothing and forfeited the lease at the end of the primary term.

The Receiver filed a request for an extension to plug the wells. April 18 2016 applied for an extension to plug wells. A predicate for an extension for plugging of a well or wells requires AN ACTIVE WELL, which as of April 15, 2016 the Receiver did not have.

If the Receiver's counsel believes that that thinking about drilling a well would preserve a lease, or even requesting a permit (which requires a current active lease he did not have) or requesting an extension to plug wells extends a lease, he's sadly mistaken. If the Receiver believes that a backwash of a minute about of oil from a saltwater injection well, not permitted for production constitutes production, again, he is sadly mistaken. If even it was considered production, it would not be close to economic production, or as we say in Texas, "production in paying qualities", again sadly mistaken. And even if it were production, and in paying qualities, you have to sell it and timely distribute the revenues, while accounting for the gas sales revenues and not withholding payment. Again, failure to preserve a lease.

There is virtually no indication of any competent management of the Hatchett Lease during the term of the lease, and the "management" that was done was so grossly negligent, that, as set forth here, Respondent re-urges this court for Leave to file suit, in Texas where venue would properly lie, or if not, before this Honorable Court. All of the Parties, experts and witnesses reside in Texas, in Callahan County and believe the local Federal District Court could find time to hear a jury trial on the merits.

The primary "paid up" term the leased covered all 24 tracts, but the requirement to hold any portion of the leases was on a tract by tract basis, written to that active

production on one tract did not perpetuate the lease during three years and on information and belief, did nothing on 23 of the 24 tracts. All all relevant time, the wells were indicated as shut in or unproductive and produced no oil or gas. At the conclusion the primary term, there was no production to commence a secondary or successive lease term. The Receiver did virtually nothing on the Hatchett Leases in the three years it managed the Receivership asset. What little the Receiver did do was to try and work over a single well, doing so in an illegal and negligent manner. The Receiver further breached the lease by failing to clean up a waste pit, maintain all weather roads, polluting lands and waters and withhold payment for gas sales and refuse to account for revenues received.

These claims asserted by Respondent are not claims against Quest Energy Management Group, Inc., Nadel or the Ponzi defendants, but against the Receiver in his capacity as receiver and his contract pumper.

WHAT DOES IT TAKE TO EVOLVE A LEASE OR HOLD A LEASE AFTER THE PRIMARY TERM?

The Receiver conceded that the 5 year primary term of the Hatchett lease expired on April 15, 2016, however it contends that planning to drill a new well, seeking extensions to plug the wells and even attempting to obtain a drilling permit is sufficient to hold a lease past its primary term. An oil and gas lease typically specifies two periods. In the first, the "primary term," the lessee is required to produce oil (we omit "and gas," to simplify) from the leased wells. If he fails to produce, the lease terminates and the wells revert to the lessor, except that the lessee can stave off reversion by paying an annual "delay rental," provided he starts producing by the end of the primary

term. In the secondary term, failure to produce oil and/or gas in paying quantities (other than temporarily) triggers immediate reversion. *Midwest Oil Corp. v. Winsauer,* 159 Tex. 560, 323 S.W.2d 944, 946 (1959); *Cobb v. Natural Gas Pipeline Co.*, 897 F.2d 1307, 1309 (5th Cir.1990); Owen L. Anderson et al., Hemingway Oil and Gas Law and Taxation §§ 6.2-6.3, pp. 217-23 (4th ed.2004). Thus, during the primary term, the lease is equivalent to an option.

The habendum clause is a fundamental provision of oil and gas leases. This clause (also called the term clause) sets forth the time period that the rights granted to the lessee under the lease are extended—i.e. how long the lease will be active.1

An habendum clause in an oil and gas lease typically contains two separate terms, the primary term and the secondary term. The primary term is a fixed period of time during which the lessee has the option, but not the obligation, to pay delay rentals and/or explore for and produce oil and gas. No actual production is necessary to keep the lease active during the primary term. Ten years used to be a common primary term; however, shorter primary terms (e.g. 1 to 5 years) are often seen in areas with proven fields or anticipated drilling.2 As with other lease terms, its length can be negotiated by the lessor and lessee; the relative bargaining power between the parties and the amount of bonus a lessee is willing to pay are important in determining term length.3
At the expiration of the primary term, the lease terminates as a matter of law unless production4 is achieved during the primary term. The time period under the secondary term is indefinite—so long as lease substances are produced, the lease remains in effect. While many leases expire at the end of the primary term without production, if

production is achieved, it is not uncommon for oil and gas leases to be held by production for many years.

In having both a primary and secondary term, the interests of both lessors and lessees are represented. The fixed primary term protects lessors from having their mineral interests endlessly tied up without production and encourages development on the land. If production is not achieved by the lessee within the primary term, the lease terminates (unless otherwise extended, such as by other lease terms) and the lessor is free to re-lease his or her mineral interests. Conversely, if production is achieved, the lessee's risk in expending substantial sums to develop the land is rewarded by extending the lease so long as production continues.5

Although there are numerous variations of habendum clauses, a typical habendum clause will read substantially as follows:

> *[T]his lease shall remain in force for a term of ___ years from this date, and as long thereafter as oil or gas or either of them is produced from said lands.6*

Additionally, the phrase "produced in paying quantities" or "produced in commercial quantities" is commonly included in the clause, along with phrases allowing for production to come from lands pooled or unitized with the leased lands.7

As noted above, the typical habendum clause requires that oil or gas be "produced" from the leased land to extend the lease beyond its primary term. In most states, "produced" means exactly that—oil or gas must actually be produced from the leased land. A minority of states, including Oklahoma and West Virginia, hold that discovery of oil or gas is sufficient—no production is actually necessary—to extend the lease beyond its primary term, although the well must be completed and capable of production, and the lessee must make diligent efforts to market.8 Another minority of

states, including Montana and Wyoming, appear to differentiate between oil and gas, with the discovery of gas being sufficient to extend the lease beyond the primary term, while actual production for oil is necessary to extend.9 The distinction arises because oil can be produced and stored economically while gas generally cannot be stored economically above the ground.10

Some habendum clauses include language that the lease will be extended "so long as oil or gas is capable of being produced in paying quantities." In such instances, actual production is not necessary to extend the lease beyond its primary term, but may require a well that can be turned "on" to produce in paying quantities without the addition of extra equipment or repair.11

Once the lease is extended into the secondary term, if production ceases the lease automatically terminates (unless otherwise extended by a different provision in the lease).12 However, courts have held that it is not required that production be entirely continuous throughout the extended term to hold the lease. Courts recognize that production may temporarily cease due to repairs, breakdowns, and reworking operations.13 Where the lease is silent, and cessation in production is litigated, the burden of proof rests on the lessee to show that the cessation was for a reasonable reason and for a reasonable amount of time. Courts vary in what constitutes a reasonable amount of time.14 For example, one court held that a four-year cessation in production was "temporary," while another court held that a six-month cessation was "permanent." To provide more certainty in the face of inconsistent court rulings, modern oil and gas leases often include a "cessation of production" clause that specifies when production must be continued after cessation for the lease to not terminate.15

MEANING OF "PRODUCED IN PAYING QUANTITIES"

A question that frequently arises when construing an habendum clause is how much production is necessary—i.e. is any amount of production sufficient to hold the lease, or must the production reach a certain level? As noted above, modern oil and gas leases commonly include the qualification that production be in "paying" or "commercial" quantities. For leases that only state "production" is required, courts generally have construed the clause to include this qualification. Thus, regardless of whether the lease includes the qualification "in paying quantities," the term "produced" typically means "produced in paying quantities."16

The question then becomes what constitutes "produced in paying quantities." The Kansas Court of Appeals stated the general rule:

[T]he phrase "in paying quantities" as used in an oil and gas lease habendum clause means production of quantities of oil or gas sufficient to yield a profit to the lessee over operating expenses, even though the drilling costs or equipping costs are never recovered, and even though the undertaking as a whole may thus result in a loss to the lessee.17

Put simply, a lease is considered "producing in paying quantities" if production revenue is greater than operating expenses. In determining production revenue, any royalty paid to the lessor is excluded, although any payment to overriding royalty owners generally are included as revenue.18 For operating expenses, any direct costs to operate, such as labor costs, electricity for pumping units, taxes (but not income taxes) payable by the working interest owner(s), and day-to-day maintenance cost are

included.19 There is some dispute among courts whether depreciation and overhead costs should be included as operating expenses.20 Initial expenditures, such as the costs of drilling, equipping, and completing are not included as operating expenses.21 Such analysis makes economic sense—after these initial expenditures, an operator will continue to operate so long as the production on a lease is marginally profitable in order to recover as much of these costs as possible.22

It is important to have a reasonable time period when evaluating production revenues against operating expenses. Leases may operate negatively in the short-term, but profitably in the long-term. One source notes that in almost every instance, a time period of at least a year was used by the courts to evaluate profitability, and frequently a time period of eighteen months to three years was used.23 In times of distressed market conditions, courts have used longer time periods or have assessed whether the lease would have been profitable under normal market conditions.24

Conclusion

An understanding of the habendum clause is crucial when negotiating a lease or when evaluating whether a lease has been held by production past its primary term. As you do so, keep in mind that other lease provisions not discussed in this article may also affect lease duration, such as shut-in royalty, pooling, unitization, Pugh, continuous operations, delay rental, and cessation of production clauses, among others. Additionally, be aware that the law varies from jurisdiction to jurisdiction, and may be different from the general principles discussed in this article.

1 See PEC Minerals LP v. Chevron U.S.A., Inc., 439 F. App'x 413, 416 (5th Cir. 2011).
2 John S. Lowe, Oil and Gas Law in a Nutshell (6th ed. 2014).
3 Id.
4 Or a lease provision that serves as a substitution for actual production such as

continuous drilling operations or payment of shut-in royalty.
5 Lowe, supra note 2.
6 3 Patrick H. Martin & Bruce M. Kramer, Williams & Meyers, Oil and Gas Law § 603.3 (2014).
7 Id.
8 See McVicker v. Horn, 322 P.2d 410 (Okla. 1958); Eastern Oil Co. v. Coulehan, 64 S.E. 836 (W. Va. 1909).
9 See Severson v. Barstow, 63 P.2d 1022 (Mont. 1936); Pryor Mt. Oil & Gas Co. v. Cross, 222 P. 570 (1924).
10 See 2 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 26.6 (rev. ed. 2014). See also Lowe, supra note 2.
11 Martin & Kramer, supra note 6.
12 See Anadarko Petroleum Corp. v. Thompson, 94 S.W.3d 550, 554 (Tex. 2002).
13 Martin & Kramer, supra note 6, at § 604.4.
14 Id.
15 I d. See also Dave Hatch, Potential Pitfalls of Continuous Drilling Provisions in HBP Fee Leases (Apr. 10, 2014), available at: http://www.hollandhart.com/pitfalls-of-continuous-drilling-provisions-in-hbp-fee-leases/.
16 1 Earl A. Brown, Earl A. Brown, Jr., & Lawrence T. Gillaspia, The Law of Oil and Gas Leases § 5.03 (2d ed. 2014).
17 Avien Corp. v. First National Oil, Inc., 79 P.3d 223, 230 (Kan. Ct. App. 2003); see also Maralex Res., Inc. v. Gilbreath, 76 P.3d 626, 630 (N.M. 2003) ("To satisfy the habendum clause production must be in 'paying quantities,' such that the income generated from oil and gas production exceeds the operating costs.").
18 Lowe, supra note 2.
19 Id. See also Martin & Kramer, supra note 6, at § 604.6(b).
20 Martin & Kramer, supra note 6, at § 604.6(b).
21 Kuntz, supra note 10, at § 26.7.
22 Martin & Kramer, supra note 6, at § 604.6(b).
23 Lowe, supra note 2.
24I d. See also Kuntz, supra note 10, at § 26.7.

THE SALVAGE EQUIPMENT

The lease terms are contractual and clear that the owner/operator had 120 days from the end of the primary term to remove any equipment, such period expiring August 15, 2016. No equipment was removed before the expiration of the 120 days.

24 SEPARATE LEASES CONTAINED IN THE HATCHETT LEASE

The Receiver argues that its nominal activities undertaking after April 15, 2016 somehow constituted sufficient activity to entitle the Receiver to preserve the not just the single 160 acre lease where it contemplated drilling a well, but the entire Hatchett lease, which consists of 24 separate leases, one for each of 24 tracts, each make subject to a separate lease and requires the separate basis for preserving a lease term after the primary term. The position is frivolous, and fraudulent and an obvious attempt to avoid the Receiver's negligence and gross misconduct. (1) Emergency Motion To Enjoin/Stay Texas Railroad Commission Administrative Proceeding Filed Against Receivership Entity Quest Energy Management Group, Inc. and would respectfully show to the court the following:

SUMMARY

The Receiver, through actions and inactions, allowed the Hatchett Lease to terminate on April 15, 2016, the expiration of the 5th year of the primary term, and no effort was made sufficient to extend the lease into the secondary term. The Receiver reports all wells as "inactive" and for which no production was obtained. Pursuant to the Lease, on the 120th day after the expiration of the lease, or August 15, 2016 the right to recover any oil and gas equipment was waived by the terms of the lease and the Receiver was advised that neither he, nor his representatives had any right to enter the property.

Notwithstanding the clear loss of all lease rights, by operation of law, the Receiver continues to asset a right to sell the expired leases. The Receiver objected to the filing of a good faith determination hearing filed by one of the mineral owners, pro se and not representing any other family member in a legal capacity. The Receiver faces

serious regulatory issues as a result of its failure to conduct basic well maintenance and management for some time. The Receiver failed to correct basic well maintenance issues and created additional violations of its own, prior to the expiration of the lease. The lease expiration prevents the Receiver from any further operation of the Hatchett wells and thus prevents any potential sale to a third party as there is nothing to sell.

A profound lack of understanding of Texas Oil and Gas law is manifest and indicates that neither the Receiver or its counsel were qualified to administer this estate. There is no evidence that the Receiver despite having three years to address management and operation issues, the Receiver spent virtually zero time and expense to resolve these regulatory issues as well as implement a maintenance and repair plan. What the Receiver and its counsel did was very little and what they did do was grossly negligent and violated the terms of the lease agreement. They still refuse to account for the gas revenues.

The Receiver made an application with the Railroad Commission for an extension on April 18, 2016 after the lease termination, and fraudulently represented that it had "a good faith claim to a continuing right to operate the wells" which extension for closing was sought. It did not. The Receiver sought relief from the Texas Rail Road Commission, and Byron Hatchett, on his own, without any involvement or knowledge of the family asked for a good faith hearing. It was the Receiver who first sought relief from the Texas Railroad Commission, Byron Hatchett simply asked for a hearing to test that misrepresentation.

THE LEASE EXPIRED ON ITS OWN TERMS

The five year lease expired, with no production, and shortly there after, the Receiver requested an extension to plug the wells. The Hatchett Lease contains a habendum clause. In the early 1900s, the modern day oil and gas lease habendum clause was developed where the primary term of the lease was followed by an indefinite secondary term that required the lessee to perform certain activities during both the primary and secondary terms to keep the lease alive.

The habendum clause means what it says, i.e., without production in paying quantities (or the commencement of operations to obtain production) at the end of the primary term, the lease terminates. All jurisdictions, except Oklahoma and Louisiana, treat the habendum clause as creating a fee simple determinable that terminates automatically upon the failure of one or more of the conditions on which it is based. Equitable remedies, such as waiver and estoppel, are generally not available to avoid termination.

MINIMUM STANDARDS FOR PRESERVING LEASE AFTER THE PRIMARY LEASE TERM

The Receiver was obligated to both maintain the lease premises and the surface condition. Burton W. Wiand, the Court-appointed Receiver for Quest Energy Management Group, Inc. ("the Receiver") violated the Hatchett lease agreement, and numerous Texas Oil and Gas Operating Rules, including Rule 8 and caused significant damages, including causing an oil spill caused by negligently designed and maintained oil waste pits, that contaminated the lands, and waters of the Hatchett Ranch,

The Receiver violated 8(b) and caused AND allowed pollution of surface water. Rule 8(b) provides that *"No pollution: No person may cause or allow pollution of surface or subsurface water."*

The Receiver violated 8(d)(2): *Prohibited pits: Any pits that are not specifically authorized by the rule and for which no permits have been obtained. The only pit absolutely prohibited by the rule is a pit used for the storage of oil.*

The Receiver violated 8(d)(4): *Authorized pits: The rule authorizes the use of several types of pits without a permit. Use of these pits is authorized without a permit only so long as they are operator and backfilled according to the requirements in the rule and only so long as use of the pit does not cause pollution.*

The Receiver violated 8(d)(4)(G) * *Additional requirements for NCFR pits*
Pit Design: Pits must be:

- *Sufficiently large and have adequate freeboard (minimum of two feet at all times) for precipitation;*
- *Designed to prevent stormwater from entering the pit; constructed with dikes that are structually sound and do not seep;*
- *Lined with a liner that has a hydraulic conductivity 1.0 x 10 -7 cm/s or less.*

The Receiver failed to comply with Monitoring Procedures: Pits must be:

- *Emptied and inspected at least annually, or*
- *Have a double liner and leak detection system that is monitored at least monthly*
- *Records of monitoring must be kept to demonstrate compliance.*

The Receiver failed to comply with District Registration: *Operator must provide written notification prior to construction or prior to use of an existing pit for non-commercial fluid recycling, including:*

- *Location of the pit with lease name and number or drilling permit number, and latitude and longitude;*
- *Dimensions of the pit and maximum capacity of the pit; or*
- *A signed statement that the operator has permission from the surface owner for construction and use of the pit.*

The Receiver breached the lease contract, failed to account for gas sales revenues he's collected despite numerous requests, the Receiver failed to maintain all weather roads, damaged roads and did not repair them, estimated to be 3.2 miles or 18,000 linear ft at a cost of $20.00 ft. or $360,000, failed to repair the damage done from the improper waste pit(s), failed to close the wells, failed to close the waste pits,

failed to timely pay over royalties, and now claims to be able to sell an expired lease and abandoned equipment, refuses to provide a release of his claim of a valid lease and and prevents the mineral owners form entering into a transaction with others.

There are substantial liabilities caused by the Receiver's breach if the lease agreement and negligence and negligent operation of the Quest Lease for which Respondents seek leave of this court to pursue such claims in Texas, or alternatively in this Court. The Receiver operating under the Quest Lease is responsible for all well plugging expenses. The Receiver was required to

Further, Respondent seeks this Court's determination that the Hatchett Lease is no longer an asset of the Quest Estate and that the Receiver has no interest in the Hatchett Ranch minerals, other than the liabilities described above and as proven before the Court

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Respectfully submitted
/s John H. Carney

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Texas Railroad Commission