IN THE SUPREME COURT
STATE OF SOUTH DAKOTA

APPLICATION OF LUFF EXPLORATION COMPANY FOR THE COMPULSORY POOLING OF MINERAL INTERESTS OWNED BY LINDA GOLDEN AND TO AUTHORIZE THE RECOVERY OF A RISK COMPENSATION PENALTY FROM GOLDEN'S SHARE OF THE PRODUCTION OF OIL FROM THE STEARNS BROTHERS B-33H WELL

Appeal Number: 27147

Appeal from the Circuit Court,
Sixth Judicial Circuit, Hughes County, South Dakota

The Honorable Mark Barnett, Circuit Court Judge, Presiding

APPELLANT'S BRIEF (SECOND CORRECTED)

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The Notice of Appeal was filed on the 21st day of July, 2014.

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JURISDICTIONAL STATEMENT

Linda Golden ("Golden") appeals from the Order of the Circuit Court dated June 17, 2014. Legal counsel for Golden was served with the Notice of Entry of Order for the Circuit Court's Order by mail on June 17, 2014. Golden's Notice of Appeal was electronically filed with the Hughes County Clerk of Courts and served by mail on counsel of record on Monday, July 21, 2014.

STATEMENT OF ISSUES

ISSUE ONE: Whether the Board erred by refusing to include a provision in its compulsory pooling order prescribing the time and manner in which Golden may elect to participate in the Stearns Brothers Well by paying her proportionate share of the reasonable actual cost of the drilling, equipping, and operation of that well.

> The Board included no such provision in its Order and rejected Golden's proposals that such a provision be included in the Board's Order.

Most Relevant Cases:

Cavanagh v. Coleman, 72 SD 274, 33 NW2d 282 (1948)
In re Dakota Transportation, 67 SD 221, 291 NW 589 (1940)
In re Yanni, 2005 SD 59, 697 NW2d 394
State Division of Human Rights, ex rel. Ewing, v. Prudential Ins. Co. of America, 273 NW2d 111 (SD 1978)

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:

SDCL 2-14-2.1
SDCL 45-9-32
ARSD 74:12:10:03

ISSUE TWO: Whether it was error for the Board to include a provision in its Order imposing a risk compensation on Golden in the circumstance where Luff had drilled an oil well on the spacing unit before the compulsory pooling order was entered.

> Over Golden's objection, the Board imposed a 100% risk compensation penalty against Golden, stating as a legal conclusion that Luff's actions in drilling an oil well on the Subject Spacing Unit prior to obtaining a pooling order binding on Golden does not prevent Luff from recovering the 100% risk compensation penalty provided for by ARSD 74:12:10:03 from Golden.

Most Relevant Cases:

AEG Processing Center No. 58, Inc., v. South Dakota Dept. of Revenue and Regulation, 2013 SD 75, 838 NW2d 843
Engelhart v. Kramer, 1997 SD 125, 570 NW2d 550
Garrett v. BankWest, Inc., 459 NW2d 883 (SD 1990)
Helmbolt v. LeMars Mut. Ins. Co., Inc., 404 NW2d 55 (SD 1987)

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:

SDCL 2-14-2(13)
SDCL 45-9-33
SDCL 45-9-35
ARSD 74:12:10:01

ISSUE THREE: Whether the Board's finding that Luff proved that it made an unsuccessful good-faith attempt to have Golden participate in the drilling and operating the Stearns Brothers Well on the Subject Spacing Unit is clearly erroneous.

Over Golden's objection, the Board expressly found that Luff had proved that it made an unsuccessful good-faith attempt as required by ARSD 74:12:10:01 to have Golden participate in the cost of the Stearns Brothers Well. (AR0474) Based in part on this finding, the Board imposed a risk compensation penalty against Golden in the estimated amount of $261,791.00.

Most Relevant Cases:

Thompson v. Consolidated Gas Utilities Corp., 300 U.S. 55, 57 S.Ct. 364, 81 L.Ed. 510
Traverse Oil Co. v. Chairman, Natural Resources Com'n, 153 Mich.App. 679, 396 NW2d 498 (Mich.App.,1986)
Ward v. Corporation Commission, 501 P.2d 503 (Okla. 1972).

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:

SDCL 45-9-31
SDCL 45-9-32
SDCL 45-9-35
ARSD 74:12:10:01

ISSUE FOUR: Whether the Board erred by imposing the arbitrary 100% risk compensation penalty provided for in ARSD 74:12:10:03 against Golden's mineral interest in the Subject Spacing Unit rather than by determining whether to impose a risk compensation penalty and, if so, in what amount based solely on the evidence presented at the hearing.

Over Golden's objection, the Board imposed the arbitrary 100% risk compensation penalty provided for in ARSD 74:12:10:03 against Golden and did

not base the imposition of that arbitrary 100% risk compensation penalty against Golden based on the actual evidence in the record.

Most Relevant Cases:

Application of Farmers State Bank of Viborg, 466 NW2d 158 (SD 1991)
Application of Kohlman, 263 NW2d 674 (SD 1978)
Daily v. City of Sioux Falls, 2011 SD 48, 802 NW2d 905
Gul v. Center for Family Medicine, 2009 SD 12, 762 NW2d 629

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:

Fourteenth Amendment to the United States Constitution
Article VI, Section 2, of the South Dakota Constitution
SDCL 1-26-18
SDCL 45-9-31
SDCL 45-9-32
SDCL 45-9-33
SDCL 45-9-35
SDCL 45-9-74
SDCL 1-26-13 through 1-26-25
ARSD 74:12:10:03

ISSUE FIVE: Whether it was clearly erroneous for the Board to find that the imposition of a 100% risk compensation penalty against Golden was just and reasonable.

The Board imposed the arbitrary 100% risk compensation penalty provided for in ARSD 74:12:10:03 against Golden but also found that the 100% risk compensation penalty imposed against Golden was just and reasonable in the absence of an adequate record to support that finding.

Most Relevant Cases:

Balvin v. Balvin, 301 N.W.2d 678 (S.D., 1981)
Estate of Podgursky, 271 N.W.2d 52 (S.D.1978)

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:

SDCL 45-9-35
ARSD 74:12:10:01
ARSD 74:12:10:03

STATEMENT OF THE CASE

Luff Exploration Company ("Luff") petitioned the South Dakota Board of Minerals and Environment ("Board") pursuant to SDCL 45-9-31, et seq., to compulsorily

pool the mineral interests owned by Golden in a certain 960 acre oil and gas spacing unit ("the Subject Spacing Unit") located in Harding County, South Dakota. Luff had drilled the Stearns Brothers B-33H Well ("the Stearns Brothers Well") on the Subject Spacing Unit months prior to the hearing before the Board on Luff's petition for a compulsory pooling order. Luff knew that Golden owned a substantial unleased and unpooled mineral interest in the Subject Spacing Unit when it drilled the Stearns Brothers Well. Luff made no attempt to negotiate a voluntary pooling agreement with Golden before drilling the Stearns Brothers Well or before seeking a compulsory pooling order from the Board.

Pursuant to SDCL 45-9-31 and 45-9-32, in the absence of a voluntary pooling agreement, a compulsory pooling order from the Board is required (1) to authorize the development of a spacing unit by authorizing the drilling and operation of a well on the spacing unit, and (2) to provide for who may drill and operate that well. In the absence of a voluntary pooling agreement, until a compulsory pooling order is entered, no one has the authority to drill and operate an oil well on that established oil and gas spacing unit. By drilling the Stearns Brothers Well on the Subject Spacing Unit without prior authorization to do so from the Board, Luff was proceeding in violation of the law.

SDCL 45-9-32 requires that a compulsory pooling order "shall prescribe" the time and manner in which all owners in the spacing unit may elect to participate in the drilling, equipping, and operation of a well on the involved spacing unit. The compulsory pooling order in this case has no such provision. The compulsory pooling order in this case wrongfully excludes Golden from electing to participate in the Stearns Brothers Well and wrongfully mandates that Golden be treated as a nonparticipating owner in the Stearns

Brothers Well, even though Golden was afforded no opportunity to first elect to be treated as a participating owner under the terms of that compulsory pooling order. The compulsory pooling order in this case wrongfully imposes a mandatory and arbitrary 100% risk compensation penalty on Golden, providing Golden no means to avoid the imposition of that risk compensation penalty.

Golden seeks to have this Court right these wrongs by ruling that the South Dakota compulsory pooling statutes found at SDCL 45-9-31 through 45-9-36 should be enforced and implemented as enacted by the Legislature. Under the requirements of those statutes, Golden should be provided the right to elect to participate in the Stearns Brothers Well by electing to pay her proportionate share of the costs of that well. Under the circumstances presented, the compulsory pooling order in this case should not include a provision imposing a risk compensation penalty in any amount against Golden's mineral interests in the Subject Spacing Unit in the event she elects not to participate in the well. Pursuant to SDCL 45-9-35, Luff should be limited to recovering out of Golden's proportionate share of the production from the Stearns Brothers Well, exclusive of a 1/8th royalty, only Golden's proportionate share of the costs of the Stearns Brothers Well, with no risk compensation penalty added thereto.

STATEMENT OF FACTS

Golden owns a substantial mineral interest in the Subject Spacing Unit. AR0003, AR0010-0011; AR0078-0079; AR0238. (References to the Administrative Record will be by "AR" followed by the page number in the Administrative Record where the referenced document is located.) Golden's is the only unleased mineral interest in the

Subject Spacing Unit and the only mineral interest owner in that spacing unit whose ownership interest is being compulsorily pooled in this proceeding. AR0079; AR0237; AR0238; AR0177; AR0477.

The Stearns Brothers Well is a horizontal oil well drilled into the B-Zone of the Red River Formation for the purpose of producing oil from that formation. AR0249. Luff drilled the Stearns Brothers Well without first negotiating a voluntary pooling agreement with Golden or obtaining a compulsory pooling order from the Board. AR0087.

The only witness to testify at the hearing before the Board was Clayton Chessman ("Chessman"). AR0076-0159. Chessman is the oil and gas landman employed by Luff who communicated with Golden in the attempt to negotiate an oil and gas lease behalf of Luff. AR0076-0077; AR0080; AR0239-0245. Chessman offered no testimony concerning the geology of the Red River B-Zone formation as the target formation for the Stearns Brothers Well or concerning any specific risks associated with the drilling, completing, equipping, and operation of the Stearns Brothers Well. AR0076-0159.

Luff had a plan to drill six oil wells in North Dakota and South Dakota in 2013. The Stearns Brothers Well was not one of those wells. One of the original six wells that Luff had planned to drill fell through. As a result, Luff was forced "at the 11th hour" to add the Stearns Brothers Well to its drilling plans as a replacement well. Luff had to cut corners in complying with state regulatory procedures in order to get the Stearns Brothers Well drilled in 2013 under the arbitrary timetable that Luff had set for itself. AR0087-0090.

When Luff decided to drill the Stearns Brothers Well, the location where Luff

proposed to drill that well was not an established spacing unit. Luff filed a Petition for a spacing order with the State to create a spacing unit for that well. No one intervened in opposition. On July 1, 2013 the DENR Secretary issued Order 16-2013 establishing the Subject Spacing Unit. AR0469; AR0478.

On June 25, 2013, Chessman e-mailed Golden proposing an oil and gas lease for the minerals that Golden owned in this proposed new 960 acre spacing unit. AR0246-0247. Chessman did not raise the subject of a possible voluntary pooling agreement between Golden and Luff in this June 25 e-mail. AR0246-0247. Chessman admitted that, in his 35 years as a petroleum landman, he had never negotiated a joint operating agreement, a form of voluntary pooling agreement, with an unleased mineral owner. AR0093.

Golden emailed Chessman on July 18, 2013 declining to lease her minerals to Luff, advising that she wished to continue her status as an unleased mineral interest owner. AR0246. On July 17, 2013 Luff drafted a letter to Golden in an attempt to satisfy the notice and good faith negotiation requirements of ARSD 74:12:10:01. AR0080-0085; AR0239-0245. Luff's July 17 letter was not delivered to Golden's home until July 25, 2013. AR0241; AR0098. This July 17 letter is the only evidence relied upon by Luff to prove that it made an "unsuccessful good-faith attempt" to have Golden participate in the risk and cost of drilling and operating the Stearns Brothers Well. AR0085. Chessman testified that the July 17 letter was "what we [Luff] consider our legal requirement to make the formal offers by certified mail" that were required to comply with ARSD 74:12:10:01. AR0085.

Luff began drilling the Stearns Brothers Well on July 28, 2013, three days after Luff's July 17 letter was delivered to Golden on July 25, 2013 and nearly three months before the Board's hearing on Luff's Petition to compulsorily pool Linda Golden's mineral interests in the Subject Spacing Unit.

STANDARD OF REVIEW

Pursuant to SDCL 1-26-36, this Court is required to give great weight to the findings made and inferences drawn by an administrative agency on questions of fact. Questions of law are reviewed de novo. If the question presented requires the Supreme Court to consider legal concepts in the mix of fact and law and to exercise judgment about the values that animate legal principals, then the question should be classified as one of law and reviewed de novo. Statutory questions and interpretation are reviewed de novo, as questions of law. The Court may affirm the decision of the agency or remand the case for further proceedings. The Court may reverse or modify the decision if substantial rights of the Appellant have been prejudiced because the administrative findings, inferences, conclusions, or decisions are in violation of constitutional or statutory provisions, in excess of the statutory authority of the agency, made upon unlawful procedure, affected by other error of law, clearly erroneous in light of the entire evidence in the record, or arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion. An agency's decision, to the extent it is based on findings of fact, will be reversed only if it is clearly erroneous in light of the entire evidence in the record. *In re Pooled Advocate Trust*, 2012 SD 24, ¶ 49, 813 NW2d 130, 146; *Easton v. Hanson School Dist. 30-1,* 2013 SD 30, ¶ 7, 829 N.W.2d 468, 471; *Knapp*

v. Hamm & Phillips Service Co., Inc., 2012 SD 82, ¶ 11, 824 NW2d 785, 788. In reviewing the circuit court's judgment on an administrative appeal, the Supreme Court must make the same review of the administrative agency's action as did the circuit court. SDCL 1-26-36. The Supreme Court's decision as to whether the administrative decision can be sustained must be made without the presumption that the circuit court's decision is correct. *Piper v. Neighborhood Youth Corps*, 241 NW2d 868 (SD 1976); *State Division of Human Rights, ex rel. Ewing v. Prudential Ins. Co. of America,* 273 NW2d 111, 113 (SD 1978).

LEGAL ARGUMENTS AND AUTHORITIES

ISSUE ONE: Whether the Board erred by refusing to include a provision in its compulsory pooling order, as required by SDCL 45-9-32, prescribing the time and manner in which Golden may elect to participate in the Stearns Brothers Well by paying her proportionate share of the reasonable actual cost of the drilling, equipping, and operation of that well.

Luff sought, and the Board issued, a compulsory pooling order that disregards the legislatively mandated requirements for compulsory pooling orders found in SDCL 45-9-31, 45-9-32, and 45-9-33. Golden seeks to have this Court remedy that error by ruling that the compulsory pooling order in this case must implement the legislatively mandated requirements for compulsory pooling orders found in SDCL 45-9-31, 45-9-32 and 45-9-33.

SDCL 45-9-32 requires that a compulsory pooling order "shall prescribe the time and manner in which all the owners in the spacing unit may elect to participate in such well drilling, equipping, and operation; and shall provide for payment of the reasonable actual cost of the well drilling, equipping, and operation by all those who elect to

participate. . . ." The Board's Order in this case contains no provision for Golden to elect to participate in the Stearns Brothers Well. AR0467-0480. The Board's Order, instead, forces Golden into the position of an owner who has elected to not participate in the Stearns Brothers Well, even though the Board's Order does not first allow Golden to elect to participate in the well. AR0478-0480.

The first rule of statutory construction is that the language expressed in the statute is the paramount consideration. The second rule of statutory construction is that words and phrases in a statute that have plain meaning and effect will be simply declared to have that plain meaning, without resort to any further need for statutory construction. *In re West River Elec. Ass'n, Inc.*, 2004 SD 11, ¶ 15, 675 NW2d 222, 226. When "shall"' is the operative verb in a statute, it is given "obligatory or mandatory" meaning: As used in the South Dakota Codified Laws to direct any action, the term "shall" manifests a mandatory directive and does not confer any discretion in carrying out the action so directed. SDCL 2–14–2.1; *Discovery Bank v. Stanley*, 2008 SD 111, ¶ 21, 757 NW2d 756, 761.

The language of the South Dakota compulsory pooling statutes could not be more plain or unambiguous. SDCL 45-9-32 requires that each compulsory pooling order ***shall authorize*** the drilling, equipping, and operation of a well on the spacing unit; ***shall provide*** who may drill and operate the well; ***shall prescribe*** the time and manner in which all the owners in the spacing unit may elect to participate in such well drilling, equipping, and operation; and ***shall provide*** for payment of the reasonable actual cost of the well drilling, equipping, and operation by all those who elect to participate.

The Board has proceeded in the apparent belief that the Board's promulgation of

the administrative rule found at ARSD 74:12:10:03 relieves the Board of the obligation to comply with the express statutory requirements for compulsory pooling laid down by the Legislature in SDCL 45-9-32. The Board erred in applying the provisions of ARSD 74:12:10:03 to this end. The provisions of ARSD 74:12:10:03 do not relieve the Board of the obligation to follow the laws as enacted by the Legislature regarding provisions that must be included in a compulsory pooling order in the State of South Dakota. The Board cannot, by adopting regulations, "amend" the statutory mandates set down by the Legislature for what must be included and provided for in a compulsory pooling order. The authority of an administrative agency to adopt rules and regulations is administrative in nature, not legislature. *Cavanagh v. Coleman*, 72 SD 274, 277, 33 NW2d 282, 284 (1948). Administrative rules and regulations adopted in contravention of statute are invalid. *Id.; In re Dakota Transportation*, 67 SD 221, 291 NW 589 (1940). An administrative rule adopted by an administrative agency can in no way expand upon the statute that it purports to implement. *State Division of Human Rights, ex rel. Ewing, v. Prudential Ins. Co. of America*, 273 NW2d 111, 114 (SD 1978). The Board does not have the authority to adopt regulations that are contrary to or inconsistent with the statutes that control compulsory pooling proceedings. Administrative rules adopted by an administrative agency that are in contravention of statutes are invalid. *In re Yanni*, 2005 SD 59, ¶ 16, 697 NW2d 394, 400.

The compulsory pooling order in this case should be revised to conform with the requirements of SDCL 45-9-31, 45-9-32, and 45-9-33 and must prescribe the time and manner in which Linda Golden may elect to participate in the drilling, equipping, and

operation of the Stearns Brothers Well by paying her proportionate share of the reasonable actual cost of the well drilling, equipping, and operation of that well.

ISSUE TWO: Whether the Board's finding that Luff made an unsuccessful good-faith attempt to have Golden participate in the risk and cost of drilling and operating the well on the Subject Spacing Unit is clearly erroneous.

ARSD 74:12:10:01 provides that an application for a compulsory pooling order pursuant to SDCL 45-9-31 may request the Board to provide for the recovery of risk compensation from an owner who elects not to participate in the risk and cost of drilling and operating a well in an established spacing unit. As written, this provision of ARSD 74:12:10:01 is consistent with the provisions of SDCL 45-9-33 that allow a compulsory pooling order to include terms and conditions upon which an owner may elect to participate in the drilling and operation of a well on a limited or carried basis. ARSD 74:12:10:01 further provides that, before a compulsory pooling order including a risk compensation provision will be entered by the Board, the applicant must prove that the applicant made an unsuccessful, good-faith attempt to have the nonparticipating owner participate in the risk and cost of drilling and operating the well.

The Board found that Luff had satisfactorily proven that it made an unsuccessful good-faith attempt to have Golden participate in the risk and cost of drilling and operating the Stearns Brothers Well. AR0473-0474. This finding of fact by the Board is clearly erroneous. There is no evidence that Luff made even the slightest attempt to negotiate in good faith with Golden for a voluntary pooling agreement whereby Golden would participate in the risk and cost of drilling and operating the Stearns Brothers Well.

The only evidence upon which the Board could base its finding that Luff had

made a good faith attempt to have Golden participate in the risk and cost of drilling and operating the Stearns Brothers Well is Luff's July 17 letter to Golden. AR0239-0245. That letter says nothing about a possible voluntary pooling agreement. Luff made no attempt to negotiate a voluntary pooling agreement with Golden before seeking a compulsory pooling order from the Board. AR0239-0245.

The finding of fact by the Board that Luff proved that it made a good faith, though unsuccessful, attempt to negotiate a voluntary pooling agreement with Golden is clearly erroneous.

Good faith negotiations to reach an agreement are characterized as follows: (1) Honesty in purpose and freedom from an intent to defraud or mislead (*SDCL 2-14-2(13); Engelhart v. Kramer*, 1997 SD 125, ¶13, 570 NW2d 550, 553); (2) Faithfulness to an agreed common purpose and consistency in responding to the justified expectations of the other party in negotiations, while demonstrating honesty in fact (*Garrett v. BankWest, Inc.,* 459 NW2d 883, 841 (SD 1990)); (3) Seriously working to resolve differences in the negotiations and to reach a common understanding of the matters under negotiation (*Bon Homme County Com'n v. American Federation of State, County, and Mun. Employees (AFSCME) Local 1743A*, 2005 SD 76,¶14, 699 NW2d 441, 448): (4) Providing the party with whom you are negotiating in good faith with information regarding plans and operations sufficient to enable that party to fully and fairly evaluate the proposals that you are making to them and extending offers in advance of taking action on the matters then under negotiation (SDCL 45-5A-4.1, 45-5A-5, and 45-5A-5.1); (5) Making *bona fide* offers (SDCL 49-16A-1); (6) Pursuing negotiations through multiple drafts and over such

period of time as is necessary to see the negotiations through (*Mattson v. Rachetto*, 1999 SD 51, ¶19, 591 NW2d 814, 818; *Deadwood Lodge No. 508, Benev. and Prot. Order of Elks of U.S. of A. v. Albert*, 319 N.W.2d 823 (SD 1982)); (6) Pursuing negotiations with the intensity, interest, and good faith of a person truly invested in the outcome of those negotiations (*Helmbolt v. LeMars Mut. Ins. Co., Inc.,* 404 NW2d 55, 56-57 (SD 1987)); and (7) Following through with the paperwork to close the deal once the agreement is reached *(Batchelor v. Emery*, 75 SD 639, 642-645, 71 NW2d 615, 616-618). The standard for judging the good faith of a party's intentions in negotiations is the objective reasonable man standard. *Engelhart v. Kramer*, 1997 SD 125, ¶20, 570 NW2d 550, 554-555. A party who is only pretending to engage in negotiations, while "running a bluff" with no actual intent of closing on a deal, is not negotiating in good faith. *Batchelor v. Emery*, 75 SD 639, 642-645, 71 NW2d 615, 616-618).

Utilizing these legal standards, the obvious conclusion is that Luff did not present any evidence to the Board that it made a good-faith, though unsuccessful attempt to negotiate a voluntary pooling agreement with Golden before seeking a compulsory pooling order from the Board.

The creation of a contract requires a meeting of the minds on all of the essential terms of an agreement. *Stern Oil Co., Inc., v. Brown*, 2012 SD 56, ¶17, 817 NW2d 395, 401. Luff made no offer to Golden concerning any proposed terms for a voluntary pooling agreement. Luff's July 17 letter to Golden did demand that Golden pay Luff $261,791.00 as her proportionate share of the costs for drilling, completing, and equipping the Stearns Brothers Well, but Luff included no proposal for the terms of a voluntary pooling

agreement pursuant to which that money would be paid to Luff by Golden. AR0239-0245. What Luff did in its July 17 letter was demanded that Golden pay them $261,791.00 without a contract to govern the relationship between the parties with respect to how that money would be utilized, how Luff would account to Golden for that money, what Luff's obligations would be as the operator of that well, or any of the financial and business issues associated with owning, operating, equipping, producing, and maintaining the proposed oil well. Demanding payment of $261,791.00 without proposing the terms of an agreement to govern the relationship between the parties concerning how that $261,791.00 will be used, applied, and accounted for and without an agreement providing for any legal obligation from Luff to Golden in copnsideration for that payment by Golden is not good faith negotiation for a voluntary pooling agreement.

In addition, the timing of Luff's July 17 letter to Golden is also evidence of Luff's lack of good faith. The letter was delivered to Golden on July 25, 2013. The letter states that Luff anticipated drilling operations for the proposed Stearns Brothers Well to begin that very same day, July 25, 2013. AR0239; AR0234-0235. Luff clearly intended to proceed with the drilling of the Stearns Brothers Well without waiting to hear from Golden.

In addition, Luff provided Golden with no information concerning why it had chosen this location for the well, no information concerning the prospects of the well, no information concerning the production or performance of any nearby or offsetting oil wells, no information concerning the geology of the target formation in the vicinity of where the well was to be drilled, no information concerning the drilling or completion

risks associated with the particular method for drilling the well that Luff proposed to use, no engineering reports, no geology reports, no well logs. AR0239-0245. Luff's July 17 letter was a demand by Luff that Golden pay Luff $261,791.00 to "buy a pig in a poke" with no contract. The July 17 letter is not proof of a good-faith effort by Luff to have Golden participate in the Stearns Brothers Well. It is proof of the exact opposite. The Board's finding that Luff made a good faith attempt to negotiate to have Golden participate in this Stearns Brothers Well is clearly erroneous.

This Court should hold that it was clear error for the Board to have found or concluded that Luff had proved that it had made a good faith, though unsuccessful, attempt to have Golden participate in the risk and cost of drilling and operating the Stearns Brothers Well before Luff sought a compulsory pooling order. ARSD 74:12:10:01 requires that, in the absence of proof that Luff had made a good faith, though unsuccessful, attempt to have Golden participate in the risk and cost of drilling and operating the well before Luff sought to obtain a compulsory pooling, no provision for the recovery of a risk compensation penalty against Golden will be included in the compulsory pooling order issued by the Board. ARSD 74:12:10:01. The failure to comply with a condition precedent provided for in a statute or administrative rule deprives one of the right to claim the benefit of that statute or administrative rule. *AEG Processing Center No. 58, Inc., v. South Dakota Dept. of Revenue and Regulation*, 2013 SD 75, ¶8, 838 NW2d 843, 847.

SDCL 45-9-35 provides that, if any of the owners of mineral interests in a given oil and gas spacing unit (i.e., Luff) drills, equips, and operate, or pays the cost of drilling,

equipping, and operating a well for the benefit of another person (i.e., Golden) as provided for in an order of pooling, then the owner (i.e., Luff) is entitled to the share of production from the spacing unit accruing to the interest of the other person (i.e., Golden), exclusive of a royalty not to exceed 1/8th of production, until the market value of the other person's (i.e., Golden's) share of the production, exclusive of the royalty, equals the sums payable by or charged to the interest of the other person (i.e., Golden). Under the provisions of this statute, Luff should be limited to recovering out of Golden's proportionate share of the income from oil produced from the Stearns Brothers Well, exclusive of a 1/8th royalty, only that amount necessary to pay Golden's proportionate share of the actual reasonable costs of drilling, completing, equipping, and operating that well, with no risk compensation penalty to be added to those costs.

ISSUE THREE: Whether a risk compensation penalty can be imposed on Golden's mineral interest when Luff drilled the Stearns Brothers Well before the compulsory pooling order in this case was issued by the Board.

Luff drilled the Stearns Brothers Well before the Board issued its order compulsorily pooling Golden's mineral interests in the Subject Spacing Unit. AR0087; AR0234-0235; AR0009-0020; AR0215-0216; AR0050-0210. Chessman testified that, over the winter preceding the summer of 2013, Luff had made the decision to drill six oil wells in North Dakota and South Dakota in 2013. AR0088. Part way through the 2013 well drilling season, Luff decided to drop one of the wells that it had originally planned to drill as part of its well drilling plan for 2013. In order to make efficient use of the well drilling contractor that Luff had previously contracted to use during the summer of 2013, Luff and then had to scramble on short notice to try to find a replacement well to drill.

AR0088. The replacement oil well that Luff put into its well drilling plans for 2013 "at the 11th hour" was the Stearns Brothers Well. AR0089. Having decided "at the 11th hour" to try to drill the Stearns Brothers Well in 2013, Luff was in a rush to make this happen. Corners had to be cut. AR0089. Chessman candidly acknowledged that, had Luff followed legally mandated procedure and sequencing for the spacing, pooling, permitting, and then drilling of the Stearns Brothers Well, Luff simply would not have been able to drill the Stearns Brothers Well as a last minute substitute well in 2013. AR0088-0090.

Luff's "personal problems" associated with its decision to make an 11th hour substitution of a new proposed oil well in its 2013 well drilling plans do not justify allowing Luff, and the Board, to disregard the laws that govern the compulsorily pooling of mineral interests in South Dakota.

In *Traverse Oil Co. v. Chairman, Natural Resources Com'n*, 153 Mich.App. 679, 694-695, 396 NW2d 498, 505 (Mich.App.,1986), the party seeking a compulsory pooling order against another interest owner had drilled an oil well on an established spacing unit without first obtaining a compulsory pooling order for that spacing unit. The moving party, the well driller, had persuaded the administrative agency with responsibility over such things in the state of Michigan to issue a compulsory pooling order that included a provision for the imposition of a risk compensation penalty in the event the party being compulsorily pooled elected not to participate in the well. On appeal, the Michigan Court of Appeals ruled that, in order for a compulsory pooling order to include a provision for a risk compensation penalty, the compulsory pooling order would have had to have been entered before the oil well was drilled and that the party whose interest was being

compulsorily pooled was entitled, under applicable Michigan statutes and regulations similar in structure to South Dakota's compulsory pooling statutes, to have the opportunity before the well was drilled to choose between electing to participate in paying the costs and expenses of the well or electing to be treated as a carried interest on that well, subject to a risk compensation penalty, under the terms of the compulsory pooling order. *Ibid*., 153 Mich.App. at 694-695, 396 NW2d at 505. In the circumstance where the party being compulsorily pooled had been deprived of the opportunity to elect to participate in the drilling costs of a well under the terms of a compulsory pooling order before the well covered by that compulsory pooling order was drilled, because the party who was seeking compulsory pooling had drilled the well before the petition for compulsory pooling was heard and decided, the Michigan Court of Appeals held that the state agency authorized to decide compulsory pooling cases in that state could not impose a risk compensation penalty against the ownership interest of the party being compulsorily pooled, despite the argument by the drilling party that the imposition of that penalty was necessary to fairly allocate the risk of a nonproductive well from among those who might benefit from a successful well. *Traverse Oil Co. v. Chairman, Natural Resources Com'n*, 153 Mich.App. 679, 694-695, 396 NW2d 498, 505 (1986).

This ruling comports with the language and intent of South Dakota's compulsory pooling statutes which refer to elections to be made under the terms of the compulsory pooling order as determined by the Board. SDCL 45-9-32 and 45-9-33. A party cannot make an election under the terms of a compulsory pooling order before that compulsory pooling order has been heard, decided, and entered. Once an oil and gas spacing unit is

established in South Dakota, in the absence of voluntary pooling, a compulsory pooling order pursuant to SDCL 45-9-31 through 45-9-36 is required in order to establish and determine the terms and conditions by which all of the mineral interests in that established oil and gas spacing unit will be pooled together for the development and operation of the well to be drilled and to establish and determine the terms and conditions by which the production of oil and gas from the spacing unit will be shared between and among the various mineral interest owners in that spacing unit, and their oil and gas lessees. SDCL 45-9-31. A compulsory pooling order is also required to provide the authorization for a particular party to be the operator authorized by the Board to drill, equip, and operate the oil well proposed to be drilled on that established oil and gas spacing unit and in order to "prescribe the time and manner in which all the owners in the spacing unit may elect to participate in the well drilling, equipping, and operation" and to "provide for the payment of the reasonable actual cost of that well drilling, equipping, and operation by those who elect to participate. . . ." SDCL 45-9-32.

There is no provision in South Dakota's compulsory pooling statutes for a party to appoint itself to be the operator of an oil and gas well to be drilled in an established oil and gas spacing unit and to then proceed, on its own authority, with the drilling, equipping, and operation of an oil well on an established oil and gas spacing unit in the absence of either a voluntary pooling agreement with the other owners or a compulsory pooling order from the Board. But that is precisely what Luff has done in this case. Luff appointed itself to be the operator of the Stearns Brothers Well and proceeded with the drilling of that well without a voluntary pooling agreement with Golden and without a

compulsory pooling order from the Board.

The United States Constitution, the Constitution of the State of South Dakota and the compulsory pooling laws of South Dakota do not allow the "taking" of one owner's mineral interests in an oil and gas spacing unit (Golden) by the oil and gas lessee of other mineral interest owners in that spacing unit (Luff) just because that oil and gas lessee (Luff) has presupposed to appoint itself to be the operator of an oil and gas well on that oil and gas spacing unit without first obtaining a compulsory pooling order from the State.

The action of the State in establishing and regulating oil and gas spacing units and in the compulsory pooling of oil and gas interests in an established oil and gas spacing unit is an exercise of the police power of the state. To allow the state itself to either establish an oil and gas spacing unit or to establish the compulsory pooling of oil and gas interests in an established oil and gas spacing unit without notice and opportunity for hearing, without due process of law, would amount to a taking of property rights without due process of law in violation of the Fourteenth Amendment to the Constitution of the United States. *Thompson v. Consolidated Gas Utilities Corp.*, 300 U.S. 55, 57 S.Ct. 364, 81 L.Ed. 510; *Ward v. Corporation Commission*, 501 P.2d 503, 507 (Okla. 1972). And if the Constitution does not allow the state itself to compulsorily pool the mineral interest ownership of a property owner in an oil and gas spacing unit without due process of law, the Constitution certainly would not allow a self-appointed operator of an oil and gas well in an established oil and gas spacing unit to "take" the mineral interest owned by another mineral interest owner in that established oil and gas spacing unit by its own unilateral

action without due process of law.

The law in compulsory pooling cases in South Dakota should be the same as was found to be appropriate in the *Traverse Oil* case in Michigan. If a party drills an oil well on an established spacing unit without benefit of having either a voluntary pooling agreement or a compulsory pooling order in place, the result should be that, at a minimum, the party who has engaged in the untimely drilling of that well should be deemed to have waived the right to have a risk compensation penalty provision included in a subsequently sought compulsory pooling order. In that circumstance, the provisions of SDCL 45-9-35 should be applied as written with the result that the party who drilled the well before entry of a compulsory pooling order should be entitled to recover out of compulsorily pooled party's share of the proceeds of production from the well, exclusive of a 1/8 royalty, only the compulsorily pooled party's proportionate share of the costs of drilling, and equipping, and operating the well in question, with no risk compensation penalty imposed on top of those costs.

ISSUE FOUR: Whether the Board erred by imposing the arbitrary 100% risk compensation penalty provided for in ARSD 74:12:10:03 on Golden's mineral interest in this spacing unit rather than by determining the amount, if any, of the non-consent penalty to be included in the Board's compulsory order in these proceedings based upon the evidence adduced at the hearing.

The Court need not reach this next issue if the Court rules in favor of Golden on either Issue Two or Issue Three above. In the alternative, should the Court rule against Golden on both Issue Two and Issue Three above and determine that Luff is entitled to have a risk compensation penalty provision included in the compulsory pooling order in this case, that risk compensation penalty should be applied only under the circumstance

where Golden has first been given the right to elect to participate in the Stearns Brothers Well under the terms of the compulsory pooling order by paying her proportionate share of the costs of that well (as required by SDCL 45-9-32 and requested by Golden in Issue One above) and where Golden, having been given the opportunity to elect to participate in paying the costs and expenses of drilling, equipping, and operating the well as required by SDCL 45-9-32, has then elected to not participate in the well by paying her proportionate share of the costs of the well up front.

Any risk compensation penalty provision that might, under that circumstance, be included in the Board's Order must necessarily be a risk compensation penalty that the Board determines to include in the compulsory pooling order based on evidence in the record before the Board regarding the specific facts and circumstances that bear upon the subject of the risks associated with the drilling, equipping, and operating the specific oil well in question at the specific location where that well is proposed to be drilled. *Application of Kohlman*, 263 NW2d 674, 678-679 (SD 1978). The arbitrary 100% risk compensation penalty provided for in ARSD 74:12:10:03 cannot be applied to dictate the outcome of risk compensation disputes presented to the Board for decision in a contested case compulsory pooling proceeding.

By imposing the 100% risk compensation penalty provided for in ARSD 74:12:10:03 against Golden's mineral interest ownership in the Subject Spacing Unit, the Board has deprived Golden of a meaningful contested case hearing on a disputed issue that is both statutorily and constitutionally required to be decided through an adjudicatory hearing process. The South Dakota compulsory pooling statutes (SDCL 45-9-31 through

45-9-36 and 45-9-74), the South Dakota Administrative Procedures Act (SDCL 1-26-13 through 1-26-25), Article VI, Section 2, of the South Dakota Constitution, and the Fourteenth Amendment to the United States Constitution all guarantee Golden, as the owner of a property right in the nature of a mineral interest in real estate, due process protection before her property rights are taken from her by the Board through the compulsory pooling process.

The Fourteenth Amendment to the United States Constitution and Article VI, Section 2 of the South Dakota Constitution provide a party with a right of due process before being deprived of life, liberty, or property. *Gul v. Center for Family Medicine*, 2009 SD 12, ¶ 19, 762 NW2d 629, 35; *Daily v. City of Sioux Falls*, 2011 SD 48, ¶ 14, 802 NW2d 905, 910-911. Due process must be afforded a party at a meaningful time and in a meaningful manner. *Gul v. Center for Family Medicine*, 2009 SD 12, ¶ 19, 762 NW 2d 629, 35, citing to and relying on *Hollander v. Douglas County*, 2000 SD 159, ¶ 17, 620 NW2d 181, 186 and *Schrank v. Pennington County Bd. Of Comm'rs*, 1998 SD 108, ¶ 13, 584 NW2d 680, 682. See also *Daily v. City of Sioux Falls*, 2011 SD 48, ¶ 24, Note 10, 802 NW2d 905, 915, citing to *Armstrong v. Manzo*, 380 US 545, 552, 85 SCt 1187, 1191, 14 LEd2d 62 (1965). Parties to an adjudicatory hearing by an administrative agency in a contested case proceeding within the meaning of SDCL 1-26-18 are entitled to due process of law. *Application of Farmers State Bank of Viborg*, 466 NW2d 158, 162 (SD 1991) citing to and relying on *In re Application of Union Carbide Corp.*, 308 NW2d 753, 758 (SD 1981) and *Valley State Bank of Canton v. Farmers State Bank of Canton*, 213 NW2d 459, 463 (SD 1973). See also *Strain v. Rapid City Sch. Bd.*, 447 NW2d 332, 336

(SD 1989) and *Gibson v. Berryhill*, 411 US 564, 93 SCt 1689, 36 LEd2d 488 (1973). The requirements of constitutional due process apply to administrative hearings. *Daily v. City of Sioux Falls,* 2011 SD 48, ¶ 14, 802 NW2d 905, 911.

ARSD 74:12:10:03 need not be, and ought not be, construed and applied in a manner that is contrary to the South Dakota compulsory pooling statutes (SDCL 45-9-31 through 45-9-36) or as being contrary to constitutional requirements for due process. If a statute or administrative rule susceptible to two reasonable constructions, one supporting the constitutionality of the statute or administrative rule and the other rendering that statute or administrative rule void as unconstitutional, a court should adopt the construction which will uphold the constitutionality of that statute or administrative rule. *Peterson Oil Co. v. Frary*, 46, SD 258, 192 NW 366, 368 (1923); *State v. Reeves*, 44 SD 568, 184 NW 993, 997 (1921). ARSD 74:12:10:03, when read together with ARSD 74:12:10:01 and SDCL 45-9-31 through 45-9-33 and SDCL 45-9-74, should be construed to apply to impose a 100% risk compensation penalty as part of a compulsory pooling order only in an uncontested compulsory pooling case where, after being provided with the required notice, no involved mineral interest owner has intervened in opposition to the petition for that compulsory pooling and objected the imposition of the risk compensation penalty provided for in ARSD 74:12:10:03. ARSD 74:12:10:03 can be construed to apply to uncontested compulsory pooling proceedings such as this and remain viable, but ARSD 74:12:10:03 cannot be construed to apply to the determination of disputed risk compensation issues in contested case administrative hearings where a party has intervened in opposition to the compulsory pooling petition and has objected to

the imposition of a risk compensation penalty against his or her ownership interest in the involved spacing unit. Risk compensation disputes in contested compulsory pooling proceedings must be decided through the adjudicatory contested case hearing procedure required by statute. SDCL 45-9-31, 45-9-32, 45-9-33, and 45-9-74.

In this case, Golden timely intervened in opposition to Luff's Petition for a compulsory pooling order and timely objected to the imposition of a risk compensation penalty against her ownership interest in the Subject Spacing Unit. AR0010-0020. With Golden having intervened in the compulsory pooling proceedings that were initiated by Luff and having objected to the imposition of a risk compensation penalty against her ownership interest in the Subject Spacing Unit, SDCL 45-9-31, 45-9-32, 45-9-33, and 45-9-74 and SDCL 1-26-13 through 1-26-25, read together, require that a contested case hearing must be held by the Board to decide all disputed issues in the case based on the evidence presented. This Court should hold that it was error as a matter of law for the Board to impose the arbitrary 100% risk compensation penalty provided for in ARSD 74:12:10:03 in a contested case compulsory pooling proceeding under SDCL 45-9-32 through 45-9-35.

ISSUE FIVE: Whether it was clearly erroneous for the Board to find or conclude, based on the evidence presented, that the imposition of a 100% risk compensation penalty against Golden was just and reasonable.

In the further alternative, should the Court determine to rule against Golden on Issue Two and Issue Three but rule in favor of Golden on Issue Four, Golden submits that it was clearly erroneous for the Board to find and conclude, based on the evidence presented at the hearing in this matter, that the imposition of a 100% risk compensation

penalty on Golden's interest in the Subject Spacing Unit was just and reasonable. AR0478. Luff intentionally made the decision to present no meaningful evidence to the Board bearing upon the subject of the risks associated with the drilling of the Stearns Brothers Well in the specific location where that well was drilled, no evidence bearing upon the characteristics of the specific geological formation that was the target zone for production of oil from that well, no evidence bearing upon the specific mechanical risks for the well associated with the specific well drilling methods utilized to drill that well, and no evidence bearing upon the risk associated with the well completion methods that were proposed for that well. It his opening statement to the Board, Luff's attorney expressly referenced ARSD 74:12:10:03 and stated that it was Luff's view that the purpose of the hearing before the Board was for Luff to show that they had met the notice and negotiation requirements of ARSD 74:12:10:01 and that, upon proving that it had complied with the notice and negotiation requirements of ARSD 74:12:10:01, Luff would be entitled to a compulsory pooling order that included the imposition of the 100% risk compensation penalty provided for in ARSD 74:12:10:03 against Golden's share of the proceeds from the well in this Spacing Unit. AR0063-0064.

Luff's witness, Chessman, did pay some lip service to discussing the concept of risk. Chessman is an oil and gas land man, an expert in negotiating oil and gas leases and agreements but not an expert in geology or petroleum engineering. Chessman testified to very generally stated concepts of risk. Chessman mentioned the phrase "mechanical risk of drilling a well," although he did not define or discuss that risk at all. AR0091. Chessman testified that "there's always risk of reservoir performance . . . [i]n the form of

whether the reservoir is full of oil or water or how much water and how much oil such that you produce an economic volume of oil." AR0091. But Chessman testified to none of the particulars of these generally identified risks as they might pertain the specific location in the geological formation into which the Stearns Brothers Well was proposed to be drilled and completed. Chessman did testify that "you have reservoir risk in permeability and porosity" and that "[m]any times this B Zone does not develop in a way that provides for a very good rate of production of fluid, whatever that fluid might be." AR0091. But, again, Chessman testified to none of the particulars of these generally identified risks as they might pertain to the specific location at which the Stearns Brothers Well was drilled or as they might pertain to what was known about the target geological formation at the specific location where the Stearns Brothers Well was proposed to be drilled and completed. AR0091.

The testimony from Chessman on the general subject of risk all fits on one page of the transcript from the hearing in this case, hardly a substantive and factually specific presentation. AR0091. A reasonable judicial or quasi-judicial tribunal should require more information than that before being asked to make a decision on risk assessment associated with an oil and gas well and before being asked to render a decision to establish the specific percentage for a risk compensation penalty to be imposed on an owner of a mineral interest in an oil and gas spacing unit that is being subjected to a compulsory pooling order. The testimony that Luff presented is not sufficient to support any findings of fact by the Board on the subject of the actual risk presented to Luff in the drilling, completing, and equipping of the Stearns Brothers Well on the specific oil and

gas spacing unit where that well was drilled. Any finding by the Board to the contrary is clearly erroneous.

On cross-examination, Chessman was asked specific questions about Luff's rate of success over the four year period including 2010, 2011, 2012, and 2013 in drilling and completing oil production wells into the B-Zone of the Red River Formation in Harding County. AR0109-0118. Every oil well that Luff had drilled into the B-Zone of the Red River Formation with the intention of having it completed as a producing oil well in that time frame was successfully drilled and successfully completed. AR0118. This is not a track record that substantiates the imposition of a 100% risk compensation penalty against Golden's interest in the Subject Spacing Unit. A 100% risk compensation penalty awards Luff "double the money" from Golden's interest in the Stearns Brothers Well, forcing Golden to pay Luff "2 to 1 odds" on Luff's chances for successfully drilloing and completing the Stearns Brothers Well as a producing oil well. Under the circumstance where Luff has, in recent years, had a 100% success rate in completing producing oil wells in the B-Zone of the Red River Formation in Harding County, the imposition of a 100% risk compensation penalty is unreasonable and unjust.

In reviewing questions regarding the sufficiency of the evidence, this Court's function on appeal is to ascertain whether or not there is evidence from which the trial court, or in this case the administrative tribunal, could make the finding of fact that were made. *Balvin v. Balvin,* 301 N.W.2d 678, 680 (S.D., 1981), citing to *Estate of Podgursky*, 271 N.W.2d 52 (S.D.1978). If this Court should insufficient evidence to support the findings of fact made, its duty is to reverse the decision of the trial court

predicated the unsubstantiated findings of fact. *Balvin v. Balvin,* 301 N.W.2d 678, 680 (S.D., 1981).

In the absence of any meaningful evidence bearing on the subject of the specific risks associated with the drilling, completing, and equipping of the Stearns Brothers Well in the specific location where that well was drilled, it was clearly erroneous for the Board to have found and concluded that the imposition of a 100% risk compensation penalty on Golden was just and reasonable. The provision in the Board's Order that imposes a 100% risk compensation penalty against Golden should be removed. The provisions of SDCL 45-9-35 should then govern and Luff should be entitled to recover out of Golden's proportionate share of the production from the Stearns Brothers Well, exclusive of a 1/8th royalty, only Golden's proportionate share of the costs of drilling, and equipping, and operating the Stearns Brothers Well, with no risk compensation penalty to be paid to Luff out of Golden's share of the production from that well.

CONCLUSION

In the absence of voluntary pooling, South Dakota's compulsory pooling statutes (SDCL 45-9-31 through 45-9-36) require a compulsory pooling order to pool the mineral interest ownership in an existing spacing unit before a well is drilled on that spacing unit. A compulsory pooling order is required in order to authorize the drilling of a well on that spacing unit and in order to designate who will be the operator authorized to drill and operate that well. The very definition of pooling in oil and gas matters means the bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules. *Circle Dot Ranch, Inc., v. Sidwell Oil and Gas, Inc.*, 891 SW2d 342, 347

(TexApp–Amarillo,1995), citing to and quoting from 6 Williams and Meyers, *Oil and Gas Law,* 901 (1994). A compulsory pooling order is also required to lay out the terms and conditions for how the nonoperating mineral interest owners in the affected oil and gas spacing unit may elect to participate in the well to be drilled on that spacing unit. SDCL 45-9-32.

Luff drilled the Stearns Brothers Well on the Subject Spacing Unit without a voluntary pooling agreement with Golden and without first obtaining a compulsory pooling order from the Board that was binding on Golden. By taking this action, Luff has "put the cart before the horse" in this compulsory pooling proceeding. This unfortunate circumstance, arising out of Luff's own unilateral and wrongful conduct, lends itself to Luff 's misplaced argument that, by the date of the hearing before the Board in this compulsory pooling proceeding, Luff had already incurred the mechanical risks associated with the drilling of the Stearns Brothers Well and that this fact should dictate that Golden should not be allowed the opportunity to elect to participate in the Stearns Brothers Well under the terms of the Board's Order because that would not be fair to Luff. These are "bad facts" that could lead to the making of "bad law" for compulsory pooling cases in South Dakota. Any superficial appeal that one might see in this argument by Luff arises out of Luff's own unilateral and wrongful conduct in drilling the Stearns Brothers Well before the Board entered a compulsory pooling order to authorize the drilling of that well in the first place and to authorize Luff to be the operator of that well and to afford Golden, as a nonoperating mineral interest owner, the opportunity to elect to participate in that well under the terms of the Board's compulsory pooling order.

Golden cannot be treated as a "nonparticipating owner" on the Stearns Brothers Well unless and until she is first afforded the opportunity to elect whether to participate in that well under the terms of the Board's compulsory pooling order and then, having been afforded that opportunity, Golden has elected not to participate in the well. SDCL 45-9-31, 45-9-32, and 45-9-33. Golden is entitled to know the terms and conditions of the Board's compulsory pooling order for the Subject Spacing Unit before having to make the decision of whether she will elect to participate in the well proposed to be drilled on that spacing unit. To prohibit a mineral interest owner from the right to participate in an oil and gas well drilled or to be drilled on an established oil and gas spacing unit in which that mineral interest owner has a property right would amount to a taking of property rights by the State without due process of law in violation of the Fourteenth Amendment of the Constitution of the United States. *Thompson v. Consolidated Gas Utilities Corp.*, 300 U.S. 55, 57 S.Ct. 364, 81 L.Ed. 510; *Ward v. Corporation Commission*, 501 P.2d 503, 507 (Okla. 1972)

This Court should hold, as a matter of law, that it was error for the Board to refuse to include a provision in the Board's Order that allowed Linda Golden the opportunity to elect to participate in the Stearns Brothers Well by paying her proportionate share of the costs of that well up front. This Court should remand this case to the Board with instructions to revise the terms of the compulsory pooling order in this case to conform to the requirements of SDCL 45-9-32 by prescribing the time and manner in which Golden may elect to participate in the Stearns Brothers Well by paying proportionate share of the reasonable actual cost of the drilling, equipping, and operation of the Stearns Brothers

Well under the terms of that Order.

This Court should hold that the finding by the Board that Luff proved that it made a good faith, though unsuccessful, attempt to have Golden participate in the Stearns Brothers Well by negotiating a voluntary pooling agreement with Golden is clearly erroneous. As a consequence, this Court should hold that Luff is barred by ARSD 74:12:10:01 from having a provision included in the compulsory pooling order in this case imposing a risk compensation penalty on Golden in the event Golden should elect, under the terms of that compulsory pooling order, to be treated as a carried interest in that well.

This Court should hold that, by drilling the Stearns Brothers Well on the Subject Spacing Unit, an established spacing unit, without a voluntary pooling agreement in place and before a compulsory pooling order was issued by the Board, Luff has deprived Golden of the opportunity to elect to participate in the Stearns Brothers Well under the terms of a compulsory pooling order before the Stearns Brothers Well was drilled. As a result, this Court should hold as a matter of law that, pursuant to the provisions of ARSD 74:12:10:01, no provision for imposition of a risk compensation penalty against Golden can be included in the compulsory pooling order in this case.

Under either of these two circumstances, in the absence of a risk compensation penalty, SDCL 45-9-35 should be applied as written. Luff, as an owner who has paid for the cost of drilling, equipping, and operating the Stearns Brothers Well for the benefit of Golden, should be limited to recovering from Golden's proportionate share of the production from that well, exclusive of a 1/8th royalty, only Golden's proportionate share

of the reasonable actual expenses for the Stearns Brothers Well, with no risk compensation penalty to be recovered by Luff out of Golden's share of the production from that well.

Should this Court rule in favor of Golden on either the Issue Two or Issue Three stated above, the Court would have no need to consider Issue Four or Issue Five. Should the Court rule adversely to Golden and in favor of Luff on both Issue Two and Issue Three with the result that Luff is held to be entitled to request that a risk compensation provision be included in the compulsory pooling order in this case, in that event, this Court should then hold, as a matter of law, that the 100% risk compensation penalty provided for in ARSD 74:12:10:03 can have no application to disputed risk compensation issues presented to the Board in a contested case compulsory pooling proceeding where an interested party has intervened in the contested case proceedings and has objected to the imposition of a risk compensation penalty against his or her mineral interest ownership in the involved spacing unit. This Court should rule that, in a contested case compulsory pooling proceeding where imposition of a risk compensation penalty has been requested and where an interested party has intervened in opposition to that petition for compulsory pooling order and has objected to the imposition of a risk compensation penalty against his or her interest in the involved spacing unit (as Golden has done in this case), disputed issues concerning risk compensation must be decided by the Board through the contested case administrative hearing process, on a case by case basis, and the disputed issues in such a case must be decided by the Board on the specific circumstances associated with the spacing unit and oil and gas well in question based on the actual

evidence presented to the Board at the hearing in the contested case proceedings. The 100% risk compensation provided for in ARSD 74:12:10:03 should be construed by this Court as applying only in uncontested compulsory pooling cases where, after having been provided all required notices, the involved mineral interest owner does not intervene in the compulsory pooling proceedings and does not object to the imposition of the risk compensation provided for in ARSD 74:12:10:03.

The Court would reach the fifth, and final, issue raised on appeal by Golden only if the Court has ruled against Golden on both Issue Two and Issue Three (i.e., ruled that Luff is not barred from seeking to have a risk compensation provision included in the compulsory pooling order in this case) and has then ruled in favor of Golden on the Issue Four (i.e., ruled that the 100% risk compensation penalty provided for in ARSD 74:12:10:03 is not to be applied to determine the outcome of disputed risk compensation issues in contested case compulsory pooling proceedings) with the result that the determination of whether a risk compensation provision should be included in the compulsory pooling order in this case and, if so, in what amount, must be decided based on the evidence actually presented to the Board at the hearing in the contested case proceedings in such cases.

If the Court reaches this final issue, the Court should rule, based on the evidence presented to the Board in this case, that it was clearly erroneous, based on the evidence presented, for the Board to have found and held that Luff has proven that the imposition of a 100% risk compensation penalty against Golden's mineral interest in the Subject Spacing Unit is just and reasonable.

Upon that ruling, the provisions of SDCL 45-9-35 would again control the financial relationship between Luff, as operator, and Golden, as a non-operating mineral interest owner, in the Subject Spacing Unit and Luff would be limited to recovering from Golden's proportionate share of the production from the Stearns Brothers Well, exclusive of a 1/8th royalty, only Golden's proportionate share of the reasonable actual expenses for the Stearns Brothers Well, with no risk compensation penalty to be recovered by Luff out of Golden's share of the production from that well.

Dated this 26th day of September, 2014.

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CERTIFICATE OF COMPLIANCE
PURSUANT TO SDCL 15-26A-66(b)(4)

The undersigned attorney hereby certifies that the foregoing brief complies with the type volume limitation provided for in SDCL 15-26A-66(b)(2). The foregoing brief, including headings, footnotes, and quotations but excluding the table of contents, table of cases, jurisdictional statement, statement of legal issues, any addendum materials, and certificates of counsel contains 9,723 words and 49,195 characters.

Dated this 26thth day of September, 2014.

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CERTIFICATE OF SERVICE

The undersigned attorney hereby certifies that he served a true and correct copy of the foregoing upon the persons indicated below by causing the same to be deposited in the United States Mail, first class postage prepaid, addressed as indicated, all on September 26, 2014, to wit:

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IN THE SUPREME COURT
STATE OF SOUTH DAKOTA

IN THE MATTER OF THE PETITION OF LUFF EXPLORATION COMPANY, DENVER, COLORADO, FOR AN ORDER POOLING ALL INTERESTS IN A SPACING UNIT FOR THE SOUTH MEDICINE POLE HILLS FIELD DESCRIBED AS THE E/2 OF SECTION 33 AND THE W/2 OF SECTION 34, TOWNSHIP 23 NORTH, RANGE 4 EAST AND THE NW/4 OF SECTION 3 AND THE NE/4 OF SECTION 4, TOWNSHIP 22 NORTH, RANGE 4 EAST, HARDING COUNTY, SOUTH DAKOTA, AND TO AUTHORIZE THE RECOVERY OF RISK COMPENSATION IN ADDITION TO THE PRO RATA SHARE OF REASONABLE, ACTUAL COSTS FROM THE INTEREST OF ANY LESSEE OR UNLEASED MINERAL OWNER WHO ELECTS NOT TO PARTICIPATE IN THE RISK AND COST OF DRILLING AND COMPLETING A WELL ON SAID SPACING UNIT; AND FOR OTHER RELIEF AS THE BOARD DEEMS APPROPRIATE	Appeal Number: 27147 **BRIEF OF APPELLEE LUFF EXPLORATION COMPANY**

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LUFF EXPLORATION COMPANY

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JURISDICTIONAL STATEMENT

Linda Golden ("Golden") appeals from a Circuit Court order entered June 17, 2014, summarily affirming a decision of the South Dakota Board of Minerals and Environment ("Board") in which the Board ordered the compulsory pooling of Golden's mineral interests in an oil well spacing unit and authorized Luff Exploration Company to recover a risk penalty from Golden's share of production. Golden was served with notice of entry of the Circuit Court Order on June 17, 2014, and her Notice of Appeal was filed July 21, 2014.

STATEMENT OF ISSUES

ISSUE ONE: Whether the Board properly applied the provisions of SDCL 45-9-32 and ARSD 74:12:10.

The Board concluded that its rules as found in Chapter 74:12:10 are the rules by which the Board has chosen to exercise the authority granted by SDCL 45-9-33 to provide alternatives whereby an owner of mineral interests may elect to lease or participate on a limited or carried basis.

Most Relevant Cases:
Application of Kohlman, 263 N.W.2d 674, 677 (S.D.1978).
Krsnak v. Department of Environment and Natural Resources, 2012 S.D. 89, 824 N.W.2d 429, 436.
State v. Guerra, 2009 S.D. 74, 772 N.W.2d 907, 916.

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:
SDCL 45-9-1.
SDCL 45-9-32.
SDCL 45-9-33.
ARSD 74:12:10.

ISSUE TWO: Whether the Board's finding that Luff made an unsuccessful good-faith attempt to have Golden participate in the risk and cost of drilling the Stearns Well is clearly erroneous.

The Board found that Luff's efforts constituted a good faith attempt to have Golden execute a lease, or participate in the risk and cost of drilling and operating the Stearns Well.

Most Relevant Cases:
Sandner v. Minnehaha County, 2002 S.D. 123, 652 N.W.2d 778.
In re Prevention of Significant Deterioration Air Quality Permit Application of Hyperion Energy Center, 2013 S.D. 10, ¶ 16, 826 N.W.2d 649.
McQuay v. Fischer Furniture, 2011 S.D. 91, ¶10, 808 N.W.2d 107, 110.
Darling v. W. River Masonry, Inc., 2009 S.D. 4, ¶10, 777 N.W.2d 363-366-67.

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:
SDCL 1-26-36.

ISSUE THREE: Whether risk compensation can be imposed on an owner that elects not to participate in the risk and cost of drilling a well, when the well in question is drilled before an order awarding the compensation is issued.

The Board concluded that drilling the Stearns well prior to obtaining the Board's order pooling Golden's interest did not preclude Luff from recovering the risk compensation provided for in SDCL 45-9-33, and ARSD 74:12:10:03.

Most Relevant Cases:
State v. Young, 2001 S.D.76, 630 N.W.2d 85.
North Central Inv. Co. v. Vander Vorste, 135 N.W.2d 23 (S.D. 1965).

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:
ARSD 74:12:10:01.
ARSD 74:12:10:03
SDCL 45-9-33.
SDCL 45-9-36.

ISSUE FOUR: Whether the Board erred in awarding the risk compensation authorized by ARSD 74:12:10:03.

The Board concluded that ARSD 74:12:10:03 provided for the proper amount of risk compensation, 100%.

Most Relevant Cases:

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:
ARSD 74:12:10:01
ARSD 74:12:10:03.
ARSD 74:09:01:01.

ISSUE FIVE: Whether it was clearly erroneous to determine that an award of 100% risk compensation was just and reasonable.

The Board concluded that allowing Luff to recover its prorated share of costs plus risk compensation equal to one-hundred percent of the reasonable actual costs, in addition to the pro rata share of costs from the interest of Golden, is just and reasonable.

Most Relevant Cases:
Application of Kohlman, 263 N.W.2d 674, 677 (S.D.1978).

Most Relevant Constitutional Provisions, Statutes, and Administrative Rules:
ARSD 74:12:10:03.

STATEMENT OF THE CASE

After Golden decided to neither participate in the risk and cost of drilling the Stearns Well, or to lease her interest to Luff, Luff submitted a petition to the Board, seeking an order pooling all interests in the 960-acre spacing unit and authorizing the recovery of risk compensation from any lessee or unleased owner who elected not to participate in the risk and cost of drilling the Stearns Well, on the spacing unit. App. 19-

21.[1] A hearing on Luff's petition was held by the Board on October 17, 2013. Following the conclusion of the hearing, the Board voted 6 to 1 to grant the relief requested by Luff in its petition. App. 183. The order was entered by the Board on November 21, 2013. App. 18. Golden appealed to Circuit Court, and that Court held for Luff. Golden now appeals to this Court.

STATEMENT OF THE FACTS

The facts and issues presented for review by the Court in this case are relatively straightforward and simple. Golden owns a 50% interest, or 80 net mineral acres in Lots 3 and 4 and the S/2NW/4 of Section 3, Township 22 North, Range 4 East. App. 36. Pursuant to an Order of the Board of Minerals and Environment, dated July 1, 2013 in Case No. 16-2013, the NW/4 of Section 3, together with the NE/4 of Section 4 in the same township and the E/2 of Section 33 and the W/2 of Section 34, Township 23 North, Range 4 East, constitutes a 960 acre spacing unit for the South Medicine Pole Hills Field. App. 76-77. Thus, Golden's interest constitutes 80/960ths, or slightly over 8% of the spacing unit. All of the other mineral owners in the 960-acre spacing unit have entered into oil and gas leases covering their interests. App. 36.

On June 25, 2013, Clayton Chessman ("Chessman"), a landman employed by Luff, sent an email to Golden on Luff's behalf, offering to lease Golden's mineral interest for lease bonus of $100 per net mineral acre with a 1/6th royalty and a 3-year primary term. App. 44-45. Golden did not respond to Chessman's email. App. 82-83.

[1] References to the record are, unless otherwise indicated, references to the appendix filed with Appellant's Brief.

On July 17, 2013, Chessman sent another email to Golden, offering to increase the lease bonus to $200 per net mineral acre. App. 44-45. Also on July 17, 2013, Chessman sent a letter to Golden by certified mail, return receipt requested, in which Chessman explained that Luff proposed to drill the Stearns Well on the spacing unit described above. App. 37-41. Chessman also enclosed an "Authority for Expenditure" or "AFE" and a proposed oil and gas lease, and explained that Golden had the opportunity to elect to participate in the well by paying her proportionate share of the costs of drilling the proposed Stearns Well[2] or to lease her mineral interest for the same terms offered in the email of the same date. *Id*. The letter further explained that if Golden did not elect either to participate or lease, Luff intended to request that the Board "provide for the recovery of risk compensation pursuant to South Dakota Administrative Rules 74:12:10." *Id.*

Golden was not a stranger to the pooling procedure authorized by South Dakota statutes and the regulations promulgated by the Board pursuant to those statutes. Golden is also an unleased mineral owner in the spacing unit for another well known as the Buckley D-32H well and she elected not to lease in that well or to participate. App. 85-86.

Golden responded to Chessman's July 17, 2013 email by sending an email stating:

> "Thank you for your generous offer. I have spoken with my attorney, Scott Sumner, and decided that I want to continue my status as an unleased mineral interest." App. 44.

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[2] Golden's Brief inaccurately describes this letter as a "demand" that "Golden pay Luff $261,791.00." Golden Brief, p. 15. As explained in the Luff Ex. 3, signing the AFE would constitute an agreement by Golden to pay her proportionate share of the actual costs incurred in drilling the proposed well. App. 37.

Golden did not otherwise respond to Chessman's July 17, 2013 letter. App. 83. She did not request more time to make a decision, she did not request the negotiation of a joint operating agreement, she did not make a counter-proposal. *Id.* She did not elect either to participate in the risk and cost of drilling the Stearns Well or to lease her interest. *Id.* Luff commenced drilling the Stearns Well on July 28, 2013. App. 87.

Luff then submitted a petition to the Board, seeking an order pooling all interests in the 960-acre spacing unit and authorizing the recovery of risk compensation from any lessee or unleased owner who elected not to participate in the risk and cost of drilling a well on the spacing unit. App. 19-21. Golden, through her counsel, submitted a Petition to Intervene. App. 24-34.

A hearing on Luff's petition was held by the Board on October 17, 2013. Mr. Chessman testified on behalf of Luff. Golden appeared through counsel but did not attend the hearing or present any testimony on her behalf. App. 74. The Board's order was entered on November 21, 2013. App. 18.

Golden appealed the decision of the Board to the Circuit Court and, on June 17, 2014, the Circuit Court, Judge Mark Barnett presiding, entered an order affirming the decision of the Board. App. 3-4.

ARGUMENT

ISSUE ONE: Whether the Board properly applied the provisions of SDCL 45-9-32 and ARSD 74:12:10:01.

State law in the form of statutes and rules speaks directly to this controversy and in Luff's favor. The Board's order, entered after testimony and vigorous argument is correct and must be upheld.

Golden's primary complaint with the Board's order in this case lies with the application of ARSD 74:12:10:01. Golden apparently does not agree with the approach to risk compensation which was implemented by the Board when it adopted the administrative rules now codified as Chapter 74:12:10. Golden, by failing to respond to Luff's attempt to have her agree to lease or participate in the risk of drilling the Stearns Well, and in its arguments to the Board, and arguments on appeal seems to act and argue as if those rules did not exist. Yet they do exist and were properly applied.

In enacting Chapter 45-9 of the South Dakota Codified Laws, the South Dakota Legislature gave the Board broad authority to regulate the development of oil and gas resources. The Legislature declared it to be "in the public interest to foster, to encourage, and to promote the development, production, and utilization of natural resources of oil and gas in the state of South Dakota in such a manner as will prevent waste." SDCL 45-9-1; *Application of Kohlman*, 263 N.W.2d 674, 677 (S.D.1978). It gave the Board the "duty to perform all the necessary quasi-legislative and quasi-judicial functions necessary to carry out the state's purpose of SDCL, Ch. 45-9." *Id.* It expressly authorized the Board to "promulgate rules pursuant to Chapter 1-26 and issue orders reasonably necessary to prevent waste, to protect correlative rights, to govern the practice or procedure before the board, and otherwise to administer" SDCL 45-9-13. To no one's surprise, the Board has done so.

Golden has consistently described the risk compensation authorized by the Board as a "penalty" and characterized Luff's position and the Board's order as wrongful and overreaching. In contrast, the State of South Dakota, acting through its Legislature and the Board of Minerals and Environment has long recognized the need to address the issue

of mineral owners who seek a "free ride" in oil and gas drilling activities. SDCL 45-9-32, which was initially enacted in 1953, expressly provides that each pooling order "shall provide for one or more just and equitable alternatives whereby an owner who does not elect to participate in the risk and cost of the drilling and operation of a well may elect to surrender his leasehold interest to the participating owners on some reasonable basis … or may elect to participate in the drilling and operation of the well, on a limited or carried basis upon terms and conditions determined by the board to be just and reasonable."

In *Kohlman,* the South Dakota Supreme Court first described the "unattractive arrangement" in which a working interest owner like Luff drills a well for the benefit of other owners and then is required "simply to carry the non-drilling interest owners at his risk." 263 N.W.2d at 676. The practice is commonly referred to as giving the non-participating owner a "free ride." *Id.* The Court held that "the authority to set a risk compensation is necessarily implied and reasonably necessary to effectuate the power and duty of the Board to impose a compulsory pooling order where the alternative of a limited or carried basis is provided." 263 N.W.2d at 679. There can be no serious question that under SDCL 45-9, the Board has the authority to award risk compensation to an operator like Luff who bears the risk and cost of drilling wells that benefit the entire state of South Dakota, (through taxes paid) other owners in the spacing unit, and owners such as Golden.

The Legislature has also expressly authorized the Board to "promulgate rules … and issue orders reasonably necessary to prevent waste, to protect correlative rights, to govern the practice or procedure before the board, and otherwise to administer" Chapter 45-9. SDCL 45-9-13. A rule is an "agency statement of general applicability that

implements, interprets, or prescribes law, policy, procedure, or practice requirements of any agency." SDCL 1-26-1(8).

It is well-recognized that a Legislature may fix a primary standard and authorize an agency such as the Board "to fill in the interstices in the legislation by promulgating rules and regulations consistent with their enabling legislation." 2 Am Jur 2d Administrative Law §127. Rulemaking is the "quasi-legislative … function" expressly recognized by the Court in *Kohlman*. 263 N.W.2d at 677. While agencies have discretion whether to proceed by general rulemaking or by individual ad hoc litigation, "the preferred method of policymaking is by the promulgation of rules." 2 Am. Jur. 2d, *supra*, at 135. And, as further noted by the Court in *Kohlman*, the Legislature has recognized that "resolving the details required in this legislative area of regulating oil and gas recovery is better left to a qualified administrative board made up of members with expertise in the field of natural resources." 263 N.W.2d at 677.

In 2004, the Board, exercising the discretion entrusted to it by the Legislature, promulgated the administrative rules included in ARSD Chapter 74:12:10. 30 SDR 193, effective June 10, 2004.[3] Chapter 74:12:10 establishes the "terms and conditions determined by the Board to be just and reasonable" as required by SDCL 45-9-33. By promulgating generally applicable policies, the Board tells operators like Luff and mineral owners like Golden, in advance, the rules which the Board will apply to future drilling activities. Operators and non-operator mineral owners alike know that the options afforded an owner are to lease, participate in the risk and cost of drilling, or be

[3] The risk compensation rules were originally promulgated as Chapter 74:10:18 and were re-promulgated as Chapter 74:12:10 in 2011. 2011 SD Reg Text 273802 (NS).

carried subject to a risk compensation. ARSD 74:12:10:01. Operators and non-operators alike know that the risk compensation allowed is 200% of the non-operator's proportionate share of the costs of drilling and completing the well when the non-operator is a lessee under an oil and gas lease or 100% of the non-operator's proportionate share of the same costs when the non-operator is an unleased mineral interest owner. ARSD 74:12:10:02 and 74:12:10:03. So, the Board has prescribed generally applicable rules setting the "terms and conditions that are just and reasonable," as required by SDCL 45-9-31. It has set the ground rules and the alternatives required by SDCL 45-9-33. And, as required by SDCL 45-9-33, all non-operating owners must be given a reasonable opportunity to elect to participate "on a limited or carried basis."

The law in South Dakota is well established that properly promulgated administrative rules "have the force of law and are presumed valid." *Krsnak v. Dept. of Environment and Natural Resources,* 2012 S.D. 89, ¶ 16, 824 N.W.2d 429; *State v. Guerra,* 2009 S.D. 74, ¶ 32, 772 N.W.2d 907, 916. The maxim that every individual is presumed to know the law extends to administrative rules. *Hieb v. Opp,* 458 N.W.2d 798, 801 (S.D.1990).

Golden inexplicably argues that she was excluded from electing to participate in the Stearns Well by paying her proportionate share of the well and that she was forced into the position of an owner who has elected not to participate. Golden Brief, pps. 4-5. To the contrary, Luff gave Golden an opportunity to elect to participate or lease, at her option. Golden chose not to take advantage of the opportunity. At Luff's request, the Board applied the rules properly in effect and awarded Luff risk compensation.

The Board properly applied SDCL 45-9-32 as administered by the Board pursuant to ARSD 74:12:10.

ISSUE TWO: Whether the Board's finding that Luff made an unsuccessful good-faith attempt to have Golden participate in the risk and cost of drilling the Stearns Well is clearly erroneous.

In its order, the Board specifically found that the July 17, 2013 letter to Golden, "particularly when combined with Luff's efforts prior to [the letter] to secure a lease from Golden, constituted a good faith attempt to have Golden execute a lease or participate in the risk and cost of drilling and operating the well." App. 12 at Finding 47. To support this finding, the Board summarized in considerable detail the communications between Chessman and Golden. App. 7-8. It noted Chessman's opinion testimony that the 30-days offered to Golden was reasonable, based on the standard joint operating agreement used in the oil and gas industry. App. 10 at Finding 38. The Board found that Luff's efforts, including the June 25, 2013 email, the July 17, 2013 e-mail, and the July 17, 2013 letter, constituted "a good faith attempt to have Golden execute a lease or participate in the risk and cost of drilling and operating the well." App. 12 at Finding 47.

In *Sandner v. Minnehaha County*, 2002 S.D. 123, 652 N.W.2d 778, the South Dakota Supreme Court determined that a finding by the Department of Labor that a worker's compensation claimant had not made a "reasonable, good faith effort" to find work was a finding of fact and applied the clearly erroneous standard. 2002 S.D. 123, ¶¶22-25. The Court said:

> We give great weight to the findings and inferences made by the agency on factual questions. We apply the clearly erroneous standard to these findings of fact meaning we carefully review the entire record

> and will reverse only if we are 'definitely and firmly convinced a mistake has been committed….' *Id.*, ¶7.

Golden does not dispute that the Board's determination constituted a finding of fact. Instead Golden argues (i) the "only evidence in the record" upon which the Board could base its finding is the July 17 letter; (ii) Luff did not offer Golden a "voluntary pooling agreement;" and (iii) therefore it was "clear error" for the Board to find that Luff engaged in a good faith attempt. Golden Brief at p. 13. Golden's argument is without merit.

First, the July 17 letter is not the "only evidence in the record" upon which the Board relied. The Board expressly relied upon Luff's course of conduct and noted specifically "Luff's efforts prior to the Golden Notice to secure a lease from Golden." AR 0474. The Board was not simply construing a deposition or medical records as noted by the Supreme Court in *McQuay v. Fischer Furniture*, 2011 S.D. 91, ¶10, 808 N.W.2d 107, 110 and *Darling v. W. River Masonry, Inc.*, 2009 S.D. 4, ¶10, 777 N.W.2d 363-366-67. The Board's findings should properly be afforded "great weight" and the Board's findings should be reversed only when those findings are "clearly erroneous in light of the entire record." *In re Prevention of Significant Deterioration Air Quality Permit Application of Hyperion Energy Center*, 2013 S.D. 10, ¶ 16, 826 N.W.2d 649.

The record supports no finding of fact other than the one made by the Board – that Luff did make a "good faith attempt to have Golden execute a lease or participate in the cost and risk of drilling and operating the well." App. 12.

Golden offered no evidence to the Board. She offered no expert testimony that a voluntary pooling agreement is a standard agreement in the oil and gas industry or that any industry custom or practice supports the use of a voluntary pooling agreement. She

offered no evidence that she desired to negotiate and enter into a voluntary pooling agreement or a joint operating agreement or any other agreement with Luff. Indeed, the record discloses that Golden's only response to Luff was that she believed Luff's offer was "generous" but that she desired to "continue her status as an unleased mineral interest." There is simply no factual basis in the record from which the Board or this Court could conclude that any further effort by Luff would have been of any use. Golden's brief does not cite any statutory or regulatory language that requires an operator to offer or negotiate a pooling agreement or any case law or legal authority from South Dakota or any other jurisdiction which determines or suggests that such a duty exists.

The Board's determination that Luff made a good faith attempt is supported by the record and is not clearly erroneous.

ISSUE THREE: Whether risk compensation can be imposed on an owner that elects not to participate in the risk and cost of drilling a well when the well in question is drilled before an order awarding the compensation is issued.

Golden argues that the Board erred in authorizing Luff to recover the penalty because the Stearns Well was already drilled, but not completed, when the hearing was held. To support this argument, Golden relies solely on a Michigan case which held a penalty could not be imposed after the well was drilled. *See* Golden Brief at 17-18 (citing *Traverse Oil Co. v. Hoeter*, 396 N.W.2d 498, 505 (Mich. Ct. App. 1986)). However, that court was interpreting a specific Michigan administrative rule which states that a pooling order must provide a working interest owner the opportunity to "await the outcome of the drilling of the well" and be carried. *See Traverse Oil*, 396 N.W.2d at 505.

Nothing in ARSD 74:12:10:01 or ARSD 74:12:10:03 requires either a pooling to

be accomplished or a penalty to be authorized prior to drilling a well. As noted and described below by the Board in Conclusion of Law 18 (App. 15), South Dakota law expressly contemplates drilling a well before force pooling. *See* SDCL 45-9-36.

Oil and gas treatises address Golden's argument and explain the reasons why it should be rejected:

> It has been urged in some instances that particular pooling statutes require that pooling occur before rather than after the drilling of a well. This argument has been rejected in *Hunter Co. v. McHugh* [11 So.2d 495, 202 La. 97 (1943) appeal dismissed, 320 U.S. 222, 64 S.Ct. 19, 88 L.Ed. 5 (1943)] in Louisiana, *Superior Oil Co. v. Foote* [214 Miss. 857, 59 So.2d 85 (1952)] in Mississippi, and *Wood Oil Co. v. Corporation Commission* [1950 OK 207, 205 Okla.537, 239 P.2d 1023 (1950)] in Oklahoma. A contrary holding would seriously impair the authority of the regulatory agency to protect the public interest in the conservation of mineral resources. A narrow construction of pooling statutes, limiting the commission's authority in this respect, should be avoided. 6 Patrick Martin and Bruce Kramer, *Williams and Meyers Oil and Gas Law* §945.

SDCL 45-9-31 expressly authorizes the Board to enter pooling orders "upon such terms as are just and reasonable, and that afford to the owner of each tract or interest in the spacing unit the opportunity to recover or receive without unnecessary expense, his or her just and equitable share." While SDCL 45-9-32 does provide that a pooling order shall authorize the drilling of a well and prescribe the time and manner in which all owners may elect to participate, SDCL 45-9-36 expressly recognizes that pooling may occur after a well is drilled and details how production is to be shared in such cases.

Statutes must be construed together and harmonized, giving effect to all their provisions. *State v. Young*, 2001 S.D.76, 630 N.W.2d 85. Where statutes are contradictory, it is the duty of the court to reconcile them and give effect to all provisions, construing them together to make them workable. *North Central Inv. Co. v. Vander*

Vorste, 135 N.W.2d 23 (S.D. 1965). If an operator has properly obtained a permit for the drilling of a well, drilled a well as authorized by the rules promulgated by the Board, and complied with the ARSD Chapter 74:12:10, there is no need for the pooling order to authorize the drilling of a well or prescribe the manner and time in which working interest owners may elect to participate in the risk and cost of drilling. Any other interpretation renders SDCL 45-9-36 meaningless. Under State law, risk compensation can be awarded after a well is drilled.

ISSUE FOUR: Whether the Board erred in awarding the risk compensation authorized by ARSD 74:12:10:03.

Golden's fourth issue appears to be an argument that the 100% risk compensation authorized by ARSD 74:12:10:03 only applies in "an uncontested compulsory pooling case where, after being provided with the required notice, no involved mineral interest owner has intervened in opposition to the petition … and objected to the imposition of risk compensation penalty." Golden Brief p. 25. Golden argues that the amount of risk compensation awarded by the Board in "risk compensation disputes in contested compulsory pooling proceedings must be decided through the adjudicatory contested case hearing procedure." *Id.* p. 26.

Luff agrees that under the applicable rules, an order of the Board is necessary to authorize the recovery of risk compensation (ARSD 74:12:10:01) and that under the Board's rules, a petition for a pooling order is a "contested case" proceeding (ARSD 74:09:01:01). In this case, Luff filed a petition for a contested case proceeding. App. 19-21. The Board in turn issued a notice of opportunity for hearing, advising all interested persons that it was holding a contested case hearing on the petition, that any interested

person had a right to intervene, and that the Board's decision would be based on the evidence received at the hearing. App. 22-23. Golden, through her attorney, filed a lengthy petition to intervene. App. 24-34. Golden, through her attorney, filed a lengthy brief. App. 53-54. While Golden did not appear personally at the hearing, her attorney did appear and actively participated in the hearing. App. 49-189. Golden's attorney argued that the 100% risk compensation authorized by the rule, supported by testimony from an expert witness, and requested by Luff, was unreasonable, but chose not to put on any evidence supporting any other risk compensation. *Id.* Golden, through her attorney, submitted voluminous post hearing briefs, proposed findings and conclusions, and objections to Luff's proposed findings and conclusions. Golden, through her attorney, submitted a motion to reconsider before the Board even approved the entry of an order. Golden, through her attorney, appeared at a later Board meeting where the sole issue was approval of a written order granting Luff the relief the Board had already authorized, and re-argued her case extensively at that time.

The Board gave Golden and her attorney every reasonable opportunity to participate in the process. Golden had the opportunity to present evidence that the risk compensation should be something other than 100% and failed to do so. The very contested case Golden now claims to seek was in fact held on October 17, 2013. There is no basis for Golden to now claim that she was not afforded due process of law.

ISSUE FIVE: Whether it was clearly erroneous to determine that an award of 100% risk compensation was just and reasonable.

Finally, Golden argues that there was no "meaningful evidence" to support a determination that the 100% risk compensation was just and reasonable. Golden Brief, p. 26-27.

The purpose of ARSD Chapter 74:12:10 is to provide certainty to operators like Luff who choose to spend money and take the substantial risk of drilling oil and gas wells in South Dakota and to provide an encouragement to develop oil and gas resources in South Dakota. App. 14 at Finding 15. The Chapter also intended to reduce the need for long, contested, expensive hearings to determine controversies over the recovery of risk compensation. *Id.* at Finding 16. The Rules show the Board had previously determined that the risk compensation used in voluntary pooling agreements ranged from 50% to 300%, that an award of 100% risk compensation was reasonable, and that determination has been upheld by the South Dakota Supreme Court. *Kohlman,* 263 N.W.2d at 678-679. It was clearly reasonable for the Board to conclude, based solely on the provisions of ARSD 74:12:10:03 that risk compensation in an amount equal to 100% of the drilling and completion costs was "just and reasonable."

But the Board did not base its decision solely on ARSD 74:12:10:03. At the October hearing, Luff presented the testimony of Clayton Chessman, exploration manager for Luff who has 37 years of experience as a land man in the oil and gas industry. App. 75. Through an entity known as Chessman Energy, LLC, Mr. Chessman also participated in the cost and risk of drilling the Stearns Well. App. 89. Mr. Chessman testified that, in his opinion, there are always risks involved in drilling and operating oil and gas wells, that the Red River formation which was the target of the Stearns Well "changes dramatically from one … location to another," and that there is

always a risk of "reservoir performance." App. 90. He testified that the 100% risk compensation authorized by ARSD 74:12:10:03 is "probably low for what's standard in the industry" and that joint operating agreements provide for at least 300% risk compensation and as high as 400 and 500 percent. App. 91. Mr. Chessman testified that in his opinion it was reasonable for the Board to provide for 100% risk compensation. App. 92. Golden's attorney objected, but the testimony was admitted over his objection. App. 93. The Board relied in part on Mr. Chessman's testimony, including his testimony that there is always risk inherent in oil and gas operations and that the standard risk compensation in the industry is 200%, to which no objection was made, and his testimony that 100% was reasonable in this case, to which Golden's attorney did object. Golden presented no evidence. Ms. Golden did not appear at the hearing and testify. Golden presented no expert or other witnesses to provide any basis for the Board to conclude that 100% was within the acceptable range of standard risk compensation in the industry or that there was no risk, or minimal risk, in drilling the Stearns Well. There is clearly "substantial evidence" in the record to support the Board's finding that 100% risk compensation was just and reasonable and that determination was not clearly erroneous in light of the whole record.

CONCLUSION

Golden now asserts to this Court that she has been excluded from electing to participate in the Stearns Well and has no means to avoid the imposition of risk compensation. Golden Brief, p. 4-5. However, Luff's July 17, 2013 letter gave Golden the opportunity to avoid the risk compensation – Luff asked her to elect to participate within 30 days from receipt of the letter. App. 37. Luff specifically advised Golden that

if she elected not to lease or participate in the risk and cost of drilling the Stearns Well, it intended to request the Board to "provide for the recovery of risk compensation pursuant to South Dakota Administrative Rules 74:12:10." Luff's actions were in compliance with ARSD Chapter 74:12:10. As administrative rules, the provisions of ARSD 74:12:10 have the force and effect of law and are presumed to be valid. Golden is charged with knowledge of the rules. Yet she made no reply to Luff's letter other than to say "I want to continue my status as an unleased owner." App. 44.

Golden also claims that she has been deprived of her right to a contested hearing before the Board – despite the fact that after intervening in this case, Golden chose to proceed without appearing personally or submitting any evidence on her behalf.

The facts, in Golden's own words, are that Golden, after consulting with her attorney, made a conscious decision not to elect to participate in the risk and cost of the Stearns Well and not to participate meaningfully in the hearing process by submitting evidence. She should not now be heard to complain of the results of either decision. There is no basis in law or fact for Golden's arguments and they should be rejected and the Board's order should be affirmed.

Dated this 20th day of November, 2014.

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CERTIFICATE OF SERVICE

I, Brett Koenecke, do hereby certify that on the 20th day of November, 2014, I caused a true and correct copy of the foregoing *Appellees Brief* to be served via email upon:

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The undersigned further certifies that two copies of the Appellee's Brief in the above-captioned action were hand delivered to Shirley A. Jameson-Fergel, Clerk of the Supreme Court, State Capitol, 500 E. Capitol Avenue, Pierre, South Dakota, 57501, on

the date above written. On that same date a copy of the Appellee's Brief in Word format was filed electronically by e-mail attachment to SCClerkBriefs@ujs.state.sd.us.

___/s/ Brett Koenecke_____
BRETT KOENECKE

CERTIFICATE OF COMPLIANCE

Brett Koenecke, hereby certifies that the foregoing Brief complies with the type volume limitation imposed by the Court by Order dated March 15, 1999. Proportionally spaced typeface Times New Roman has been used. Brief contains 5,448 words and does not exceed 40 pages. Microsoft Word processing software has been used.

Dated this 20th day of November, 2014.

____/s/ Brett Koenecke_____
BRETT M. KOENECKE

IN THE SUPREME COURT
STATE OF SOUTH DAKOTA

No. 27147

IN THE MATTER OF THE PETITION OF LUFF EXPLORATION COMPANY, DENVER, COLORADO, FOR AN ORDER POOLING ALL INTERESTS IN A SPACING UNIT FOR THE SOUTH MEDICINE POLE HILLS FIELD DESCRIBED AS THE E/2 OF SECTION 33 AND THE W/2 OF SECTION 34, TOWNSHIP 23 NORTH, RANGE 4 EAST AND THE NW/4 OF SECTION 3 AND THE NE/4 OF SECTION 4, TOWNSHIP 22 NORTH, RANGE 4 EAST, HARDING COUNTY, SOUTH DAKOTA, AND TO AUTHORIZE THE RECOVERY OF RISK COMPENSATION IN ADDITION TO THE PRO RATA SHARE OF REASONABLE ACTUAL COSTS FROM THE INTEREST OF ANY LESSEE OR UNLEASED MINERAL OWNER WHO ELECTS NOT TO PARTICIPATE IN THE RISK AND COST OF DRILLING AND COMPLETING A WELL ON SAID SPACING UNIT; AND FOR OTHER RELIEF AS THE BOARD DEEMS APPROPRIATE.

APPEAL FROM THE CIRCUIT COURT
SIXTH JUDICIAL CIRCUIT, HUGHES COUNTY, SOUTH DAKOTA

THE HONORABLE MARK W. BARNETT, Circuit Court Judge

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Notice of Appeal filed July 21, 2014.

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IN THE SUPREME COURT
STATE OF SOUTH DAKOTA

No. 27147

IN THE MATTER OF THE PETITION OF LUFF EXPLORATION COMPANY, DENVER, COLORADO, FOR AN ORDER POOLING ALL INTERESTS IN A SPACING UNIT FOR THE SOUTH MEDICINE POLE HILLS FIELD DESCRIBED AS THE E/2 OF SECTION 33 AND THE W/2 OF SECTION 34, TOWNSHIP 23 NORTH, RANGE 4 EAST AND THE NW/4 OF SECTION 3 AND THE NE/4 OF SECTION 4, TOWNSHIP 22 NORTH, RANGE 4 EAST, HARDING COUNTY, SOUTH DAKOTA, AND TO AUTHORIZE THE RECOVERY OF RISK COMPENSATION IN ADDITION TO THE PRO RATA SHARE OF REASONABLE ACTUAL COSTS FROM THE INTEREST OF ANY LESSEE OR UNLEASED MINERAL OWNER WHO ELECTS NOT TO PARTICIPATE IN THE RISK AND COST OF DRILLING AND COMPLETING A WELL ON SAID SPACING UNIT; AND FOR OTHER RELIEF AS THE BOARD DEEMS APPROPRIATE.

PRELIMINARY STATEMENT

The Administrative Record is numbered separately from the remainder of the Electronic Settled Record ("ESR"). References to the Administrative Record are designated as "AR." As the transcripts of the contested case proceeding have been placed in the Administrative Record and paginated, transcript references are "AR ___ (TR)." The South Dakota Board of Minerals and Environment's ("BME") Findings of Fact are designated as: "AR ___ (FOF ¶ ___)." The BME's Conclusions of Law are cited: "AR ___ (COL ¶ ___)." Appellant Linda Golden will be referred to as "Golden." The Appellate Brief of Linda Golden is cited as "LGB ____." Each citation is followed by the appropriate page number(s).

JURISDICTIONAL STATEMENT

The final agency decision and Order in this contested case proceeding (Oil & Gas Case No. 28-2013) was issued on November 21, 2013. AR 464-65 (vote and oral order). Notice of Entry of Findings of Fact, Conclusions of Law and Order were served on the parties on November 22 and, due to an address change, on December 3, 2013. AR 467-83. Golden filed a Notice of Appeal with the Sixth Circuit Court on December 6, 2013. ESR 1-5. The circuit court entered its Letter Decision and Order summarily affirming the BME's decision on June 17, 2014. ESR 46-49. Notice of entry was served on June 17, 2014. ESR 50-51. On July 21, 2014, Golden filed a Notice of Appeal to this Court. ESR 52-54. Jurisdiction is appropriate pursuant to SDCL 15-26A-3.

STATEMENT OF LEGAL ISSUES AND AUTHORITIES[1]

I

WHETHER THE BME WAS REQUIRED BY SDCL 45-9-32 TO ISSUE AN ADDITIONAL ORDER PRESCRIBING THE TIME AND MANNER IN WHICH GOLDEN COULD ELECT TO PARTICIPATE IN THE WELL WHEN GOLDEN WAS ALREADY PROVIDED, BY ARSD 74:12:10:01, WITH TIME TO MAKE AN ELECTION AND THE CONDITIONS OF ELECTION WERE FOUND REASONABLE BY THE BME?

[1] Golden's Statement of Legal Issues is arranged differently than the arguments regarding those issues. The DENR will address Golden's arguments as presented in her Statement of Legal Issues.

The BME's decision did not require an additional election period.

SDCL 45-9-32

SDCL 45-9-33

ARSD 74:12:10:01

Sioux Falls Shopping News, Inc. v. Department of Revenue and Regulation, 2008 S.D. 34, 749 N.W.2d 522.

Martinmaas v. Engelmann, 2000 S.D. 85, 612 N.W.2d 600.

Anderson v. City of Sioux Falls, 384 N.W.2d 666 (S.D. 1986)

II

WHETHER THE BME IS AUTHORIZED TO ENTER A COMPULSORY POOLING ORDER CONTAINING A RISK COMPENSATION PROVISION AFTER THE DRILLING OF A WELL ON A SPACING UNIT?

The BME held that it was.

SDCL 45-9-36

Bennion v. ANR Production Company, 819 P.2d 343 (Utah 1991).

Texaco Inc. v. Industrial Commission of North Dakota, 448 N.W.2d 621 (N.D. 1989).

Traverse Oil Company v. Chairman, Natural Resources Commission, 396 N.W.2d 498 (Mich.App. 1986).

III

WHETHER LUFF MADE A GOOD-FAITH ATTEMPT TO HAVE GOLDEN PARTICIPATE IN THE WELL?

The BME determined that Luff made a good-faith attempt to have Golden participate in the well.

Bonne Homme County Com'n v. American Federation of State and Mun. Employees (AFSCMF), 2005 S.D. 76, 699 N.W.2d 441.

Engelhart v. Kramer, 1997 S.D. 124, 570 N.W.2d 550.

Englehart v. Larson, 1997 S.D. 84, 566 N.W.2d 152.

IV

WHETHER THE BME'S APPLICATION OF THE RISK COMPENSATION ESTABLISHED IN ARSD 74:12:10:03 IS CLEARLY ERRONEOUS, ARBITRARY, CAPRICIOUS, OR IN VIOLATION OF CONSTITUTIONAL OR STATUTORY PROVISIONS?[2]

The BME held that it was not.

ARSD 74:12:10:01

ARSD 74:12:10:03

Davis v. State, 2011 S.D. 51, 804 N.W.2d 618.

State v. Andrews, 2007 S.D. 29, 730 N.W.2d 416.

Application of Kohlman, 263 N.W.2d 674 (S.D. 1978)

Bennion v. ANR Production Company, 819 P.2d 343 (Utah 1991).

STATEMENT OF THE CASE

This case arises as an administrative appeal under SDCL ch. 1-26 of an oil and gas order issued by the BME. ESR 1-5. Appellant Golden challenges a BME decision ordering the compulsory pooling of Golden's mineral interests in an oil well spacing unit, and authorizing the operator Luff Exploration Company ("Luff") to recover

[2] DENR's argument on this issue incorporates Golden's fourth and fifth issues.

risk compensation from her pro rata share of the oil produced from that spacing unit. ESR 52-67. The Department of Environment and Natural Resources Oil and Gas Program ("DENR") is an Appellee in this administrative appeal.

Luff drills and operates oil wells within the State. Luff petitioned the BME for the "compulsory pooling" of the mineral interests in a 960 acre spacing unit in the South Medicine Pole Hills Oil Field. AR 0001-04. Luff also requested authorization to recover, in addition to their pro rata share of reasonable and actual costs associated with the well in that spacing unit, "risk compensation" from the "non-participating" mineral interest owners. *Id.* Golden is an unleased mineral owner in the relevant spacing unit who did not agree to participate in the well by either leasing her mineral interest or in paying her pro rata share of well costs. AR 0009-20. Golden intervened in the agency proceeding, and resisted Luff's Petition. *Id.*

The final agency decision and order in this contested case proceeding (Oil & Gas Case No. 28-2013) was issued on November 21, 2013. AR 464-65 (vote and oral order). Notice of Entry of Findings of Fact, Conclusions of Law and Order were served on the parties on November 22 and, due to an address change, on December 3, 2013. AR 467-83. Golden filed a Notice of Appeal with the Sixth Circuit Court on December 6, 2013. ESR 1-5. The Honorable Mark W. Barnett, Circuit Court Judge, entered a Letter Decision and Order

summarily affirming the BME's decision on June 17, 2014. ESR 46-49.

STATEMENT OF FACTS

1. Background of Compulsory Pooling.

The BME is a board within the South Dakota Department of Environment and Natural Resources. SDCL 1-40-25. One of the statutory duties of the BME is regulation of oil and gas development within the state. SDCL 45-9-1.1. The purpose of this regulatory program has been established by the Legislature:

> It is hereby declared that it is in the public interest to foster, to encourage, and to promote the development, production, and utilization of natural resources of oil and gas in the State of South Dakota in such a manner as will prevent waste; to authorize and to provide for the operation and development of oil and gas properties in such a manner that a greater ultimate recovery of oil and gas be had and that the correlative rights of all owners be fully protected; and to encourage, to authorize, and to provide for cycling, recycling, pressure maintenance, and secondary recovery operations in order that the greatest possible economic recovery of oil and gas be obtained within the state to the end that the landowners, the royalty owners, the producers, and the general public realize and enjoy the greatest possible good from these vital natural resources.

SDCL 45-9-1. The waste of oil and gas is prohibited, and the BME is specifically enjoined to prevent waste and protect correlative rights. SDCL §§ 45-9-3, 45-9-13.

The location and drilling of oil wells are regulated. SDCL 45-9-4; ARSD Article 74:12 (Appendix 2). Oil well operators are required to

obtain well drilling permits from the Secretary of DENR. SDCL 45-9-4; ARSD 74:12:02:01.

"Spacing" is the term used to describe how many oil wells can be drilled in a specified spatial area of land. It is:

> The regulation of the number and location of wells over an oil or gas reservoir, as a conservation measure. It is generally agreed today that increased recovery from a reservoir is not a function of the number of wells drilled. Thus to the extent that more wells are drilled than are necessary for maximum recovery, there is economic waste, since the cost of drilling the unnecessary wells need not have been incurred. . . .
>
> In addition to curbing such waste, well spacing also prevents injury to the reservoir. Excessive rates of withdrawal from a reservoir, particularly where the rate in one section of the field is disproportionate to that in another, can result in physical waste from irregular or premature water or gas encroachment.

William & Meyers, *Manual of Oil and Gas Terms*, 15th Ed., Matthew Bender & Company, Inc. 2012, at 1135-36.

Authority for the BME to establish spacing units appears at SDCL 45-9-20: "When necessary to prevent waste, to avoid the drilling of unnecessary wells, or to protect correlative rights, the [BME] shall establish spacing units for a [reservoir],[3] . . ." *See also*

---

[3] The statute uses the term "pool", which is defined at SDCL 45-9-2(10) as "an underground reservoir containing a common accumulation of oil or gas or both; each zone of a structure that is completely separated from any other zone in the same structure is a pool." This use of "pool" concerns a different concept than the "pooling" at issue in this case. For clarity, the term "reservoir" will be used in this brief to describe the underground formation containing oil.

SDCL §§ 45-9-21 through -29. The BME has by rule established statewide spacing for oil wells at one well per governmental quarter-quarter section. ARSD 74:12:02:04. As a result, an operator who has drilled a producing well and who desires to drill additional wells into the producing reservoir must obtain a specific "spacing order":

> After the discovery of oil or gas in a [reservoir] not covered by an order of the board, the operator or other interested person shall file a petition for a contested case hearing requesting a specified spacing pattern and proposed field name. The petition must comply with § 74:09:01:01. After notice, and hearing if held, the board or secretary, as appropriate shall issue an order prescribing a spacing pattern for the development of the [reservoir] and the name of the field.
>
> During the interim period between the discovery and the issuance of the order, no permits may be issued for the drilling of offsets[4] to the discovery well unless there is a showing of good cause that may include lease expiration.

ARSD 74:12:02:06. Spacing orders set forth the size, shape and location of the lands involved (SDCL 45-9-26), the name of the geologic formation from which oil may be produced, the number of wells that may be drilled in each spacing unit, and restrictions on the location of wells (such as a certain distance from the spacing unit's boundaries). *See generally* ch. 45-9.

By its nature, a spacing unit affects the owners of the mineral interests in that spacing unit. In order for each of these owners to

[4] An "offset" well is defined at ARSD 74:12:01:01(20) as "a well drilled in a spacing unit adjacent to a spacing unit in which a discovery well has been drilled to further define the [reservoir]."

receive their share of the oil produced from their mineral interests, the mineral interests are grouped or "pooled," and each owner receives their pro rata share (based on the percentage of surface acreage owned) of the oil. Pooling generally occurs by voluntary agreement between the lessees who hold oil and gas leases authorizing them to produce oil from the involved lands. On occasion, however, a tract in a spacing unit is unleased, or a lessee refuses to voluntarily participate in a well. This triggers a "compulsory pooling" process (SDCL §§ 45-9-30 through -36) by which the mineral interests in the spacing unit are joined.

There are two main types of mineral interest owners who can be affected by a spacing unit: the mineral estate owner, and the lessee who has obtained an oil lease. The owner of the mineral estate of real property may be the owner of the surface estate of that property, or may own a severed mineral estate, where the minerals have been severed by grant or reservation from the surface estate of the land. *Manual of Oil & Gas Terms* at 606. A mineral estate owner may lease the minerals to another person or entity, authorizing the lessee to drill and complete wells and produce oil from the mineral property. In exchange, the mineral owner is provided compensation, including a reservation of a "royalty" in any oil produced from the property that is *exclusive of costs*. A mineral estate owner who has executed an oil or gas lease is referred to as a "royalty owner." AR 0122 (TR). Under the

lease terms, the lessee has the right to drill or participate in the drilling of an oil well.

A mineral estate owner who has *not* executed an oil and gas lease is referred to as an "unleased mineral owner." An unleased mineral owner whose mineral interests are affected by a spacing unit can: execute a lease and become a royalty owner; participate in a well by paying his pro rata share of the drilling, completion and production costs (which makes him a participating unleased mineral owner); or continue as a nonparticipating unleased mineral owner.

The owners of oil or gas leases obtained from mineral estate owners, are "working interest owners." A "working interest" is:

> The operating interest under an oil and gas lease. The owner of the working interest has the exclusive right to exploit the minerals on the land.
>
> In the simple situation of a lessor [a mineral estate owner] who executes a lease, reserving 1/8th royalty, to a lessee who creates no burdens on his estate [i.e., free from costs of production], the working interest consists of 7/8ths of production subject to all costs of exploration and development, the lessor receives his 1/8th of production free of such costs….

Manual of Oil & Gas Terms at 1147. Working interest owners who agree to participate in a well by paying their pro rata share of well costs, are "participating owners." Working interest owners who refuse to participate in a well are "non-participating owners" (and can be subject to the compulsory pooling process).

So long as mineral interest owners agree to participate in a well (by lease or participation agreement), a spacing order results in voluntary pooling under SDCL 45-9-30. Issues arise, however, when a mineral interest owner--an unleased mineral estate owner, a lessee (working interest owner), or both--object to the pooling of the interests within the spacing unit. "Compulsory pooling" is the process established to protect the rights of both the participating and non-participating owners when agreement cannot be reached. "Compulsory pooling" is:

> The bringing together, as required by law or a valid order or regulation, of separately owned (or separate interests) small tracts sufficient for the granting of a well permit under applicable spacing rules. Compulsory process for pooling is now available in nearly all producing states. Pooling is important in preventing the drilling of unnecessary and uneconomic wells, which will result in physical and economic waste. …

Manual of Oil & Gas Terms at 179. The South Dakota statutes concerning compulsory pooling are SDCL §§ 45-9-30 through -36.

This case involves the compulsory pooling of the unleased mineral estate of Golden, and, in particular, one of the terms and conditions imposed by the compulsory pooling order: "risk compensation". "Risk Compensation" is

> [I]ntended to relieve the nondrilling [non-participating] interest owner from *having to advance his proportionate share of drilling costs but provide extra compensation from production (if oil is found) to the drilling party who has advanced the entire drilling costs and who would absorb the entire cost of a "dry hole."*

Application of Kohlman, 263 N.W.2d 674, 675 (S.D. 1978) (holding that the BME had authority to impose risk compensation in compulsory pooling orders under SDCL 45-9-33)(emphasis added). It is basically a method by which working interest owners are compensated for the risk associated with oil wells from non-participating owners who do not provide their pro rata share of well costs up-front, even though their interest requires them to pay a share of well costs. Risk compensation is collected by the participating owners from the non-participating owner's share of production from the well. If no oil is produced from the well, this share of well costs is never obtained from the non-participating owner.

The BME has adopted certain rules concerning risk compensation in compulsory pooling. ARSD 74:12:10:01 provides that an applicant for a compulsory pooling order may request the recovery of risk compensation in addition to actual prorated costs, from a non-participating owner. ARSD 74:12:10:03 provides:

> If the nonparticipating owner's interest in the spacing unit is not subject to a lease or other contract for development, the risk compensation is one-hundred percent of the nonparticipating owner's share of the reasonable actual costs of drilling, reworking, side-tracking, deepening, plugging back, testing, completing and recompleting the well and the costs of newly acquired equipment in the well including the wellhead connection. Risk compensation may be recovered *only out of production from the pooled spacing unit, exclusive of a one-eighth royalty as provided for in SDCL 45-9-35.*

(Emphasis added). SDCL 45-9-35 states that if an owner pays the costs of drilling, equipping and operating a well "for the benefit of another person as provided for in an order of pooling," the owner is entitled to a share of production from the spacing unit "accruing to the interest of the other person, exclusive of a royalty not to exceed one-eighth of the production, until the market value of the other person's share of the production exclusive of such royalty, equals the sums payable by or charged to the interest of the other person. . . ."

The BME adopted, *inter alia*, ARSD 74:12:10:01 and 74:12:10:03 to provide alternatives whereby an owner who does not elect to participate in the risks and costs of drilling may elect to lease or participate on a limited or carried basis with the application of a risk penalty provision. AR 476 (COL ¶¶ 14-16). Because the administrative rules carry the "force and effect of law," as long as certain conditions are met, the BME's administrative rules operate to fulfill several of the requirements of SDCL §§ 45-9-30 through -36. *Sioux Falls Shopping News, Inc. v Department of Revenue*, 2008 S.D. 34, ¶ 24, 749 N.W.2d 522, 527 (administrative rules have the "force and effect of law").

Under the BME's regulations, before the applicant may seek imposition of a risk compensation provision, ARSD 74:12:10:01 requires that certain conditions be met. Subsection (1) requires a showing that "an unsuccessful good-faith attempt was made to have

the nonparticipating owner execute a *lease or participate in the risk and cost* of drilling and operating the well." Subsection (2) further provides the nonparticipating owner notice that if he or she does *not elect to participate* in either the costs of drilling and operating the well or chooses not to execute a lease, the applicant will request the recovery of *risk compensation*. (Emphasis added).

As applied to the statutory provisions, subsection (1) of ARSD 74:12:10:01 provides the owner the opportunity to *participate in the risk and cost* of drilling the well as provided for in SDCL 45-9-32 or *surrender his or her leasehold interest* as envisioned by SDCL 45-9-33. Furthermore, in accord with SDCL 45-9-33, by choosing not to participate in the risk and cost of drilling and operating a well or entering into a lease, the owner elects the third option--to participate on a *limited or carried basis* with the application of risk compensation. *See Kohlman*, 263 N.W.2d at 679 (risk compensation is necessarily implied where the alternative of a limited or carried basis is provided) (emphasis added). The BME has presumptively set risk compensation as "one-hundred percent of the nonparticipating owner's share of the reasonable actual costs of drilling . . . the well" and other costs such as wellhead connection. ARSD 74:12:10:03.

The above elections and application of risk compensation are not absolute. The owner is free, pursuant to SDCL 45-9-58, to initiate the contested case procedure. At the time of the hearing the applicant

must affirmatively show that, by a preponderance of evidence, the offers were in fact made in good-faith. *See* ARSD 74:12:10:01 (requiring proof of a good-faith offer); 74:09:01:16 (requiring that a demonstration of a fact be proven by a preponderance of the evidence). Without such a finding, the applicant is not entitled to the risk compensation provisions outlined in rule. *See* ARSD 74:12:10:01(2) (entry of order requires proof of good faith offer). If, however, the BME finds that the offer to participate and the lease offer were made in good faith, only the risk penalty remains subject to challenge under ARSD 74:12:10:01(2).

2. Facts Presented to the BME.

On June 25, 2013, Luff employee Clayton Chessman sent an email to Golden acknowledging her ownership of unleased minerals in certain land in Section 3 of Township 22 North, Range 3 East, of Harding County. AR 0246-47. He explained Luff's desire to drill a well that would produce oil from Golden's mineral lands, and explained why leasing rather than compulsory pooling could be in Golden's best interests. *Id.* The email offered Golden an oil lease with Luff for $100 per net mineral acre with a 1/6 (16.666667%) royalty for a three-year primary term. AR 0083-84 (TR); AR 0246-47; AR 0469 (FOF ¶ 9). Golden did not respond to this email. AR 0084 (TR); AR 0469 (FOF ¶ 10). Luff and Golden had a pre-existing relationship regarding another oil well in Harding County (the Buckley D-32H well), into

which Golden was previously compulsorily pooled. Under that prior compulsory pooling order, Golden is an unleased mineral owner, and is required to pay her share of the well's costs *and* "risk compensation" of one hundred percent. AR 0086-87 (TR); AR 0468 (FOF ¶¶ 4-5).

On July 1, 2013, the Secretary of DENR issued an uncontested Oil & Gas Order (Oil & Gas Case No. 16-2013) that established, inter alia, a "spacing unit" for oil drilling of 960 acres within the South Medicine Pole Hills Field in the Red River "B" reservoir. AR 0469 (FOF ¶ 11). The lands placed in this spacing unit were the East Half of Section 33 and the West Half of Section 34, Township 23 North, Range 4 East; and the Northwest Quarter of Section 3 and the Northeast Quarter of Section 4, Township 22 North, Range 4 East, all in Harding County, South Dakota. The land in the spacing unit consisted of six separately owned tracts, with separately owned interests within the tracts. AR 0078-79 (TR); AR 0237-38. No voluntary pooling agreement existed for all the tracts in the spacing unit, as unleased mineral interests owned by Golden were within this spacing unit. AR 0079 (TR); AR 0469 (FOF ¶¶ 13-14).

On July 2, 2013, Luff submitted an Application for Permit to Drill an oil well, referred to as the Stearns Brothers B-33H well, on the spacing unit established in Oil & Gas Case 16-2013. AR 0249-50; AR 0469 (FOF ¶ 15). The Permit to Drill this oil well was issued by DENR on July 11, 2013. AR 0249; AR 0470 (FOF ¶ 16).

On July 17, 2013, Chessman again contacted Golden, sending a certified letter. AR 0080 (TR); AR 0239-45; AR 0470 (FOF ¶ 18). This letter also explained that Golden owned an undivided fifty percent interest in certain lots in Section 3 of Township 22 North, Range 4 East of the lands subject to a spacing unit, and that these lands were unleased. The letter attached both an "Authority for Expenditure" or "AFE" (AR 0242-43) if Golden wished to participate in the oil well, and a lease (AR 0244-45) if Golden wished to lease her mineral estate to Luff. At this time, the lease terms offered were $200 per net acre, a one-sixth royalty rate, and a three-year primary term on a standard form oil and gas lease. AR 0082 (TR). Luff requested that Golden make her election (participation or execution of the lease) within thirty days from July 17, 2013. AR 0080-81 (TR); AR 0470 (FOF ¶ 19). Luff further advised that, if Golden declined the lease and elected not to participate in the well, it was Luff's intention to request compulsory pooling, including risk compensation, from the BME. AR 0081 (TR); AR 0470 (FOF ¶ 20). Chessman also sent an email to Golden on July 17, attaching his June 25 email and increasing the lease bonus consideration to $200 per net mineral acre. AR 0246-47.

Golden responded on July 18 to Chessman's July 17 email. Golden indicated that she wanted to continue in her status as an unleased mineral owner. AR 0084 (TR); AR 0246; AR 0470

(FOF ¶¶ 21-22). Golden never responded to Chessman's July 17 certified letter, which she received on July 25, 2013. AR 0241.

On July 23, 2013, Luff petitioned the BME for a compulsory pooling order. AR 0002-04 (*see also* AR 0212-14); AR 0471 (FOF ¶ 24). A copy of the Petition (AR 0002) and the Notice of Opportunity for Hearing (AR 0005) was sent to all interested persons. AR 0080 (TR). Appellant Golden received these documents on August 9, 2013. AR 0234. The Notice of Opportunity for Hearing was also published in the *Nation's Center News* of Harding County. AR 0007.

On August 28, 2013, Golden filed a Petition to Intervene. AR 0010-20. A contested case proceeding was scheduled before the BME and held on October 17, 2013. AR 0050. Golden appeared through counsel only. AR 0472 (FOF ¶ 33). The only witness who offered testimony at the contested case proceeding was Luff's witness Clayton Chessman. AR 0472 (FOF ¶ 35).

At the time of the hearing, the Stearns Brothers B-33H well had been drilled in the spacing unit, but the well had not been made operational and was not producing oil. AR 0087 (TR); AR 0471 (FOF ¶ 26); AR 0472 (FOF ¶ 34). Luff's witness Chessman testified that the well was drilled prior to hearing because of drill rig scheduling issues. AR 0088-89 (TR), 0101-02 (TR). Chessman testified that the result of drilling prior to hearing was that Luff was accepting the risks associated with the initial drilling, and Golden received the benefit of

now knowing that the well was successfully drilled to depth. AR 0101, 0108 (TR).

Luff's witness Chessman testified that he had more than 30 years' experience as a landman, which involved getting the rights to be able to drill the well through leases or agreements. AR 0076-77 (TR); AR 0472 (FOF ¶ 36). Making offers and agreements for participation in a well are part of a landman's duties. AR 0077 (TR). Chessman testified that the lease terms offered Golden were reasonable, were based upon lease terms recently negotiated with another mineral owner in the spacing unit, and that allowing a thirty day time period in which to make an election of participation was reasonable and in accord with custom and practice in the oil and gas industry. AR 0080-83, 0097-98 (TR); AR 0472 (FOF ¶ 37).

Chessman also testified about the risks associated with the drilling and development of oil wells. He testified that, while the mechanical drilling risks had already been resolved because the well had been drilled, the risks of production still existed because what the well is capable of, and what it will eventually produce, is unknown. AR 0091 (TR). He testified that wells in the Red River "B" oil reservoir, which is the formation from which the well is to produce, involved risk. AR 0091 (TR). He testified about various oil wells drilled in the general location of the proposed well, some of which were successfully completed as oil wells, and some of which produced too much water or

were otherwise uneconomic to keep as producing wells and were converted to "injection wells."[5] AR 0109-20 (TR); AR 0472 (FOF ¶ 39). Chessman testified that many wells do not recover the costs of drilling and completion. AR 0127-32 (TR); AR 0472 (FOF ¶ 40).

Chessman testified that his opinion was that 100% risk compensation was reasonable, and was in fact low in comparison to the standard in the industry. AR 0092-94 (TR); AR 0473 (FOF ¶ 41). He testified that Golden's share of the estimated well costs were $261,791, and with 100% risk compensation Golden would be required to pay a total of slightly less than $520,000 if risk compensation was imposed. AR 0144-45 (TR).

The BME concluded that issuance of a compulsory pooling order was authorized by SDCL 45-9-31. AR 0474-75 (COL ¶ 4). The BME also concluded that risks exist in the drilling of oil wells, that risk compensation's purpose is to balance the costs, benefits, and risks of drilling among non-participating and participating parties, and that risk compensation is an integral part of compulsory pooling process

[5] An "injection well" is a "well employed for the introduction into an underground stratum of water, gas or other fluid under pressure. Injection wells are employed . . . for a variety of other purposes, including: (1) Pressure Maintenance, to introduce a fluid into a producing formation to maintain underground pressures which would otherwise be reduced by virtue of the production of oil and/or gas. . . ." *Manual of Oil & Gas Terms* at 501.

and protects the correlative rights of all the mineral owners. AR 0475-76 (COL ¶¶ 6-10).

The BME further held that its risk compensation rules were established to provide certainty to parties wishing to drill oil and gas wells and thereby encourage oil and gas development in the state, and to reduce the need for hearings to determine matters related to the recovery of risk compensation. AR 0476 (COL ¶¶ 15-16). The BME held that 100% risk compensation under the facts presented in this case was just and reasonable:

> Allowing the recovery of risk compensation equal to one-hundred percent of the reasonable actual costs of drilling and completing the Well and the costs of newly acquired equipment in addition to the pro rata share of such costs from the interest of Ms. Golden is just and reasonable.

AR 0278 (COL ¶ 24).

As a result, the BME entered Findings of Fact, Conclusions of Law and an Order that compulsory pooled the lands in the spacing unit and authorized Luff to recover, from Golden's share of production, her pro rata share of the reasonable actual costs of drilling, equipping, and operating the well, and 100% risk compensation. AR 0479 (BME Order ¶¶ 6-7).

ARGUMENTS

A. Standard of Review.

The standard of review for administrative appeals is established in SDCL 1-26-36. *Easton v. Hanson School District 30-1,* 2013 S.D. 30,

¶ 7, 829 N.W.2d 468, 471; *In re PSD Air Quality Permit of Hyperion,* 2013 S.D. 10, ¶ 16, 826 N.W.2d 649, 654. A reviewing court is required to give great weight to "the findings made and inferences drawn by an agency on questions of fact." SDCL 1-26-36; *Easton,* 2013 S.D. 30 at ¶ 7, 829 N.W.2d at 471. However, an agency's factual findings based on documentary evidence are viewed de novo; an agency's factual findings based on oral testimony is based on the clearly erroneous standard of SDCL 1-26-36(5). *Peterson v. Evangelical Lutheran Good Samaritan Society,* 2012 S.D. 52, ¶¶ 13-19, 816 N.W.2d 843, 847-49. Questions of law are reviewed de novo. *Easton,* 2013 S.D. 30 at ¶ 7, 829 N.W.2d at 471.

A reviewing court may reverse or modify an agency decision only if substantial rights of the appellants have been prejudiced because the administrative findings, conclusions, or decision is, inter alia, affected by error of law, clearly erroneous in light of the entire evidence in the record, or arbitrary or an abuse of discretion. SDCL 1-26-36; *Hyperion,* 2013 S.D. 10 at ¶ 16, 826 N.W.2d at 654.

I

THE BME WAS NOT REQUIRED BY SDCL 45-9-32 TO ISSUE AN ADDITIONAL ORDER PRESCRIBING THE TIME AND MANNER IN WHICH GOLDEN COULD ELECT TO PARTICIPATE IN THE WELL WHEN GOLDEN WAS ALREADY PROVIDED, BY APPLICATION OF ARSD 74:12:10:01, WITH TIME TO MAKE AN ELECTION AND THE CONDITIONS OF ELECTION WERE FOUND REASONABLE BY THE BME.

In the absence of voluntary pooling, the BME is authorized to issue a compulsory pooling order. SDCL 45-9-31. SDCL 45-9-32 states that a pooling order:

> shall authorize the drilling, equipping, and operation of a well on the spacing unit; shall provide who may drill and operate the well; shall prescribe the time and manner in which all the owners in the spacing unit may elect to participate in such well drilling, equipping, and operation; and shall provide for payment of the reasonable actual cost of the well drilling, equipping, and operation by all those who elect to participate, plus a reasonable charge for supervision and interest.

Golden argues that SDCL 45-9-32, through the use of the word shall, requires the BME, *in all situations*, to issue an additional order after a contested case proceeding prescribing "the time and manner in which all the owners in a spacing unit may elect to participate." LGB 10 (emphasis added). SDCL 45-9-32, however, does not stand alone.

> Since statutes must be construed according to their intent, the intent must be determined from the statute as a whole, as well as enactments relating to the same subject…When the question is which of two enactments the legislature intended to apply to a particular situation, the terms of a statute relating to a particular subject will prevail over the general terms of another statute.

Martinmaas v. Engelmann, 2000 S.D. 85 ¶ 49, 612 N.W.2d 600, 611 (citations omitted). Like statutes, administrative rules "have the force of law and are presumed valid." *Sioux Falls Shopping News, Inc.*, 2008 S.D. 34 at 24, 749 N.W.2d 522. Accordingly, statutes and rules "must be construed together, giving effect as far as possible to all parts thereof, so as to harmonize them and effectuate the legislative

intentions as therein expressed." *Anderson v. City of Sioux Falls*, 384 N.W.2d 666, 669 (S.D. 1986) (citing *Hanley v. Murphy*, 40 Cal.2d 572, 576, 255 P.2d 1, 3 (1953)). As harmonized, the statutes and rules provide the required election period *before* the contested case hearing.

The language of SDCL 45-9-32 stating, "[a compulsory pooling order] shall prescribe the time and manner in which all the owners in the spacing unit may elect to participate . . . ," clearly presumes the owner has not yet made an election prior to hearing. In other words, for SDCL 45-9-32 to apply, the owner must meet the condition precedent: *i.e.* not having made an election. ARSD 74:12:10:01 implements SDCL 45-9-32 and 45-9-33 and causes the election to be made prior to an administrative hearing. With the election already made, the condition precedent fails and the additional election period found in SDCL 45-9-32 is no longer applicable. Only in cases where the BME finds the requirements of ARSD 74:12:10:01 have not been met, causing the election to fail, does the BME provide an additional election period under SDCL 45-9-32.

In the present case, Luff tendered the offers as required by ARSD 74:12:10:01 on July 17, 2013, by means of written notice. AR 470 (FOF ¶¶ 18-20). Luff additionally sent, on the same day, an email to Ms. Golden updating Luff's previous offer by increasing the lease bonus consideration to $200 per acre. AR 470 (FOF ¶ 17) (the email and hard copy offer contained the same basic terms). AR 0246

(BME Exhibit 4); AR 0239 (BME Exhibit 3). Golden, who had a previous business relationship with Luff, and who previously elected not to lease or participate in the costs and risks of drilling a well, responded to Luff's email and again elected not to lease or participate by stating, "Thank you for your generous offer. I have spoken to my attorney, Scott Sumner, and have decided to continue my status as an unleased mineral interest." AR 470 (FOF ¶ 21).

The BME found that Golden's response to Luff's offer sent by email was "clearly unequivocal that she wished to continue her statues as an unleased mineral interest." AR 470 (FOF ¶ 22). The BME additionally found that Golden did not respond to Luff's offer within thirty days as provided in the written notice. AR 32 (FOF ¶ 32). Golden never altered her rejection of these terms by responding to Luff's formal letter offer, which was mailed to Golden on July 17 and received by her on July 25, or accepting the offer at any point up to August 16 (the thirty day time period Luff provided for response). *See also* AR 0477 (COL ¶ 17) (concluding in part that "Luff made an unsuccessful good-faith attempt to have Golden execute a lease or participate in the risk and cost of drilling and operating the Well."). In accordance with the provisions authorized by statute and rule, Golden was given the opportunity to lease her mineral interests or participate in the risks and costs of participating in the drilling and operation of the well. Golden rejected these options prior to hearing.

Although Golden rejected the option to lease or participate, the offer remained subject to challenge at a contested case hearing. SDCL §§ 45-9-32 and 45-9-33 both impose the requirement that the terms of participation and the lease provisions should be "reasonable." In cases of dispute, the BME is authorized to set the terms. *Id.* In keeping with these provisions, the BME requires that the applicant's offer to the owner must be made in good-faith. ARSD 74:12:10:01. Golden was free to challenge, and did in fact challenge, the offer's reasonableness by claiming it was not made in good-faith.[6] The BME found that Luff's offer was made in good-faith. AR 0477 (FOF ¶ 17). With this finding, Golden's election not to participate in the risk and cost of drilling a well became conclusive and the additional election period found in SDCL 45-9-32 became moot. As a result of this election, the only remaining issue for hearing became whether to apply the risk compensation provision.

Had the BME found that the terms and conditions of Luff's offer were not reasonable or in "good-faith," the prerequisites of ARSD 74:12:10:01 would not have been met and the election not to participate would have been nullified. In the absence of an election, SDCL §§ 45-9-32 and 45-9-33 would require the BME to set terms

[6] The BME's finding of good-faith is addressed further in response to issue III.

that were "just and reasonable" by ordering an additional election period in which the owner could elect to participate either in the risks and costs of drilling and operating a well, or if requested, surrendering a leasehold interest or participating on a limited or carried basis. In this case, the election was established by ARSD 74:12:10:01 and in conformance with the statutes and rules, the BME correctly moved forward with Golden's objection to the risk compensation provision.

II

THE BME IS AUTHORIZED TO ENTER A COMPULSORY POOLING ORDER CONTAINING A RISK COMPENSATION PROVISION AFTER THE DRILLING OF A WELL ON A SPACING UNIT.

The BME found that it had authority to enter a compulsory pooling order after the drilling of a well in that spacing unit. In support of this decision, Conclusion of Law paragraph 18 states, "SDCL 45-9-36 contemplates instances were a well may be drilled and completed before a compulsory pooling order is issued." AR 477. SDCL 45-9-36 provides:

> In instances where a well is completed prior to the pooling of interests in a spacing unit, the sharing of production shall be from the effective date of the pooling except that, in calculating costs, credit shall be given for the value of the owner's share of any prior production from the well.

The language of SDCL 45-9-36 not only provides for the pooling of interests *after* drilling a well, it also contemplates situations where the well is actually producing and provides credit for the pre-pooling

recovery. Golden admits that nothing in South Dakota statute prevents the drilling of a well before a compulsory pooling is ordered. AR 161:4-5 (stating "there's nothing that expressly prohibits it as I see it"). While it may be preferable to pool prior to drilling, drilling before pooling does not relieve the owner from the compulsory pooling order in South Dakota. The "sounder approach" is to allow compulsory pooling after drilling by means of Retroactive Orders. Joseph E. Hallock, *The Comparisons, Contrasts, and Effects of Compulsory Pooling Statutes*, ROCKY MTN. MIN. L. INST., Oil and Gas Chapter 15, p. 8 (1982).

The BME additionally concluded that "Luff's actions in drilling the well prior to obtaining a pooling order covering Golden's interest do not prevent Luff from recovering the risk compensation provided by ARSD 74:12:10:03." AR 477 (COL ¶ 22). Golden does not object to Luff being the operator and does not object to the well being drilled at its current location. AR 161 (TR). Nonetheless, Golden objects to the risk compensation provision. The application of risk compensation, after drilling, remains consistent with the prevention of waste, providing for greater recovery of oil, and the protection of correlative rights and South Dakota public policy[7]. *Bennion v. ANR Production*

[7] Contrary to Golden's argument, Luff's drilling of the well prior to providing Golden the ability to elect participation actually places

(continued . . .)

Company, 819 P.2d 343, 347 (Utah 1991) (risk compensation prevents waste, allows greater recovery and protects correlative rights)); SDCL 45-9-1. To implement this policy, "the pooling order may be made retroactive to the time production started and, *insofar as costs are concerned, to the start of drilling operations*." *Texaco Inc. v. Industrial Commission of North Dakota*, 448 N.W.2d 621, 624 (N.D. 1989) (emphasis added).

Golden's citation to the Michigan case, *Traverse Oil Company*, does nothing to diminish BME's findings. LGB 18. In *Traverse Oil Company*, the court found that the risk compensation penalty was

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(. . . continued)
Golden in a superior position. As stated in William & Meyers, *Manual of Oil and Gas Terms*,

> It is, as a general rule, only when the well is successful that a nonconsenting party will attempt to belatedly join the unit. The entire rational for the assessment of nonconsent penalties is that party which waits to see whether the drilling is successful and, when it is, then elects to join the unit in order to participate in the fruits of the endeavor, has, in effect managed to avoid all the risks attendant in the drilling venture. Since the nonconsenting party has effectively managed to avoid exposure to the risks of drilling, it is only fair that his return be less than the return of those who ventured to drill when the ultimate success was still in issue. The nonconsent penalty is basically a mechanism of accomplishing this result.

William & Meyers, *Manual of Oil and Gas Terms*, 15th Ed., Matthew Bender & Company, Inc. 2012 at 614.

improperly assessed because the applicant failed to follow appropriate procedure - "[the mineral interest owner] was not afforded the opportunity to participate in the drilling costs and avoid the penalty because the wells were completed before pooling was ordered." *Traverse Oil Company v. Chairman, Natural Resources Commission*, 396 N.W.2d 498, 505 (Mich.App. 1986). Here, much to the contrary, Golden was given the opportunity to participate in the drilling costs and was additionally afforded a lease option. Golden rejected those offers. The BME found that Luff followed the proper procedures. Nothing in South Dakota rule or statute precludes retroactive pooling or the application of risk compensation.

III

THE BME CORRECTLY FOUND THAT LUFF MADE A GOOD-FAITH ATTEMPT TO HAVE GOLDEN PARTICIPATE IN THE WELL.

The term "good-faith" is defined by SDCL 2-14-2(13) as:

> an honest intention to abstain from taking any unconscientious advantage of another, even through the forms or technicalities of law, together with an absence of all information or belief of facts which would render the transaction unconscientious;

Engelhart v. Kramer, 1997 S.D. 124, ¶ 13, 570 N.W.2d 550, 553. Good faith has also been defined as:

> A state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or seek unconscionable advantage.

BLACK'S LAW DICTIONARY, 762 (9th Ed. 2009). The exact definition of good-faith varies by context but emphasizes "faithfulness to an agreed upon common purpose and consistency with the justified expectations of the other party." *Engelhart*, 1997 S.D. 124 at ¶ 13, 570 N.W.2d at 553 (citing *Garrett v. BankWest, Inc.*, 459 N.W.2d 833, 841 (S.D.1990)).

The BME made a number of findings regarding the nature and context of Luff's offer. In Finding of Fact ¶ 47, the BME summarized these findings: "The Golden notice, particularly when combined with Luff's efforts prior to the Golden Notice to secure a lease from Golden, constituted a good faith attempt to have Golden execute a lease or participate in the risk and cost of drilling and operating the well." AR 474.

The record before the Court contains no evidence that Luff acted to take an unconscientious or unconscionable advantage of Golden. Rather, the evidence describes an observance by Luff of "reasonable commercial standards of fair dealing in a given trade or business." The only witness, Clayton Chessman, testified that the lease terms offered to Golden and the election period was reasonable and in conformance with the industry standard. AR 472 (FOF ¶¶ 36-38). As a testament to the reasonableness of Luff's negotiations, Luff *sua sponte* offered Golden the same terms and conditions (by means of an identical standard form which doubled the net per acre bonus),

negotiated by Attorney Max Main and accepted by Mr. Weingarden.[8] AR 0246.

It is undisputed that Golden and Luff failed to reach a voluntary agreement prior to hearing. Despite the generous terms offered by Luff, Golden had made her decision. The concept of good-faith, however, does not require that parties actually reach an agreement. *Bonne Homme County Com'n v. American Federation of State and Mun. Employees (AFSCMF)*, 2005 S.D. 76, ¶ 14, 699 N.W.2d 441, 448. It simply requires that the parties negotiate toward that end in good faith. Despite Luff having made two offers, the later with more favorable terms, it was Golden, not Luff that chose to discontinue negotiations by rejecting Luff's offer. Golden made no attempt to seek additional information or negotiate further with Luff. AR 471 (FOF ¶¶ 31-32).

At hearing, Golden did not dispute the lease terms offered by Luff. AR 473 (FOF ¶ 42). Rather, Golden spoke approvingly of Luff's operation, stating at hearing, "We do not object to the reasonableness of [Luff's] costs. I mean, we have faith in Luff as an excellent operator. We have no qualms about them being forthright and honest about it." AR 161:13-16. In fact, Golden responded to Luff's offers by email

[8] Alan Weingarden owned the other 50% of the mineral interest held by Golden.

writing, "Thank you for your generous offer. I have spoken with my attorney, Scott Sumner, and decided that I want to continue my status as an unleased mineral interest." AR 246. Golden's argument that Luff's offer was not made in good-faith is belied by her previous statements.

The concept of good-faith requires, in part, the determination of honesty and fairness. The ability of the BME to assess the credibility of the witness and weigh the testimony should be given great deference. *Englehart v. Larson*, 1997 S.D. 84, ¶ 19, 566 N.W.2d 152, 156 (citation omitted). The BME had the opportunity to observe Chessman's testimony and nothing in the record contradicts BME's finding that Luff acted in good-faith with honesty and in observance of reasonable commercial standards. The BME's finding that Luff acted in good-faith should be upheld.

IV & V

BME'S APPLICATION OF THE RISK COMPENSATION ESTABLISHED IN ARSD 74:12:10:03 WAS NOT CLEARLY ERRONEOUS, ARBITRARY, CAPRICIOUS, OR IN VIOLATION OF CONSTITUTIONAL OR STATUTORY PROVISIONS.[9]

In cases such as this, if the procedures set out in ARSD 74:12:10:01 are followed and upheld by the BME, ARSD 74:12:10:03

[9] The Department's argument on this issue incorporates Golden's fourth and fifth issues.

presumptively sets risk compensation at "one-hundred percent of the nonparticipating owner's share of the reasonable actual costs of drilling . . .[and] completing . . . the well." ARSD 74:12:10:01(2) continues to allow an owner to object to the provision by opposing the application for the compulsory pooling order. Golden exercised this option and challenged the risk compensation provision. After listening to the testimony, the BME concluded:

> Allowing the recovery of risk compensation equal to one-hundred percent of the reasonable and actual costs of drilling and completing the Well and the costs of the newly acquired equipment in addition to the pro rata share of such costs from the interests of Ms. Golden is just and reasonable.

AR 478 (COL ¶ 24).

Golden argues that the statutory and administrative provisions should be construed to allow risk compensation "only in an uncontested compulsory pooling case where, after being provided with the required notice, no involved mineral interest owner has intervened in opposition . . . and objected to the imposition of the risk compensation penalty . . ." LGB 25. Golden's reading asks the Court to disregard significant portions of ARSD 74:12:10:01. ARSD 74:12:10:01 provides in pertinent part:

> In the application for a compulsory pooling order . . . the *applicant may request the board to provide for the recovery of risk compensation* . . . from an owner who elects not to participate in the risk and cost of drilling and operating a well . . . Before an order is entered with such a provision, the applicant must:

> (1) Provide proof that an unsuccessful, good-faith attempt was made to have the nonparticipating owner execute a lease or participate in the risk and cost of drilling and operating the well; and
>
> (2) Notify the nonparticipating owner . . . that the applicant intends to request the board to provide for the recovery of risk compensation and that the nonparticipating owner may object to the risk compensation provision by responding in opposition to the application for the compulsory pooling order.

(Emphasis added). Golden would have the Court read the above provisions, which provide for the inclusion of a risk compensation provision in a contested case proceeding, out of existence. The rules of statutory construction, however, forbid such a reading: "[w]e should not adopt an interpretation of a statute that renders the statute meaningless when the Legislature obviously passed it for a reason." *Schafer v. Shopko Stores, Inc.*, 2007 S.D. 116, ¶ 7, 741 N.W.2d 758, 761 (citations omitted).

Golden argues that such a procedure deprives her of due process and is unconstitutional. Challenges to the constitutionality of administrative rules are governed by the same presumptions given to statutes. *CID v. South Dakota Dept. of Social Services*, 1999 S.D. 108, ¶¶ 18-21, 598 N.W.2d 887, 892-93.

> We have consistently considered the constitutionality of legislative acts according to "well-known principles": "Any legislative act is accorded a presumption in favor of constitutionality and that presumption is not overcome until the unconstitutionality of the act is clearly and unmistakably shown and there is no reasonable doubt that it violates fundamental constitutional principles." The "presumption imposes on the party against whom it is directed the burden of going forward with evidence to

> rebut or meet the presumption. . . ." A presumption is rebutted "[w]hen substantial, credible evidence has been introduced. . . ." A presumption of constitutionality requires weighty evidence to overcome it. Challengers also have the burden of persuading the court that "there is no reasonable doubt that it violates fundamental constitutional principles."

Davis v. State, 2011 S.D. 51, ¶ 16, 804 N.W.2d 618, 628 (citations omitted).

Golden does not state whether her argument presents a facial challenge or an "as applied" challenge. For Golden to prevail on a facial challenge, she must prove that the law is "invalid *in toto*--and therefore incapable of any valid application." *State v. Andrews*, 2007 S.D. 29, ¶ 6, 730 N.W.2d 416, 419 (citations omitted). Golden waives a facial challenge by arguing ARSD 74:12:10:01 and 74:12:10:03 can be construed in a constitutional manner. LGB 25. Likewise, Golden cannot prevail on a facial challenge because the South Dakota Supreme Court previously authorized the imposition of risk compensation of 100%. *See generally*, *Kohlman*, 263 N.W.2d 674 (S.D. 1978). Golden, therefore is relegated to an "as applied" challenge.[10]

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[10] Nonetheless, even a facial challenge would fail. In general, "with respect to pooling or unitization orders, the nonconsent or risk penalty may be fixed by the statute, or the statute may give discretion to the agency to set the risk penalty within a determined range." William & Meyers, *Manual of Oil and Gas Terms*,15th Ed., Matthew Bender & Company, Inc. 2012, at 614. See also Patrick H. Martin, *Unleased and Unjoined Owners—Forced Pooling and Cotenancy Issues*, ROCKY MTN. MIN. L. INST., Chapter 18, pp. 6-7 (July 22-24, 2010). Golden's

(continued . . .)

"In analyzing as applied challenges, a court must examine the complainant's conduct and the specific facts of the case at hand." *Andrews*, 2007 S.D. 29 at ¶ 8, 730 N.W.2d at 420. As such, Golden must illustrate that the provisions were unconstitutional as applied to her. The BME did not automatically apply the risk compensation provisions from ARSD 74:12:10:01 and ARSD 74:12:10:03 to Golden. When Golden questioned whether the BME was simply applying the risk compensation based on rule alone, Hearing Chair Morris responded:

> Okay. The Board undertook evidence in this case and, in my view, is that whether, from an evidentiary standpoint, the evidence supports the risk compensation. And it would be my opinion, or my position as the Board, if neither party put on any evidence to the extent it was placed, and in all likelihood, the risk compensation would be imposed.
>
> So my position as Chair is *because of the evidentiary nature that was presented to the Board, the facts support an assessment of a 100 percent risk compensation*. So it would be, in my view, speculative as to whether the Board would or would not have imposed the compensation if there would have been no evidence presented.

(. . . continued)
argument that a set risk compensation provision is unconstitutional is contrary to the current industry standards. In *Bennion*, the argument was made that such a provision was in violation of due process provisions because it failed to take "into account the risks involved in [the owner's] particular case." *Bennion*, 819 P.2d at 349. Based on the inherent risks involved with drilling, the Court rejected the due process argument and upheld the Legislature's imposition of a minimum consent penalty of 150 percent in all cases. *Id.*

AR 429:20-430:7. Chairman Morris's comments explain that had no evidence been presented on the issue of risk compensation by either party, the BME "in all likelihood" would have simply deferred to the risk compensation provision found in rule. In this case, the BME considered that evidence and specifically found that the facts supported an "assessment of a 100 percent risk compensation." *Id.* *See also* AR 473 (FOF ¶¶ 39-41) (findings regarding Chessman's testimony).

While the percentages may vary, "inherent in the drilling of *any* well is a risk of mechanical problems, price fluctuations, or insufficient production to cover costs"--the risk is never zero. *Bennion*, 819 P.2d at 349. The industry practice in voluntary pooling nonconsent agreements ranges from "200 to 300 percent for developmental wells, at least 300 percent for most exploratory (wildcat) wells, and in very expensive areas, particularly offshore operations, as much as 1000 percent." *Manual of Oil and Gas Terms* at 614. The South Dakota Supreme Court previously found that "the 100% Risk compensation [entered by the board] was reasonable under the circumstances." *Kohlman*, 263 N.W.2d at 679 (acknowledging an Oklahoma case authorizing risk compensation of 250%). Chessman testified that "in his opinion a risk compensation equal to 100% of the costs of drilling, completing and equipping the well to the point of the wellhead was reasonable and less than the standard risk compensation in the

industry of 200%." AR 473 (FOF ¶ 41). Based on the testimony presented at hearing, the BME concluded,

> Allowing the recovery of risk compensation equal to one-hundred percent of the reasonable actual costs of drilling and completing the Well and the costs of newly acquired equipment in addition to the pro rata share of such costs from the interest of Ms. Golden is just and reasonable.

AR-478 (FOF ¶ 24). No witness testified to the contrary. *Id.* at ¶ 34.

The BME's decision is consistent with *Kohlman* and the uncontested industry standards. The Order imposing a 100% risk penalty is not clearly erroneous, arbitrary or capricious. Golden has likewise failed to meet the weighty burden necessary to show the provisions are unconstitutional. The DENR respectfully requests the Court uphold the application of the risk compensation provision.

CONCLUSION

Through the promulgation of ARSD 74:12:10:01 and 74:12:10:03, the BME set up a procedure for implementing the compulsory pooling provisions of SDCL ch. 45-9. The BME found that Luff complied with those provisions in good-faith and applied a risk compensation provision that was just and reasonable. The DENR respectfully requests that the Order of the BME be affirmed in all respects.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

1. I certify that the Appellee's Brief is within the limitation provided for in SDCL 15-26A-66(b) using Bookman Old Style typeface in 12 point type. Appellee's Brief contains 8,393 words.

2. I certify that the word processing software used to prepare this brief is Microsoft Word 2010.

Dated this _____ day of November, 2014.

/s/ Richard M. Williams
Richard M. Williams
Assistant Attorney General

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this _____ day of November, 2014, a true and correct copy of Appellee's Brief in the above-captioned matter was served via electronic mail upon Scott Sumner, *scott@sumnerlawoffice.com;* John Morrison, jmorrison@crowleyfleck.com; and Brett Koenecke, koenecke@magt.com.

/s/ Richard M. Williams
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