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Old Faves and New Raves: How Case Law Has Affected Form Joint Operating Agreements—Problems and Solutions (Part One)

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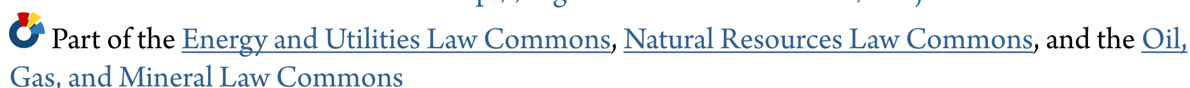
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Oil and Gas, Natural Resources, and Energy Journal

VOLUME 1 NUMBER 1

OLD FAVES AND NEW RAVES: HOW CASE LAW HAS AFFECTED FORM JOINT OPERATING AGREEMENTS—PROBLEMS AND SOLUTIONS (PART ONE)*

CHRISTOPHER S. KULANDER**

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* Due to considerations of length, this article is being published in two parts. The second part will appear in vol. 1, no. 2.

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I. Introduction

Joint ownership of oil and gas exploration and production rights—whether held through fee mineral ownership or ownership of an oil and gas lease—arise in many ways. Co-tenants of a mineral estate may each lease to different companies, or companies leasing adjacent acreage may be required to pool their leases to form a drilling unit. Individual leases may be jointly held by several lessees. Farmout agreements may give rise to co-ownership of working interest once, for example, payout is achieved. Mineral title also tends to become increasingly fragmented over time, leaving many working interest owners with undivided leasehold interests covering a production area or even a single well. Other times, joint ownership is the result of a deliberate decision to spread the cost and risk of drilling and development. For example, the holder of a lease may partially assign or farmout part of their lease to another party to share risk.

Regardless of how joint ownership arises, an agreement should be reached on a variety of matters including initial drilling, payment of expenses, operation of the well, division of production, and further development of the property. The joint operating agreement ("JOA") serves this function. A JOA describes the geographic area it covers and specifies the fractional interests owned in this area by the various parties having working interests in the area. Typically, one of these parties is designated

the "operator" with authority to incur expenses and make operational decisions. Occasionally, a party, such as a lease owner who has assigned all of its lease interests to investors, is named as a "contract" operator. A contract operator has standing to enforce the JOA and may bring suit on behalf of the participants, even though it lacks any interest in the area covered by the JOA.[1] The other contracting parties are referred to as "non-operators." Each non-operator's share of both costs and production is usually based on its fractional interest in the JOA's area. A typical JOA is a lengthy agreement that addresses many issues, including whether and how different combinations of parties can develop the area and how the operator will incur costs and bill the non-operators for their share of costs. A JOA also addresses how production is to be physically divided among the parties in accordance with each party's interest in the area or well.[2] A JOA almost always provides the operator with ample remedies against non-operators who do not pay their share of operating expenses.[3]

A. Paper Goal and Format

A domestic onshore JOA, at its core, is typically about a 10-20 page (legal-sized) standardized document (a "Form JOA"), plus exhibits, containing comprehensive provisions addressing the ownership of oil and gas drilling rights and the drilling, operation, and production of onshore oil and gas wells on those rights. Common sense seasoned with experience makes clear, however, that the words of a form contract like a Form JOA cannot possibly account for every permutation of oil and gas operations, resulting in a close, but often conflicting, reading by lawyers when conflicts arise. In addition, the parties to a JOA that was signed more than a dozen years ago could not have foreseen the current era of unconventional shale oil and shale gas development. Yet, a JOA, like a deed, may govern the rights of the parties for many decades and long survive any individual who was involved in its negotiation.

Judges, litigators, and non-oil and gas corporate attorneys have often been unsatisfied concerning what they often see as a lack of lucidity and specifics in JOAs concerning the rights and duties of parties conducting joint operations. Conversely, oil and gas lawyers and landmen have

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1. *See* Basic Energy Service, Inc. v. D-S-B Properties, Inc., 367. S.W.3d 254 (Tex. App. 2011, no pet.); Long v. Rim Operating, Inc., 345 S.W.3d 79 (Tex. App.—2011, pet. denied).

2. ERNEST SMITH & JACQUELINE WEAVER, TEXAS LAW OF OIL AND GAS § 17.3(A) (1) (Matthew Bender 2007) (2d ed. 1998).

3. *Id.*

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complained that even with the form aspect of the terms, negotiating a JOA for each drilling project still takes too long and is unresponsive to the need for quick operational action. Both complaints are at times correct, and when litigious disputes erupt among JOA signatories, the forms are open to numerous interpretations.

The result of these interpretative disputes in the aggregate is that case law has, over time, construed almost every major provision of the JOA, although not necessarily consistently, which has helped to keep oil and gas professors busy writing articles and challenging students. Some of the provisions discussed in this paper appear in some of the Form JOAs but not in others or, at least, not in the same precise terms. This paper seeks to both list and detail some—*but certainly not all*—of the most common provisions encountered in the Form JOAs that have been shaped by case law. In order to make this exercise less tedious, the author has provided examples that describe a scenario and then invites you to speculate how a court might resolve the conflict.[4] After each scenario, case law that is relevant or analogous to the scenario is briefly discussed.

Because extensive coverage of all JOA-relevant case law would fill a textbook,[5] I have taken selective liberty in picking topics believed to be the genesis of the greatest amount of litigation. I have avoided lengthy ruminations of case law background and the developmental history of certain clauses as the various JOA forms have progressed. My objective is to provide a primer (or reminder) on the effect of case law on the Form JOAs and on the pitfalls that may not be immediately recognizable to practitioners unfamiliar with the Form JOA. Finally, throughout this paper, I have cited articles that might prove useful to practitioners who desire a greater in-depth discussion.

B. History of Joint Operations and Form JOAs

The need for JOAs began to arise in the early-mid 1900s for a number of reasons. Spacing and density conservation laws arose, requiring the pooling of leases. Also, as wells were drilled deeper and thus became more

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4. Each party name in the presented scenarios references a luminary in popular music, which also invites you to test yourself on your knowledge of rock and pop performers. This format was inspired by both (i) the 2014 Texas State Bar Environmental Law Superconference that used popular music as themes and (ii) the author's friend Byron Hoffmann, rock musicologist.

5. For a textbook-sized article—perhaps the most complete article on case law and joint operation agreements see JOHN REEVES, *Compendium of Cases Construing the Model Form Operation Agreement*, 52 Rocky Mountain Mineral Law Institute, Chapter 11 (2006).

expensive, joint investment to spread risk became more appealing. As mineral ownership became more fragmented and, consequently, as more and different lessees found themselves sharing leaseholds over the same, overlapping, or adjacent tracts, joint operations became more necessary. In addition, as described below, concerns about joint-and-several liability arose. The owners of undivided mineral interests, and their lessees, found that some of the common law rules of co-tenancy and mining partnerships did not sit comfortably with their oil and gas development plans.

At first, many operators had their own preferred form of operating agreement, leading to delay as negotiations and "form wars" occurred between potential co-developers. In the 1950s, starting in Oklahoma, industry negotiators, landmen, and lawyers began to conceive of a model form for joint operations.[6] Eventually, the Ross Martin Company in Tulsa published the "Kraftbilt Form 610" JOA in 1956, the first widespread Form JOA.[7] Approximately ten years later, the American Association of Petroleum Landmen ("AAPL") assumed control of the 1956 form, renaming it the "AAPL Model Form 610 JOA," (the "1956 Form").[8]

Descendants of the 1956 Form are now the most popular JOA forms in use.[9] While one may encounter other JOA forms, most have evolved, in part, from one of the forms developed by the AAPL, including offshore domestic JOAs.[10] "As a result, judicial and academic concepts developed in the context of one JOA or one dispute are increasingly viewed as generally applicable to all JOAs."[11] Nevertheless, as will be illustrated throughout this article, individual words and phrases make a difference. Thus, a small change in a JOA provision from one form to the next may fundamentally alter the substance and effect of the provision.

The AAPL has promulgated several revisions of the 1956 form: the 1977 AAPL 610 Form JOA (the "1977 Form"), in the 1982 AAPL 610 Form JOA (the "1982 Form"), and the 1989 AAPL 610 Form JOA (the "1989 Form").

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6. Paul Yale, *The AAPL Operating Agreement and the Deadbeat Non-Operator*, Proceedings of the 27th Annual Energy Law Institute for Attorneys and Landmen at page D-5, South Texas College of Law, Houston, Aug. 27-28, 2014.

7. *Id*.

8. *Id*. American Association of Petroleum Landmen, http://www.landman.org/.

9. Gary Conine, *Property Provisions of the Operating Agreement—Interpretation, Validity and Enforceability*, 19 TEX. TECH L. REV. 1263, 1273-74 (1988).

10. Ernest Smith, *The Future of Oil and Gas Jurisprudence, Joint Operating Agreement Jurisprudence*, 33 WASHBURN L.J. 834, 835 (Summer 1994).

11. *Id*.

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The 1989 Form was revised during the bleakness of the mid and late 1980s, when oil prices sank, banks failed, and bankruptcies in the oil and gas business washed over upstream operations, resulting in parties defaulting on their financial and operational obligations. These events highlighted shortcomings with the first three form JOAs—namely deadbeat operators and non-operators.[12] Hence, the 1989 Form contains expanded and additional provisions addressing defaulting parties, including advance payment requirements, suspended contractual rights of defaulting parties, and expanded non-consent penalties.[13] The 1989 Form also simplified the operator-removal procedure and added another removal option for use when the operator fails in its financial obligations.

The various AAPL Form JOAs are in such widespread use that experienced oil and gas practitioners have much of their general content committed to memory. Nevertheless, like any standardized form, Form JOAs do not contain provisions for every situation and not all provisions are necessarily acceptable to all JOA parties. Many "old hands" have their own customary changes that they make to each form as a matter of course.[14] Customized provisions are usually the first provisions reviewed by potential counterparties and their counsel.

By 2013, the horizontal drilling craze finally prompted the AAPL to revise its 1989 Form to address operational issues associated with horizontal drilling. This form, the "Horizontal Modifications" Form (the "Horz. Form"), is the 1989 Form modified, as necessary, to better address horizontal drilling.[15] For example, the Horz. Form has added, revised, and supplemented several definitions to account for horizontal well drilling, such as the term "Deepen," which has been supplemented to account for the possible extension of the lateral portion of a horizontal well. The Horz. Form does not respond to case law,[16] but is essentially a stopgap form

12. Yale, *supra* note 6.

13. *Id*.

14. *See e.g*. Christopher Kulander and Mark Mathews, *Additional Provisions to Form Joint Operating Agreements*, Oil, Gas & Energy Resources Law Section Report, State Bar of Texas, Vol. 33, No. 2, 2008.

15. *See* Michael Cooper, et al., *A Form for All Directions: A.A.P.L.'s "New" 1989 Horizontal Well JOA*, Client Alert, Oct. 10, 2013, *available at* https://www.haynesboone.com/a-form-for-all-directions-aapls-new-1989-horizontal-well-joa-10-10-2013/.

16. Interview with Michel Curry, Attorney, Henry Resources, LLC, Midland, Texas, and AAPL Form revision committee member (Oct. 28, 2014).

addressing new terminology and issues relating to horizontal well proposals and elections.[17] This revision does not address coalbed methane operations.

A new major revision of the 1989 Form is expected in the autumn of 2015. This new version is being crafted by lawyers and landmen under the auspices of the AAPL. This process has been ongoing for several years.[18] The new form will include the new provisions for horizontal drilling but will also substantially revise the 1989 Form in light of case law and technological advances since publication of the 1989 Form.[19]

II. Joint Operations Without a Joint Operating Agreement

What happens when no JOA is in place? Joint operations without a JOA are generally a bad idea, but such operations still occur among legally unsophisticated parties, where tax considerations loom, after bankruptcy where one or more parties have rejected a JOA as an executory contract, or where other factors exist that require immediate drilling, such as drainage, imminent expiration of leases, or simple impatience. In recent years, some companies have been more willing to drill a well without a JOA—apparently to maintain the confidentiality of their drilling techniques.

Several co-ownership scenarios give rise to joint operations. If the mineral interest is owned by several parties or if some of these co-tenants lease to different companies, the legal doctrines involving co-tenancy will apply unless the parties enter into a JOA. What if one co-tenant mineral owner does not want development?

Problem: *Anderson owns a* $1/10^{th}$ *working interest in Acres Wild. Anderson's co-tenants, who are owners of the other* $9/10^{ths}$ *working interest, drilled a well and began producing without his consent. Anderson sues for waste, trespass, and for* $1/10^{th}$ *of the value of production (free of cost). How will the court rule?*

In *Prairie Oil & Gas Co. v. Allen*, the court held that "[a $1/10^{th}$ working interest owner] is entitled to an accounting from [the operator] Skelly Company for the market value of the oil produced less the reasonable and necessary expense of developing, extracting and marketing the same."[20] In most states, any co-owner may develop hydrocarbons on jointly owned

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17. *Id*.
18. *Id*. (The latest Form JOA has been likened by a couple practitioners to the oft-delayed *Chinese Democracy* album by Guns N' Roses.)
19. *Id*.
20. 2 F.2d 566, 574 (8th Cir. 1924—applying Oklahoma law).

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lands without the consent of other co-owners. In such circumstance, the "operating" co-owner assumes the total risk of any dry holes, but must account to the other co-owners for the net profits of production—typically on a well-by-well basis,[21] after recovering out of revenues the non-operating co-owners' pro-rata share of drilling, completion, and day-to-day operating costs.[22] Under co-tenancy law, the non-drilling co-tenant is thus given a risk-free ride on the well and yet is entitled to its undivided share of any net profits. JOAs substantially modify this common law.

If co-tenants jointly drill a well without a JOA, they risk being classified as a partnership or joint venture. A partnership or joint venture can arise as a matter of law even when the parties did not intend to form a partnership.[23] Among other concerns, a partnership or joint venture relationship makes the parties jointly and severally liable for all expenses and resulting liabilities of the partnership or joint venture. One of the biggest advantages of JOAs is that a well-drafted JOA contractually disclaims joint and several liability.

Problem: *Vinnie, Tony, and Ronnie each orally agreed to own a proportionate share in the proposed Wishing Well No. 1 in Roberts County, Texas. They agreed to share expenses and profits, and—again without a written agreement—chose Ronnie to be the operator. Ronnie intentionally drilled a directional well that bottomed beneath adjoining land owned by Ozzy. The well produced directly from Ozzy's land for ten years, and the conversion of Ozzy's oil was not discovered until the deviation of the well was measured after the Texas Railroad Commission shut in the well and completed a directional survey. During the civil trial for conversion, how might Ozzy and/or the state show that Vinnie, Tony, and Ronnie were partners or joint operators in light of the absence of a JOA?*

In *State v. Harrington*,[24] the Texas Supreme Court found a mining partnership existed between defendants in the circumstances described above, opining,

> All of the elements of a mining partnership–joint ownership, joint operations, sharing of profits, community of interest and mutual agency representing the mining partnership in

21. For example, if Well A is dry and Well B is a producer, the operating co-owner cannot deduct drilling costs for Well A from the profits due the non-operating co-owners from production from Well B.

22. *See* Cox v. Davidson, 397 S.W.2d 200 (Tex. 1965).

23. Ernest Smith, *Duties and Obligations Owed by an Operator to Non-Operator Investors and Other Interest Owners*, 32 ROCKY MT. MIN. L. INST., 12-1, 12-5 (1986).

24. 407 S.W.2d 467 (Tex. 1966).

> management and operation—were proved without dispute [… and the] record shows that each defendant made admissions conclusively establishing that an oral agreement was entered into before the well was drilled whereby they would own the lease proportionately and would share in the expenses and profits. It is immaterial that conveyances of interests to some of the partners were executed after the well was drilled. There was no written or oral agreement to limit the rights or duties of any one of the defendants so as to preclude liability, responsibility, control, operation or management of the lease.[25]

Thus, the omission of a JOA with the disclaimer of a joint venture and mining partnership, almost guarantees that the three parties in the above fact pattern, will be jointly and severally liable for the directional drilling. Damages are likely to be calculated from the onset of production because the conversion was not discoverable until the Railroad Commission ordered a directional survey. Moreover, a well-drafted JOA may preclude a suit by Ozzy against the non-operator parties.

Problem: *Daltrey Gas approached Entwistle Oil for the purpose of forming a partnership for the development of the Money Disposal Project. Both orally agreed to the partnership, on the condition that Entwistle Oil would supply the pipe and be allowed to oversee the completion operations, which were to be done with Entwistle's own workover rig. They further agreed that Daltrey Gas would be the operator and front all expenses and that Entwistle Oil would reimburse its 50% share to Daltrey Gas upon completion of the well. Both parties were aware of the fact that in the eventuality of a dry hole, the well would have to be plugged and abandoned. Entwistle Oil put Daltrey Gas in contact with Mr. Moon, its agent. With Mr. Moon overseeing the operation, Daltrey Gas began running casing. Shortly thereafter, drilling was completed, and Daltrey Gas requested Entwistle Oil's workover rig from Mr. Moon. Mr. Moon refused to provide the workover rig and refused any more involvement with the well. Daltrey Gas then rented a workover rig and completed a dry hole. Daltrey Gas plugged and abandoned the well. Entwistle Oil refused to pay its share, arguing that it had withdrawn from the partnership. Will the court find a partnership existed?*

25. *Id.* at 477.

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In *Tabco Exploration v. Tadlock Pipe & Equip.*,[26] the court found that "a partnership was created by an oral agreement" and that the party in Entwistle Oil's position was liable for half of the expenses incurred by the partnership.[27]

Other reasons lend themselves to utilization of JOAs. First, absent a JOA allowing for non-consent penalties (or perhaps absent a compulsory pooling order), the operator will not receive non-consent penalties from a party that refuses to participate in a subsequent well. Second, Form JOAs typically allow for attorney's fee if litigation is necessary to collect a debt arising from work done under the JOA. Third, JOAs typically provide for liens and other methods to recuperate losses against a signatory that does not pay its share of operation costs.

A. Incomplete and Unexecuted JOAs and Ancillary Documents

The author continues to encounter incompletely executed JOAs, JOAs missing attachments and exhibits, and AMI and Recording Memorandum that have not been recorded or even contemplated. Such miscues breed litigation. The JOA and its ancillary documents, such as the Recording Memorandum and, if present, any AMI Agreement should be signed by all parties and recorded as necessary. Some JOAs fail to specify what ancillary documents and exhibits are part or not part of the JOA and also fail to specify which documents control in the event of a conflict.

Problem: *Ferry Production, operator, along with non-operators Eno Engineering and Manzanera Management, executed a 1982 Form JOA encompassing leases over the Bogus Prospect. The JOA was executed by the three parties and Article II stated that an AMI Agreement was attached to the JOA as Exhibit B. At the time of execution (also the effective date) of the JOA, the AMI Agreement had not been completed and was included in the JOA several months later, blank signature lines and all. A couple of years later, various successor interest owners got into a squabble over the application of the AMI Agreement to some newly-acquired leases. One acquirer argued that the AMI Agreement did not apply because it wasn't included in the JOA, was never executed, and was not completed at the time of execution of the JOA. Does the AMI Agreement apply to the successor interest owners?*

26. 617 So. 2d 606, 607-612 (La. Ct. App. 1993).
27. *Id.* at 608.

A separate, unsigned, document must be "sufficiently related" to the "main" document (for example, the JOA) for which incorporation is sought.[28] This typically means that the main agreement must expressly reference the unsigned one. Furthermore, the unsigned document for which incorporation is sought should be complete at the time of execution of the main agreement so that the statute of frauds can be satisfied. Oral testimony or a claim of estoppel (which is a defense, not a cause of action) may not be enough to warrant unsigned, non-existent, or incomplete agreement incorporation.[29]

III. Relationship of the Parties and Form JOA Interpretation

A. Standards of Conduct Required of the Operator

The exact standard of conduct that an operator owes to the other parties in the JOA has been long debated. Each of the Form JOA models has attempted to define the obligations of the various parties. The most important portions of the 1989 Form that speak to the duty of the operator to the non-operators are in Articles V, VI.G, and VII.A.

A number of cases have addressed the question of whether the operator owes a fiduciary duty to the non-operators. The opening paragraph of Article V of the 1989 Form specifically rejects this standard. In place of the agency principals previously attributed to the operator, the 1989 Form labels the operator an independent contractor and then holds the operator to the standard of a reasonable prudent operator.

In contrast, earlier forms did not expressly repudiate an agency relationship, define the operator as an independent contractor, or require parties to act in good faith. Thus, courts still find agency and fiduciary relationships in older forms in particular circumstances. While operators typically want to avoid owing a fiduciary duty to non-operators, the mere existence of an agreement between an operator and non-operator is not sufficient to avoid this duty. Even with a written agreement courts will consider whether the agreement or the conduct of the parties nevertheless creates a partnership, joint venture, or agency relationship that may trigger a fiduciary duty. Courts will generally find a joint venture where the parties have (1) a community of interest, (2) an agreement to share profits, (3) an agreement to share losses, and (4) a mutual right of control or management

28. Crowder v. Tri-C Resources, Inc. 821 S.W.2d 393 (Tex. App.—Houston [1st Dist.] 1991, no writ.

29. *Id.*

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of the enterprise. Oftentimes, the key issue is whether the venturers had the mutual right to control or management of the enterprise.

Problem: *Hall Oil Co., Oates Gas Co. and others have entered into an agreement, designating Hall as the operator. After a disagreement over the way Hall Oil Co. operated the Maneater No. 1 well, Oates and the other non-operators removed Hall as operator. Later, Oates sued Hall for fraud and breach of fiduciary duty pursuant to the terms of the agreement, which identified the parties as "Joint Venturers" and allowed the parties to vote on "Joint Venture business." What duty does Hall owe Oates?*

In *Russell v. French & Assocs.*,[30] an operator of oil and gas wells, that had been previously removed and replaced by the non-operators, brought an appeal against a judgment declaring that the operator had committed fraud, misrepresentation, and breach of fiduciary duty against non-operator investors. The court found that a joint venture existed between the parties and that the operator owed a fiduciary duty. The pivotal issue was whether the parties had an agreement for mutual management. The court found that this element was satisfied because non-operators had a right to vote on enterprise matters and that they had exercised authority to remove the operator. Mutual management completed the necessary elements for the finding of a joint venture, thus triggering a fiduciary duty.

Problem: *Simon Oil entered into a JOA, as the operator, with Garfunkel Gas, a non-operator, covering the Fakin' It Field. Under the agreement, if the non-operator failed to take its production in kind or otherwise dispose of it, the operator is allowed to sell the non-operator's production share and recover from the proceeds the monies necessary to cover the non-operator's proportionate share of the costs of production. Later, after some alleged stalling during production and stealing of funds, Garfunkel Gas sued for breach of a fiduciary duty and other acts of misconduct related to Simon Oil having sold Garfunkel's production share. What factors will the court consider?*

In *Reserve Oil, Inc. v. Dixon*,[31] the federal 10th Circuit Court of Appeals, considering a project in Oklahoma, held that the 1956 Form, and through its description of the later Model Forms to the time of the case, 1983, established a "trustee-type" relationship that required "fair dealings." The court found that the operator had complete control over the non-operator's

30. 709 S.W.2d 312 (Tex. App.—Texarkana 1986, writ ref'd n.r.e.).
31. 711 F.2d 951 (10th Cir. 1983).

production share when the non-operator failed to take its share. However, the court did not find a "general agency relationship" as that notion was "specifically disavowed" in the 1956 Form.

Article VI.G of the 1989 Form permits the operator to sell or buy any of the production from the "Contract Area"[32] that the non-operator chooses not to take. Any such sale is to be "in a manner commercially reasonable" under the circumstances, but operator has not duty to share an existing market or obtain a price equal to that received in any existing market.

Problem: *Blackmore Petroleum, Lord Oil, and others execute a 1977 Form JOA. Specifically, Blackmore is the operator and Lord Oil is a non-operator of the Lazy Unit. A dispute erupted over the prices Blackmore Petroleum received for the sale of production from the Contract Area under the terms of a gas purchase contract. Should the outcome hinge on the legal relationship between Blackmore and Lord?*

In *Johnston v. American Cometra, Inc.*,[33] the court held that the operator had acted as an agent of the non-operators in entering into a gas purchase agreement on behalf of itself and the non-operators. The court quoted Professor Ernest Smith: "[T]he act of selling for another implies a principal-agent relationship. An operator who markets gas on behalf of non-operators may have a duty to protect the rights of such non-operators in the event of a gas purchase."[34] The agency relationship imposed a fiduciary duty on the operator regarding its actions in marketing the non-operator's gas. Nevertheless, the operator had an express contractual right under the JOA to cease marketing the non-operator's share of production at any time.[35]

A similar result occurred where the operator sold the non-operator's gas through a pipeline subsidiary. In *Atlantic Richfield Co. v. Long Trusts*,[36] a court held that a pipeline company—owned by the operator—was the alter ego of the operator and the agent of the non-operator because it had sold gas in the name of its parent company. In both *Atlantic Richfield* and *Johnston*, the courts apparently disregarded the exculpatory provisions of

32. "Contract Area" is defined in the 1989 Form as "…all of the lands, Oil and Gas Lease and/or Oil and Gas Interests intended to be developed and operated for Oil and Gas purposes under this agreement." This definition will be used throughout this paper.
33. 837 S.W.2d 711 (Tex. App.—Austin, 1992, writ denied).
34. *See* Smith, *supra* note 23.
35. *See e.g.*, The Long Trusts v. Griffin, 222 S.W.3d 412 (Tex. 2006).
36. 860 S.W.2d 439 (Tex. App.—Texarkana, 1993).

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the pre-1989 Forms as not being relevant to operator's sale of the non-operator's share of production.

Atlantic Richfield stands as an exception to the general notion that Form JOAs do not give rise to an agency relationship. Read narrowly, *Atlantic Richfield* establishes that, in Texas, an agency relationship results when an operator sells a non-operator's share of gas. While the court pulls up short of imposing a true fiduciary duty on the operator, it appears to conclude that, when an operator sells a non-operator's gas, a sort of "fiduciary lite" relationship is established that obligates the operator to provide the non-operator with an account of gas sales and to avoid both conflicts of interests and acting adversely to the non-operator in its role as operator/seller. One commentator has noted that some other states calibrate the relationship between the operator and non-operators differently than Texas.[37]

B. Liability Among JOA Parties—Generally

Importantly, JOAs are intended to achieve for the parties several liability, rather than joint liability. Liabilities for JOA parties are essentially limited to each party's investment as opposed to joint liability as in the case of partnership.[38] The operator's role is that of an independent contractor and not a partner of the non-operators.[39] In order to facilitate this separation of liability, delegation of managerial authority to the operator for exploration and development within the Contract Area is a main focus of the JOA. The key is that the non-operators' lack of operational control negates the joint control required for a joint venture or mining partnership:

Problem: *Page, as operator, and Plant, Jones, and Bonham, as non-operators, entered into a JOA. The JOA provided that the operator had to secure the approval of the non-operators for any expense over $2500.00. Plant, Jones, and Bonham were regularly billed for their proportionate share of expenses and always paid Page as provided in the JOA. Page hired Crunge Drilling, Inc. and several other contractors both before and*

37. Allen Cummings, *The Joint Operating Agreement—the Basics*, Chapter 4: Proceedings of Oil, Gas and Energy Resources 101 CLE at 8, State Bar of Texas, Houston, Oct. 17, 2012.

38. John Lowe, *Some Recurring Issues in Operating Agreements and What AAPL's Drafting Committee Might Do About Them*, 60 ROCKY MTN. MIN. L. INST. ___ (2014)(in press).

39. *See* Howard Boigon and Christine Murphy, *Liabilities of Nonoperating Mineral Interest Owners*, 51 U. COLO. L. REV. 153, 161 (1980) citing *Mikel Drilling Co. v. Dunkin*, 318 P.2d 435 (Okla. 1957); *Dana v. Searight*, 47 F.2d 38 (10th Cir. 1931); and *Riss v. Harvey*, 354 P2d 594 (Colo. 1960)).

after entering into the JOA. After joint operations commenced, however, Page filed for bankruptcy. Crunge and several other creditors to the now bankrupt Page sued Plant, Jones, and Bonham arguing that the JOA parties were partners. Will the non-operators be liable to the creditors?

Even before the advent of the Form JOAs, Texas courts recognized that the elements of a joint venture could be avoided through the lack of joint control. In *Luling Oil & Gas Co. v. Humble Oil & Ref. Co.,*[40] the Texas Supreme Court observed: "Joint owners of an oil and gas lease may, without forming a partnership, contract for the operation of the leases by one of them…without creating a joint adventure or a mining partnership."[41] In *Ayco Dev. Corp. v. G.E.T. Serv. Co.*,[42] the Texas Supreme Court defined the basic principal that "defendants … as a matter of law … are not liable as joint venturers … [because] the unambiguous contracts and the proof show no more than that the Ayco defendants invested in the venture, but had and exercised no right to participate in the control or operation of the venture."[43]

Earlier, in *Berchelmann v. Western Co.*,[44] the Texas Court of Appeals in El Paso presented an eloquent and nuanced explanation that the "very operating agreements themselves, wherein appellants were designated as the 'non-operators' and [the now bankrupt company] as the 'operator' do not contain the basic elements of sharing of liability, control, risk and profits, along with the elements of agency, necessary to constitute a partnership or mining partnership. It is our opinion that the relationship here concerned was…a working agreement between [the now bankrupt company] as operator and appellants as non-operators. The latter were to contribute their proportionate shares of the expenses incurred and controlled by [the bankrupt operator] which, by definite agreement as represented by the written instruments and other documentary evidence, was in control of both the drilling and production. We see no valid legal reason to hold the appellants liable for debts incurred by the operator. The operator used its own credit, made its own transactions, and finally wound up being adjudicated bankrupt."

40. 191 S.W.2d 716 (Tex. 1945).
41. *Id.* at 718.
42. 616 S.W.2d 184 (Tex. 1981).
43. *Id.* at 186.
44. 363 S.W.2d 875 (Tex. Civ. App.—El Paso 1963, writ ref'd n.r.e.).

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Two commentators have noted that delegation of operational control to one party may work to shield the non-operating co-owners from liability.[45] A few jurisdictions have found in favor of creditors or parties seeking personal injury or property claims. In these cases, the claimants tried to find the crucial element of control in the provisions of the JOA that give certain limited decision-making rights to the non-operators, such as the clause that requires consent of all non-operators before the operator can plug and abandon the Initial Well.[46] In *Lavy v. Pitts*,[47] a workman who was injured when natural gas that was leaking from a well exploded, sought—albeit unsuccessfully—to find the requisite element of non-operator control in the JOA provision authorizing removal of the operator if it failed to conduct operations in a good and workmanlike manner.

Even in jurisdictions whose courts view the JOA's provisions as negating a mining partnership or joint venture, a non-operator who disregards the terms of the agreement and takes an active role in the conduct of operations could be held jointly liable for the operator's debts or tort liabilities. In contrast, if the JOA is expressly made subject to some other contract, such as a farmout that grants partial managerial rights to a non-operator, the non-operator may be deemed to have sufficient control over the operations, even though it has never exercised such rights.

1. Limitations of Leasehold Burdens

Form JOAs typically cap the leasehold burdens—all types of royalty—that will be carried jointly by all the signatories of the JOA. Thus, if one particular lease included in a Contract Area is subject to a burdensome royalty share, the lessee of that particular leasehold will exclusively pay the overage between the base maximum set forth in the JOA and the actual royalty burden. For example, Line 17 of the 1989 Form's Contract Area description provides the ceiling on the leasehold burdens that will be carried jointly by all the members of the JOA. The portion of any burden above this ceiling will be carried exclusively by the party who created it and its successors. For example, assume that Line 17 of the 1989 Form is filled in such that the obligations will be jointly applied up to 15.0% (such as a 12.5% landowner's royalty and 2.5% overriding royalty). If a member

45. Boigon and Murphy, *supra* note 39 at 158.

46. "Initial Well" is defined in the 1989 Form as "…the well required to be drilled by the parties hereto as provided in Article VI.A." This definition, that of the first well drilled under the JOA that all the signatories of the JOA agree to participate in, will be used throughout this paper.

47. 29 S.W.3d 353 (Tex. App.—Eastland 2000, pet. denied).

of the agreement contributes a lease with a total burden of 19.0%, then the 4.0% burden over the 15.0% limit would be borne *solely* by the participant who created that burden and not by the other members of the agreement.

2. Tax Considerations

JOAs provide that each party owns its interests separately for tax purposes. While the tax results are similar to those for partners in a partnership, mining partnerships are often avoided for tax reasons. The mining partnership is a separate entity for tax purposes, perhaps resulting in double or even triple taxation, with taxes being levied at a partnership level, a corporate level (through partnership distributions), and a personal level (via reported income for dividends).[48] If a single operation with multiple owners is set up as a stand-alone corporation, not only may double taxation occur, but participants may be unable to take advantage of losses for taxation purposes.[49]

C. Operator Authority

The JOA operator is usually a working interest holder and often times has the largest share of the total property comprising the Contract Area. The operator is not paid for taking the position but can often reap "off the books" benefits such as work for its employees, use of its equipment, and overhead payments as allowed by the JOA and its accounting exhibit.[50] In practice, the operator also benefits from being the operational manager because it has control of day-to-day operations.

1. Operator's Ability to Set Rates

Article V.D.1 of the 1989 Form provides that all wells drilled in the Contract Area are to be drilled at rates prevailing in the region. The JOA allows the operator to use its own equipment and assets in operations it conducts on its own provided that the rates charged by the operator must be comparable with the prevailing rates in the area and must be agreed upon in writing before the commencement of operations. Furthermore, all services provided and material furnished by affiliates of the operator must be at competitive rates agreed upon in writing and following the customs and standards of the petroleum industry.

48. Yale, *supra* note 6.

49. *See* Charles Galvin, *The "Ought" and "Is" of Oil and Gas Taxation*, 73 HARV. L. REV. 1441, 1495-96 (1960).

50. *Id.*

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Problem: *Meisner Oil, operator under a 1989 Form, drilled an Initial Well that ended up being located 630 feet from the well site described in the JOA and other notices. Non-operators Henley, Frey, and Leadon discover this error and further discover that this deviation has resulted in increased costs. Are the non-operators liable for the costs?*

In *Hamilton v. Texas Oil & Gas Corp*,[51] the court held that an expert's opinion that "the costs of site preparation would increase four or five times due to the change in location" was sufficient evidence to support the jury's finding that the non-operator was not liable for its proportionate share of the *increased* cost of preparation. The court's holding was dependent upon the fact that sufficient evidence supported the jury's finding of gross negligence.[52] Note, however, that the threshold for gross negligence is often difficult for non-operators to reach.

Problem: *Non-operators Stradlin, Adler, and McKagan entered into a JOA designating Rose Oil as operator. The agreement provided that the non-operators were to pay 15.0% of the costs Rose Oil incurred in drilling the initial well. The agreement also provided that Rose was to commence drilling the Initial Well on or before December 31, 1991. On December 1, 1991 Stradlin, Adler and McKagan paid Rose the estimated 15.0% of the costs of drilling the Initial Well, amounting to $33,000 each. Rose did not begin drilling until January 24, 1992, and 15.0% of the cost of drilling the well ended up costing them $48,000 each, nearly 50% more than the estimated cost. Stradlin, Adler, and McKagan refused to pay, citing the delay. Rose Oil sued for the additional costs. What result?*

In *Argos Resources, Inc. v. May Petroleum, Inc.*,[53] the court explained "the operating agreement in the present case falls under the two general rules that time is ordinarily not of the essence and that a [operator] need only prove substantial performance to recover on his contract. We conclude further that time was not of the essence in the operating agreement before us and that [operator] consequently did not forfeit its rights under the agreement when it failed to begin drilling on or before [the date specified in the JOA"].

More recently, in a case involving a 1989 Form, *Shell Rocky Mountain Prod., LLC v. Ultra Resources, Inc.*,[54] 10th Circuit Court of Appeals

51. 648 S.W.2d 316, 324 (Tex. App.—El Paso 1982, writ ref'd).
52. *Id.* at 323.
53. 693 S.W.2d 663, 665 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).
54. 415 F.3d 1158 (10th Cir. Wyo. 2005).

considered a dispute over a previous settlement agreement wherein Ultra, a non-operator, sought damages against the operator, Shell, which it alleged had breached the provision requiring that drilling and operating costs either be based on competitive bids or, if incurred by the Operator, that they "not exceed the prevailing rates in the area." Specifically, the duty provision of Article V.D.1 of the 1989 Form provides:

> Competitive Rates and Use of Affiliates: All wells drilled on the Contract Area shall be drilled on a competitive contract basis at the usual rates prevailing in the area. If it so desires, Operator may employ its own tools and equipment in the drilling of wells, but its charges therefor shall not exceed the prevailing rates in the area and the rate of such charges shall be agreed upon by the parties in writing before drilling operations are commenced, and such work shall be performed by Operator under the same terms and conditions as are customary and usual in the area in contracts of independent contractors who are doing work of a similar nature.

Ultra alleged that Shell, acting as operator, breached the competitive rate provision of Article V.D.1 by charging drilling costs to the non-operating working interest owners in excess of the prevailing rates in the area. Shell's principal defense was based on Article V.A, which provided that the operator "shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liaiblity incurred, except such as may result from gross negligence or willful misconduct." Shell argued that this provision absolved it of all liability unless Ultra could show gross negligence or wilfull misconduct on Shell's part.

The Tenth Circuit rejected Shell's arguments, relying on an article by commentator Gary Conine.[55] Conine argues that the exculpatory language in Article V.A. limiting liability to gross negligence and willful misconduct applies only to the operator's failure to conduct operations in a "good and workmanlike manner," or its tortious conduct. It is inapplicable to claims that the operator has breached express contractual provisions or has failed to perform its administrative duties. As we shall see, this conclusion is not necessarily applicable to all of the Form JOAs.

55. Gary Conine, "The Prudent Operator Standard: Applications Beyond the Oil and Gas Lease," 41 Nat. Resources J. 23 (2001).

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2. Contact with Third Parties

According to Article V.D.1. of the 1989 Form, and unless otherwise provided for in customized or additional provisions of the JOA or other attachments, an operator is free to contract with any party, subject to the reasonable and prudent operator standard. However, Article V.D.1., requires that "wells drilled in the Contract Area shall be drilled on a competitive contract basis at the usual rates prevailing in the area." Article V.D.1. also allows the operator to perform the work itself and to use its own tools; however, operator's "charges shall be agreed upon by the parties in writing before drilling operations are commenced." In addition, the clause also provides that "work shall be performed by operator under the same terms and conditions as are customary and usual in the area in contracts of independent contractors who are doing work of a similar nature."

Problem: *Crosby Contracting, Stills Gas, and Nash Oil, working interest owners, executed a JOA. Crosby was designated operator. Crosby solicited bids to drill the Initial Well as required by Article V.D.1 of the 1989 Form* ("All wells drilled on the Contract Area shall be drilled on a competitive contract basis at the usual rates prevailing in the area."). *The bidding invitation specified that the drilling contract be priced on a footage basis. Several companies returned bids, many of which were either calculated on a day-rate or a turn-key basis. Only one of the returned bids was submitted on a footage basis. Crosby hired one of the drilling contractors who bid on a day-rate basis. Transportation of the rig to the drill site was an additional cost. The contractor drilled the well using a workover rig, which increased the drilling time compared to a conventional drilling rig, adding more to the costs. The well was a dry hole. In addition, the bills sent by Crosby to Stills and Nash considerably eclipsed the cost estimate. Stills and Nash refused to pay. During the ensuing litigation, Stills and Nash admitted that they owe something, but not the full amount reflected in Crosby's bill. How much will they be charged?*

In *Haas v. Gulf Coast Natural Gas Co.*,[56] the court reversed and remanded the trial court's award of damages to the operator due to insufficient evidence to show that the well was drilled "on a competitive contract basis." Supporting this conclusion was the fact that the operator awarded the contract on a day-rate basis when the written estimate circulated by the operator and signed by the non-operators called for the

56. 484 S.W.2d 127 (Tex. Civ. App.—Corpus Christi 1972, no writ).

well to be drilled on a footage basis.[57] However, the appellate court did not suggest that the non-operators owed nothing for the work that was performed.[58]

D. Liability to JOA Creditors

Typically, as in Article V.A of the 1989 Form, the operator is provided the exclusive right and duty to contract for material and services for the Contract Area and is generally exclusively liable for payment. If the operator fails to pay or become insolvent, the creditors have attempted to hold non-operators liable.

Problem: *Lessee and operator Tyler Oil decided to hire Perry's P-waves to conduct seismic reflection operations on one of the leaseholds covered by a JOA. Tyler Oil solicited the non-operators for approval and—getting that through a unanimous vote according to the terms of the JOA—collected the prorata share of the seismic survey from each of the non-operators. During the seismic data gathering, however, financial Tyler Oil finds itself in financial trouble, forcing a bankruptcy filing. Perry's P-Waves sues the non-operators to recover for the amount unpaid, arguing that all the non-operators were liable for the joint operations contracted for by Tyler Oil. Can it collect?*

In *Blocker Exploration Co. v. Frontier Exploration, Inc.*,[59] the operator entered into an agreement with a seismic company for the performance of seismic acquisition work. When operator failed to make full payment and filed for bankruptcy, the seismic company brought suit against a non-operator for the remaining amount due, alleging that a mining partnership existed between the operator and non-operator. The trial court granted defendant non-operator's motion for summary judgment on the ground that an essential element of a mining partnership – joint operations – was missing under the JOA.

The Court first noted that, in the absence of active participation by the non-operator in conducting the operations, there must follow an examination of the pertinent operating agreement to see if it gives the non-operators a right to participate in management or control of operations. Under the agreement in *Blocker*, the various rights given the non-operator, such as the right to receive information and to go non-consent at various stages of the project, were held not rise to the level of control required for a

57. *Id.* at 131.
58. *Id.* at 133-134.
59. 740 P.2d 983 (Colo.1987).

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finding of a mining partnership. *Blocker* illustrates why an operating agreement is essential for the protection of non-operators from creditors. In the absence of an agreement delegating authority to the operator, the non-operating participants can probably be held liable for unpaid expenses due creditors under a mining partnership theory. Creditors are normally subrogated to the operator's claims against non-operators who have failed to pay their proportionate share of drilling, operating and related costs.

E. Form Interpretation and Deleted Language

Parties utilizing Form JOAs can remove discrete portions of the form language. The Forms, which are available through the AAPL as a proprietary electronic and printable document, show by strikethrough any deletion, contrasting them to documents compiled by personal computers, whereon the users typically remove all deleted portions when compiling the final contract. Deleted portions of Form JOAs can provide insight into the intent of the parties.

Problem: *Valory Petroleum and Schon Oil executed a 1989 Form covering the Troubled Prospect. Later a dispute erupted regarding whether the JOA was meant to include a gas balancing agreement. Valory Petroleum claimed that no such agreement was included in the JOA even though Schon Oil signed a gas balancing agreement (while Valory Petroleum did not) and even though evidence arising from discovery showed that the parties had conducted and completed negotiations to craft the alleged gas balancing agreement. Article II of the JOA, however, contained a list of exhibits to the JOA and Exhibit "E"—the lettered exhibit set aside for a possible gas balancing agreement—is struck through. If parole evidence is allowed to be considered by the court, can the fact that Exhibit "E" was struck through be introduced as proof that no gas balancing agreement was intended to be attached to the JOA?*

In *Houston Exploration Co. v. Wellington Underwriting Agencies, Inc.*,[60] the Texas Supreme Court considered whether deleted provisions of a form contract can be used to help interpret the contract and intent of the parties. Offshore Specialty Fabricators and Houston Exploration were part of a group constructing an offshore drilling platform in the Gulf of Mexico. They hired Tysers International Insurance & Reinsurance Brokers to help them obtain property damage insurance to cover platform construction. Tysers, in turn, negotiated with Wellington Underwriting Agencies. The

60. 352 S.W.3d 462 (Tex. 2011).

negotiations involved striking through various provisions in a form "WELCAR 2001 Offshore Construction Project Policy." The form, as altered, with the deletions visible became the operative insurance policy.

Offshore Specialty Fabricators and Houston Exploration later submitted a claim to the insurance company for damage to the platform incurred during construction. This claim included amounts incurred for keeping repair vessels on standby by during rough weather. Wellington paid the property damage portion of the claim but denied the standby claim, noting that Paragraph 13 of the form policy, which was struck through, would have expressly covered the standby costs. The claimants sued, seeking to recover the unpaid weather-related standby portion of the claim. The trial court found that the stricken language was not part of the form contract, so considering it would be a violation of the parol evidence rule. The trial court also found that the non-struck portions of the form contract, which included blanket language providing coverage against "all risks," was unambiguous.

The court of appeals reversed, and the Supreme Court affirmed. Both courts noted the struck language in the form policy that would have expressly covered the standby claim. The Supreme Court first opined that the parol evidence rule "does not prohibit consideration of surrounding circumstances that inform, rather than vary from or contradict, the contract text."[61] Furthermore, after the Court noted that "[t]he manner in which the insurance policy in this case was negotiated … is crucial to understanding its terms,"[62] the Supreme Court pointed out that while the signatories did not draft the form contract text, they excluded certain risks by striking through language.

While the claimants argued that the deleted text was irrelevant to interpreting the contract, the court held that this argument "not only ignores but distorts the negotiation process."[63] The Court cited two prior Texas Supreme Court opinions, each holding that deletions to a form contract were significant in the contract's interpretation.[64] While the claimants believed that deletions in a form contract should be considered the same as deletions in drafts versions of non-form contracts, the Court responded that, "the law has long recognized that changes in a printed form must be

61. *Id*. at 469.
62. *Id*. at 470.
63. *Id*.
64. *Id*. citing Gibson v. Turner, 294 S.W.2d 781 (Tex. 1956) (concerning an oil and gas lease); Pipe Line Co. v. Dwyer, 374 S.W.2d 662 (Tex. 1964) (concerning a pipeline easement).

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accorded special weight in construing the instrument"[65] The majority also wrote that, "[i]t may be that deletions in drafts indicate the parties' intent in the final agreement, but we need not decide that issue here."[66] Therefore, *Houston Exploration*—while not involving a Form JOA—seemingly provides a limitation on the parol evidence rule with regards to Form JOAs: struck-through language will be noteworthy in interpreting the meaning of the remaining language.

IV. Authorization for Expenditures ("AFEs")

While JOAs are mainly agreements under which the signatories jointly develop oil and gas leases, at least one commentator has pointed out that Form JOAs endure as a means to restrain an operator from taking advantage of its position and of the other parties.[67] Because all JOA parties contribute money to fund joint operations, the JOA and its accounting exhibit address how costs are to be contained and how the operator can be assured of securing each parties' share of costs. Generally, the operator is not supposed to suffer a loss or gain a profit by reason of its operator status. Rather, the operator's cost exposure is limited to its participating interest share in the Contract Area. The JOA describes the recourse that signatories have against any party that defaults on its obligations—setting out remedies for operators against non-operators—and vice versa.

A. Consent to Operations Clauses and AFEs Generally

Joint operations can consist of drilling, exploration, deepening, sidetracking, and other such operations. These operations are commonly preceded by circulation of an "Authorization for Expenditure" ("AFE"). AFEs are described in the more recent Form JOAs.

AFEs can serve as ballots that indicate whether a party to a JOA will join in a proposed operation. Such voting arises out of the need for parties of the JOA to propose operations and for other JOA parties to either join or not. Most JOAs include a "nonconsent" provision that any party can invoke with respect to all operations other than those connected with the Initial Well and in some other special circumstances. AAPL Form JOAs provide that participants have a specified number of days (typically either 30 or 60, depending which form is being used) in which to respond to the proposal for additional operations, and that a party that does not respond within the

65. *Id*. at 472.
66. *Id*.
67. Yale, *supra* note 6 at D-3.

specified period is deemed to have opted to go "non-consent." The JOAs further provide that the party making the proposal will commence work on the proposed operations within a specified period after the expiration of the notice period.

JOAs typically provide that parties going non-consent do not have to pay for operations in which they are not participating. On the other hand, if the operation is a success, the parties that participated in the operation are then allowed to recover their actual costs for the operation, and then an amount, as previously decided in the JOA as an expressed percentage—typically an integer multiple of the drilling and completion costs and generally between 200% to 500% of the costs of drilling and completion—is reached. This penalty is to prevent risk-free "free riders" from get unencumbered profits without assuming the same risks as the consenting parties for conducting a particular operation.[68] If the AFE was not sent under the appropriate circumstances, as defined in the JOA, and a non-operator is subsequently charged a non-consent penalty, then the non-operator may have wrongfully lost money.

B. Consent to Operations Clauses and Co-tenancy

Despite very clear language in the older versions of the Form JOAs that certain operations were prohibited without the consent of all the parties in the operating agreement, courts in Texas have ruled such articles do not modify the parties' co-tenancy rights and the provision's result was simply to protect non-consenters from being charged for operations exceeding the stated minimum. Consider the following case, keeping in mind the consequences of using older vintage Form JOAs:

Problem: *Hetfield Oil was the operator and Ulrich Gas a non-operator under the terms of a 1982 Form. Hetfield Oil proposed that the Contract Area should be unitized and, subsequently, a well that was capable of producing several hundred barrels of oil a day was to be converted into an injection well for waterflood operations. Ulrich Gas thought that the move was hasty and that the well targeted for conversion should remain a producer. Ulrich Gas therefore objected to the proposal, bringing a claim after Hetfield Oil ignored Ulrich Gas' objection and converted the well.*

In court, Ulrich Gas argued that if a well is producing in paying quantities, no operations can be conducted on it that would halt such production unless all the interest owners consented. In support of this,

68. *See, e.g. Beckham Res., Inc. v. Mantle Res., L.L.C.*, (Tex. App.—Corpus Christi Feb. 25, 2010, pet. denied) (mem.op.).

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Ulrich Gas points to two provisions in the 1982 Form. The first, VII.D.2 "Limitation of Expenditures" provision, states:

> "Without the consent of all parties, no well shall be reworked or plugged back except a well reworked or plugged back pursuant to the provisions of Article VI.B.2."[69]

The second, Article VII.D.3 "Expenditures and Liability of the Parties" of the 1982 Form states:

> "Without the consent of all parties, Operator shall not undertake any single project reasonably estimated to require an expenditure in excess of _______ Dollars ($______) except in connection with a well, the drilling, reworking, deepening, completing, recompleting or plugging back of which has been previously authorized by, or pursuant to, this agreement;…"

How should a court interpret these provisions?

In *Cone v. Fagadau*,[70] the Texas Court of Appeals in Eastland apparently focused on the co-tenant relationship instead of the operating agreement's modification of it. Regarding Article VII.D.3, the court opined:

> "The relationship between Cone and the other working interest owners of the contact area was that of co-tenants of the various leaseholds which comprise the contact area, a co-tenant has the right to extract minerals from common property without first obtaining the consent of his co-tenants. …If a co-tenant owning a small interest in the land had to give has consent before the others could move towards securing the, he could arbitrarily destroy the valuable quality of the land."

What this suggests is that the Articles quoted above from the 1982 Form, despite the seemingly plain language modifying the co-tenancy relationship, may not, in fact, modify the relationship but only ensure that those who consent cannot be charged for any portion of the operation.[71]

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69. Article VI.B.2 of the operating agreement is related to the non-consent provisions pertinent to reworking a well not then producing in paying quantities.

70. 68 S.W.3d 147 (Tex. App.—Eastland 2001, pet. denied).

71. In the article "The *AAPL Model Form Operating Agreement After* Cone v. Fagadau—*Where Are We Now?*" in the July/August, 2003 edition of *Landman*, author and oil and gas lawyer Michel Curry suggested language expanding coverage of Article VII.D.3 from just accounting purposes to also act as an absolute prohibition on such expenditures except in compliance with the express terms of Article VII.D.3.

C. AFEs and Modifications of JOA

Questions have arisen concerning whether or not AFEs can change the express terms of a JOA.

Problem: *An operator, Lee Oil, circulates a JOA to all working interest owners wherein the Contract Area was described to cover the proposed drilling of wells to a "depth of 2,000 feet or the Pratt formation, whichever is less" over a certain lateral extent. All parties receiving the JOA executed it. One well, Well 1, is drilled under the "Initial Well" provision and is a success. Lee Oil then circulated an AFE to cover costs to drill and complete a second well in the Contract Area of the JOA, Well 2. This AFE was not expressly consented to by any non-operator, however, several non-operators contributed their proportionate share of the costs anyway. Two non-operators, Peart Petroleum and Lifeson Gas, did not consent to the AFE nor did they contribute their proportionate share of the costs of Well 2. Lee Oil drilled Well 2 to a depth of 2,112 feet and brought in a producing well. With respect to Well 2, Lee Oil treated Peart and Lifeson as non-consent working interest owners under the terms of the JOA.*

A dispute arose over whether or not the terms of the JOA applied, particularly the non-consent penalty. The operator argued that the AFE for Well 2 modified the express terms of the JOA to cover a well drilled to 2,000 feet or more. The two non-operators argued that the AFE had not modified the JOA and that they were not subject to the non-consent penalty. Has the AFE modified the express terms of the JOA?

In *Hill v. Heritage Resources, Inc.*, as part of a large body of very contentious litigation covering several issues and parties, a Texas appellate court held that additional consideration was needed to modify the JOA, and further opined that "[t]he…J.O.A. was entered into by sixteen entities, besides Heritage.[72] Accordingly, any modification of the contract would require the mutual assent of all the parties." Additionally, the court found that "there is no evidence of a clear intent on behalf of the parties to modify the J.O.A. [and further that] formal modification of the…J.O.A. was never expressly addressed or requested."[73]

Simply stated, after execution of a JOA, the majority view is that an operator cannot unilaterally modify the JOA just through the circulation of an AFE. However, unless the terms of the AFE or the work done under the

72. 964 S.W.2d 89, 112 – 115 (Tex. App.—El. Paso 1997, pet. denied).
73. *Id.*

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AFE contradict or leave the domain covered by the JOA, once signed, the terms *can* be binding even if the costs rise above the estimate of the AFE.

D. Cost Overruns

Problem: *Under the terms of a JOA, operator Young sent out an AFE and non-operators Scott and Johnson executed it. Drilling commences. During drilling, however, when the expenditure amount contained in the AFE was reached, Scott declared that it would pay no more of the costs of drilling even though the target depth had not yet been reached. Young and Johnson decided to continue drilling and continue operations until the target formation was reached and tested. Due to the test results and Scott's absence, Young and Johnson agreed to terminate further development. Is Scott liable for its proportionate share of the continued drilling?*

In *M & T, Inc. v. Fuel Resources Dev. Co.*,[74] the Federal District of Colorado explained that, "[i]n the oil and gas industry, it is understood and accepted that when one signs an AFE, he is committed to his proportionate share of the necessary costs in drilling to the objective specified in the AFE, unless the parties mutually agree to terminate drilling earlier or to attempt a completion at a shallower formation. The industry norms are consistent with the contracts and the parties' course of dealing with each other [as to the well in question]."[75] *M & T, Inc.* illustrates not only the use of the AFE but the problem of major cost overruns. One provision of the operating agreement (Article VII.D.3 of the three most recent versions of the Form JOA) imposes a maximum limit on reasonably estimated expenditures that the operator can incur on a new project without the consent of all non-operators. This would be of no help to the non-operator in *M & T, Inc.*, however, as the overruns in that case related entirely to the Initial Well, which had already been authorized in the form terms of the JOA.

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74. 518 F. Supp. 285, (D. Colo. 1981).

75. *Id*. at 289. *But See* Sonat Exploration Co. v. Mann, 785 F.2d 1232 (5th Cir. 1986) (applying Mississippi law) in which the 5th Circuit found that, despite defendants having signed an AFE, defendants were not bound to pay for their share of costs because defendants had not also signed the JOA. The 5th Circuit explained that "[Plaintiff] first argues that an AFE, standing alone, constitutes a binding promise to pay a stated share of drilling and completion costs. No supporting authority was furnished to the trial court and our attention has been invited to none. Our research discloses no authority for the proposition that an AFE is enforceable against one who has not signed an accompanying operating agreement. The case cited by appellant, M & T, Inc. involved an AFE issued pursuant to a valid operating agreement between the parties." (*Id.* at 1234.)

http://digitalcommons.law.ou.edu/onej/vol1/iss1/2

In the above scenario, consider the outcome if the following clause had been introduced to the JOA: "Parties further agree that written approval shall be required for any expenditures that exceed the AFEs attached hereto by twenty-five percent (25.00%) or more." This usually serves to remove doubt, as a Texas Court of Appeals held when ruling that such a written approval requirement applies to overall costs, stating, "the AFE referred to in the approval clause is the total AFE set out by the parties for the [prospect]"[76]

Problem: *Betts Petroleum, operator of the Wastin' Time Field under a 1956 Form, sent non-operator Allman Gas notice and an election ballot* after *drilling and completing a new well. Allman Gas elected to go non-consent. Betts Petroleum then applied the 300% non-consent penalty to the share of the proceeds attributable to Allman Gas. Allman Gas sued, contesting application of the non-consent penalty, and arguing it did not get notice and a ballot prior to the drilling of the well as required by the JOA. The JOA, however, did not contain any limitation on when the operator could commence work on a project. Can the penalty be enforced?*

In *Bonn Operating Co. v. Devon Energy Production Co.*,[77] the operator under a 1956 Form sent the non-operator notice *after* it had drilled and completed a new well. The JOA contained a subsequent operations clause providing that a party who desires to drill a well "may give the other party written notice of the proposed operation" and that the other JOA parties then have thirty days to respond. The non-consent penalty was 300%.

The non-operator responded that it elected to go non-consent, and then objected when the operator charged the non-operator's share of production with the non-consent penalty as well as its proportionate share of the total costs of the new well. In subsequent litigation the non-operator contended that the operator could not charge the non-consent penalty because the operator had failed to give notice prior to drilling the well, as it alleged was required by the JOA.

The court rejected this argument, pointing out that the JOA did not place any limitation on when the operator could commence work. Moreover, because the operator's drilling and related operations were essentially completed before notice was sent to the non-operator, the non-operator had the highly unusual advantage of being able to determine all costs associated

76. Pegasus Energy Group, Inc. v. Cheyenne Petroleum Co., 3 S.W.3d 112, 122 (Tex. App.—Corpus Christi 1999, pet. denied).

77. 613 F.3d 532 (5th Cir. 2010).

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with drilling and any risk associated with the well before deciding whether to consent or not.

E. Consent to Subsequent Operations

All Form JOAs contain terms that govern how wells will be drilled or operations conducted and completed after the Initial Well is complete.[78] Unlike the Initial Well, the drilling of which is a project usually described in some detail in the JOA itself and to which all parties to the JOA would presumably be interested in participating (or they would not have signed the JOA), these subsequent operations are less likely to be specifically and individually defined and are less likely to see 100% participation from the JOA signatories. Each of the Form JOAs therefore contains both protocols by which the signatories can propose subsequent wells and operations and also chose to participate in the wells and operations proposed by others.

Problem: *Davies Petroleum, as operator, and Knopfler Oil, as non-operator, executed a 1977 Form covering the Lola lease. They agreed that the Initial Well would target the Iron Hand formation at a depth of 9000 feet TD. After drilling to within 500 feet of the top of the Iron Hand formation, however, Davies Petroleum began to encounter difficulties and proposed, as it believed was required under Article VI.B of the JOA, a sidetrack operation to reach the Iron Hand formation from another direction. After receiving the sidetrack proposal, Knopfler Oil refused to pay for its share of the higher costs of the sidetrack operation. Davies Petroleum continued with the sidetrack operation. The operation was a failure and Knopfler Oil continued to refuse to pay any portion of the costs for the sidetrack operation. Davies Petroleum sued Knopfler Oil for its share of the sidetrack operation costs. Knopfler Oil claimed that the sidetrack operation was not part of the drilling of the Initial Well, but rather was a subsequent operation for which it had not consented. Will this argument succeed?*

One vector of invective has been disputes regarding whether and, if so, what activity conducted on the Initial Well after drilling is complete constitutes "subsequent operations." In *Holt Oil & Gas Corp. v. Harvey*,[79] the Fifth Circuit considered whether a sidetrack operation conducted on an Initial Well was a subsequent operation under the terms of the 1977 Form. The facts of *Holt*, identical to the scenario above, and the terms of Article

78. *See* § 12 of the 1956 Form and art. VI.B of the 1977, 1982, and 1989 forms.
79. 801 F.2d 773 (5th Cir. 1986).

VI.B of the 1977 Form, caused the court to admit that it was not clear if the sidetracking counted as part of drilling the Initial Well or if it was a "subsequent operation." Specifically, the court noted that neither the definition of Initial Well nor the definition of subsequent operations made it clear into what category the sidetracking fell, nor could the court find any indication elsewhere in the JOA to definitively place the sidetrack into a particular category. Ultimately, the court concluded that the record indicated the existence of enough evidence for the trial jury to find that the sidetracking was part of the Initial Well.

1. Proper Notice of Subsequent Operations

All the Form JOAs provide that the time interval that each party receives to make a decision on whether or not to participate in a proposed operation begins when that party receives written notice of the proposal. Because of the time limits placed upon the return of a participation ballot after it is received and the non-consent penalty in the Form JOAs, and because some JOAs provide that parties can even lose *any* future interest in operations in which they choose not to participate, disputes have erupted over what information must go into the election notice.

Problem: *Hynde Gas, as operator, and Chambers Oil, as non-operator, executed a 1977 Form covering the Loose Screw Prospect. After several wells were completed, Hynde Gas proposed a well to the Precious formation at a particular location. The notice contained a description of the well to be drilled, its location, proposed TD, and target formation. Is that enough information for Chambers Oil to make an informed decision whether or not to participate?*

In *Acadienergy, Inc. v. McCord Exploration Co.*,[80] a Louisiana court examined what is necessary for proper notice for a proposed subsequent operation under the 1977 Form. Article VI.B.1 of the Form JOA specifically set forth the requirements in proposing subsequent operations to the Initial Well. After a examining the clause, the court parsed out five datum due the recipient to constitute proper notice: (1) a description of the well or project; (2) well or project location; (3) the depth of a proposed well; (4) the formation being targeted for completion or reworking; and (5) an estimate of the cost. The court found proper notice had not been given by the proposer—even though the non-responding notice recipient had indicated elsewhere it did not agree with the objective formation for

80. 596 So.2d 1334 (La. App. 3 Cir. 1992).

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completion—because a change had been made between the TD location on the notice and in subsequent actuality. In addition, the notice recipient had both expressed a desire to join in an operation at the eventual location and asked for more information concerning the initial proposal. Another case in Texas, after citing a notification clause in the JOA germane to that case that was similar to that found in *Acadienergy*, held that an AFE, if it comes freighted with the necessary information described above, was detailed enough to count as an adequate proposal for a subsequent operation.[81]

2. Commencement of Operations

The length of the election period given to the non-operator often depends on whether a rig is on site to conduct the operation or not. Some opportunities will not last until the end of the election period and the operator may want to immediately start drilling activities. However, determining exactly when an operator can begin work that requires consent elections by the other party is difficult using the Form JOAs. For example, Article VI.B of the 1977 Form does not make absolutely clear that the operator can commence work immediately instead of waiting until the end of the election period.

Problem: *Orr Operating, operator under a 1977 Form, sent out notices and a request for consent regarding a proposal to drill a well. The JOA required a thirty-day notice period for proposed subsequent operations under Article VI.B Two days after sending out the notices, Orr Operating started drilling. A non-operator, Ocasec Oil, challenged the drilling, arguing that the consent period, as defined in the JOA, had to run before operations for the proposed operation can begin. Is Ocasec Oil correct?*

In *Valance Operating Company v. Elmagene W. Dorsett*,[82] Operator Valence gave non-operator Dorsett written notice of its intent to drill eight wells from 1996 to 2001. Dorsett received the notices but did not consent to the drilling of any of the wells and did not contribute to the drilling costs. In each case, Valence had begun site work—and in a couple of cases actual drilling operations—before thirty days had elapsed after Dorsett's receipt of the consent notice. Valence imposed the non-consent penalty described in Article VI.B.2 and Dorsett sued. The Texas Supreme Court held that, since the relevant non-consent penalties were enforceable and nothing was

81. French v. Joseph E. Seagram & Sons, Inc., 439 S.W.2d 448 (Tex. Civ. App—El Paso 1969, writ ref'd n.r.e.).
82. 164 S.W.3d 656 (Tex. 2005).

expressed in the JOA to the contrary, the operator could immediately begin work on a proposed operation before expiration of the notice period.

To avoid such litigious delay and cost, a custom clause may be considered deciding whether or not the operator has the latitude to commence operations immediately. If so, the non-consent penalties should be expressly enforceable notwithstanding the commencement of operations prior to the expiration of the election period.

Questions also exist about how to order follow up operations once the initial target is reached. Parties to the JOA may have different priorities about the next step—whether to deepen or plugback, recomplete an existing payzone, or send out a lateral—and choosing one may foreclose the opportunity to do another. Parties may want to consider adding a custom provision that establishes a priority among various operations that might be proposed once the target formation or depth is achieved.

Problem: *Emmett Oil, as operator, executed a 1989 Form along with Moore Gas and Levine Production, both as non-operators, which included the following clause regarding subsequent operations in Article VI.B.1:*

> Proposed Operations: If any party hereto should desire to drill any well on the Contract Area other than the Initial Well, or if any party should desire to Rework, Sidetrack, Deepen, Recomplete or Plug Back a dry hole or a well no longer capable of producing in paying quantities in which such party has not otherwise relinquished its interest in the proposed objective Zone under this agreement, the party desiring to drill, Rework, Sidetrack, Deepen, Recomplete or Plug Back such a well shall give written notice of the proposed operation to the parties who have not otherwise relinquished their interest in such objective Zone under this agreement and to all other parties in the case of a proposal for Sidetracking or Deepening, specifying the work to be performed, the location, proposed depth, objective Zone and the estimated cost of the operation. The parties to whom such a notice is delivered shall have thirty (30) days after receipt of the notice within which to notify the party proposing to do the work whether they elect to participate in the cost of the proposed operation. Failure of a party to whom such notice is delivered to reply within the period above fixed shall constitute an election by that party not to participate in the cost of the proposed operation.

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The Initial Well was drilled and completed. Emmett Oil sent the non-operators a certified letter proposing subsequent operations. Specifically, Emmett Oil proposed to drill and operate a second well. Moore Gas did not respond to this proposal within the thirty day window but did send Emmett Oil a proposal that Moore Gas would drill and operate the second well within the thirty day window. Emmett Oil filed an action requesting the court to declare it the operator of the proposed well. Who is the operator now?

In *Nearburg v. Yates Petroleum Corp.*,[83] Nearburg sent Yates a certified letter proposing to drill an additional well in accordance with the terms of Article VI.B in the 1977 Form to which they were both signatories. Yates received this letter on Dec. 1, 1994 but failed to respond within thirty days. Yates did, however, send Nearburg a letter dated Jan. 11, 1995, stating that Yates proposed to drill the same well. On Dec. 29, 1994, Yates had also obtained a permit to allow it, as operator, to drill the same well. Nearburg filed a complaint alleging that Yates' actions violated Nearburg's rights under the JOA and prevented Nearburg from obtaining a drilling permit for the subsequent well. Nearburg sought to be named operator of the subsequent well. In response, Yates asserted that an election not to participate (*i.e.* Yates non-response non-consent to Nearburg's notice of Dec. 1, 1994) constituted an offer to relinquish the party's interest in production from a proposed operation, and that this offer could be accepted by the proposing party (*i.e.* Nearburg) by "actually commencing work" within sixty days of the end of the election period, as described in Article VI.B.2. Therefore, until Nearburg, the proposing party, accepted performance by drilling, Yates had the right to change its election by withdrawing its offer, meaning it terminated its offer to relinquish its interest by its Jan. 11, 1995 letter communicating its intent to participate in the drilling of the subsequent well.[84]

The Court of Appeals in New Mexico found this interpretation "strained" and held that the party that initially proposed a subsequent well under the terms of the JOA (*i.e.* Nearburg) became the operator of that well and that Yates' election not to participate in drilling was not an "offer" that could be withdrawn before the proposing party signified its "acceptance" by commencing work on proposed operation. Practically speaking, this interpretation of the non-consent penalty provisions in the 1977 Form meant the non-consent provisions acted as a covenant (to pay the penalty)

83. 943 P.2d 560 (N.M. App. 1997).

84. Whatever one thinks of this argument, it certainly is creative.

triggered by a condition precedent (either failing to elect to join—a default non-consent under most JOAs—or an actual election not to join) instead of a contract option. In deciding, the court reasoned, "The operating agreement provisions are clear. Failure to elect to participate within thirty days of receiving notice of a proposed operation constitutes an election not to participate. When this condition occurs, the non-consent penalty results."[85]

3. Changing a Consent or Non Consent

If, after receiving notice of a proposal to drill a new well, a party makes an election, can it change its election if the change is made before the end of the period?

Problem: *Grohl Oil, a non-operator, consented to participate in drilling a well proposed by operator Novoselic Natural Gas. The 1982 Form under which the parties were operating provided that parties have thirty days to consent or not consent after receiving a proposal. Grohl Oil answered the proposal affirmatively ten days after being given notice by the operator. Ten days after that, when Grohl Oil received an AFE associated with the operation, Grohl Oil changed decision and rescinded the approval, instead going non-consent. Novoselic Natural Gas had already started the operations described in the consent notice and AFE and sues, claiming Grohl Oil could not change its election. Can Grohl Oil rescind its consent?*

A divided court ruled in *XTO Energy, Inc. v. Smith Production, Inc.*[86] that a party could not change its election despite the fact that the consent period had not yet run. Specifically, the plaintiff non-operator initially notified the operator of its decision to go non-consent as to the subsequent operations. All of the other non-operators elected to participate and advised the operator that they would carry the non-consenting party's share of expenses. Before the notification period elapsed, the plaintiff non-operator notified the operator that it was revoking its prior non-consent and had elected to participate in the new wells. The operator responded that the plaintiff non-operator could not change its election and it would be deemed to have relinquished its interest in the new wells to the consenting parties, who would recover plaintiff's share of expenses from its share of production in the new wells plus a 300% penalty, as provided for in the JOA. Plaintiff non-operator filed suit against the operator, arguing that it

85. *Id.* at 571.

86. 282 S.W.3d 672 (Tex. App.—Houston [14th Dist.] 2009, pet. granted, cause dism'd).

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had the right to change its decision within 30 days after receiving notification of the proposal for subsequent operations and that the operator and other parties were not entitled to withhold the non-consent penalty.

In ruling against the non-operator that attempted to rescind its non-consent, the court relied on Article VI.B of the 1982 Form which provides that when the party proposing the new operations receives all notifications, the proposing party must "immediately … advise the Consenting Parties of the total interest of the parties approving" the proposal, and if it recommends that the proposal operations proceed, the Consenting Parties, as defined in the form, have 48 hours in which to notify the proposing party whether they wish to carry a proportionate part of the non-consenter's share. The court reasoned that although the JOA does not deal expressly with changes of election within the notice period, a construction that precludes changes is more consistent with the "immediate" notification requirement. The court also believed such a construction also better accorded with the time-sensitive nature of the proposing party's obligations so that it can make the necessary arrangements to begin drilling within the 90 days specified under the parties' JOA.

4. No Written Consent Given

Problem: *Mercury Oil and Deacon Gas executed a JOA as operator and non-operator, respectively. Deacon Gas consented on the telephone to the drilling of two (2) wells in the Moose Pasture Project with costs to be borne equally, but no AFEs were ever circulated for the wells. Mercury Oil drills both wells as operator. One well results in a very marginal well, and the other is completely dry. Deacon Gas refused to pay for its half of the project. Mercury Oil sues to recover Deacon Gas' portion of the costs. In response, Deacon Gas argued that because no AFEs were sent, it did not consent to the operations. Is Deacon Gas correct?*

The other side of proper notice is proper election. In *C & C Partners v. Sun Exploration & Production Co.*,[87] the Texas Court of Appeals in Dallas considered a dispute between an operator and non-operator under the terms of a JOA of unknown vintage. C & C Partners and Sun agreed to jointly participate in oil and gas operations on several drilling prospects. Sun eventually sued C & C to recover C & C's unpaid share of the drilling and plugging costs for one well, the completion costs for two other wells, and the drilling and completion costs for three additional wells.

87. 783 S.W.2d 707 (Tex. App.—Dallas 1989, writ denied).

C & C argued on appeal it did not consent to the operations for which Sun sought recovery of costs, claiming the consent requirements of the JOA had to be evidenced in writing by means of AFEs. And since, according to C & C, no AFEs evidencing consent were introduced into evidence, C & C was not liable because of the failure of a condition precedent.

The court held that the contract did not require any specific form of consent. After concluding that the contract provisions regarding consent were unambiguous and that the contracts clearly required consent, the court also noted the JOA did not specify that any particular form of consent was required and therefore consent given over the telephone would be permitted in many circumstances. However, the court also noted that a telephoned notice or response, whether to give consent or not, was required to be followed up by confirmation in writing, opining further that the only requirement of a writing would be in the case of *confirmation of consent or non-consent* or confirmation of notice of a proposed operation. Therefore, it was held confirmation of consent was obviously distinct and separate from consent itself, that the contract did not state that consent was invalid or ineffective if it was not confirmed in writing, and that the provisions on consent mentioned nothing about the exclusive need for executed AFEs to show consent or not.[88]

The aforementioned *Hill v. Heritage Resources, Inc*., however, touched upon the issue of lack of proper consent, and went the other way when considering a 1982 Form. In that case, one party asserted—citing *C & C Partners*—that oral consent to an operation sufficed. The court of appeals in El Paso disagreed, however, finding that Article XII of the 1982 Form expressly required a written format for all notices and that telephonic consent only sufficed for proposals to "rework, plug back or drill deeper." Given the proliferation of types of communications in recent years—email, text messages, even "tweeting"—such disputes will likely continue.

F. "In or Out" Clause and Changes in Ownership Percentages

The effect non-consenting parties can have on the percentage interests of the consenting parties if the proposed operation is thereafter initiated—particularly to the proposer of the operation—is important. The 1989 Form has four options for parties considering whether or not to participate in subsequent operations. They can (i) not participate—go "non-consent" (ii) limit their participation to their original fractional interest, (iii) pay a share

88. *Id.*, at 714-715. (C & C's parole evidence suggesting that the JOA be interpreted differently was set aside as the court held as a matter of law that the JOA's terms were unambiguous.)

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proportionate to their interest relative to the interests of all consenting parties, or (iv) pay as in (iii) plus take on any whole or portion of the expense of non-consenting parties share that the other consenting parties elected not to take.[89] Some JOAs may also contain an 'In or Out' clause providing that upon commencement of an operation, parties that choose not to participate forfeit their interest in the well. Any interest of a non-consenting party that is not picked up by a consenting party will be deemed carried by the proposer—provided the proposer does not withdraw the proposal. Depending on the language of the JOA at issue, such interest assignments can have ramifications on the operatorship due to possible changes in who owns the majority interest.

Problem: *Heath Oil, acting as a contract operator* (i.e. *without a working interest in the Contract Area of the relevant JOA) circulated an AFE proposing to 'clean the wellbore' of the Pink Slip No. 1 well, operations upon which were governed by a 1977 Form. Wallace Gas, a minority 33% interest owner, was the only one of several non-operators that agreed to participate in the project. Wallace Gas paid for its own interest's participation. Wallace Gas likewise sought to assume the working interest of the non-consent owners through activation of an "in and out" clause that provided for relinquishment of the non-consented working interests upon commencement of the proposed operation. To that end, Wallace Gas sent Heath Oil a second check with the written condition that the check only be applied to Wallace Oil's "purchase of its portion of the…non-consent interests." Together with the working interest it already owned, this additional working interest would have made Wallace Gas the majority working interest owner in the Contract Area.*

Heath Oil, however, knowing that Wallace Gas was past due on its billing payments, informed Wallace Gas that it was not sure how it was supposed to apply the money and placed the second tranche of money in an escrow account. Heath Oil then proposed conducting an 'acid workover' process to access new reserves. This operation was delayed for lack of acid but Heath Oil secured an extension on the lease. Meanwhile, Wallace Gas first informed Heath Oil that it did not agree with the proposed operation and, because the acid workover was not completed, further claimed that it should be the operator. Second, Wallace Gas subsequently cut the locks on the fence surrounding the Pink Slip No. 1 and commenced the operations. Heath Oil withdrew its AFE proposal. In the ensuing litigation, the court must figure out who the operator is and who is owed money.

89. AAPL 1989 Form art. VI.B.2.(a).

In *Stable Energy, L.P. v. Kachina Oil & Gas, Inc.*,[90] when considering a similar quandary, the Texas Court of Appeals in Austin held that because a certain project proposed by the operator Kachina was never started, ownership of the interests of parties who did not agree to participate never transferred to the parties seeking to become the majority-owning operator.

First considering Article V.B.1 of the JOA—"If Operator…no longer owns an interest in the Contract Area…it shall cease to be Operator without any action by Non Operator, except the selection of a successor."[91]—the court noted that contract operator Kachina was indeed vulnerable to replacement. Noting also the passage in Article VI.B.2.—"the successor Operator shall be selected by the affirmative vote of two (2) or more parties owning a majority interest based on ownership."[92]—the court noted that the would-be successor operator could have been deemed the operator if it owned a majority interest when it so claimed—before taking over physical operations.

Ultimately, however, the court also noted language in Article VI.B.2 of the JOA: "*Upon commencement of operations* for the . . . reworking . . . of any such well by Consenting Parties . . . each Non-Consenting Party shall be deemed to have relinquished to Consenting Parties . . . all of such Non-Consenting Party's interest in the well and share of production therefrom."[93] The court rejected the arguments that the ownership interest transferred because the work originally proposed by the contract operator was commenced after the party seeking to replace the operator seized control of the well.[94] The would-be operator declared that it was elected as operator *prior* to seizing the well and commencing operations, but it could not have acquired the additional interests necessary to be a majority working interest owner until *after* it entered and commenced operations, as required by the JOA "in or out" clause. For that reason, the election of the new operator was held ineffective. Operator removal will be considered in more in the second article in this series.

G. "Other Operations" Clauses, AFEs, and JIBs

After the AFEs circulate, the newer JOA Forms provide a mechanism by which each participating working interest owner receives 'joint interest

90. 52 S.W.3d 327 (Tex. App.—Austin 2001, no pet.).

91. *Id*. at 332. (The opinion states the JOA was executed in 1980 but does not make clear what JOA form, if any, it was. The author believes it to be a 1977 Form.)

92. *Id*.

93. *Id*. (emphasis added)

94. *Id.*, at 332-333.

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billings' ("JIBs") for its proportionate share of operating expenses.[95] Newer JOAs provide significant leverage to the project operator, as the operator is allowed to put a lien on any party in default on its joint interest billings. On the other hand, one way Form JOAs rein in expensive and potentially unwanted activities by the operator is the "other operations" clause. When the high costs usually associated with oil and gas operations meet the necessity for the operator to employ a quick response to an unexpected occurrence or to just react to changing circumstances, the "other operations" clause is often the source of disputes.[96] For example, Article VI.D. of the 1989 Form provides:

> Operator shall not undertake any single project reasonably estimated to require an expenditure in excess of ______ Dollars ($______) except in connection with drilling, sidetracking, reworking, deepening, completing, recompleting, or plugging back of a well that has been previously authorized by or pursuant to this agreement, provided however, that in case of explosion, flood or other sudden emergency, whether of the same or different nature, Operator may take such steps and incur such expenses as in its opinion are required to deal with the emergency to safeguard life and property but Operator, as promptly as possible, shall report the emergency to the other parties. If Operator prepares an AFE for its own use, Operator shall furnish any Non-Operator so requesting an information copy thereof for any single project costing in excess of _____ Dollars ($____).

Any operator concerned about invoking the "other operations" clause in a Form JOA should seek non-operator approval before attempting any activity that could be construed as an "other operation." Some cases have defined the "other operations" clause quite broadly to include any operations that cost more than the dollar limit provided for in the JOA and that have either not been specifically authorized by the parties or that are necessary to correct a "sudden emergency."[97] Such broad interpretation of the "other operations" clause as provided for in the 1977, 1982, and 1989

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95. *See, e.g.*, Article VII in the 1989 Form.

96. Nicholas Laurent, *A Day in the Life of a JOA—Selected Daily Operational Issues*, Proceedings of the 24th Annual Energy Law Institute for Attorneys and Landmen at P-2, South Texas College of Law, Houston, Sep. 1, 2011.

97. *See* Abraxas Petroleum Corp. v. Hornburg, 20 S.W.3d 741, 756-57 (Tex. App.—El Paso 2000, no pet.).

forms could possibly require an AFE for operations that are considered either routine maintenance or that are recommended by trade associations such as the American Petroleum Institute or the International Association of Drilling Contractors, unless those operations were specifically addressed in a prior AFE or JOA custom provision and approved by the non-operator(s).

Heightened regulatory oversight of oil and gas operations related to threatened spills and other environmental problems raises concerns about an operator's ability to promptly react to potential environmental hazards or to conduct other operations necessary stave off a problem that, in the future, may cost more to fix when it rises to "emergency" levels. For example, the operator may encounter a condition has not yet led to a full-blown "emergency" but that nevertheless may need to be handled promptly to avoid potential liability under a state groundwater contamination regulation. In such a situation, there may not be enough time to formally issue an AFE and await responses.

Problem: *Nugent Oil, operator, and Bon Jovi Gas, non-operator, executed a 1977 Form over the Runaway Prospect in the state of Shock. While recompleting a well—an operation for which Bon Jovi Gas had received an AFE it subsequently approved—Nugent Oil noticed that a large fracwater disposal pit dug for the recompletion operation and other contemplated production activities is not lined with clay. The state oil and gas commission for Shock had been considering for a number of years a regulation that would require clay liners for fracwater pits. Other options have been considered also, however, such as requiring metal tanks or simply having no requirements. Knowing that lining the pit with clay will be a lot more expensive after the pond is in use, Nugent Oil paid $25,000 to make the change but did not send Bon Jovi Gas an AFE for the project, thinking it was covered both under the prior AFE and that the project was an "emergency operation" as described by the JOA. Later, Bon Jovi Gas received a JIB for the work and balked at paying, claiming it had not approved the operation, that it was not specifically related to the recompletion project, and that the state had not settled on any fracwater pit liner requirements. Nugent Oil sued to recover the portion of the lining operation it says it was owed by Bon Jovi Gas. Can it recover?*

In *Paint Rock Operating, LLC v. Chisholm Exploration, Inc.*,[98] Justice Rick Strange issued the opinion of the Eastland Court of Appeals in Texas that considered a situation wherein an operator had presented a non-

98. 339 S.W.3d 771 (Tex. App.—Eastland 2011, no pet.).

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operator a JIB with unapproved charges—costs never previously described in an approved AFE—that were included in a longer list of charges that the non-operator had expressly approved in prior AFEs. Both the AFE and subsequent JIBs were promulgated under the terms of a 1977 JOA.[99] The non-operator returned the JIBs with the contested charges redacted and a check for the uncontested charges. The non-operator refused to pay because it had received no AFE for the contested charges. The operator sued to recover the disputed charges, alleging that charges were for necessary repairs and that the non-operator had not timely challenged the charges in the JIBs. The contested charges were in excess of the $10,000 limit in the "other operations" clause in the JOA.

The court held that the operator breached the terms of the JOA if it only sends a JIB to a non-operator that includes expenses in excess of the previously settled "other operations" amount without first providing an AFE describing same. In addition, the operator could be liable for attorneys' fees or other damages for performing "other operations" without first issuing an AFE. Therefore, an operator should always ensure AFEs are sent when repair or other surprise costs manifest themselves, and keep the "other operations" amount limit in mind when incurring emergency costs—particularly with the 1989 Form.

(to be continued in Vol. 1, No. 2)

99. While the case does not make very clear what form JOA was at issue, Justice Strange informed the author that it was a 1977 JOA. (Personal communication, May 14, 2015).